Risk, Ownership, Equity: 2011 Erwin N. Griswold Lecture

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In John Ford's *They Were Expendable*, sailors at a Manila bar in December 1941 wait for Boats (played by Ward Bond) to toast Doc's retirement.[1] They even turn down the radio (missing news of Pearl Harbor) to hear him. But Boats says he isn't giving a speech—"I just got something to say." I, too, got some things to say: praise for a famous lawyer, criticism of some famous cases, and—as corollary to the criticism—emphasis on the importance of risk.

The praise is easy as pie. Erwin Griswold was a summa academic, solicitor general, and probably the most successful tax litigator who ever represented the Treasury. When Dean Griswold first left public service, Chief Justice Hughes said that this would cost the government a great deal of money. His name on this lecture resonates both as a tax lawyer and an American. At his death, Harvard Law School called its midwestern Republican dean "a champion of civil rights and foe of McCarthyism."[2] Time should not dim how much integrity and guts it took to do that; he was the dean in more ways than one.

Criticism of famous old cases is not as easy, but it matters because everything goes back.[3] Chimes of the National Broadcasting Company spell out the notes G, E, and C because its original owner was General Electric.[4] Telephone area codes (212 for New York City, 312 for Chicago) are based on the smallest number of clicks that rotary phones made in 1947.[5] "The past," Faulkner wrote, "is never dead. It's never even past."[6]

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[1] They Were Expendable (Metro-Goldwyn-Mayer 1945).

[2] Dennis Hevesi, *Erwin Griswold Is Dead at 90; Served as a Solicitor General*, N.Y. Times, Nov. 21, 1994, at B10.

[3] Tax law attracts a formidable bunch: Griswold, deans at Pennsylvania and Columbia law schools, Harry Blackmun and Robert Jackson, and (at least for a while) Sumner Redstone and Lloyd Blankfein. The talent pool most certainly includes this audience, so my talk skips over some basics.

[4] *See, e.g.*, Robert M. Morris, *The NBC Network Chimes*, Old Timer's Bull., June 1979, *available at* http://www.antiquewireless.org/otb/chimes.htm.

[5] *See, e.g.*, Leslie Knowlton, *By the Numbers*, L.A. Times, Oct. 15, 1997, *available at* http://articles.latimes.com/1997/oct/15/news/ls-42829.

[6] William Faulkner, Requiem for a Nun 92 (Random House 1951) (1950).

This talk of the past grows out of an NYU course I give called Classic Cases. Each year the students and I read old decisions as if they were new, and see them cited for conclusions they do not support and issues they do not present. Technical analysis of cases like *Helvering v. Gregory*,[7] *Helvering v. Horst*,[8] *Helvering v. Clifford*,[9] and *Commissioner v. Court Holding Co.*[10] has virtually vanished. What remain are their unhelpful statements about the right to avoid tax and the importance of substance.[11]

In fact, the most frequently cited supports for economic substance involve transactions in which nothing economic happens—distribution of corporate property to its sole shareholder. The shareholder does not become richer or poorer, because directly-owned assets go up by the exact same amount that corporate-owned assets go down. The character of investment also stays the same. Change occurs only in the form of legal ownership.

Nevertheless, two such distributions—one to Mrs. Evelyn Gregory, the other to Mrs. Louis Miller[12]—have become touchstones of economic substance. Moreover, it is a mistake to cite *Court Holding* for *any* substance. As Justice Black explained, the decision in *Court Holding* was procedural.[13] It deferred (under the now obsolete *Dobson* rule) to an unsupported Tax Court conclusion that a corporation, rather than its shareholder, in "substance" made the sale.[14]

Gregory and *Court Holding* therefore present a noneconomic issue. Apart from tax, the transfers made no difference to anyone. *Court Holding* has been accepted as substance, but as Judge Renato Beghé has said, its substance is that of negotiation.[15] As to *Gregory*, a close reading shows that Judge Hand's

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[7] 69 F.2d 809 (2d Cir. 1934).

[8] 311 U.S. 112 (1940).

[9] 309 U.S. 331 (1940).

[10] 324 U.S. 331 (1945).

[11] In *Goldstein v. Commissioner*, Judge Waterman wrote, "[t]his area of the law is particularly full of black-letter maxims that prove singularly unhelpful in deciding cases." 364 F.2d 734, 742 n.7 (2d Cir. 1966). The language is in a footnote to a citation of *Gregory v. Helvering*. 293 U.S. 465 (1935).

[12] *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

[13] United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454 n.3 (1950).

[14] *Id.* In *Court Holding*, the conclusion of a reasoned Fifth Circuit opinion as to the ability to rescind a transaction for tax purposes held that the shareholder had made the sale. *See* 324 U.S. at 332–33. The Service has now apparently adopted that approach, because the contract in *Court Holding* was unenforceable. *See* Rev. Rul. 1980-58, 1980-1 C.B. 181 (relying on Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940)).

[15] Martin Ice Cream Co. v. Commissioner, 110 T.C. 189, 212–13 (1998). The views of Judge Beghé, a Dante scholar, are entitled to considerable weight.

iconic language and conclusion about substance were unnecessary.[16]

I. Connections and Definitions

Tax lawyers share delight in making connections—between chimes and area codes, between the tunes of Twinkle Twinkle Little Star and Baa Baa Black Sheep (and the alphabet song, too). Developing materials for my NYU course entailed trying to make connections among Supreme Court decisions—finding a pattern, a common thread.

To me, *Frank Lyon Co. v. United States* represented the clearest symptom of a broken tax system: All cash to one person, all deductions to another.[17] Because every shopping mall financing invoked that case, the thought must have been that it had approved the separation of tax from economic ownership. But well before *Frank Lyon*, *Commissioner v. Brown* (*Clay Brown*) had sanctioned the same separation.[18] It used the criterion of state law to determine tax ownership, explicitly stated that economic risk did not determine ownership, and upheld a transaction with no nontax motive and certain eco-

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[16] United Mortgage Corporation (UMC), owned by Mrs. Gregory, transferred property to a new corporation, Averill, which issued shares directly to Mrs. Gregory. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934). *Gregory* held that receipt of the Averill stock was taxable to Mrs. Gregory because the transaction did not constitute a reorganization. *Id.* at 811. But even if it had been a reorganization, Mrs. Gregory's receipt of the Averill stock would not have qualified for nonrecognition of dividend income. Section 112(g) allowed nonrecognition only if UMC had distributed the Averill stock to her. The only construct that meets the nonrecognition requirement would be that UMC transferred the property to Averill in exchange for the Averill stock, which UMC then distributed to Mrs. Gregory.

The Commissioner made that analysis, contending that UMC had distributed the property rather than the Averill stock to Mrs. Gregory. Judge Learned Hand disagreed, making an unacknowledged construct of two deemed offsetting transfers: UMC's transfer of the property in exchange for the Averill stock, and distribution by UMC of the stock of Averill. Because the values were the same, he did not see any difference in result. *See id.* But without that unacknowledged construct (sleight of Hand), his historic analysis of substance would not have been necessary.

