

# 2019 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Proper Application of the Judicial Doctrines and the Elimination of Section “I Don’t Like It”

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I am honored to have been asked to deliver the Griswold Lecture this year. I know that it is customary at these presentations to say a few words honoring Dean Griswold, but I am unable to do so because I never met or heard Dean Griswold, and I am loath to repeat stories I have heard from others, which would be hearsay at best. I did go back and read the initial Griswold Lecture delivered by the Dean himself and entitled, *Is the Tax Law Going to Seed?*<sup>1</sup> and was impressed by both his wit and perspective.

I have attended many of the Griswold Lectures over the past 25 years since I was invited to join the American College of Tax Counsel. I am very honored to be included in the list of lecturers. Several of the prior Griswold Lectures have been the most memorable presentations I have heard, including particularly Carr Ferguson’s admonition during the height of the late ‘90s tax shelter era that tax counsel must advise their clients to consider how a court would rule when it considered all of the facts involving a transaction.<sup>2</sup> I fully agreed with Carr and was concerned that the inevitable legislative reaction to those tax shelters would be both overbroad and overbearing—which it was. This lecture provides a forum to deliver a message that people need to hear but in some cases may not want to hear. And I hope that I can continue in that tradition.

I will, however, depart from one tradition of the Griswold Lecture in that I am not wearing a tie. As I have often stated, I only wear ties to weddings, funerals, and when I go to court, and this lecture is none of those. When I

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<sup>1</sup> Erwin N. Griswold, *Is the Tax Law Going to Seed?*, AMERICAN COLLEGE OF TAX COUNSEL (Feb. 5, 1993), <https://www.actconline.org/griswold-lecture-on-tax-policy/> [<https://perma.cc/GS5G-SBYY>].

<sup>2</sup> M. Carr Ferguson, *How Will A Court Rule?*, 53 TAX LAW. 721 (2000).

told my wonderful wife, Jane, that I was not going to wear a tie, she said that I should. When I demurred, she immediately responded, "Well, it's your funeral." My only response was that at least I would be comfortable at my own funeral.

I plan to focus today on the proper application of the judicial doctrines and the most infamous section of the Internal Revenue Code—section "I Don't Like It." I want to emphasize what this lecture is not—it is not an attack on the judicial doctrines. The key judicial doctrines—economic substance, substance over form, and the step transaction doctrine—are all important elements of statutory interpretation and, if they are appropriately applied by the courts and the IRS in the appropriate order, are necessary for the tax system to function properly. The problem which arises is that the IRS and the courts will sometimes see a transaction that achieves tax results that are more favorable than they believe is appropriate, and they will wrongly apply the judicial doctrines or, if the judicial doctrines don't seem to apply to alter the tax results which are clearly allowed by the applicable law, simply say that the doctrines apply in situations where they clearly are inapplicable. Or there will be a strained reading of the Code in order to eliminate a result which is viewed as too favorable to the taxpayer. This is what I refer to as section "I Don't Like It"—the stretching and misapplication of the Code and the judicial doctrines to undo the results that are clearly permissible by the existing provisions of law as amplified by the judicial doctrines.

Any discussion of the judicial doctrines must start, of course, with *Gregory v. Helvering*.<sup>3</sup> We are all familiar with both the Second Circuit and the Supreme Court decisions in that case. As a reminder, the facts in that case were succinctly stated by Judge Learned Hand in his opinion in the Second Circuit:

The taxpayer owned all the shares of the United Mortgage Corporation, among whose assets were some of the shares of another company, the Monitor Securities Corporation. In 1928 it became possible to sell the Monitor shares at a large profit, but if this had been done directly, the United Mortgage Corporation would have been obliged to pay a normal tax on the resulting gain, and the taxpayer, if she wished to touch her profit, must do so in the form of a dividend, on which a surtax would have been assessed against her personally. To reduce these taxes as much as possible, the following plan was conceived and put through: The taxpayer incorporated in Delaware a new company, . . . called the Averill Corporation, to which the United Mortgage Corporation transferred all its shares in the Monitor Securities Corporation. . . . Being so possessed of all the Averill shares, she wound up the Averill company three days later, receiving as a liquidating dividend the Monitor shares, which she thereupon sold. It is not disputed that all these

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<sup>3</sup>Gregory v. Helvering, 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

steps were part of one purpose to reduce taxes, and that the Averill Corporation, which was in existence for only a few days, conducted no business and was intended to conduct none, except to act as conduit for the Monitor shares . . . .<sup>4</sup>

After noting that the Board of Tax Appeals had stated that a taxpayer's intent was not relevant and that the Board had held in favor of the taxpayer, Judge Learned Hand penned perhaps the most famous two sentences in tax jurisprudence:

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.<sup>5</sup>

However, as we all know, that was not the end of the story. Judge Hand then emphasized that the intent of the statute must be given effect.

Therefore, if what was done here, was what was intended by section 112(i)(1)(B), it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition.<sup>6</sup>

It is important to carefully consider what Judge Hand stated—reducing tax to zero was permissible. But the statute must be enforced in accordance with its meaning. In fact, Judge Hand went on to emphasize what the statute allowed:

The purpose of the section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as “realizing” any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate “reorganizations.”<sup>7</sup>

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<sup>4</sup> *Gregory*, 69 F.2d at 810.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 811.

