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Tax Avoidance and Income Measurement

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TAX AVOIDANCE AND INCOME MEASUREMENT

*Joshua D. Rosenberg**

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I. INTRODUCTION

In the American tax system, a person's taxable income for any year is intended to reflect three factors: the taxpayer's economic income; the extent to which the taxpayer has earned tax benefits by engaging in tax-favored behavior; and the extent to which Congress believed that the imposition of tax might impose an undue hardship on the taxpayer.

If this system were a pure income tax system, each person's taxable income would simply mirror her economic income for the year. To

the extent that the system attempts to encourage people to change their behavior in certain ways, one might expect a person's taxable income to reflect the extent to which she has so changed her behavior. Finally, to the extent that the system attempts to avoid imposing a hardship on taxpayers in certain given statuses (*i.e.*, poverty, cash-poor, etc.), one might expect taxable income to reflect also the extent to which the taxpayer enjoys (or suffers, as the case may be) that status at the end of the year.

Unfortunately, however, none of the above factors is easily subject to year-end measurement.¹ Because of perceived difficulties in directly measuring these accepted indicia of tax liability, the system has never attempted to engage in such measurements. Instead, the system looks to discrete and identifiable events (transactions) that have occurred during the year and that reflect, albeit often indirectly, the factor(s) intended to be measured.²

By so doing, the system avoids the need to make precise measurements of the relevant factors, instead relying on a series of objective binary determinations to establish a person's taxable income. Rather than measuring, for example, a person's net worth or change in behavior, the system simply measures whether or not the person has engaged in certain specific tax-significant transactions, and bases taxable income on those determinations.

While it is true that engaging in these tax-significant transactions will often reflect the existence of one or more of the relevant factors (*i.e.*, economic income, behavior change, or status) sought to be measured by reference to that transaction, it is also true that engaging in any particular transaction is nothing *more* than a reflection. Like Plato's shadows on the cave wall, what appears in the reflection is not always identical to what actually exists. Measuring taxable income by reference to transactions has two major potential sources of inaccuracy: (1) at times, neither the actions necessary to consummate the transaction nor the consequences flowing from the transaction will accurately reflect the particular factor(s) believed to be measured by reference to that transaction;³ and (2) whether or not a taxpayer has engaged in a particular transaction is a question which must be answered either "yes" or "no," but the indicia of tax liability intended to be measured by reference to that transaction exist in varying degrees that cannot be accurately reflected by any purely bipolar

1. See *infra* Part I.A.1.

2. See *infra* Part I.B.1.

3. See *infra* Part I.B.2.

characterization.⁴

As a result of the indirect way in which we measure the intended indicia of taxable income, some inaccuracy in the measurement of economic income and in the distribution of tax benefits is inevitable. In a system such as ours, where every well-advised taxpayer has both the time to examine and the motivation to exploit these inaccuracies, the extent of inaccuracy could soon move from the inevitable to the intolerable. What would normally be minor discrepancies between the existence of a particular factor and the occurrence of some transaction that generally reflects that factor become unacceptably magnified, especially in a system where every taxpayer is attempting to exploit those discrepancies in order to maximize profits while minimizing taxable income and other unfavorable factors.

This article assumes that the use of transactions to measure taxable income, and the resultant mismeasurement and opportunities for abuse, will remain an inevitable part of our income tax system.⁵ Given that assumption, this article proceeds to show that, if nothing else, the system's own need for self-preservation requires it to be able to respond to the problems suggested above in a meaningful way. Because any legislative response to these abuses will necessarily be *ex post* in nature, exclusive reliance on legislative responses is likely to result in the best-advised taxpayers always staying a year or two ahead of Congress and, thereby, avoiding taxes indefinitely. This article explores what the judicial and administrative approaches to these mismeasurement problems have been, examines the problems inherent in that approach, and suggests an alternative that is more equitable, more intellectually honest, and more workable.

In the past, courts and the Internal Revenue Service have responded to the predictable taxpayer attempts to exploit the system's weaknesses by informing taxpayers that tax minimization is only to be expected, but that tax avoidance is unacceptable. Never, however, are taxpayers told what distinguishes the two. While much of the judicial analysis purports to rest on the distinction between tax avoidance and business purpose, the truth is that the well-advised taxpayer will always take into consideration *both* the economic *and* the tax aspects of any business decision. Further, when a taxpayer is found to have engaged in tax avoidance, he is then told that his problem is *not* tax

4. See *infra* Part II.A.

5. But see, e.g., Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (suggesting, implicitly, that reliance on transactions is not always necessary).

avoidance, but it is only that he did not really do what he did,⁶ or that the Internal Revenue Code does not really say what it says.⁷ Essentially, the judicial and administrative responses to the mismeasurement problems that inhere in the system consist of a series of fictions that simply do not withstand scrutiny.

This article suggests that there will always be some divergence between taxable income as determined by reference to transactions and taxable income that would result from a completely accurate measurement of the factors that are intended to be reflected therein. This divergence increases unnecessarily and unacceptably when taxpayers are either permitted to act or required to report in a way that intentionally exaggerates the mismeasurement. In order to prevent abuse of the system, taxpayers who act in a way that is intended to exaggerate the mismeasurement of any particular attribute, position, or status (including economic income) should be deprived of the benefit that is intended to accompany that attribute, position, or status.

In addition, because measuring particular tax-significant factors that exist along a continuum by reference only to bipolar alternatives is an administrative tool that almost always results in mismeasurement of the factor in question, the system ought to be more receptive to nonpolar measurements when the accuracy or revenue gained by that alternative outweighs the extra administrative burden that it might entail. Finally, the article explains that the existence of taxpayer abuse is itself a question not of bipolar extremes, but of placement somewhere along a continuum between purity (*i.e.*, acceptable tax planning) and evil (*i.e.*, tax avoidance). As a result, courts cannot and, therefore, should not try to do more than attempt to place the taxpayer's behavior at its appropriate point along that continuum. Such an approach would result not only in a more accurate distribution of tax benefits and burdens, but also in a system that was both more equitable and more intellectually honest than the system that currently exists.

This article first will explain our system of "transaction taxation" and will further explore the problems caused by the transactional focus of our tax system. It then will consider the current judicial responses to these problems and examine their inadequacies. Finally, it will set forth and explore the alternative responses suggested above in more detail.

6. This is the implication of the step transaction doctrine. See *infra* Parts II.A.4 & II.B.2.

7. This is a result of application of the business purpose test. See *infra* Parts II.A.3 & II.B.1.

A. *The Structure of the Federal Income Tax*

1. *Economic Income*

At least one of the goals of any income tax system is the accurate measurement of income. Fortunately (and surprisingly, in light of the usual disagreement over almost every aspect of both theory and practice prevalent among today's economists), most economists agree, at least theoretically, on what income is. The Haig-Simons approach, generally accepted today, defines income for any year as the sum of (1) the market value of what the taxpayer consumed during the year, plus (2) the change in the value of the taxpayer's property rights between the beginning and end of the period in question.⁸ Because the Haig-Simons approach links income to changes in the taxpayer's net worth during the taxable year, accurate measurement of income for any year requires a complete accounting of the taxpayer's net worth at both the beginning and the end of the year in question.⁹

Because neither the value of annual consumption nor the annual changes in value of all of a taxpayer's property are easily measurable,¹⁰ a more feasible method of accounting for, as opposed to merely defining, income has generally involved focusing on the source of property rather than on its use or its change in value. Under this approach, income could be viewed as a combination of wages, interest, dividends, and other amounts which a person either receives or becomes entitled to receive.¹¹

The appeal of this focus on receipts rather than on valuation lies

8. H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938). This definition does not itself suggest how the "value" of rights can be determined. While most commentators conclude that market value is the appropriate definition of value, property can have value to a particular taxpayer that exceeds (or is less than) its market value. See Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 STAN. L. REV. 1023, 1092 (1985).