Alternatively, Mrs. Gregory could have qualified for nonrecognition if the Averill stock had been distributed to her in a reorganization as a shareholder of Averill. But before the transaction, Mrs. Gregory either was or was not a shareholder of Averill. If she was not, Averill stock could not have been distributed to her as an Averill shareholder; if she was, Averill stock was not distributed to her at all—she already owned it. The construct would be that the property that UMC transferred to Averill was distributed to her and then contributed by her to Averill, much as if UMC had transferred the property to her family or creditor rather than to her corporation.

To get to the reorganization issue then, Judge Hand had to both impute transactions that did not occur and to recognize a transaction that today would be considered not to occur—the mayfly existence of Averill. Recent research has found a note in which Augustus Hand, also on the panel, suggested to his brother that he simply disregard the four-day existence of Averill. *See* Leandra Letterman, *W(h)ither Economic Substance?*, 95 Iowa L. Rev. 389, 420 (2010) (citing Assaf Likhovski, *The Story of* Gregory*: How Are Tax Avoidance Cases Decided?*, *in* Business Tax Stories 89, 95, 115–20 (Steven A. Bank & Kirk J. Stark eds., 2005)).

[17] 435 U.S. 561 (1978).

[18] 380 U.S. 563 (1965).

nomic loss.[19] Congress overruled the *result* in *Clay Brown*, so that it is now considered primarily a case of concern to tax-exempts.[20] But that overruling implicitly accepts the *reasoning* of *Clay Brown*—that you can transfer tax ownership without transferring risk.

Tax thinking boils a transaction down to who gets what and why, so that much of tax practice consists of finding logical definitions of ordinary English words. In both *Clay Brown* and *Frank Lyon*, the issue was whether a sale had taken place. To say whether something constitutes a sale or lease, debt or equity, a transfer of property, or the performance of services, necessarily defines what sale, lease, debt, or equity means. What underlies all those terms is the concept of ownership, the central and fundamental basis of tax law. Income, deductions, and credits belong (are attributed) to the owner of property that generates them. That is why they are called tax attributes.

The basic question then becomes: What determines tax ownership? This talk, like my NYU course, concludes that tax ownership should primarily be determined by risk of loss. The course settled on risk because several important Supreme Court cases felt wrong—not only *Frank Lyon* and *Clay Brown*, but also *United States v. Consumer Life Insurance*[21] and *Cottage Savings Ass'n v. Commissioner*.[22] They all allowed transfer of ownership without transfer of risk.[23] Misperceiving risk has caused bank failures, real estate collapse, and concern over the Euro. A transaction in which Enron sold Nigerian barges to Merrill Lynch, booking the profit while keeping the risk, resulted in a Merrill banker of 30 years being sent to federal prison. A lawyer's training teaches him, above all, to look for and avoid risk. That is how I practiced, and that is what my clients wanted me to do.

The words debt and equity ordinarily arise in the context of corporate instruments: but nearly every ownership case—*Clay Brown*, *Frank Lyon*, *Horst*, and *Clifford*—presents a debt–equity issue. Who has a claim *to* the property (equity), and who has a claim *against* the property (debt). Thus, if risk should determine ownership and ownership presents a debt–equity issue, risk should likewise inform debt–equity classification. Equity is riskier because it is subordinated to debt, and at some point even what is called debt of an enterprise entails enough risk to constitute equity.

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[19] *See id.* at 570.

[20] I.R.C. § 514(a); *see also* S. Rep. No. 91-552 (1969); H.R. Rep. No. 91-413 (1969).

[21] 430 U.S. 725 (1977).

[22] 499 U.S. 554 (1991).

[23] Other cases considered risk determinative. *See, e.g.*, Neb. Dep't of Revenue v. Loewenstein, 513 U.S. 123 (1994); Helvering v. Le Gierse, 312 U.S. 531 (1941); Comtel Corp. v. Commissioner, 376 F.2d 791 (2d Cir. 1967). A revenue ruling, Rev. Rul. 1982-150, 1982-2 C.B. 110, even suggests that disregarding risk might be criminal. *See supra* text accompanying note 92. The amount of reward, which is why people enter transactions, generally correlates with the degree of risk.

Debt–equity tax decisions often list more than a dozen unranked factors.[24] But a bank loan officer knows it comes down to one: the risk of not getting repaid.[25] When Congress wanted to curb individual shelters, it limited tax losses to amounts at risk.[26] Will Rogers expressed the same idea. He said he was not as much interested in the return on his capital as the return *of* his capital.[27]

Confusion over ownership, debt versus equity, and ultimately the importance of risk in large part has led to codification of an economic substance doctrine. Despite urging, the government has so far shied away from giving specific examples of what it means, saying only, "The IRS will continue to rely on relevant case law under the common-law economic substance doctrine."[28] That position makes eminent sense because the cases are a morass.

A real economic substance doctrine would try to set criteria for ownership, an issue cases have had trouble with since *Lucas v. Earl*[29] met *Poe v. Seaborn*.[30] If economic substance cannot explain the most basic text—who owns what—it may not yet be time to write the commentary. If I had to codify economic substance, I would start first by mandating that *Clay Brown* and the other three cases should be considered to have come out the other way.

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[24] The Supreme Court case of *John Kelley Co. v. Commissioner* considered debt versus equity to be a factual question. 326 U.S. 521, 527 (1946). More relevant is the Second Circuit's statement in *Gajewski v. Commissioner*—that to say something was a factual question required determining which legal standard to apply to those facts. 723 F.2d 1062, 1066 (2d Cir. 1983). That criterion was disregarded in *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), a study in confusion.

[25] The person last in line with the most to lose (and generally the most to gain) cares the most and sleeps the least. *See, e.g.*, William D. Cohan, Op-Ed., *Make Wall Street Risk It All*, N.Y. Times, Oct. 8, 2010, at A27 (asserting that financial executives would temper their bets made with shareholders' money if they were held responsible for the losses). The case of *Murphy Logging Co. v. United States*, 239 F. Supp. 794 (D. Or. 1965), *rev'd*, 378 F.2d 222 (9th Cir. 1967), essentially used the bank–officer test in distinguishing debt from equity. Although the case was reversed on illogical grounds, Wall Street law firms accepted the force of its logic in assessing eurodollar offerings of the 1960s. See Revenue Ruling 1974-464, 1974-2 C.B. 46, for the return to tax logic.

[26] I.R.C. § 465.

[27] Consistent with this view, I teach what are thought of as assignment-of-income cases—*Helvering v. Horst*, 311 U.S. 112 (1940), *Helvering v. Clifford*, 309 U.S. 331 (1940), and *Commissioner v. Banks*, 543 U.S. 426 (2005)—as ownership and therefore debt–equity cases.

[28] Notice 2010-62, 2010-40 I.R.B. 411. A subsequent IRS procedural directive narrowed it. *See* Marie Sapirie & Shamik Travedi, *Economic Substance Directive Limits Strict Liability Penalties*, Tax Notes (TA) 339 (July 25, 2011).

[29] 281 U.S. 111 (1930).