Judge Hand then went on to say that for purposes of calculating the amount of tax owed by Mrs. Gregory, the transaction should be treated as a “sham” and not given effect for tax purposes. The Supreme Court effectively adopted Judge Hand’s opinion and reasoning, emphasizing that holding otherwise “would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.”<sup>8</sup>

The result in *Gregory* was of course correct, and the case is usually cited as the foundation of the economic substance doctrine. I would add that there is an alternative way to look at *Gregory*, which may be more consistent with its holding, which is that the case did not establish the “economic substance doctrine” but, rather, simply provided a judicial gloss to the meaning of the word “reorganization.” Under this approach, *Gregory* can best be viewed as a judicial clarification that a corporate reorganization can only be viewed in a manner consistent with what Congress believed a reorganization to be, and that a transaction is not a reorganization merely because a taxpayer labels it as such. This approach to *Gregory* puts a much narrower spin on the decision, and in my view it probably is more consistent with what the courts thought they were doing at the time the *Gregory* decisions were issued.

However, I will be spending your time today drilling down into the details of the economic substance doctrine and the other judicial doctrines, and I think that a good argument could be made that *Gregory* was correctly decided but that an incorrect explanation has been given in subsequent authorities. Specifically, what the Second Circuit did was disregard the steps that Mrs. Gregory had undertaken because those steps were mere form and not substance—in other words, the courts looked at the substance of the transaction and not its form. Or you can view this decision as an application of the step transaction doctrine, in that steps which were transitory and not integral to the larger transaction were simply disregarded. And many practitioners viewed the *Gregory* decision in that light until *ACM*,<sup>9</sup> in which the courts took *Gregory* beyond its historical bounds.

I will turn to *ACM* in a moment. But nowadays, most people view *Gregory* as the source of the economic substance doctrine, in that it called a transaction a “sham” and allowed for the courts to disregard and give no tax consequences to a transaction that occurred but should not be respected. You should note, however, that Judge Hand’s usage of the word “sham” was in the context of the computation of the deficiency and not an integral part of the reasoning of his decision.

*Gregory* has become the source of continuing confusion, because it necessitates a distinction between transactions which are shams in fact and transactions that are disregarded under the economic substance doctrine.

A sham in fact is a transaction that never happened, and by definition such transactions should not be given any respect for tax purposes. For example, a

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<sup>8</sup> *Gregory*, 293 U.S. at 470.

<sup>9</sup> *ACM P’ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

taxpayer who claims tax benefits with respect to cattle that were never purchased<sup>10</sup> or commodity straddles that never occurred is involved in a transaction which is a sham in fact.<sup>11</sup> These are the easy situations—it is self-evident that a transaction that never occurred has no tax impact.

The economic substance doctrine only applies to transactions that actually occurred. To refer to such transactions as “shams” when they actually took place is not good form, especially since the two parts of the analysis required under the economic substance doctrine are in no way linked to the customary meaning of the word “sham.” I am uncomfortable calling transactions which actually occurred “sham transactions” because of the potential confusion in this area. For purposes of this presentation, I will avoid using that label for transactions that actually occurred but are not given tax effect under the economic substance doctrine. And I have the rather immodest hope that after this presentation, some judges will recognize that utilization of the phrase “sham transaction” to address a transaction that is not given tax effect under the economic substance doctrine is not appropriate.

So when you look closely at *Gregory*, I believe that the decision should be viewed as providing an interpretation of “reorganizations” rather than as the font of the economic substance doctrine. Even if the decision embodies judicial doctrines, it would better be viewed as an application of the substance over form doctrine or its corollary, the step transaction doctrine. Let’s spend a moment discussing those two doctrines in the context of the economic substance doctrine. The economic substance doctrine focuses on whether or not a transaction should be respected for tax purposes. A transaction which lacks economic substance is completely disregarded and given no tax effect. In contrast, under the substance over form doctrine, a transaction is given tax effect even if the form of the transaction would have resulted in a different tax impact. In other words, the transaction subject to the substance over form doctrine is given effect for tax purposes although that effect will depend upon the true substance of the transaction and not its form.

The step transaction doctrine is, in my view, just a corollary of that general rule, because it says that meaningless steps are disregarded in considering the tax consequences of a transaction that actually occurred and must be given tax effect. A transfer of property from A to B, followed immediately by a mandatory transfer of property from B to C, is the classic situation which will be viewed as a transfer from A to C, and if the tax consequences of the two-step versus the one-step approach are different, then the direct approach will be given priority. To put it differently, a taxpayer cannot alter the tax consequences of a transaction by introducing meaningless additional steps.

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<sup>10</sup> *Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221 (1981).

<sup>11</sup> *Krumhorn v. Commissioner*, 103 T.C. 29, 46 (1994) (asserting that the disputed transactions were factual shams “[g]iven the lack of business formalities, the irregularities in the documentation of the purported trades, the correlation of losses and gains with tax needs, the lack of margin payments, and the zeroing out of account balances”).