9. For example, if Taxpayer's only asset is a home worth \$150,000 on January 1 and worth \$180,000 on December 31, Taxpayer has \$30,000 of income for the year.

10. See Shakow, *supra* note 5, at 1113.

11. This definition is not identical (or even close) to the definition of income that appears in the Code. Indeed, the Code eschews even an attempt at a definition of "income," setting forth instead definitions of "Gross Income," "Adjusted Gross Income," and "Taxable Income." See I.R.C. §§ 61, 62, 63 (1982). Of these, the concept of adjusted gross income most closely approximates "net income," but the use of the term "approximates" in the previous phrase is similar to its use in the following sentence: "Of all birds, the ostrich most closely approximates an elephant."

The Haig-Simons definition also differs substantially from that offered by the Supreme Court in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) ("Income may be defined as the gain derived from capital, from labor, or from both combined . . ."). To the extent that the Court's statement attempts to define income rather than explain what it is that our system (which we choose to label as an "income tax") taxes, it is inaccurate. The fact is that "[t]he income tax laws do not profess to embody perfect economic theory," *Weiss v. Wiener*, 279 U.S. 333, 335 (1929). Mr. Justice Holmes' statement to that effect reflected much more than mere disagreement with the *Eisner* majority.

less in its accuracy than in its administrative practicality.¹² It is easier to value property on a single occasion (when it is received, or when the taxpayer's rights become fixed) than it would be to do so annually.¹³ In addition, a one-time valuation upon receipt of property generally simplifies the *process* of valuation. Most receipts (other than gifts, which are tax-free in any event¹⁴) are the result of the taxpayer's transfer of property or services with a value equal to that of the property received. Valuation of property on receipt, therefore, is a simple task if either the value received *or* the value *provided* by the taxpayer consists of cash or of some other asset having a readily determinable market value.¹⁵ Chances of a straightforward and simple valuation are thus doubled.¹⁶

Because the federal tax system is, by dint of both constitutional

12. In addition to its administrative attractiveness, an income tax that focuses on receipts seems to be more politically attractive than a system that requires annual valuation and taxation of consumption and savings. If a taxpayer receives cash or property during the year, it seems only fair to the average citizen that the government should take its share of that receipt, especially when the receipt consists of cash. On the other hand, the imposition of a tax on someone who has "received" nothing and who has done nothing other than use (consume) her own property, or hold property which has increased in value, might well prove to be beyond the tolerance of the general public. The entire realization concept is often explained by reference to the fact that as long as a taxpayer retains a specific property, he has only that property and no cash with which to pay any tax.

Whether the system *ought* to tax unrealized appreciation is another question, to which many answers have been suggested. See, e.g., Wetzler, *Capital Gains and Losses*, in COMPREHENSIVE INCOME TAXATION 115-62 (J. Pechman ed. 1977), and articles cited therein; Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967); Powell, *Income from Corporate Dividends*, 35 HARV. L. REV. 362, 376 (1922). These opinions range from advocating that all unrealized appreciation should be taxed annually, e.g., J. SNEED, THE CONFIGURATIONS OF GROSS INCOME 71 (1967); to suggestions that annual inventorying of all goods may be desirable but is impractical, e.g., U.S. DEPT. OF THE TREAS., BLUEPRINTS FOR BASIC TAX REFORM 81 (1977); to suggestions that annual inventory accounting should be imposed where it is practical, such as with publicly traded stocks, see Slawson, *supra*, at 644-47; to arguments that the realization requirement is constitutionally mandated, see Roehner & Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953); to arguments that even realized gains should not be taxed, see Wallich, *Taxation of Capital Gains in the Light of Recent Economic Developments*, 18 NATL. TAX J. 133 (1965).

13. See generally Shallow, *supra* note 5, at 1113.

14. I.R.C. § 102(a) (1982).

15. In fact, the values of the exchanged properties may not always be equal. See *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954) (unequal properties exchanged). See generally Kohl, *The Identification Theory of Basis*, 40 TAX L. REV. 623, 640 (1985) (citing and discussing cases of unequal exchange). Section 1060 requires asset by asset valuation, in any event, on the purchase of a business. See I.R.C. § 1060 (1982).

16. Basing the incidence of taxation on receipts does have some particular complicating factors, such as the need to determine when property is received and who has received it. Doctrines such as that of "constructive receipt," see Treas. Reg. § 1.451-2 (as amended in 1979), have grown in response to predictable taxpayer efforts to take advantage of questions raised by the "receipt" requirement. Cases in which problems relating to the definition of "receipt" have arisen include *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (employer's payment of employee's taxes held income to employee), and *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) (cancellation of indebtedness held gross income to former obligor).

mandate¹⁷ and congressional intent,¹⁸ an *income* tax, the utility of receipts accounting is dependent on its ability to reflect income accurately. On the surface, pure source accounting¹⁹ and economic income may appear fully compatible. If *A* earns and receives \$100 cash in year one, she will spend (consume) part and save the rest, so that the \$100 receipt will mirror the sum of consumption plus increased net worth. If *B* earns nothing but spends \$100 on consumption, receipts (of zero) again mirror economic income (\$100 consumption minus \$100 decrease in net worth). Finally, if *C* spends \$100 on an investment that becomes worthless, the expenditure of \$100 equals the \$100 decrease in net worth.

This correlation between receipts and economic income does not always hold true. To the extent that property held by the taxpayer increases or decreases in value, there is a change in the taxpayer's net worth and, therefore, in income, which, if the system is to remain accurate, must be reflected by a corresponding receipt or payment. Under our system, these changes in value are generally accounted for at the time of each asset's disposition.²⁰ Instead of allowing taxpayers to deduct the full value of any assets they transfer and requiring them to include in income all value received in addition to amounts consumed after or upon receipt (thus taxing as net income only those receipts which themselves increase the taxpayer's wealth, *e.g.*, wages and bargain purchases), our system essentially allows taxpayers who transfer assets to deduct only that amount which has been previously accounted for by having been included in income upon (or in the case of accrued original issue discount,²¹ after) receipt of the transferred asset and which was not deducted (*e.g.*, as depreciation) while the taxpayer held the asset.²² By allowing a deduction on payment only for amounts previously taxed (and not already deducted), and including in income the entire amount received in the exchange, the system accounts for the appreciation or decline in value of any particular asset

17. U.S. CONST. art. I, § 9, cl. 4 restricts other direct taxes. The sixteenth amendment grants the power to lay and collect income taxes.

18. I.R.C. § 61 (1982).

19. *I.e.*, including all receipts in income and deducting all payments.

20. Certain predictable elements of a change in an asset's value, such as increases in value due to the accrual of original issue discount, I.R.C. §§ 1272-74 (Supp. IV 1986), and depreciation, I.R.C. § 168 (1982), are accounted for prior to disposition of the asset. But these elements rarely correlate exactly with the asset's overall change in value, which will be accounted for only at disposition.