[30] 282 U.S. 101 (1930). *Lucas* brushed aside state law. 281 U.S. at 114. *Seaborn* minutely examined the law of Washington State and relied on it to reach the opposite result, distinguishing *Lucas* on the state law ownership grounds that Justice Holmes said were irrelevant. 282 U.S. at 110, 117. Both can be viewed as debt–equity cases: whether the wife owned one-half of the husband's earnings or a claim against him measured by that amount.

II. Ownership as Control

Much as the *Gregory* and *Court Holding* assignment-of-income cases had nothing to do with economic substance, the *Clifford* and *Horst* cases should have had nothing to do with control. In the first, Mr. Clifford transferred property to a trust of which he was trustee.[31] For five years the trust income would go to his wife, after which the property would revert to him.[32] The government contended that trust income for his wife was taxable to Mr. Clifford under what is now section 61.[33] Justice Douglas's opinion agreed,[34] relying on substance without saying what it was:

> Technical considerations, niceties of the law of trusts or conveyances . . . should not obscure the basic issue. . . . [The family] is in reality but one economic unit . . . .
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> . . . [A]s a result of the terms of the trust and the intimacy of the familial relationship [Mr. Clifford] retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights are considered.[35]

In determining substance, the opinion took into account the short duration of the trust, the wife's status as beneficiary, Mr. Clifford's control of the investments as trustee, and that Mr. Clifford was rich.[36] But "[o]ur point here is that no one fact is normally decisive . . . ."[37] More concisely, this means we will not say what matters. Justice Roberts's dissent made the point that a statute to tax the grantor on income from *Clifford*-type trusts had failed to pass Congress.[38] Section 671(a), the current statute taxing income from *Clifford*-type trusts to the grantor, precludes applying section 61.

With that background—*i.e.* no standard for substance, Congress's repudiation of the opinion's reliance on section 61, and Douglas as a tax justice—few cases should cite *Clifford*. But a LexisNexis search shows more than fifty instances, including *Frank Lyon*. Control, intimacy, and wealth do not ownership make. The issue is whether Mrs. Clifford owned a five-year equity interest in assets of the trust or a debt claim *against* those assets (measured by the amount of the trust's income). Yet despite being meaningless, obsolete,

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[31] *Clifford*, 309 U.S. at 332–33.

[32] *Id.*

[33] *See id.* at 334.

[34] The case was decided before Justice Douglas began voting against the government in most tax cases. *See generally* Bernard Wolfman et al., Dissent Without Opinion: The Behavior of Justice William O. Douglas in Federal Tax Cases (1975).

[35] *Clifford*, 309 U.S. at 334–36.

[36] *Id.* at 335.

[37] *Id.* at 336.

[38] *Id.* at 340 (Roberts, J., dissenting). Another point noted was that regulations let the Service use any standard it chose to determine who was taxable on trust income under section 61.

and incorrect, *Clifford* is still cited as support for control as tax ownership.

The *Horst* case links ownership with control more directly. Shortly before their due date, Mr. Horst detached negotiable interest coupons from bonds and gave them to his son.[39] The son collected them in the same year.[40] The Supreme Court included interest from the coupons in the father's income because "[t]he power to dispose of income is the equivalent of ownership of it."[41]

But that is just not so. Trustees of the Ford Foundation do not own the income they disburse, nor do the trust officers at Citibank.[42] The income should have been included in Mr. Horst's income because he owned both the bond and coupon while the interest accrued. A statute to prevent nongift coupon stripping[43] now requires the *Horst* result, but because the interest accrued during ownership rather than owing to any notion of control.[44]

In 2005, however, the Supreme Court relied on *Horst* to tax income to an assignor of property.[45] Following a takeover of his employer, Mr. Banaitis, a bank trust officer, refused to cheat customers and was fired.[46] He eventually received about $9 million for that wrong, of which about $4 million went to lawyers.[47] A then quirk under the alternative minimum tax, which denied deduction for legal fees, resulted in his being taxed on the entire $9 million.[48] The Ninth Circuit—in about as sympathetic a mood possible—held that the $4 million was not a deduction from his income but originally gross income of the lawyers.[49] The reason was that under state law they had a lien on the recovery.[50] The Supreme Court reversed, because Banaitis had ultimate control over pursuing and settling the claim. Justice Kennedy wrote as follows:

> In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance the question becomes whether the assignor retains dominion over the income-generating asset, because the taxpayer "who owns or controls the source of the income, also controls the disposition of that which he could

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[39] Helvering v. Horst, 311 U.S. 112, 114 (1940).

[40] *Id.*

[41] *Id.* at 118.

[42] Stewart Clifford, the son of the taxpayers, became head of the trust department there.

[43] I.R.C. § 1286.

[44] One reason the *Horst* opinion gives for equating control with ownership is that a person may procure similar satisfaction in the enjoyment of income by giving appreciated stock either as a gift or as payment for groceries. 311 U.S. at 117. But using stock to pay for groceries is taxed as a sale, whereas giving stock as a gift is not.

[45] *See* Commissioner v. Banks, 543 U.S. 426 (2005).

[46] *See* Commissioner v. Banaitis, 340 F.3d 1074, 1076 (9th Cir. 2003).

[47] *Banks*, 543 U.S. at 431.

[48] *See Banaitis*, 340 F.3d at 1078.

[49] *Id.* at 1083.

[50] *Id.* at 1082.

> have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.[51]

That language may have been useful in responding to the Ninth Circuit's reasoning. But as with *Horst*, the issue should come down to ownership and accrual of the claim, not control over its pursuit. An investor who has risk may demand control over an enterprise, but the converse does not hold. A person with control—say, a trustee or hedge fund manager—will not demand risk. Mr. Banaitis was the one injured, and compensation for that injury belonged to him. Ownership accrued when he was fired. Regardless of who could settle, his lawyers had not been dismissed for refusing to cheat customers. When an accident victim loses her arm and a tort lawyer shares in one-third of the recovery, tax law does not treat the lawyer as having lost one-third of *his* arm. The lawyer's income represents compensation for services, not compensation for injury. In debt–equity language, his fee represents a claim *against* the injured person measured by the amount recovered, not a claim of having incurred the injury himself.

III. Ownership as Determined Under State Law

A dictionary definition of doctrine is that of a principle of law supported by past decisions. The Service's statement about continuing to rely on common law economic substance doctrine surely has to deal with the four Supreme Court cases previously mentioned: *Clay Brown*, *Frank Lyon*, *Consumer Life*, and *Cottage Savings*. Each upholds a transaction with no nontax motive, no nontax economic effect, and no nontax profit. The incomprehensible *Frank Lyon* opinion may not have thought it was doing so, but it was mistaken.[52]

Let me start with *Clay Brown*. In that case the Brown family sold stock in their corporation to a charity for a $1.3 million ten-year nonrecourse note, payable only out of cash the business generated.[53] The charity liquidated the corporation and leased its assets to a new company (Newco) formed by the Browns' lawyers with little capital.[54] Rent paid for the lease of business assets would be the entire cash flow that the business generated. In turn, the charity

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[51] *Banks*, 543 U.S. at 434–35 (citations omitted).