Let me pause here for a moment to go back to our friend, Mrs. Gregory. When you think about the transaction that she engaged in, she transferred stock of a corporation to a new entity and then distributed the stock of the new entity and immediately liquidated it. It was perfectly appropriate to view this transaction as a stock distribution. Whether looked at under the substance over form doctrine or the step transaction doctrine, Mrs. Gregory should have lost that case. But the decision really had nothing to do with the economic substance doctrine.

Let me ask you to engage in a thought experiment. What if Mrs. Gregory had held Averill for two years before winding it up? Would you get to the same result? Would the transactions have lacked economic substance? Did Mrs. Gregory lose solely because of poor tax advice?

Nonetheless, people refer to *Gregory* as the source of the economic substance doctrine. The economic substance doctrine requires application of a two-part inquiry, referred to as the objective test and the subjective test. Under the objective test, a transaction will be respected only if it changes the taxpayer's economic position in a meaningful way apart from federal tax effects. Under the subjective test, a transaction is respected if the taxpayer has a substantial business purpose for engaging in the transaction apart from federal tax effects.

This two-part test has been the source of endless confusion, especially since it was unclear for decades whether the test was a conjunctive test or a disjunctive test. Under the conjunctive test, a taxpayer's transaction could be disregarded for tax purpose if it flunked either the subjective or objective test, whereas under the disjunctive approach, a transaction would be respected for tax purposes if it had either an objective or subjective business purpose. As we'll discuss in a few moments, the alleged codification of the judicial doctrine accomplished little other than a clarification that the conjunctive test, and not the disjunctive one, rules.

I want to return, again, to Mrs. Gregory for a moment. The transaction that she engaged in arguably flunks both sides of this test, in that there was no business purpose for the transfer of subsidiary stock and there was no purpose for it other than to reduce federal tax consequences. But as I noted a few minutes ago, the form of the transaction was inconsistent with its substance, which was a dividend of the Monitor stock. A different result might have been obtained if Averill was not immediately liquidated. This leads to an important point in discussing the application of the judicial doctrines, including particularly the economic substance doctrine and the step transaction doctrine—the ordering rules.

I have looked far and wide, and, interestingly, there appear to be few cases which discuss the ordering rules for the judicial doctrines. There are decisions which address the distinctions between the doctrines, usually in situations in which the Commissioner attempted to contend that a transaction lacked economic substance when, in fact, the appropriate attack on the transaction was

under the substance over form doctrine. My favorite decision in that regard is *AWG Leasing*.<sup>12</sup> I suspect that few of you are familiar with *AWG Leasing*, which is a well-reasoned decision of the district court in the Northern District of Ohio. This was an early sale-in, lease-out, or SILO, case involving an investment by two large banks, Key Corp and PNC, in a waste recycling facility located in Wuppertal, Germany. The banks formed an entity to acquire tax ownership of the waste recycling facility and then lease it back to the German municipal entity that had built the facility. The game, of course, was that the German municipal entity had no use for any depreciation deductions, but the US banks did. The banks paid \$423 million for this investment, but most of the money was placed into an escrow to ensure that money was there so that at the end of the lease term, the municipal entity could pay back the investment under either a put or call option. Prior to the time that the put or call was exercised, the banks made a profit from their investment which was similar to the profit from an investment of \$423 million. Importantly, the transaction was not treated as a sale for German legal or tax purposes, and there was no change in the legal liability of the German owner as a result of this transaction.

What is interesting about this decision is not that the taxpayers lost—of course they lost—but the court’s reasoning. The IRS primarily attacked the claimed depreciation deductions on the ground that the transaction lacked economic substance. The district court flatly rejected this argument, stating that the banks had a reasonable possibility of earning a pre-tax profit from the investment based on the return from the lease, even if the banks’ primary motivation for entering into the transaction was the anticipated tax benefits. In other words, the court refused to take the bait offered by the IRS that the anticipated tax benefits had to be weighed against the amount of the pre-tax profit. However, the court then concluded that in substance the transaction was simply a loan of money from the banks to the German municipal entity, with collateral in the form of an escrow which would be sufficient to repay the loan at the end of its term. The return earned by the banks was similar to the return they would earn on any loan, and the possibility of upside was remote. Thus, because the banks were merely lenders to the German municipal entity, the claimed depreciation deductions were denied.<sup>13</sup>

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<sup>12</sup> *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

<sup>13</sup> Another case illustrative of this point is *Chemtech Royalty Associates, L.P. v. United States*, 766 F.3d 453 (5th Cir. 2014), in which the district court held that a partnership between Dow Chemical and five foreign banks lacked economic substance and also held that the banks’ interests were debt rather than equity. The district court also held that the partnership should be treated as a sham on the basis that the banks were not really partners. The Fifth Circuit affirmed on the grounds that the foreign banks were not really lenders, but the Fifth Circuit did not address debt-versus-equity or economic substance on the grounds that it did not need to apply those doctrines to reach its decision.