21. I.R.C. § 1272 (Supp. IV 1986).

22. The basis (the amount allowed to be "deducted" on the disposition) of depreciable property will be adjusted for amounts previously deducted as depreciation. *See* I.R.C. § 1016 (1982).

at the time of the asset's exchange.²³

2. Taxpayer Behavior and Status

a. Nonincentive tax benefits. Measuring economic income in an administrable manner is obviously not the only goal of our income tax system. Because it represents the most comprehensive forum for interaction between taxpayers and the government, the system also serves as a useful tool for the implementation of economic and social policies.

To the extent that the government seeks to assist taxpayers of a certain status, it may decide that the most efficient type of assistance it can offer is a simple cash payment. Because tax payments and refunds are the way in which cash is most often transferred between taxpayers and the government, the economic equivalent of a cash payment from the government to a taxpayer can be most easily accomplished by simply reducing the amount of tax collected from that taxpayer. While taxpayers thought to be in need of governmental aid may be identified purely by reference to some status that exists independently of any particular event or transaction,²⁴ more often these persons are identified instead by reference to specific transactions and events that have occurred during the year. While it is often the case that having experienced some particular event or transaction is itself the very status that was the initial trigger for legislative generosity,²⁵ more frequently that trigger is a status that is different from, but usually related to, the transaction that gives rise to the tax benefit. Typical of these provi-

23. This account is theoretically, but not technically, accurate. The system does not generally allow a deduction on the transfer of an asset for the full amount taxed upon receipt of that asset; nor does it require inclusion of the full value received. Instead, the system provides the taxpayer with a "basis" in each asset, which represents the amount taxed, and not yet deducted, see I.R.C. § 1016 (1982), upon receipt of the asset. I.R.C. § 1011 (1982). Upon the sale or exchange of the transferred asset, the taxpayer's basis in the asset offsets her amount realized, and the tax is imposed only to the extent that the amount realized exceeds the taxpayer's adjusted basis, see I.R.C. § 1001(a)-(b) (1982). If the taxpayer's basis in the transferred asset exceeds her amount realized, the difference is a deductible loss (subject to various other limitations, see, e.g., I.R.C. §§ 165, 267, 1011, 1041 (1982 & Supp. IV 1986)). The net result is the same as if the taxpayer had deducted her basis in the transferred asset and included as income the full amount realized. With respect to certain payments that generate deductions without corresponding receipts (e.g., certain charitable contributions, I.R.C. § 170(a)-(e)(1)(A) (1982)), deduction of basis is technically, as well as theoretically, inaccurate. For additional in-depth discussion of the role of "basis" in our system, see Kohl, *supra* note 15.

24. See, e.g., I.R.C. § 22 (Supp. IV 1986), which gives a tax credit to the elderly and the permanently and totally disabled, independent of any particular events that have occurred during the year.

25. See, e.g., I.R.C. § 165(c) (Supp. IV 1986), which allows a deduction for certain casualty losses. Apparently, the status of having experienced loss in a casualty is exactly what Congress sought to benefit in the first place, so that reference to such an event in the section defining the benefit is unavoidable. See also I.R.C. § 213 (1982), which allows a deduction for certain medical expenses paid during the year. To obtain a medical expense deduction, the taxpayer must both incur and pay medical expenses.

sions is the exemption from taxation of damages received on account of personal injury.²⁶ While the receipt of damage payments does not itself make the taxpayer worthy of assistance from the government, the taxpayer who receives those payments will have suffered personal injury, and the system can use the exemption of those *payments* to assist those who have been injured.²⁷

b. Tax incentives. In addition to measuring income and providing help to certain persons thought to be in need, the tax system is also used by the government to motivate certain desired behavior changes. To the extent that the government seeks to encourage taxpayers to save more, to spend more, to invest more in certain ways, or otherwise to change their behavior, it may simply decide to give a cash reward to persons who are willing to change their behavior. As suggested above, reducing the amount of tax due, or increasing the refund due the taxpayer, is a simple way of accomplishing this cash transfer.

Ideally, these payments ought to be made only to those who actually change their behavior in the intended ways. To the extent that payment is made to one who does not engage in the desired conduct, the payment is misdirected. To the extent that payment is made to one who would have engaged in the desired behavior even absent that payment, the payment is simply wasted.²⁸ Unfortunately, measuring the extent to which a person has changed her behavior in response to some potential tax benefit would be impossible, or would at the least require sophisticated psychological testing beyond the current capabilities of the Internal Revenue Service.

Rather than attempting to make these impossible measurements, the system conditions tax incentive benefits on the taxpayer's engaging in certain tax-favored transactions. Instead of trying to determine whether a person has changed his savings habits in response to a specific incentive, the government grants tax benefits, such as deferral or exemption of tax, to individuals who make certain expenditures that

26. I.R.C. § 104 (1982).

27. Some might suggest that damages for personal injury are exempted not because the recipient is in need of governmental assistance but because the payment itself does nothing more than make the taxpayer whole for damages she has suffered (and therefore could not be income in any event). That the Code exempts damage payments would similarly justify exempting payments such as wages, which make the taxpayer "whole" for lost time and expanded efforts. More to the point, if *A* loses a kidney in an accident and receives \$50,000, she has no more or less economic income than *B*, who *sells* a kidney for \$50,000. Nonetheless, *B*, but not *A*, will be taxed on her receipt. The different tax treatment reflects something other than mere economic income.

28. The statement in the text assumes that the provision at issue is a pure tax incentive and neither a pure nonincentive tax benefit nor a combined benefit-incentive provision. *See infra* Part I.A.2.c.

are normally indicative of increased savings.²⁹ Instead of analyzing whether a taxpayer is making productive use of certain assets, the system simply gives accelerated depreciation deductions to those who place such assets in service.³⁰ As a result of these and other similar kinds of provisions, tax incentives are distributed in a manageable and efficient manner.

c. Combinations of incentive and nonincentive benefits. One unfortunate aspect of any income tax system is that it will necessarily be perceived as penalizing those occurrences which result in tax liability on the part of the taxpayer. To the extent that the event that precipitates liability is the accrual of income, however, any systematic deterrent to such accrual caused by its accompanying tax liability will be more than offset by the economic incentive to such activity resulting from the activity's own inherent financial productivity.³¹ Unfortunately, in our system, taxation often *is* imposed on transactions which do not produce income, and it is often *not* imposed on the actual accrual of income. While exchanges generally precipitate imposition of tax, very few arm's-length exchanges ever generate income. To illustrate, if *A* transfers Property 1, worth \$100, and receives in exchange Property 2, also worth \$100, the exchange produces no economic income for *A*. Both before and after the exchange, she has property worth \$100. Nonetheless, the exchange probably *will* have tax consequences. If *A* had previously purchased Property 1 for \$60, the exchange would generate taxable income of \$40; but, far from being income generated by the exchange, the income is that which accrued and went untaxed prior to the exchange. The exchange itself generates only *tax* liability, not income.³² On the other hand, *A*'s continued pos-

29. Examples of these provisions are I.R.C. § 101 (1982), which exempts from taxation all gains on the collection of life insurance proceeds, and I.R.C. § 72 (1982), which defers from tax the "build-up" in value of most annuity contracts. Compare with the latter provision I.R.C. § 1272 (1982), which requires current inclusion of original issue discount income.