[52] Professor Louis Del Cotto considers the problem with understanding *Frank Lyon* to arise "from both the multiplicity of factors relied on by the Court and failure to rank them in importance." Louis A. Del Cotto, *Sale and Leaseback: A Hollow Sound When Tapped?*, 37 Tax L. Rev. 1, 40 (1981). Similarly, Justice Thomas dismissed *Frank Lyon*'s examination of "the substance and economic realities of the transaction" because the examination "included identification of 27 specific facts." Neb. Dep't of Revenue v. Loewenstein, 513 U.S. 123, 134 (1994).

[53] Commissioner v. Brown (*Clay Brown*), 380 U.S. 563, 567 (1965).

[54] *Id.*

would use all the rent (less ten percent) to pay the $1.3 million note.[55]

At the corporate level, the intention was to eliminate tax by having Newco deduct all of its profits as rent:[56] the corresponding rental income received by the charity would be exempt. At the shareholder level, the intent was to afford capital gain rather than dividend income to the Browns. In countering this, the government declined to make fact-specific debt–equity arguments. One argument might have been that rents paid by Newco to the charity were nondeductible dividends; another, that the Browns' note should be characterized as preferred stock in Newco rather than debt of the charity; a third, that lack of cash flow to charity gave it a remainder interest. Instead, the government's chief lawyer, Wayne Barnett (who wrote the brief and argued the case), wanted to establish a broader principle. He argued that the sellers had not transferred tax ownership because there was no risk-shifting.[57] Because the charity had brought nothing to the table—neither a substantial down payment nor special skills—the sellers retained the same risk of loss in the business after the transaction but gave up some future earnings. This was the debt–equity argument, applied at the highest and most abstract concept of ownership.

The government's technical argument used principles of oil and gas tax law.[58] In that industry, right to a fixed amount payable only out of oil produced was then considered retention of the oil itself (and therefore income from its sale).[59] The payment was known as a carried interest because the person who drilled the well would "carry" the owner of the fixed payment by bearing all expense.[60]

Justice White's majority opinion rejects this in the clearest language possible:

> Having abandoned in the Court of Appeals the argument that this transaction was a sham, the Commissioner now admits that there was real substance in what occurred between the Institute and the Brown family. The transaction was a sale under local law. . . .
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> Whatever substance the transaction might have had, however, the Commissioner claims that it did not have the substance of a sale . . . . His argument is that since the Institute invested nothing, assumed no independent liabil-

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[55] *Id.* To forestall any *Horst*-like association of control over the income with its ownership, Brown resigned and ceased running the business. *Id.* at 568.

[56] *Id.*

[57] *Id.* at 570.

[58] *Id.* at 575.

[59] *See id.*

[60] As an amicus brief pointed out, maintaining that the Brown family retained an interest in profits of the business overlooked the fact that they could have received that profits interest only if it had been distributed to them by the corporation. Brief for Attorney Dana Latham et al. as Amici Curiae Supporting Respondents, Commissioner v. Brown (*Clay Brown*), 380 U.S. 563 (1965) (No. 63), 1964 WL 81287 at *76–77. But potential taxation of such a distribution was of no concern to the government.

> ity for the purchase price and promised only to pay over a percentage of the earnings of the company, the entire risk of the transaction remained on the sellers. Apparently, to qualify as a sale, a transfer of property for money or the promise of money must be to a financially responsible buyer who undertakes to pay the purchase price other than from the earnings or the assets themselves or there must be a substantial down payment which shifts at least part of the risk to the buyer and furnishes some cushion against loss to the seller.
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> . . . A "sale," however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code.
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> "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent," [citing a case involving state law] . . . . The transaction which occurred in this case was obviously a transfer of property for a fixed price payable in money.[61]

The first sentence of that last paragraph relies on commercial law to make a tax definition. But characterization of local law does not control that of tax. A lease with an option to purchase for one dollar may be a lease under local law; deeply subordinated debt in a thinly capitalized corporation may be debt under local law.[62] As for the transfer being a sale in the ordinary sense of the word, the concurrence of Justice Harlan (for whom Barnett had clerked) had this to say, "Were it not for the tax laws, [Clay Brown's] transaction with the [charity] would make no sense, except as one arising from a charitable impulse."[63]

The transfer of a tax attribute—business income—was therefore upheld despite lack of any nontax motive or nontax profit. Brown in effect traded his remainder interest in the business for two tax benefits: exemption from tax at the corporate level, and capital gain rather than dividend treatment at the shareholder level. Harlan recognized that, but added,

> [h]owever the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source. The Code gives the [charity] a tax exemption which makes it capable of taking a greater after-tax return from a business than could a non-tax-exempt individual or a corporation. [The stockholders] traded a

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[61] Commissioner v. Brown (*Clay Brown*), 380 U.S. 563, 569–71 (1965) (citations omitted).

[62] Moreover, the price was *not* fixed: it set a limit (but not a floor) on the amount of cash that Brown could receive.

[63] *Clay Brown*, 380 U.S. at 579.

> residual interest in their business for a faster payout [at capital gains rates] made possible by the [charity's] exemption.[64]

Harlan's concurrence, cited in *Frank Lyon*, implies that the Browns' acquisition of a tax attribute was a business purpose like any other.[65]

The Brown family's total dependence on future earnings should have been equity. Regardless of whether the concept of carried interests applied outside of oil and gas, either the charity's ten-year right to all the new corporation's cash was a dividend rather than deductible rent, or Mr. Brown's note payable only out of such cash was stock in that corporation. Instead, *Clay Brown* called contingent payments a fixed price, labeled equity as debt, and defined tax ownership with reference to a state characterization of a sale in its common and ordinary meaning. That reasoning prevailed despite Justice Harlan's saying that, as a sale, the transaction made no sense.

Frank Lyon recapitulates *Clay Brown*, allowing the transfer of tax attributes without transfer of risk.[66] The mechanics differ: *Frank Lyon* allowed the transfer of deductions from an exempt entity (a bank)[67] to a taxable entity (an appliance store), whereas *Clay Brown* allowed the transfer of income from a taxable entity (a lumber corporation) to an exempt entity (the charity). But the cases achieve the same result: nontaxation of business income to the transferee while cash from the business stays with the transferor.

Surfeit inhibits too much discussion of *Frank Lyon*. Every author except John Grisham (who tried tax law but found it too hard[68]) has written about it. Let me point out just three mistakes the opinion makes that have not surfaced. In brief, the Frank Lyon Company (Frank Lyon) bought a building from Worthen Bank for $7.5 million, using $7 million borrowed from New York Life and $500,000 borrowed from Worthen itself.[69] Frank Lyon then leased the building back to Worthen for an amount equal to payments on the $7 million New York Life mortgage.[70] Worthen had an option to buy the building for any unpaid balance of the New York Life mortgage, plus Lyon's

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[64] *Id.* at 579–80 (Harlan, J., concurring). Under that logic, there was risk-shifting, but only by reason of tax law. The charity's exemption, which could double the business's after-tax profits, reduced the seller's risk more than would a substantial down payment. On the other hand, a debt whose payment depends on a controversial tax outcome may have the risk of equity.