Even though cases have not discussed the ordering rules for the doctrines, I think there is such a rule implicit in the nature of the doctrines. As I discussed earlier, the substance over form doctrine applies to transactions which occurred but in which the tax consequences should be based on the substance of the transaction rather than its form, while the economic substance doctrine applies to transactions which occurred but in situations in which is necessary to completely disregard the transaction. Thus, from a logical perspective, the appropriate first step in any decision tree for purposes of applying these doctrines is to ask whether there was a real transaction. If the answer to this question is no, then the transaction is a sham in fact and must be disregarded. If there was a real transaction, then the next step is to consider whether the substance of the transaction was the same as its form. In all situations, the substance of the transaction should be given tax effect. And logically, only after a court has considered the tax consequences of the substance of a transaction should any thought be given to whether the transaction which actually occurred should be disregarded for tax purposes under the economic substance doctrine.

This leads me to point to one of the situations in which I think the IRS, at that time under Bill Wilkins's leadership as Chief Counsel, got something right. (As an aside, you might want to note the time and place of my statement that the IRS got something right—it is a statement I rarely make.) As everyone in this room knows, Congress "codified" the economic substance doctrine in 2010 with the enactment of section 7701(o),<sup>14</sup> but it is a stretch to say that Congress codified anything.

When Congress addressed the economic substance doctrine in 2010, it was caught on the horns of a dilemma. On the one hand, Congress wanted to use codification to make the law consistent and to raise revenue; on the other hand, Congress did not want to freeze the law or limit the courts' ability to apply the economic substance doctrine. To address these concerns, Congress essentially punted the scope of the economic substance doctrine back to the courts by saying that any transaction to which the economic substance is "relevant" would be subject to that doctrine. And the doctrine would be relevant if it would have applied under the law absent codification. In other words, the codification of the economic substance doctrine did nothing to address its scope or reach, except that Congress clarified that the economic substance doctrine could apply to situations in which the taxpayer failed either the subjective or objective test.

The IRS put out several notices concerning this new provision of the Code.<sup>15</sup> Interestingly, the IRS did not attempt to define economic substance, which seems correct given that Congress could not come up with a decision

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<sup>14</sup> I.R.C. § 7701(o).

<sup>15</sup> See Notice 2010-62, 2010-2 C.B. 411; C.C.N. 2012-008 (Apr. 3, 2012), <https://www.irs.gov/pub/irs-ccdm/cc-2012-008.pdf> [<https://perma.cc/53LC-FWB5>].



but relied upon the courts' decisions. More importantly, in guidance to Examination and Appeals on the Codified Economic Substance Doctrine in 2011, the IRS concluded that the economic substance doctrine only should be applied in situations in which the other judicial doctrines are not applicable.<sup>16</sup> If the field wants to challenge a transaction under the judicial doctrines, the revenue agents are generally required to apply the substance over form and other judicial doctrines first before asserting that a transaction should not be respected under the economic substance doctrine. I believe the IRS got it right. I want to build on this field advice and propose a formal catechism which should be adopted by the courts for the application of the judicial doctrines.

First, was the transaction a sham in fact? If it was, it is ignored.

Second, apply the Code and regulations to the form of the transaction before applying the judicial doctrines.

Third, what was the substance of the transaction? The transaction should be taxed according to its substance.

Fourth, if the substance of the transaction is different than its form, how do the Code and regulations apply to the transaction in light of its substance?

Fifth and last, after the substance of the transaction has been determined, does it have economic substance within the meaning of section 7701(o)? If not, then the transaction can be disregarded. Otherwise, the substance of the transaction must be given tax effect according to the terms of the Code and regulations.

Concerning the economic substance doctrine, this brings me to another decision that I want to spend a few minutes discussing, which is *ACM*.<sup>17</sup> I could make a pretty good argument that much of the current confusion concerning the scope and application of the judicial doctrines is grounded in the Tax Court's and Third Circuit's decisions in *ACM*, which applied the economic substance doctrine to a transaction that should have been otherwise attacked. As you will recall, the case arose because Colgate-Palmolive had a capital gain of over \$100 million, and it wanted to create an offsetting loss to reduce its overall tax liability. In 1989, Colgate formed a partnership, *ACM*, with a subsidiary of ABN Bank. Colgate contributed \$30 million to the partnership and ABN put in \$170 million, so that the partnership was owned 85% by ABN. The partnership then acquired notes issued by Citicorp, and a mere three weeks later, the partnership sold most of the notes in exchange for cash and contingent notes. Under the regulations, because contingent notes were issued as part of the transaction, basis was spread over the term of the contingent notes, so that there was a large gain taxable in 1989 even

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<sup>16</sup> IRS LARGE BUSINESS & INTERNATIONAL DIVISION, LB&I-4-0711-015, GUIDANCE FOR EXAMINERS AND MANAGERS ON THE CODIFIED ECONOMIC SUBSTANCE DOCTRINE AND RELATED PENALTIES (2011).

<sup>17</sup> *ACM P'ship v. Commissioner*, 73 T.C.M. (CCH) 2189, T.C.M. (RIA) ¶ 97,115 (1997), *aff'd in part, rev'd in part, and remanded*, 157 F.3d 231 (3d Cir. 1998).

though there was no real economic gain—the basis spreading required by the regulations caused an acceleration of gain. Because of the 85–15 ownership of the partnership, this gain was allocated largely to ABN, which was not taxable because it was a foreign person. Two years later, after ABN's interest was redeemed, the remaining notes (which had a large basis and a low fair market value) were sold, resulting in a loss recognized by Colgate that could be used to offset the prior capital gain.