30. I.R.C. § 168 (1982).

31. Tax scholars and economists have long debated whether, and to what extent, imposition of tax liability on income received for personal services, even if accurately imposed, diminishes the worker's incentive. The service provider who values her time at \$7 per hour and receives \$10 per hour for her services will theoretically be dissuaded from doing work she would perform in a tax-free world when her marginal combined state, federal, and local tax bracket exceeds 30% (thereby resulting in after-tax income of less than \$7 per hour). Whether the theory has practical consequences is debatable. See W. KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX 405-27 (1976).

In any event, this article is concerned primarily with income from property rather than from services. Regardless of whether or not a taxpayer may be deterred from *working* by a decreased after-tax return, no taxpayer will be deterred by taxation from having property produce income. Assuming the person's combined marginal rate is less than 100%, the choice between *some* after-tax return and *no* after-tax return (*i.e.*, because of no income) appears to be a simple one.

32. Indeed, one can easily imagine an exchange actually *reducing* real income but nonethe-

session of Property 1 while it increased in value from \$60 to \$100 generated only income, and *no* tax liability. To the extent that tax is imposed at the time of actions which do not themselves generate income at least equal to the tax liability which they cause, the system simply deters such actions.³³

By and large, Congress has chosen simply to accept the system's negative impact with respect to most exchanges. It has deviated from the general transaction-tax approach only occasionally, usually by exempting from taxation certain limited types of economically desirable exchanges thought not to work any real change in the substance of the taxpayer's economic position in any event.³⁴ In such situations Congress has generally seen fit to require the transferee to accede to the transferor's basis in the asset³⁵ or to require the transferor to attach

less generating tax liability. If, in the example in the text, Property 2 is actually worth only \$97, the exchange itself will decrease *A*'s net worth (and, correspondingly, her real income) by \$3. Because the exchange triggers tax on *A*'s pre-exchange gain, however, *A* will be taxed on \$37 of income at that time.

33. This is *not* to suggest that *A* would decide not to *acquire* the property in the first place, but only that she might later decide to *hold* that property rather than to sell it. In order to be worthwhile in an after-tax world, the *exchange* would have to generate real income at least equal to the excess of the cost of present taxation over the present cost of the future tax which would be predicted to be imposed upon some later exchange.

34. Examples of these "economically neutral" exchanges are the organization and reorganization of corporations, I.R.C. §§ 351, 368 (1982). The shareholder's exchange of assets for stock (in the case of organizations) is not taxed because "the new property [received in these exchanges] is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations . . . the new corporate structure, and the new property are substantially continuations of the old . . ." Treas. Reg. § 1.1002-1 (c)(1960). See also B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 14.01 (5th ed. 1987); S. LIND, S. SCHWARZ, D. LATHROPE & J. ROSENBERG, *CASES AND MATERIALS ON FUNDAMENTALS OF CORPORATE TAXATION* 58 (1985); I.R.C. § 1031(a) (1982) (granting nonrecognition to exchanges where the property received is of "like kind" to the asset transferred).

At the foundation of these nonrecognition provisions, which rely on no change in substance, lies the implicit assumption that there is some *legitimate* basis for the imposition of taxation only when the taxpayer is changing the "substance" of her investment; and this assumption itself seems premised on the proposition that the imposition of taxation upon the exchange of particular assets rests not on administrative considerations but on real "substantive" economic notions of income.

These nonrecognition provisions are also frequently justified because taxing the formation or reorganization of corporations would penalize economically productive and efficient actions. See, e.g., S. REP. NO. 275, 67th Cong., 1st Sess. (1921), reprinted in 95A INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (B. Reams ed. 1979); see also *G.K. Manufacturing v. Helvering*, 296 U.S. 389 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); Hellerstein, *Mergers, Taxes and Realism*, 71 HARV. L. REV. 254 (1957); Dane, *The Case for Nonrecognition of Gain in Reorganization Exchanges*, 36 TAXES 244 (1958). While the enactment and retention of these provisions was motivated in part (and perhaps even *primarily*) by a desire to refrain from interfering with economically sound business judgments, it is significant that there are *many* situations where the taxation of exchanges blatantly interferes with economically motivated decisions, see, e.g., text at notes 37-38 *infra*, but nonrecognition is offered *only* where there is no change in the "substance" of the taxpayer's investment.

35. E.g., I.R.C. §§ 362, 1015 (1982).

that basis to some other asset,³⁶ thereby simply deferring taxation of the gain previously accrued to the transferred asset (as well as changing the person to be taxed on that gain).³⁷

While these provisions are neither pure benefit provisions nor pure incentive provisions, they have aspects of both of the kinds of provisions discussed above. They are not typical benefit provisions because the persons who are assisted by them are not thought to need governmental assistance. They are not typical incentive provisions because the tax-favored exchanges are not rewarded any more than is a taxpayer's failure to engage in any exchange at all. Rather than being intended to encourage the particular transaction at issue, these provisions are intended only to remove the punishment that the tax system would otherwise impose on such exchanges.

Nonetheless, these provisions function at times like benefit provisions, at other times like incentive provisions, and at still other times like a combination of the two. Because most exchanges *are* taxed, the exemption from tax of certain kinds of exchanges benefits persons who engage in those exchanges, as compared to those who engage in other kinds of exchanges.³⁸ Similarly, while deferral of taxation provides no incentive to make any particular exchange when the sole alternative is retention of the asset, to the taxpayer who intends to exchange that asset in any event, the tax deferral provisions may act as an incentive

36. *E.g.*, I.R.C. §§ 1031, 1034 (1982).

37. This statement admittedly ignores some of the significant economic effects of transferred basis provisions. Theoretically, the net value of property received by the corporation in any transferred basis exchange is equal to the fair market value of the property minus the present value of the cost of any future tax liability built into the property due to a below-market-value transferred basis. Assuming an arms'-length exchange between well represented parties, the transferor will receive stock in an amount which takes into account the built-in future tax liability assumed by the transferee. As a result, this future tax burden *will* be effectively borne by the transferor, to whom the "income" actually accrued.

This analysis is not quite complete, however, for several reasons: (1) the transferee's tax liability is deferred (perhaps permanently if the property is not depreciable and if the transferee does not intend to sell the property); (2) the eventual tax will probably be imposed on a person in a different tax bracket; (3) at least in tax-free incorporations, the later tax will be doubled because the lower basis is taken by both the transferee (in the property) *and* the transferor (in the stock received in the exchange). It may be that the effect of (3) will negate the effects of (1) and (2). If so, the result is only by chance. In addition, if that *is* the result, it would defeat a major purpose of the statute — to avoid discouraging otherwise good business decisions by imposition of tax. Unless the present value of the future tax burden imposed under nonrecognition provisions is *less* than taxes triggered by present recognition, the nonrecognition provisions are of only limited utility. They may prevent current cash flow problems that might result from current taxation, but they do so only at the same cost to the taxpayer as any market rate bank loan. *See* Levin, *The Case for a Stepped-Up Basis to the Transferee in Certain Reorganizations*, 17 TAX L. REV. 511 (1962) (suggesting that transferred basis provisions in corporate reorganizations are generally misguided and ineffective).