[65] *Id.* Frequent citation to *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), for the necessity of a pretax profit almost always omits its footnote 5—which restricts the decision to the context of interest deductions. In hindsight, the lawyer for the Goldsteins should have cited the certain pretax loss in *Clay Brown* and asked, "*Licet Iove, non licet bove?*"

[66] Frank Lyon Co. v. United States, 435 U.S. 561 (1978). Justice White, who wrote the *Clay Brown* opinion, dissented in *Frank Lyon*. *Id.* at 584.

[67] Although the government conceded that the bank was as taxable as Frank Lyon Co., artificially high bad debt deductions allowed a bank effective exemption from the corporate income tax. *See* Rev. Rul. 1965-92, 1965-1 C.B. 112.

[68] John Grisham, Op-Ed., *Boxers, Briefs and Books*, N.Y. Times, Sept. 6, 2010, at A19.

[69] *Frank Lyon*, 435 U.S. at 566.

[70] *Id.*

$500,000 investment and a six-percent return on that investment.[71]

The first error, one of fact, was calling Worthen's $500,000 loan to Frank Lyon "unrelated" to the sale–leaseback.[72] In fact, it was central. As part of a bidding competition, Frank Lyon had offered to rebate most or all of its six-percent return on its $500,000 investment by reducing the amount of rent Worthen would pay to it (and it would forward to New York Life). New York Life would not agree. Not only did that lender insist that rent equal the mortgage payments, it also insisted that Frank Lyon not be able to get its hands on the money. As a result, not only did the mortgage require that Worthen's rent payments be made directly to New York Life, it also required that any claims that Worthen had against Frank Lyon could not be used to reduce money paid to New York Life on the mortgage.[73]

The second error also relates to the borrowing. Frank Lyon had no need to borrow a $500,000 down payment, or any money, from Worthen Bank. One motive of Frank Lyon for obtaining the deductions was its concern about the accumulated earnings tax, which is imposed only on companies that have more money than they need. Frank Lyon therefore made an unnecessary borrowing, at a much higher rate than its purported six-percent return. This let it rebate most, all, or more than all of that return. To summarize, Frank Lyon made no cash investment and expected no cash return. Its deal was to reduce Worthen's cost of borrowing from New York Life and in return receive tax benefits.[74]

The third error, one of logic, contains perhaps the most famous and risk-disregarding sentence in recent tax history: "In short, we hold that where, as here, there is a genuine multiple-party transaction . . . the government should honor the allocation of rights and duties effectuated by the parties."[75] But the sentence is circular. The transaction involved three parties only because the Court held that Frank Lyon bought the building; if Frank Lyon were an agent of New York Life, as the government argued, there would be only two.

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[71] *Id.* at 567. The lawyer who lost *Frank Lyon* in the Eighth Circuit, the late Gaston Williamson (head of the Rose Law Firm in Little Rock and a Rhodes scholar), hired Erwin Griswold to argue the appeal. Griswold, then in private practice, applied for certiorari. A professor then at the Service told me why his superior had agreed to support the petition. "Hell," he said, "if we can't win *Frank Lyon*, we can't win anything."

[72] *See id.* at 565.

[73] The terms show the unimportance New York Life placed on the recourse nature of Lyon's obligation to it. Although legal liability to New York Life influenced the Court, *id.* at 576–77, New York Life felt that any obligation of Lyon was guaranteed by—in fact was—the direct obligation of a bank.

[74] As Justice Stevens's dissenting opinion points out, Goldman Sachs's proposal for the sale–leaseback would have required Worthen to pay a substantially higher option price. *Id.* at 585 n.2 (Stevens, J., dissenting). Because the firm knew that there were other bidders, that price probably reflected the minimum amount it (and its lawyers) considered necessary to confer tax ownership.

[75] *Id.* at 583–84.

The language of *Consumer Life*, the third Supreme Court case to divorce ownership from risk, echoes that of *Clay Brown* and *Frank Lyon*:

> *Clay Brown*: "This argument has rationality but . . . . [w]e would hesitate to discount unduly the power of pure reason and the argument is not without force."[76]

> *Frank Lyon*: "We recognize that the Government's position, and that taken by the Court of Appeals, is not without superficial appeal . . . . We, however, as did the District Court, find this theorizing incompatible with the substance and economic realties of the transaction . . . ."[77]

> *Consumer Life*: "The question before us, however, is not whether the Government's position is sustainable as a matter of abstract logic. Rather it is whether Congress intended a 'reserves follow the risk' rule . . . ."[78]

Consumer Life resulted from a government argument that an insurance company responsible for paying claims (that bore the actual insurance risk) should be considered for tax purposes as having the liability to pay them.[79] The liabilities, called reserves, would have disqualified Consumer Life from favorable tax treatment as a life insurance company.[80] Consumer Life therefore compensated another corporation to take the reserves on its books for both regulatory and tax purposes. Again deferring to state law, one of the two reasons the Court gave for separating reserves from risk was that the "treatment was in accord with customary practice as policed by state regulatory authorities."[81] Justice White—who wrote *Clay Brown* but dissented in *Frank Lyon* and *Consumer Life*—put it this way: "I cannot believe that Congress intended to allow an insurance company to shelter its nonlife insurance income from taxation merely by assuming an incidental amount of life insurance risks and engaging another company to hold its reserves . . . ."[82]

All three cases resemble safe harbor leasing, a statutory provision that consciously allowed the free transfer of deductions without other economic effect.[83] Lawyers nicknamed these transactions tax benefit transfers, or TBTs. The above Supreme Court cases allow TBTs without benefit of statute, and that statute produced such unwonted results that it was soon repealed.

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[76] Commissioner v. Brown (*Clay Brown*), 380 U.S. 563, 570, 573 (1965). The last time I spoke with Wayne Barnett, he quoted the first words of the second sentence from memory.

[77] *Frank Lyon*, 435 U.S. at 581–82.

[78] Consumer Life Ins. v. United States, 430 U.S. 725, 740 (1977) (footnote omitted).

[79] *See id.* at 731.

[80] *Id.* at 727–28.

[81] *Id.* at 750. Note that the state regulatory authorities, concerned primarily about an insurance company's solvency, may have had little incentive or ability to change it.

[82] *Id.* at 756–57 (White, J., dissenting).

[83] I.R.C. § 168(f), *repealed by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 12(b), 98 Stat. 494, 504.