The Tax Court's opinion immediately reaches the conclusion that the transaction lacked economic substance because tax avoidance was the reason for the partnership's purchase and sale of the Citicorp notes. The court emphasized that the taxpayer (Colgate) desired to take advantage of a loss that was not economically inherent in the object of the sale but which the taxpayer created artificially. A divided Third Circuit affirmed, although the Third Circuit also noted that Colgate did not make a real economic investment in the Citicorp notes which gave rise to the loss. The Third Circuit emphasized that the investment was made for a very short term and was in response to a proposal from a tax shelter promoter, which described the transaction as a Contingent Installment Note Sale (or CINS) transaction. This is the classic situation in which a clever acronym devised by an investment banker came back to haunt a taxpayer.

The dissent in the Third Circuit contended that, consistent with Learned Hand's opinion in *Gregory*, the taxpayer had the right to order its affairs so as to reduce its tax liability. According to the dissent, the transaction was within the scope of *Cottage Savings*,<sup>18</sup> in that there was an exchange of property which must be respected. The dissent also believed that the majority opinion was based more on a "smell test" than the law.

My view has always been that *ACM* reached the right conclusion but for the wrong reason. The partnership held the Citicorp notes for a mere three weeks, and they were the type of asset that was exceedingly unlikely to vary in value during that period of time. Thus, if the Tax Court had first applied the substance over form doctrine, it would simply have ignored the purchase and sale of the Citicorp notes, so that there was no real gain which had to be allocated to ABN. The Tax Court leapt to the conclusion that the transaction lacked economic substance when there was a narrower, and more accurate, basis for its decision, which was to look at the substance of the transaction which really occurred.

Let me posit another thought experiment for everyone in this room. Assume that Colgate came to you with this proposed transaction, but further assume that the facts were different. What if Colgate and ABN formed a partnership in 1989 which acquired the Citicorp notes as an investment. The partnership then reached out to you in 1992 and stated that it wanted to sell the notes at a gain. The partnership never spoke to Merrill Lynch or any other "tax shelter promoter." Would you have advised the partnership to utilize a

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<sup>18</sup> *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991).

contingent installment sale of the notes in order to allocate a large, nontaxable gain to the foreign partner?

I am asking this question because that circumstance, in fact, happened to me. In 1995, a partnership asked me to advise them concerning the potential sale of a subsidiary which the partnership had owned for 15 years. The partnership had multiple assets; this subsidiary ran an operating business which was not a U.S. real property holding company. The partnership was owned 83% by a foreign person and 17% by a U.S. person; the foreign partner wanted to redeem its investment. There was a small gain inherent in the subsidiary which was to be sold. I looked at the transaction and told the client that they could use the installment sale regulations to create a large gain which would be allocated to the foreign person and there then would be a large offsetting loss due to the basis shifting that would occur. And I advised them that this result simply followed the applicable regulations, which the IRS had drafted to artificially accelerate gain but which could now be used as a sword against the IRS.

As it turns out, my client did not undertake the proposed transaction, but not because they or their accountants disagreed. The buyer faded from the scene and another buyer emerged that wanted to buy only assets for a much greater price. The increased cash purchase price was larger than the tax savings from my proposed installment sale transaction, so the client appropriately sold the assets. But I have always wondered how the Tax Court would have responded to my transaction, in which there was an old-and-cold partnership with foreign partners using the contingent installment sale regulations against the government. And I suspect that even now, post-*ACM*, my advice to my client would be the same.

I think that there was some merit to the observation of the dissenting Third Circuit judge in *ACM* that the majority opinion was primarily based on the court's dislike of the tax consequences of the transaction. The Tax Court leapt to apply the economic substance doctrine to disallow the claimed tax benefits. I have also viewed the decision in *ACM* as one of the first cases to apply my least favorite section of the Code, section "I Don't Like It."

I had my first encounter with this section of the Code in 1998 when I read the Tax Court's unanimous decision in *Nelson v. Commissioner*.<sup>19</sup> That case involved an individual taxpayer who had a long-standing S corporation engaged in the auto supply business which went belly up. The COD income which arose as a result of the cancellation of indebtedness of the S corporation was excluded under section 108(d)(7), but the taxpayer claimed he was entitled to increase the basis of his shares in the S corporation under section 1367 because the COD income was an item of tax-exempt income which flowed through to the shareholder under section 1366(a)(1)(A). Congress had enacted section 1366(a)(1)(A) to prevent the taxation of interest on tax-exempt bonds which are held by an S corporation, and it was obvious that Congress

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<sup>19</sup> *Nelson v. Commissioner*, 110 T.C. 114 (1998).

never thought about what happened to income that was excluded under section 108 instead of section 103. But in *Nelson*, you had a taxpayer claiming a basis increase even though the COD income had never been taxable to him. Moreover, attribute reduction did not apply because section 108(b) defers attribute reduction to the beginning of the following taxable year, and at that point the S corporation had no tax attributes to reduce.

Needless to say, neither the IRS nor the Tax Court liked this result. The Tax Court's decision started with the language of the Code, but then it quickly moved to the purpose of section 1366(a) and the rationale that if Congress had intended to allow a taxpayer to increase the basis of S corporation stock through excluded COD income, Congress would have explicitly so stated. The Tax Court emphasized that its constricted reading of the statutory language was consistent with the purpose of the statutory language and what must have been Congress' intent, because otherwise the result was inappropriate.