38. This exemption does *not* provide a benefit when the taxpayer is compared to the person who simply makes *no* exchange.

to the would-be transferor to engage in one of those favored exchanges.

B. *Problems with the Tax Structure*

While our system's reliance on transactions is generally useful and often accurate, it is not without problems. Among the major problems that arise are (1) difficulties in characterizing specific transactions, (2) inaccuracy in the system's measurement of economic income and other tax-relevant statuses, and (3) the system's unintended normative impact. These are discussed below.

1. *Difficulties of Characterization*

Any system which bases taxation on exchanges and which treats different exchanges differently must, of course, set forth objective criteria by which to distinguish among the different transactions. Characterization of an exchange as a specific type of transaction depends on determining what asset is exchanged for what other asset and then ascertaining the presence of whatever other factors the Code uses to define the transaction in question. Unfortunately, neither of these determinations can always be readily made.

Theoretically, an "exchange" of assets between *A* and *B* exists only if *A* transfers property to *B*, *B* transfers property to *A*, *A*'s transfer caused *B*'s action, and *B*'s transfer caused *A*'s action. Practically, even simple linear causation (*i.e.*, that *A*'s transfer could cause *B*'s action) more often than not does not exist, and finding the type of *mutual* and reciprocal causation required to define an exchange precisely is impossible.³⁹

39. The concept of reciprocity should be familiar to students of contract law. If a contract is challenged, it may be necessary to establish some sort of reciprocity to uphold the purported agreement against the challenging party. In tax law the question is generally not whether a particular agreed-upon exchange will be upheld against one of the parties, because the transaction has already been completed. All that is at issue is a determination, from an *ex post* viewpoint, of whether a particular transfer made by one party caused, and was in turn caused by, a particular transfer by the other party to the exchange.

It is quite possible that there simply was no reciprocal agreement or exchange, but that each party was independently motivated. To illustrate, assume that *A* transfers a car to *B* and *B* transfers a truck to *A*. We may say that *A*'s promise is the "consideration" for *B*'s truck and vice versa, and that *A* and *B* have formed a binding contract. We cannot, however, state with any degree of precision that *A*'s transfer of the car to *B* is the action that "caused" *B*'s transfer of the truck to *A*. *B*'s action might have been caused primarily by *B*'s frustration with her truck, by some subconscious attraction to *A*, by a previously made vow to dispose of her truck in a transaction with the first person to come along on a particular day, or by any combinations of hundreds of possible causes. Each of these causal factors may be a "but for" cause for *B*'s action, while none is the exclusive cause (Tort scholars long ago realized that the discovery of linear causation is impossible, simply because it does not exist. See W. PROSSER & R. KEETON, PROSSER AND KEETON ON TORTS 265 (5th ed. 1984)). One might suggest that *A*'s transfer is the "legal" cause, but that is true only in a contract action, as opposed to a tort action. Unfortunately, resort

Even when the existence of a particular exchange is clear, the appropriate characterization of that exchange as a particular *transaction* may not be. Characterization may depend on numerous other facts and relationships which simply may not be readily observable.⁴⁰ Other times, characterization depends on facts which are not merely difficult to observe, but impossible to determine. Whether the relationship between some person and some property constitutes "ownership" or "tenancy"; whether an instrument represents "debt" or "equity"; whether property is held "primarily" for sale to customers in the ordinary course of business; and whether or not a transfer is

to contract law to define exchanges is often inappropriate when the parties are not dealing at arm's length in any event.

The difficulty of establishing relationships between exchanges may become apparent from simply listing some of the different tests for determining whether actions should be viewed together. One statutory test is time: *e.g.*, I.R.C. § 246(c)(2) (Supp. IV 1986) (tests of 45 and 90 days for relating purchase and sale of stock to a purpose to take advantage of § 243 dividend received deductions); I.R.C. § 302(c)(2)(A)(ii) (1982) (10-year period of abstinence from involvement in corporation by distributee for waiver of family attribution); I.R.C. § 302(e)(1)(A) (1982) (partial liquidation pursuant to a plan completed within two years); I.R.C. § 302(e)(3)(A) (1982) (qualified trade or business must be active and not purchased within five years); I.R.C. § 332(b)(2)-(3) (1982) (liquidation of subsidiary must be within a year if no plan is adopted; within three years from year of adoption if plan is adopted).

Another test is "plan": I.R.C. §§ 332, 337 (1982 & Supp. IV 1986) (liquidation); I.R.C. § 302(e) (1982) (partial liquidation); I.R.C. §§ 354, 368 (1982 & Supp. IV 1986) (reorganization); I.R.C. § 302(b)(2)(D) (1982) (series of redemptions).

A third test is "immediately after": I.R.C. § 351 (1982) (incorporation); I.R.C. § 355(b)(1)(A) (1982) (reorganization); I.R.C. § 368 (1982 & Supp. IV 1986) (reorganization).

Still another statutory test is "principal purpose": I.R.C. § 269 (1982 & Supp. IV 1986) (acquisitions made to evade or avoid tax); I.R.C. § 269A (1982 & Supp. IV 1986) (personal service corporations formed or availed of for tax avoidance purpose); I.R.C. § 302(c)(2)(B) (1982) (waiver of family attribution); I.R.C. § 306(b)(4) (1982) (redemption of § 306 stock).

Other tests include "view": I.R.C. § 341 (1982 & Supp. IV 1986) (collapsible corporations); "purpose": I.R.C. § 357(b) (1982) (assumption of liability for tax avoidance purpose); common control: I.R.C. § 532 (1982) (accumulated earnings tax); and merely "related": I.R.C. § 707(a)(2)(A)(ii) (Supp. IV 1986) (contribution to and allocation by partnership).

40. Indeed, the kinds of information required to differentiate among transactions are legion. In addition to depending on the value and class of assets received, tax consequences may depend on the *use* to which the exchanged asset was put by the taxpayer, *e.g.*, I.R.C. § 121 (1982), or the taxpayer's intended use of the asset received, I.R.C. §§ 1031, 1033 (1982). Other tax consequences depend on the length of *time* the taxpayer had used the exchanged asset. For example, the amount of the investment tax credit required to be recaptured by a taxpayer under I.R.C. § 47 (1982) depends on the length of time the taxpayer has held the property for which the credit was originally granted. *See* I.R.C. § 47(a)(5)(B) (Supp. IV 1986). The tax consequences of other exchanges may depend on the *person* to whom or from whom the property is transferred. *See, e.g.*, I.R.C. §§ 267, 351, 1041 (1982 & Supp. IV 1986) (all of which defer (or in the case of § 267, disallow) gain or loss on exchanges made between certain related parties). Sections 162, 165, 174, 195, and numerous other provisions condition deductibility of payments on the taxpayer's purpose for making them (*i.e.*, whether they are for business, investment, consumption, research, etc.). In other situations, the kind of asset received, such as installment obligations, I.R.C. § 453 (1982), or like-kind exchanges, I.R.C. § 1031 (1982), governs the tax consequences. And finally, some tax benefits hinge on facts completely independent from any actions or intentions on the part of either the taxpayer or the person with whom the taxpayer makes the exchange. For example, § 354 and § 361 give tax-free status to certain exchanges occurring within the context of statutory reorganizations; and whether or not a particular exchange is part of a reorganization under § 368 may depend on factors beyond a taxpayer's control or knowledge.

made out of “detached, disinterested generosity” are examples of the kinds of questions which must be answered before exchanges can be characterized as some particular kind of transaction. Answering these questions often requires judgments that often may be well reasoned and well founded in actual analysis, but which are just as often necessarily imprecise.