In the fourth case, *Cottage Savings*, Justice Marshall telegraphed his result when he wrote "because of the importance of this issue to the S&L industry . . . , we granted certiorari."[84] *Cottage Savings* held that mortgage obligations that federal regulators ruled "substantially identical" for book purposes were "materially different" for tax purposes. The Commissioner, represented by John Roberts, argued that properties were materially different "only if they differ in economic substance."[85] The Court, however, considered them materially different "so long as they embody legally distinct entitlements"; the exchanged loans met this standard because they "were made to different obligors and secured by different homes."[86]

The decision reduced economic substance to niceties of state law, and upheld tax benefits for a transaction that lacked both nontax motive and nontax profit. In *ACM Partnership v. Commissioner*, Judge McKee of the Third Circuit pointed out this distortion of economic substance.[87]

IV. Ownership as Risk

The other position on ownership, that risk is what matters, might begin with *Helvering v. F. & R. Lazarus & Co*.[88] In that case the Supreme Court allowed a taxpayer to challenge its own form, and held that the sale and leaseback of buildings should be treated for tax purposes as a borrowing.[89] Lazarus had leased the buildings for 99 years (their entire useful life).[90] Economically, it had borrowed on property it owned and had given title to the lessor as security.[91]

The Service has more ability to challenge a taxpayer's form, and it made an emphatic statement about risk in a revenue ruling. B invested $100 in corporation X and simultaneously received $70 from A for granting him an option to buy X for $30. A thus bore the risk of decline in value of the X stock from $100 to $30. The ruling considers A the actual owner of corporation X, and as such A is required to file certain returns. Failure to file those returns, it

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[84] Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 558 (1991). Justice Marshall did add, secondarily, that there was a conflict among the circuits. *Id.*

[85] *Id.* at 562.

[86] *Id.* at 566. *Cottage Savings* involves a taxpayer telling one story to the Service and another to regulators, so it could have been decided for the government on the ground of consistency. *See id.* at 558. In *Commissioner v. Bollinger*, Justice Scalia allowed a taxpayer to take inconsistent positions for tax and regulatory purposes when the taxpayer was consciously waiving a statute (usury) intended for his own protection. 485 U.S. 340, 348 (1988). By contrast, *Cottage Savings* allowed the taxpayer to take inconsistent tax and regulatory positions even though the regulatory purpose was to protect *depositors* rather than the bank. *See* 499 U.S. at 557. The depositors, and ultimately all taxpayers, did not waive their regulatory protection. *See id.* at 556–57; Commissioner v. First Sec. Bank of Utah, N.A., 405 U.S. 394 (1972) (regulatory authority overrides economic ownership of income).

[87] 157 F.3d 231, 264–65 (3d Cir. 1998) (McKee, J., dissenting).

[88] 308 U.S. 252 (1939).

[89] *Id.* at 252–53.

[90] *Id.* at 253.

[91] *See id.*

concludes, "will subject A to criminal and civil penalties."[92]

In *Comtel Corp. v. Commissioner*, the case centered on a more plausible option price.[93] Zeckendorf sold shares in the Commodore Hotel (now, in Donald Trump's first successful deal, the remodeled Grand Hyatt[94]) to Comtel, a newly formed corporation.[95] Comtel granted Zeckendorf an option to repurchase shares of the hotel at the original sale price plus the equivalent of substantial interest.[96] When Zeckendorf exercised the option, Comtel reported nontaxable gain from the sale of shares.[97] The Second Circuit, however, held that the profit was not gain but interest on a loan.[98] Zeckendorf (a corporation) never relinquished ownership of the shares because it was economically compelled to exercise the option: compulsion stemmed from the economic loss that Zeckendorf and its parent would bear if the option were not exercised.[99]

Given *Lazarus* and *Comtel*, a sale and legally required repurchase at a fixed price (known as a repo) should more obviously be treated as a loan. A personal encounter showed me the truth of this. Owing to religious beliefs, many people will not lend money at interest. Accordingly, a company I did tax work for would sell gold at the market price—say, $100—and agree to buy it back in three months for $102, regardless of the gold's then value. I advised them that the two dollars could and should be treated as interest. The business flourished, and one day I asked an executive how they managed to acquire so much gold. "What gold?" he said.

Almost thirty years after *Comtel*, the repo issue came to the Supreme Court as a matter of state taxation. Banks would sell Treasury obligations to investment trusts for $100 and agree to buy them back in three months for $102. If the trusts owned the Treasury obligations, the trusts had loaned money to the Treasury and a state could not tax the two dollars.[100] If the banks remained owners of the Treasury obligations, the investors had loaned money to the banks and a state could tax the two dollars.[101] The State's highest court had held that Nebraska could not tax the interest, and its department of revenue appealed.[102] Justice Thomas's opinion held that Nebraska could tax the inter-

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[92] Rev. Rul. 1982-150, 1982-2 C.B. 110.

[93] 376 F.2d 791 (2d Cir. 1967).

[94] *See* Marilyn Bender, *The Empire and Ego of Donald Trump*, N.Y. Times, Aug. 7, 1983, at 1.

[95] *Comtel*, 376 F.2d at 792.

[96] *Id.* at 793.

[97] *Id.* A sale would have been nontaxable at the corporate level under then section 337, and Comtel's shareholders would have realized long-term capital gain at a time when individual tax rates on interest approached 90%.

[98] *Id.* at 792.

[99] *Id.* at 794–97. Zeckendorf was a subordinated shareholder in Comtel, and its parent had guaranteed Comtel against any loss on resale. *Id.* at 793.

[100] 513 U.S. 123, 125 (1994).

[101] *Id.*

[102] *Id.* at 127. More than a dozen state attorneys general filed amicus briefs.

est because the repo interest paid to the trusts bore no relation to the interest accrued on the Treasury obligations.[103] Here, any equity interest in the property—a stake in whether its value went down *or* up—was offset by the obligation to resell it at a fixed price unrelated to its value.[104]

Whatever its language, *Nebraska Department of Revenue v. Loewenstein* correlates an equity interest to a stake in the property's value. An offsetting transaction, by neutralizing that relationship, changes the fluctuating interest of equity into the fixed return of debt. The sale of hotel shares by Zeckendorf became a loan to Zeckendorf because the purchaser Comtel had no stake in the hotel's value, the sale of imaginary gold by my client became a loan because my client had no stake in the imaginary gold's value, and the sale of Treasury obligations by banks became a loan to the banks because the trusts had no stake in the return on (value of) those obligations.

Accordingly, once an offsetting transaction neutralizes the risk of fluctuations in value, equity becomes debt. This concept applies (as in Enron-Merrill Lynch) outside of income tax—for example, in the Supreme Court estate tax case of *Helvering v. Le Gierse*.[105] Under the law at the time, a certain amount of life insurance proceeds could be excluded from estate tax. Therefore, at the age of 80, Mrs. Le Gierse bought an annuity plus $25,000 of life insurance for approximately $27,000.[106] (She was not required to take an exam.[107]) A month later she died. Justice Murphy's opinion analyzed the issue as that of risk, stating that

> annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other. From the company's viewpoint insurance looks to longevity, annuity to transiency. . . .
>
> . . . .
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> . . . Any risk that the prepayment would earn less than the amount paid to [Mrs. Le Gierse] as an annuity was an investment risk similar to the investment risk assumed by a bank: it was not an insurance risk as explained above.[108]

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[103] *Id.* at 130, 137. Thomas's opinion, however, disclaimed that it was deciding ownership:

> A sale–repurchase characterization presumably would make the Trusts the "owners" of the federal securities during the term of the repo. But the dispositive question is whether the Trusts earned interest on "obligations of the United States Government," not whether the Trusts "owned" such obligations. As respondent himself concedes, "[t]he concept of 'ownership' is simply not an issue . . . ."