I wrote an article describing this decision,<sup>20</sup> and I compared it to one of my favorite episodes in history, the Battle of Copenhagen. That was the battle in 1799 when Admiral Nelson, later Lord Nelson, was second in command of the British Fleet. Admiral Nelson was engaging the enemy when his commanding officer sent a message by semaphore flags saying he should withdraw. Admiral Nelson held his telescope up to his blind eye and said, "I don't see any message." I commented back then that it appeared to me that the Tax Court had regarded the plain words of the Code with a blind eye to reach its conclusion.

I'm sure you all know what happened next. Notwithstanding that the Tax Court's decision was reviewed and unanimous, the appellate courts did not all agree, and then the Supreme Court reviewed *Nelson* under the case name of *Gitlitz v. Commissioner*.<sup>21</sup> The Justices ruled eight to one that the plain language of the Code had to be given effect. The IRS argued in the Supreme Court that this result was clearly unintended by Congress, and from a policy perspective, it could not be contended that Congress intended that a taxpayer could both exclude income and get a basis increase. Justice Thomas addressed this concern squarely: "Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."<sup>22</sup>

Let's pause for a moment and make sure we all agree that the result in *Gitlitz* would not be affected by the judicial doctrines. First, there was no sham in fact—there was real cancellation of indebtedness. Turning second to the substance over form doctrine, the taxpayer had an old-and-cold S corpo-

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<sup>20</sup> Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. TAX'N 272 (1998).

<sup>21</sup> *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

<sup>22</sup> *Id.* at 220.

ration that went bankrupt, and its creditors had to forgive debt. So the substance of the transaction which gave rise to the benefit was the same as its form.

Likewise, I think it was inarguable that the transaction had economic substance. The taxpayer did not form the S corporation to get a tax benefit; he formed it to conduct his auto supply business. And the COD income arose with respect to the cancellation of bona fide, third party debts. So the economic substance doctrine was inapplicable, too.

So the Tax Court in *Nelson* instead disallowed the claimed tax benefits through, in my view, a strained reading of the Code. The result of the plain language was not something that made any sense from the perspective of tax policy or tax theory, so the words were stretched in order to disallow the claimed tax benefit. As you can imagine, this is not an approach that I believe is appropriate.<sup>23</sup> I hasten to add that when I see a strained interpretation of the Code to attack legitimate tax planning, it irks me. But what really bothers me is when the IRS attempts to disavow the impact of regulations or rulings that it drafted. We saw such an attempted disavowal in *Woods Investment*, in which the Tax Court allowed a double deduction because of the manner in which the IRS had written the consolidated return rules concerning losses.<sup>24</sup> Nonetheless, going back to *ACM*, there the court allowed the IRS to get around the impact of a regulation that the IRS had written in order to accelerate income—the IRS needs to be cautious when it drafts regulations lest it find those regulations being used against it.

Sometimes I will hear a tax lawyer or accountant remark, when looking at a regulation that has been turned against the government, that a taxpayer can't do that because the regulation was not intended to reach that result. The usual justification for this approach is *Gregory*, with the individual stating that the regulation must be applied solely in a manner consistent with its apparent intent. I prefer the *Woods Investment* approach, which is that if the IRS writes a regulation, it must live with that regulation, even if it reaches a result that is not what the government originally intended.

Another decision which I believe illustrates the application of section "I Don't Like It" is *Castle Harbour*.<sup>25</sup> As most of you know, this case made a tour through the courts which would have made Dickens proud, resulting in six separate decisions, with the Second Circuit continually reversing decisions of the district court. The underlying transaction arose because General Electric (GE) owned a fleet of aircraft which were fully depreciated. GE was advised that if it contributed the aircraft to a partnership with Dutch banks in

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<sup>23</sup> See also *The Limited, Inc. v. Commissioner*, 113 T.C. 169 (1999) (in which the Tax Court adopted a strained reading of the word "bank" in order to avoid a tax result it did not like), *rev'd*, 286 F.3d 324 (6th Cir. 2002).

<sup>24</sup> *Woods Inv. Co. v. Commissioner*, 85 T.C. 274 (1985).

<sup>25</sup> *TIFD III-E, Inc. v. United States*, 604 Fed. Appx. 69 (2d Cir. 2015) ("Castle Harbour 6").

which the banks received a preferred interest, and GE received a capital account in which the values of the aircraft were booked up to their fair value, the resulting depreciation would be allocated back to GE, essentially allowing GE to re-depreciate aircraft that had already been depreciated for tax purposes. A very clever trick allowed by the rules at that time; the law has since been changed to prevent that result.