2. *Mismeasurement*

a. Economic income. Because our system accounts for actual changes in the value of any asset only when a taxpayer sells or exchanges that asset (certain predictable *elements* of value, such as accrued interest or depreciation, are accounted for on an annual basis, but these elements rarely correlate exactly with actual value), the system accurately measures income⁴¹ for a specific year only if all of the taxpayer’s noncash assets are sold or exchanged by the end of that year. To the extent that the taxpayer holds assets which have changed in value during the year and which are not sold, a corresponding change in the taxpayer’s net worth is simply not accounted for.

Indeed, it is possible for our system to misstate income to a greater degree than would a system that simply *ignores* any change in value of a taxpayer’s assets. For example, if Taxpayer purchases two assets on January 1, for \$1,000 each, and Asset One becomes worth \$1,600 while Asset Two becomes worth \$50, Taxpayer’s net worth has decreased by \$350 — from \$2,000 to \$1,650. Under our system, if Taxpayer sells both assets, taxable income will also be minus \$350 — a \$600 gain on Asset One and a \$950 loss on Asset Two. However, if Taxpayer sells only Asset One, taxable income will overstate economic income by \$950; and if she sells only Asset Two, taxable income will understate real income by \$600. Merely failing to impose any tax on Taxpayer would come closer to mirroring the actual results in either of these situations than does our current system.

Much of the mismeasurement caused by a transaction (or asset) focus may be only temporary. In the above example, if Taxpayer sells only one asset in a given year, income for that year will be misstated by the amount of untaxed gain or loss in the retained asset. However, if Taxpayer later sells the remaining asset, income will be misstated in the opposite direction, and by the same amount,⁴² in the year of sale. The final result will present an accurate picture of net income for the

41. Economic income is the real change in the taxpayer’s net worth.

42. This assumes no change in value of the retained asset during the interim.

entire period beginning with the acquisition of both assets and ending with the final sale.

Unfortunately, while the apparently transitory nature of income misstatement⁴³ may slightly alleviate the *degree* of mismeasurement, it is far from a *cure* for that mismeasurement. Taxation is imposed on an annual basis. To the extent a person is undertaxed⁴⁴ in one year, that person retains the "unpaid" tax for that year. The compound return on that unpaid tax accrues to the taxpayer until the year in which the previously "unpaid" tax is paid. Payment of the original unpaid tax at a later date fails to account adequately for the return which has accrued between the year of "unpaid" tax and the year of actual payment.⁴⁵ Similarly, collection of "too much" tax in one year and "too little" tax in a subsequent year fails to account adequately for the deprivation of investment potential during the interim. Essentially, deferral of a payment is equivalent to reduction of that payment; and it is no more accurate to state that the system measures

43. A problem with the proposition that the system eventually corrects its current misstatement of income is that even over the course of a lifetime many appreciated assets are *never* sold. If a taxpayer dies without having sold an asset, the effect on her net worth of the change in value of that asset will simply never be accounted for, and income will have been permanently misstated.

44. *I.e.*, taxed on a taxable income that is less than her economic income.

45. For example, assume that *A* purchases stock for \$100,000 in 1986, and the stock surges in value to \$1,000,000 by the end of the year. After 1986, the stock increases in value by 10% each year for the next 30 years, at which time *A* sells the stock. If *A* is taxed on his accumulation during 1986 at a 30% rate, his tax will be \$300,000, leaving an investment of \$700,000. If *A* is taxed on the 10% annual growth at the same 30% rate during each of the next 30 years, he will be left with \$5,327,000, which represents a 7% annual return (compounded annually) on his initial (post-1986) \$700,000 investment. On the other hand, if *A* is not taxed until he sells his stock, he will have \$1,000,000 worth of stock at the end of 1986, which will grow at an annual rate of 10%, and will be worth \$17,400,000 at the end of 30 years. If *A*'s gain is then taxed at a 30% rate, *A* will be left with \$12,180,000, or almost two and a third times the amount he would have under a system of annual taxation.

To put it another way, if *A* were taxed at a 30% rate on his \$900,000 accrued gain in 1986, he would have \$630,000 of that amount left to invest, which, invested *tax free* at 10%, would earn \$63,000 during 1987, leaving *A* with \$693,000 at the end of 1987. If, instead, tax on the \$900,000 were deferred for one year, *A* would be left with the full \$900,000 accumulation at the end of 1986, yielding, at the same 10%, \$90,000 during 1987. If *A* were then taxed at a 30% rate on his full \$990,000 gain, he would be left with the same \$693,000. The effect of deferral of tax on the 1986 gain for one year is thus to give *A* the equivalent of a *tax-free* 10% return on this untaxed gain. Each year *A* remains untaxed on his 1986 gain is another year of effective exemption from tax of the 10% yield on that gain. In addition, each year *A*'s further appreciation goes untaxed represents a year in which that compounded yield is also effectively made tax-exempt. Thus, deferral of taxation is itself equivalent to misstatement of income. Note that timing would not be important if the delay in collection was equally imposed on all taxes. The loss of revenue resulting from the time value of the delay could be counteracted by increased rates, and the total revenue collected would be the same as if there had been no delay. See W. ANDREWS, *BASIC FEDERAL INCOME TAXATION* 115-18 (3d ed. 1985); Davies, *Income-Plus-Wealth: In Search of a Better Tax Base*, 15 *RUTGERS L.J.* 849 (1984); see also C. SHOUP, *PUBLIC FINANCE* 25-26 (1969).

income, albeit not annually, than it is to state that the system measures annually, albeit not income.

b. Taxpayer behavior and status. Unfortunately, the system is no more able to measure other tax-significant statuses adequately by reference to particular exchanges than it is able to measure economic income by that kind of reference. For example, while the lack of cash receipts may well indicate a lack of cash,⁴⁶ some persons who receive no cash in a particular year may nonetheless possess significant liquid assets, and others who have significant cash receipts may have spent those amounts even before receipt. Similarly, while the purchase of life insurance or annuity contracts may well indicate increased savings as a result of tax incentives, it may simply reflect a preexisting desire to make those investments even absent any tax incentives, or it may not indicate any increase in savings at all (*i.e.*, because the acquisitions are accompanied by the taxpayer's incurring liabilities equal in amount to the value of the newly acquired investment).

In a like vein, the fact that the specific statutory requirements of any particular nonrecognition provision may be met by some exchange does not always indicate that the status intended to be insured by those requirements (*e.g.*, absence of a change in the "substance" of any specific investment) will have been met. Like the definitional elements of other transactions, those requirements are often merely reflective of, rather than identical to, the real statuses intended to be measured.

3. *The System's Unintended Normative Impact*

Some mismeasurement of economic income and taxpayer status is a necessary corollary to the system's transactional focus; and the very existence of the system is testimony to the fact that considerations of administrative convenience, economic efficiency, and social policy simply outweigh the virtues of absolute accuracy. Unfortunately, however, the system's inaccuracy generates another problem which is often in direct conflict with those very same goals. Simply put, the system unintentionally motivates taxpayers to act in unproductive, often counterproductive, ways in order to secure tax benefits.