Id. at 133–34.

[104] *Id.* at 130.

[105] 312 U.S. 531 (1941).

[106] *Id.* at 536–37.

[107] *Id.* at 537.

[108] *Id.* at 541–42.

In other words, the company's equity in the life insurance policy would increase the longer Mrs. Le Gierse lived,[109] and its equity in the annuity would correspondingly decrease the shorter she lived. Taken together, the offset eliminated mortality risk, and the result was debt. The company had made a loan to Mrs. Le Gierse with death affecting only its maturity.

Risk should offset not only the characterization of property but the characterization of income as well. To illustrate, it helps to analyze whether a transaction should be treated as a transfer of property or a performance of services.[110]

The distinction between transferring property and furnishing services should depend on an analysis of what the furnisher's risk relates to. When J.K. Rowling and Ernest Hemingway wrote their books, they had the risk of loss and—quite apart from copyright law—should have been considered to have transferred property. By contrast, a newspaper reporter has no risk or equity to transfer. Picasso and de Kooning were not guaranteed payment, whereas a portrait photographer like Bradford Bachrach is. When Donald Trump commissions the building of a casino, he has the risk of the property's value; the construction company building it for him does not.[111] The reporter, the portrait photographer, and the construction company do bear risk, but that risk relates to the competence and cost of their services not to the value of the property they are creating. That is why they are performing services.

I bring up this somewhat compelling logic in part because a brouhaha has arisen over taxation of money managers on what are called "carried interests." One fund manager even compared a legislative proposal to tax his income at ordinary rates to the Nazi invasion of Poland. But money managers do not bear investment risk. Although their income is measured by a fund's increase in value, so far as relevant, they invest nothing. Without investment risk, it becomes difficult to reason that they have an equity interest in the fund rather

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[109] Life and health insurance policies seem to be the only ones not named for the risk *against* which they protect.

[110] A recent case, *Container Corp. v. Commissioner*, spoke of services as primarily involving "human capital." 134 T.C. No. 5, at 22–23, 2010 WL 571831, at *8 (2010) ("The common meaning of 'labor or personal services' implies the continuous use of human capital, 'as opposed to the salable product of the person's skill.'") (citations omitted). But substantial nonhuman capital goes into performing services. Delta Airlines furnished services by flying me down here, as would have Amtrak had I taken a train. In neither case was there a rental of property (the seat), and both cases involve more nonhuman capital than used in giving me a haircut. The case was affirmed without reliance on the idea of human capital. Container Corp. v. Commissioner, 11-1 U.S.T.C. ¶ 50,351, 107 A.F.T.R.2d 1831 (5th Cir. 2011).

[111] Regulations governing computer software use this criterion. *See* Reg. § 1.861-18(h), Ex. 15. So does the OECD as to non-legally protected property. Commentary on Article 12 of its model treaty states that know-how is not transferred as if the transferor either guarantees the result or is required to play a part. Model Tax Convention on Income and on Capital, Condensed Version art. 12, cmt. 11.1 (Org. for Econ. Co-operation & Dev. 2010). In other words, if the purported transferor of property bears the risk of the know-how not working for the transferee, he is using the property himself to perform services.

than a debt claim against it (for services).[112] Thus, controversy over proposed carried interest legislation makes no sense.

Money managers would have you believe that equity treatment of a carried interest derives from the Magna Carta. But outside the oil and gas industry, carried interest has never been a United States tax concept, and for more than 40 years even a carried interest in minerals has been characterized as debt rather than equity.[113] Today, yesterday, and since the beginning, fund managers have had compensation income on what they call their carried interest. If the government were to bring a case, I would write the brief for free—and my fellow volunteers might fill the main reading room of the recently renamed New York Public Library building.[114]

In particular, I do not think that managers of takeover funds understand the utter shamelessness of their position. They make money by buying a corporation with the proceeds of high-yield subordinated bonds. Those bonds, which have the risk and yield of equity, replace stock of the corporation. The company's value goes up because its taxes go down, so that the company can distribute deductible interest instead of nondeductible dividends. Thus, at the corporate level, the managers are claiming that what is economically equity is debt; then, at the individual level, they are claiming that what is economically debt is equity. They make the money by savaging our tax system—and when they take the money, they savage it once again. To repeat, *outside Texas there is not now and never has been such a thing as a carried interest*, and since 1969 Texas has not had one either. A tort lawyer does not lose one-third of his arm.[115]

V. Ownership as Economic Substance

Failure to consider risk has culminated in three repo transactions being decided on the grounds of economic substance: *ACM Partnership v. Commissioner*,[116]

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[112] One gets an ownership interest in property either in exchange for other property or for performing services. If you receive an interest for money, the consideration represents income on which you have already been taxed. If you receive an interest for services, the services represent consideration on which you will now be taxed. Obtaining an ownership interest without past or current taxation skips a logical beat: The interest is not carried, it is *earned.*

[113] *See* Commissioner v. Brown (*Clay Brown*), 380 U.S. 563, 575–77 (1965); Bryant v. Commissioner, 399 F.2d. 800, 806 (5th Cir. 1968) ("A taxpayer does not have an economic interest in property merely because his right to payments is linked to profits, dividends, farm produce or the like."); *cf.* Commissioner v. Banaitis, 543 U.S. 426 (2005). As to minerals, see section 636(b), added by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 503(a), 83 Stat. 487, 630–31.

[114] A statutory override of misconstrued current law, to make fund managers pay ordinary rates on their future income, would carry with it significant costs. The statute—by accepting performance of services as a transfer of property—tinkers with the essence of tax law: The meaning of words. That misreading can skew characterization, timing, or source of income in other contexts, which in turn invites constant epicycles to correct. *Cf.* I.R.C. 7701(e).

[115] The President and the press have accepted the assertions of the hedgies. *See, e.g.*, James B. Stewart, *The Dogma Tax Rates*, N.Y. Times, Aug. 20, 2011, at B1.

[116] 157 F.3d 231 (3d Cir. 1998).

Compaq Computer Corp. v. Commissioner,[117] and *IES Industries v. United States*.[118] In the first, *ACM*, "ACM" stands for the initials of its partners: "A" for Allegemeine, a Dutch bank not taxable on U.S. capital gain; "C" for Colgate, a company that had U.S. capital gain; and "M" for Merrill Lynch, a firm that worked on saving corporations from paying tax on U.S. capital gain.[119]

Merrill proposed a transaction in which A, C, and M would put money into a partnership; an artificial capital gain would be allocated to the Dutch bank, whose stake would then be redeemed.[120] A corresponding artificial capital loss would be incurred, allocated to Colgate, and used to offset its real capital gain.[121] In the Tax Court the Service made the following arguments, in order as listed in the opinion:

- The transaction lacked economic substance;
- The bank's investment in the partnership constituted debt rather than equity (the bank even booked it as a loan); and
- Allocation of the artificial gain to the bank had no effect on the amount of cash it received.