The IRS could not attack the way the partnership rules applied, so it took the position that the Dutch banks should not be treated as a partner. The district court rejected the IRS's contention, but the Second Circuit agreed with the IRS and reversed. Interestingly, the IRS did not contend in the Second Circuit in the first go round that the Dutch banks were lenders; the IRS took the position that the money was neither a capital contribution nor a loan, which is logically impossible. If so, what was it? Apparently the IRS was concerned that if the Dutch banks were treated as lenders, any payments to them would have been exempt from withholding under the portfolio interest rules. The Second Circuit followed this approach in *Castle Harbour 2*,<sup>26</sup> but in *Castle Harbour 4*<sup>27</sup> the Second Circuit had to confront the illogic of that position and announced that the Dutch banks were actually lenders for tax purposes. So, even though the Dutch banks had greater participation rights than the holders of any publicly-issued preferred stock in the market and did not have creditors' rights, these preferred partnership interests were held to be loans in substance. This was a purely result-oriented decision. Those of you who have foreign clients which own preferred stock in a corporation or preferred equity in a partnership should focus on whether, under *Castle Harbour*, the dividends or allocations of income should be treated as interest exempt from withholding.

I want to spend one minute discussing one other aspect of the Second Circuit's decisions in *Castle Harbour*, *Castle Harbour 6*. In that decision, the Second Circuit reversed the district court's factual finding that GE had a reasonable basis for its claimed deductions, and the Second Circuit concluded that penalties should apply. This is one of the more egregious examples of section "I Don't Like It" being applied, because a district court judge had found in favor of the taxpayer in three separate, well-reasoned opinions. I understand that the Second Circuit could reverse on the merits—that is its right, even if in my view it was wrong—but I think that the Second Circuit strayed from the legitimate path when it penalized a taxpayer after the district court held in the taxpayer's favor. Indeed, I would propose as an axiom of the tax law that negligence or substantial understatement penalties are not applicable if the trial court holds in the taxpayer's favor. If a federal judge holds in favor of the taxpayer, that is sufficient proof to me that the taxpayer's position

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<sup>26</sup> TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) ("Castle Harbour 2").

<sup>27</sup> TIFD III-E, Inc. v. United States, 666 F.3d 836 (2d Cir. 2012) ("Castle Harbour 4").

was at least reasonable. For this same reason, I think that penalties were inappropriate in the recent *STARS* cases, which also applied section “I Don’t Like It.”<sup>28</sup>

Another decision I found questionable is *Sundrup*, in which a trucking business conducted as a sole proprietorship was contributed into three corporations with various contracts between them.<sup>29</sup> On their tax returns, the Sundrups claimed a variety of tax benefits as a result of the three corporations, including the deduction of some expenses that were personal in nature. The IRS disallowed these benefits, asserting that there was no nontax business purpose for any of the transactions between the various entities. The Service also argued that each of them was without economic substance and a sham. The taxpayers contended, in contrast, that the entities should be respected. According to the taxpayers, the entities were established to provide protection against liabilities and were not part of a scheme to deduct personal expenses.

The essence of the Tax Court’s opinion was effectively contained in one paragraph:

Based upon our examination of the entire record before us, we find that the only intended objective of the respective transactions . . . was the Sundrups’ tax-avoidance objective of having [a corporation] pay the Sundrups’ personal living expenses . . . . [W]e find that the respective transactions at issue were not entered into for nontax business reasons, [but] were entered into only for tax-avoidance reasons, and did not have economic substance.<sup>30</sup>

So the transaction involved the payment of personal expenses. Isn’t the substance of that transaction a dividend? Why did the court refer to economic substance in this type of situation?

And what if the corporations had not paid Mr. Sundrup’s personal expenses? In that event, provided that all formalities were followed, the taxpayer should win under *Moline Properties*.<sup>31</sup> Taxpayers who fail to properly respect the corporate formalities will lose, but if done correctly, multiple entities can yield tax benefits. *Sundrup* is a case where the judge did not like what the taxpayer was doing and disallowed claimed deductions by applying section “I Don’t Like It” rather than applying the law.

What is important about this distinction is that any challenge to the taxpayer’s claimed benefits from using multiple entities to run a business should not have been based on the economic substance doctrine. Instead, if the ordering rules had been applied, the challenge to the tax benefits should have

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<sup>28</sup> See *Santander Holdings USA, Inc. v. United States*, 977 F. Supp. 2d 46 (D. Mass. 2013); *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015); *Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015).

<sup>29</sup> *Sundrup v. Commissioner*, 100 T.C.M. (CCH) 403, 2010 T.C.M. (RIA) ¶ 2010-249.

<sup>30</sup> *Sundrup*, 100 T.C.M. (CCH) 403, 2010 T.C.M. (RIA) ¶ 2010-249, at 1484–85.

<sup>31</sup> *Moline Props., Inc. v. Commissioner*, 319 U.S. 436 (1943).

been based on the substance of the transaction, which was the payment of personal expenses (a disguised dividend).<sup>32</sup>