To the extent that it seeks merely to measure economic income, the tax law has an essentially non-normative intent. In drafting many of the Code's major provisions, legislators were attempting not to discourage people from acting in economically productive ways but simply to *measure* the extent of that economic productivity (*i.e.*, economic

46. See, *e.g.*, I.R.C. § 453 (1982) (defers taxation in certain cases until cash is received).

income) in an administratively feasible manner. Nor, like most private law, is the tax law concerned with influencing relationships among private individuals. Instead, the Code is designed to allow those charged with enforcing its provisions to look to relationships among taxpayers only as a means of measuring the economic rights of the individuals involved.

Unfortunately, the Code tends to *act* both as a normative indicator for individuals generally and as a prescription of ways for individuals to conduct their affairs *inter se*. As suggested above, because taxation is generally imposed on exchanges, taxpayers are unintentionally encouraged to avoid making exchanges in which they might otherwise engage; since some exchanges are taxed less than others (or not at all), taxpayers who make exchanges may be encouraged to make those particular tax-free exchanges. Unfortunately, because those tax-free exchanges are not always defined by reference to the actual statuses which they are intended to benefit, taxpayers can often mirror the economic consequences of a single taxable transaction by instead engaging in a series of tax-free transactions, so that the incentive towards these tax-free transactions becomes substantial.

Because they may tend to mismeasure the status upon which incentives are intended to be based, *intended* incentive provisions may also have unintended effects, by encouraging taxpayers to engage in one or more transactions that will generate tax savings without resulting either from or in the actual status actually intended to be encouraged. As suggested above, taxpayers who borrow funds in order to engage in transactions that are rewarded as indicators of increased savings are among those who achieve a tax benefit without coming any closer to achieving the status intended to be rewarded.

C. Summary

All of the above problems flow from the same basic systemic flaws: the tax system is intended to measure economic income and other taxpayer behavior or status, but for administrative purposes it instead bases tax consequences on transactions. Taxpayers can have economic income without transactions; and most transactions do not themselves generate economic income. Most transactions represent the realization of accrued income; but for social, economic, or equitable reasons, many of these are not taxed. Because of perceived needs for administrable laws, tax-favored transactions are defined by reference to particular objective and verifiable facts rather than to the general social or economic goals that they are designed to further. But the objective facts referred to in the statute are often not coterminous with the so-

cial and economic goals that they are intended to implement. As a result, taxpayers can arrange their affairs so that the objective statutory requirements are met but the underlying economic or social objectives are not. In many other cases, the facts referred to in statutory definitions (*i.e.*, the question of what is exchanged for what) are simply not ascertainable. Often the truth is that the actual facts are different shades of grey in a system that acknowledges only black or white.

II. SYSTEMIC RESPONSES TO THE PROBLEMS

The basic structure of our tax system appears to be here to stay, and the problems of mismeasurement, unintended motivation of taxpayers, and some imprecision in the definition of transactions are all, to some extent, inherent in that structure. These problems are, in very real ways, interdependent and mutually compounding: a system that accurately measured economic income and other significant statuses would not unintentionally influence taxpayer behavior; a system that relied on transactions that could be described only with some minimal imprecision would not be subjected to manipulation if different characterizations did not dramatically alter taxable income; and a transaction-based system that was not full of taxpayers seeking both to act and to characterize their actions in ways that minimize tax liability would provide a more trustworthy measurement of each person's taxable income. Clearly, it is the compounding of these different problems that makes them as significant as they are; as a result, current tax jurisprudence uniformly addresses each of these issues in conjunction with one another. This article will examine that jurisprudential approach and suggest an alternative.

Essentially, this article suggests that even though the three problems raised above are mutually compounding in *effect*, they are at their *sources* entirely separate problems. Current judicial approaches to the problems have failed to acknowledge that they are indeed separate and, as a result, they have never satisfactorily been able to address any of them. In addition, because courts have been unable to *segregate* the issues that arise, they have been uniformly unable to devise remedies that tend to *deal* with those issues. Problems actually generated by inherent imprecision have been "solved" not by acknowledging, but by denying, that imprecision, and problems of taxpayer motivation have been "solved" by asserting that the problem was *not* motivation but imprecision.

This article suggests that only when these problems are segregated as separate issues can they be addressed in a meaningful way. To seg-

regate these issues ultimately requires acknowledgement that any transaction-based system is flawed — it is necessarily inaccurate, imprecise, and improperly normative; but to acknowledge these inherent flaws is the only way to begin to address them.

A. *Current Doctrines*

Essentially, while many doctrines have grown around both unclear characterization of actions and tax-motivated behavior, these doctrines have never really been very clearly articulated or classified. Instead, the Internal Revenue Service and the courts are more likely simply to cite, rather than explain, one or more of these doctrines to justify withholding various tax benefits. When more than one doctrine is cited, a court may view them as alternative justifications for its decision, or as merely alternative names for a single rationale. Against such a background, the summary that follows necessarily will not conform with all of the different uses of the relevant terms which have been adopted. However, it should provide insight into the scope and variety of rationales and will explain generally how each “works.”

1. *Sham Transaction*

The “sham transaction” label has long been a popular one; and its popularity in part appears to stem from its flexibility. At one time or another it has been used to describe actions that fit into all of the categories that follow.⁴⁷ Simply for the sake of categorization, it is used here to connote its most narrow legal construction and the one that most closely resembles its general usage outside of tax. So defined, a “sham transaction” is one that never occurred.⁴⁸ If tax consequences depend on representations regarding changes in legal rights and if those changes simply did not occur, the reported “transaction” is a sham. Since most “shams,” in this sense of the word, are nothing less than tax fraud, they (as opposed to what penalties should be imposed for them) are not often seriously litigated,⁴⁹ and will not be discussed in depth herein.

47. *E.g.*, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Knetsch v. United States*, 364 U.S. 361, 365 (1960); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 207 (1983), *modified*, 752 F.2d 89 (4th Cir. 1985). See *infra* text accompanying notes 58-62, 279.

48. This connotation is significantly narrower than that often used by the experts. See B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 4.3.3 (1981).

49. The most widely known example of this kind of “sham” is the case of *Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959), *affg.* 30 T.C. 1178 (1958). In that case, the purported (and reported) transaction was as follows: Goodstein borrowed \$10,000,000 from Lender. Goodstein transferred this money, plus \$15,000 of his own funds, to Broker. Broker took a \$15,000 commission and used the remaining \$10,000,000 to buy bonds from Seller. The bonds were pledged with Lender to secure Goodstein's \$10,000,000 obligation. Goodstein then bor-

2. Substance Versus Form

As with "sham," references to substance versus form have been parts of a wide range of cases and have been imbued with numerous different meanings. Because of the flexibility which courts have shown in applying this expression, it cannot seriously be contended that there is a single "correct" application of the doctrine. The assignment of the words to the transactions that follow is admittedly for the purpose of identifying and labelling a specific kind of approach taken by some courts rather than for the purpose of either fully describing all the situations in which courts have applied the "substance versus form" terminology, or suggesting that one of those applications is more "correct" than the others. That said, the substance versus form doctrine will be used here to describe the situation where (1) there is no factual dispute as to the significant legal and economic interactions and relationships (*i.e.*, the rights and liabilities of the parties) involved;⁵⁰ and (2) there are at least two alternative tax transactions which can describe those interactions. Examples of this type of substance versus form question are less common than might be expected, in part because it is fairly rare that the significant legal and economic relationships upon which characterization depends are clearly established. Typical of these are the debt-equity problem⁵¹ and questions regarding

rowed more from Lender to pay the (deductible) interest owed to Lender on the first loan. When it was time for repayment to Lender, Lender would merely foreclose on the pledged bonds. The tax consequences to Goodstein were substantial current interest deductions and complete deferral of income accruing on the pledged bonds. The "legal" transaction was quite different. Broker actually purchased the bonds from Seller out of its own funds. Goodstein paid \$15,000 to Broker. Lender, which had no funds, asked Broker to sell the pledged bonds. One half hour after Broker had purchased the bonds from Seller, it sold them back at the same price. It was over the next year and a half that Goodstein purported to pay deductible "interest" to Lender.