In a long memorandum opinion, the Tax Court disallowed the loss on the ground that the transaction had no economic substance.[122] The Third Circuit affirmed on the same ground.[123] Judge McKee dissented, noting that the transaction had as much economic substance as did *Cottage Savings* and characterizing economic substance as a "smell test."[124]

A small outfit named Twenty-First Securities accomplished what the thundering herd could not—eliminating capital gain without risk. It proposed that a company buy foreign stock on the record date that entitled its holder to a dividend, and then immediately sell the stock at a capital loss (the price would go down by the amount of dividend that the buyer after a record date would not receive). The tax saving would be about ten percent of the dividend.[125]

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[117] 277 F.3d 778 (5th Cir. 2001).

[118] 253 F.3d 350 (8th Cir. 2001).

[119] *See ACM P'ship*, 157 F.3d at 233.

[120] *See id.* at 236.

[121] *Id.* at 244, 252. The opinion notes Merrill telling Colgate what Colgate's business reasons are for doing the transaction. *See id.* at 234–35.

[122] ACM P'ship v. Commissioner, 73 T.C.M. (CCH) 2189, 2229, 1997 T.C.M. (RIA) ¶ 97,115, at 741. But of course it had economic substance: it was a loan plus a fee for playing charades.

[123] *ACM P'ship*, 157 F.3d at 260.

[124] *Id.* at 265 (McKee, J., dissenting).

[125] *See, e.g.*, Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 779–80 (5th Cir. 2001). The sellers were tax-exempt institutions like pension funds. If they were entitled to a dividend of $100 less 15% foreign tax, their net dividend would be $85. If the stock price were X, they might be willing to sell for X plus $85. The taxable buyer could credit the $15 foreign tax, so the buyer's net $20 U.S. tax on the dividend ($35 minus $20) would be more than offset by the $30 tax it saved by reselling the stock at a loss of $85.

Twenty-First Securities successfully shopped the deal to both Compaq Computer and to IES, an Iowa public utility.[126] Compaq bought and resold $887 million of stock in Royal Dutch Petroleum to save about $2 million in tax. IES saved about $19 million in tax. How much stock it bought is not clear; but if the dividend were two percent of the value, it would have had to buy and resell about $4.5 billion of stock. At a bar association panel, the general tax counsel of a large corporation stated that Twenty-First Securities had approached him with this proposal, and he had told the financial vice president that it would work if they held the stock for a week. "Are you crazy?" the man said, "Get out of my office."

In *Compaq*, the court found as a fact that the transaction was "deliberately predetermined and designed to . . . yield a specific result and to eliminate all economic risk."[127] The court also imposed a negligence penalty.[128] Compaq appealed both the result and the penalty. As to the latter, Compaq argued that a negligence penalty was inappropriate because an economic substance standard was "inherently imprecise."[129] The penalty issue was not reached because the appeals court held for Compaq on the merits. Discussion began with quotation of the three-party genuine transaction language of *Frank Lyon*.[130]

The Eighth Circuit in *IES*, when faced with a similar transaction, reversed a district court and praised IES's minimization of risk:

> The government argues that the transactions must be characterized as shams because there was no risk of loss. We disagree. The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions.[131]

This was not an unsophisticated panel. One of the judges had a brilliant academic record at Yale and Harvard, and would (but for illness) have been nominated by President Clinton for the Supreme Court. The author of the decision, Judge Bowman, had worked at one of the top Wall Street firms. Yet they, like the panel in *Compaq*, did not see that a half-point decline in the stocks would wipe out any tax profit—and a larger decline, as the financial vice president realized, would have gotten everyone fired. Somewhere, someplace, somehow, someone had to be playing "What gold?"

This criticism of an economic substance standard, much less its codification, must be taken seriously. I have not read any case decided for the government on lack of economic substance that could not have been won on

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[126] *See id.* at 779; IES Indus. v. United States, 253 F.3d 350, 352 (2001).
[127] Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 219 (1999).
[128] *Id.* at 227.
[129] *Id.*
[130] *Compaq*, 277 F.3d at 782.
[131] IES Indus. v. United States, 253 F.3d 350, 355 (8th Cir. 2001).

technical issues. *ACM*, *Compaq*, and *IES* are all the same repo.[132] Moreover, under codified economic substance, a legal opinion does not protect the taxpayer from penalties. But in the poster boy lack of economic substance case, *ACM*, the taxpayer received an unimpeachable one—unqualified, well reasoned, and from a federal appeals court judge. Whether a dissent prevents the penalty has not to my knowledge been raised.

As *Compaq* and Judge McKee maintained, economic substance is, at least in part, inherently imprecise and a smell test. More fundamentally, it goes against a lawyer's entire training: what I was taught at Dean Griswold's law school, what I teach, the way I practiced, the way I believe others practice. I was taught to be specific, to decide a case or write an opinion on the narrowest possible grounds, to state what facts made you decide the way you did.

A focus on specifics also sharpens reliance on technical arguments. It would make the government less reluctant to assert penalties that permit reasoned advice as a defense than to unleash the all-or-nothing 40% bomb. *ACM* did not pass technical muster in at least three ways.[133] Given the three strikes you're out rule, and especially after learning that the bank had insisted on booking the partnership interest as a loan, I would have gone after the whole lot—A, C, M, and the lawyers—in a way that would have given them pause. Instead, the case's economic substance was litigated on the one issue that the taxpayer could and should have won.

V. Conclusion

That's what I got to say. I know the details of many of the cases I have discussed both because I read them each year and because I was there when they came out fresh. There are few greater rushes than to get inside another's mind. To see the clarity of *Le Gierse*, Justice Frankfurter's dissent in *Wodehouse*, and Wayne Barnett's briefs in *Clay Brown* and *Tufts* still get to me. Sometimes tax lives up to Noël Coward's statement that "[w]ork is more fun than fun."[134]

So I thank the American College of Tax Counsel—and especially Joan Arnold, one of the best students I have ever taught—for inviting me here. It has been a privilege and pleasure to honor a tax lawyer in front of other tax lawyers; and of course to be one myself.

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[132] Cases like *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.N.J. 2009) (put together by the ACM group), and *Castle Harbour-I LLC v. United States*, 660 F. Supp. 2d 367 (D. Conn. 2009), are generally debt masquerading as equity or vice versa. Moreover, acquiring offsetting risks might fall within *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

The Third Circuit explicitly affirmed *Schering-Plough* on grounds without reaching "its alternative conclusion that the [t]ransactions lacked economic substance." Merck & Co. v. U.S., 11-1 U.S.T.C. ¶ 50,461, 107 A.F.T.R.2d. 2596 n.10 (3d Cir. 2011). The opinion also cites to *Comtrel.*

[133] The third is that the tax result depended on an installment sale price being contingent, whereas economically it was determined. *See* ACM P'ship v. Commissioner, 157 F.3d 231, 250 (3d Cir. 1998).

[134] *Sayings of the Week*, Observer (London), June 23, 1968, at 8.