Another aspect of some recent court decisions that bothers me is a statement that a taxpayer's actions should be disregarded because they were "tax motivated." We appear to have gotten very far from Judge Learned Hand's statement in *Gregory* that a taxpayer is free to arrange his affairs so as to minimize his tax liability. Indeed, there are many actions which a taxpayer takes for tax reasons, but I don't believe that the IRS can challenge them based on a taxpayer's "motivation." The most obvious, of course, are elections provided by the Code and regulations, such as electing subchapter S status or making a check-the-box election. A taxpayer can also arrange her affairs by using debt instead of equity, or engaging in a like-kind exchange rather than a taxable sale, and no one would question the validity of this planning, even though it is clearly tax "motivated." Likewise, a taxpayer can trigger a loss inherent in bona fide investment assets, such as by selling stock, in order to obtain a tax benefit from that loss, provided that the taxpayer does not engage in a wash-sale transaction. I also believe that a taxpayer can transfer assets to a corporation to obtain a tax benefit even if there is no other business purpose for the transfer. As long as a transaction is in substance the same as its form, I struggle with understanding why a taxpayer cannot engage in a real transaction in order to obtain tax benefits, particularly those that Congress has provided. *Gregory* certainly should not be viewed as implying that such active tax planning is impermissible, no matter which view of *Gregory* is taken. I am particularly bothered by court decisions, of which there have been too many, which make statements like "the taxpayer had no nontax business purpose" for the structure of a transaction in which the taxpayer intends to make a real economic profit but has used tax planning to minimize the resulting tax liability.

I want to close with one final case which strikes me similarly, *Summa Holdings, Inc. v. Commissioner*, which involves the interaction between DISCs and Roth IRAs.<sup>33</sup> This case was litigated by my firm, but I was not involved directly or indirectly in the transactions addressed or the litigation. In this case, the taxpayer caused a DISC to be formed by a Roth IRA. In disallowing the claimed benefits, the Tax Court stated:

The parties stipulated that petitioners' sole reason for entering into the transaction at issue was to transfer money into the Benenson Roth IRAs so that income on assets could accumulate and be distributed tax free. Petitioners

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<sup>32</sup> See *Robucci v. Commissioner*, 101 T.C.M. (CCH) 1060, 2011 T.C.M. (RIA) ¶ 2011-019.

<sup>33</sup> *Summa Holdings, Inc. v. Commissioner*, 109 T.C.M. (CCH) 1612, 2015 T.C.M. (RIA) ¶ 2015-119, *rev'd*, 848 F.3d 779 (6th Cir. 2017), *Benenson v. Commissioner*, 887 F.3d 511 (1st Cir. 2018), *Benenson v. Commissioner*, 910 F.3d 690 (2d Cir. 2018).



had no nontax business purpose for the transactions, nor did they receive any economic benefit from the transactions.<sup>34</sup>

These two sentences are complete non sequiturs. A DISC is an artificial entity used to save taxes. No one has a business purpose for creating a Roth IRA other than to allow investments to grow tax free. And everyone who has a Roth IRA receives an economic benefit as the Roth IRA increases in value. To utilize buzzwords like “no nontax business purpose” and “no economic benefit” in the context of a transaction involving a DISC and a Roth IRA is basically to disregard the proper scope of the judicial doctrines. And the court then went on to state that it was applying the substance over form doctrine to disallow the claimed tax benefits, even though the transaction’s form was its substance. This decision has now been reversed by three courts of appeals.<sup>35</sup>

In summary, there is a very simple thesis underlying my presentation today—if we want to preserve the judicial doctrines we must respect them. They need to be applied properly and in the proper order. There are transactions which should be subject to attack under the economic substance doctrine, such as *Rice’s Toyota World*,<sup>36</sup> *Goldstein*,<sup>37</sup> and Son of Boss transactions, but in many situations the IRS and the courts have used the economic substance doctrine inappropriately, particularly in situations in which the substance of the transaction was not considered first. *ACM* is the classic case which needs to be reconsidered—it may have been correctly decided, but for the wrong reasons, and it has resulted in continuing legal confusion due to its overbroad interpretation of *Gregory*. The judicial doctrines should be applied in the proper order where they properly apply and not as a “catch all”

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<sup>34</sup> *Summa Holdings, Inc.*, 109 T.C.M. (CCH) 1612, 2015 T.C.M. (RIA) ¶ 2015-119, at 886.

<sup>35</sup> See cases cited *supra* note 33.

<sup>36</sup> *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). *Rice’s Toyota World* involved a sale-leaseback transaction entered into by the taxpayer to generate accelerated depreciation and interest expense deductions in the early years of the lease. The Fourth Circuit held that a transaction will be treated as having no economic substance if “the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.”

<sup>37</sup> *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966). *Goldstein* involved a woman who won the Irish Sweepstakes and who formulated a plan to use section 163 to obtain interest deductions to reduce the tax burden on her sweepstakes winnings. The taxpayer borrowed \$945,000 at four-percent interest and invested the proceeds in U.S. Treasury securities maturing in three or four years, with a face amount of \$1,000,000, which paid interest of one and a half percent. The loans were secured by the Treasury notes, and it was contemplated that the overall transactions would result in economic losses, but that the net result would be tax benefits. While the Tax Court rejected the transactions as “shams,” the Court of Appeals concluded that the transactions were not “shams” because the transactions did, in fact, take place and therefore could not be ignored as “shams.” However, it affirmed the Commissioner’s decision to disallow the deductions on the grounds that the taxpayer’s purpose in entering into the transaction was solely to obtain tax benefits.

to disallow tax benefits otherwise provided by the Code and regulations. Likewise, strained readings of the Code and regulations in order to get the “right answer” must be avoided. If that is not done, at some point we will be living in a world without any respect for the law. Decisions will depend upon the application of section “I Don’t Like It,” which is a rule of men and not laws. I hope and trust that we will never get there.