The Tax Court determined that Goodstein was entitled to no deduction because the series of transactions was pursuant to a preconceived plan that lacked economic substance and should be ignored for tax purposes. 30 T.C. at 1188. For further development of this "economic substance" concept, see *infra* Part II.A.2. On appeal, the First Circuit did not comment upon the asserted lack of economic substance and instead decided that the *legal* relationship that existed between Goodstein and Lender was not that of borrower and lender, so that payments from one to the other could not be interest. See 267 F.2d at 131. It is just this lack of a purported legal relationship that defines what is here referred to as a "sham."

50. Or, if there *was* a factual dispute as to these rights and liabilities, the questions of fact have been resolved.

51. With respect to the debt-equity issue, generally, if an instrument denominated as "debt" in fact represents an investment in the corporation, in the sense that the return on, and of, the investment is dependent on corporate success, that instrument will be classified as "equity" for tax purposes. The determinant of tax liability is thus not the "form" of the instrument, but the "substance" of the legal rights created therein. As noted, the problem arises from the fact that the "substance" of the instrument is neither exactly like debt nor exactly like equity, but has some elements of each. Unlike "sham" cases, where the taxpayer misrepresents the *facts* of the relevant legal and economic rights and liabilities, the facts may be apparent; and the "substance versus form" question is merely what tax term best describes those facts. See, *e.g.*, *United States v. Snyder Bros.*, 367 F.2d 980 (5th Cir. 1966), *cert. denied*, 386 U.S. 956 (1967) (20-year debenture).

whether certain kinds of property transactions are sales, leases, or simply mortgages.

3. *Business Purpose*

Like the sham and substance versus form approaches, considerations of "business purpose," or a taxpayer's lack thereof, have appeared in numerous cases and for numerous reasons;⁵² and the business purpose test is indeed often seen as a synonym for sham or substance versus form.

As used here, and as most commonly used by members of the tax bar, the test means something quite different from these other doctrines: certain transactions defined in the Code carry with them a requirement not specifically mentioned therein, and that requirement is that the exchanges be engaged in for some legitimate business purpose.⁵³ As commonly used, the business purpose doctrine is nothing more than a nonstatutory element of the definition of certain transactions.⁵⁴

4. *Step Transaction Doctrine*

Each of the above doctrines, when applied to a given exchange, may change the tax consequences sought by the taxpayer entering into that exchange. None of the doctrines can be applied without first de-

tures which were held *pro rata* by shareholders and were subordinated to other debt were found to be "equity"). This kind of substance versus form issue is *not* at the heart of all debt-equity controversies. Indeed, many debt-equity cases involve essentially factual determinations, such as whether the shareholder/creditor actually intends to enforce repayment. *See, e.g., Lyon, Federal Income Taxation*, ANN. SUR. AM. LAW 123, 142 (1957). Such cases are significant, but are not of the kind here referred to as "substance versus form."

52. For a general history of the beginnings of the business purpose requirement, see Spear, "Corporate Business Purpose" in *Reorganization*, 3 TAX L. REV. 225 (1947); Michaelson, "Business Purpose" and *Tax Free Reorganization*, 61 YALE L.J. 14 (1952).

53. The most widely used example of this concept originates in corporate reorganizations where the courts and the Internal Revenue Service have often held that exchanges seemingly meeting the reorganization definitions of § 368(a) are not reorganizations because they lack a "business purpose." *See infra* text at note 59. The same reasoning has been applied to classify purported "dividends" as nondividends, *Basic Inc. v. United States*, 549 F.2d 740 (Ct. Cl. 1977); purportedly deductible interest as noninterest, *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); and to several other kinds of transactions. *See infra* text at notes 63-65.

54. This article deals, in part, with the use of this extrastatutory business purpose requirement. There are, in addition, several Code sections that specifically refer to business purpose or an equivalent state of mind, *e.g., I.R.C. § 269* (1982 & Supp. IV 1986) (corporate acquisitions made to avoid taxes); *I.R.C. § 357* (1982) (assumption of liabilities in transfers pursuant to §§ 351, 361, 371, or 374 must not have tax avoidance purpose); *I.R.C. § 531* (1982) (accumulated earnings tax on corporations formed or availed of to avoid tax on shareholders); *I.R.C. § 302(c)(2)(B)* (1982) (restricting waivers of family attribution, for purposes of determining tax consequences of redemptions, to certain transfers not having tax avoidance as a principal purpose).

termining the exchange(s) to which its application is to be made. In other words, an essential prerequisite to characterizing taxpayer actions is a description of the specific actions to be characterized. The step transaction doctrine is the tool by which the courts determine what *actions* make up a single *transaction*. Sometimes explicitly, and sometimes by implication, this doctrine permeates the tax field and has aptly been described as "a successful cultural imperialist, on which the sun never sets."⁵⁵ Often courts specifically describe their holdings as applications of the doctrine,⁵⁶ but just as significantly, many courts which do not view themselves as applying the doctrine base their decisions on an assumption that the actions to be characterized (*e.g.*, for purposes of applying the substance versus form doctrine) are not the actions isolated for characterization by the taxpayer.⁵⁷ Because the step transaction doctrine determines only what actions are to be looked at together to determine the "substance" of the transaction, its application is necessarily (but, again, not always explicitly) followed by application of the substance versus form doctrine, in that courts must determine the appropriate tax characterization of the redefined exchanges.

B. Problems with the Responses

Rather than counteract the problems caused by the system's transaction-based focus, the above doctrines have been consistently applied in a manner which is so colored by that focus that they might be said to have exacerbated rather than solved the system's problems. Despite some appearance of reasonableness and consistency, none of the doctrines has any coherent application. What follows is an in-depth analysis of the history and application of these doctrines.

55. B. BITTKER, *supra* note 48, ¶ 4.3.5. The step transaction doctrine has only recently made its way into the English law, see *W.T. Ramsay Ltd. v. Inland Revenue Commrs.*, 1982 App. Cas. 300. Introduction of the doctrine has met with mixed reactions. See Bartlett, *The Constitutionality of the Ramsay Principle*, 1985 BRIT. TAX REV. 338.

56. Many of the thousands of these cases are described in Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAXN. 247 (1954); Note, *Step Transactions*, 24 U. MIAMI L. REV. 60 (1969); Hobbet, *The Step Transaction Doctrine and Its Effect on Corporate Transactions*, 19 TUL. TAX INST. 102 (1970).

57. *E.g.*, *Knetsch v. United States*, 364 U.S. 361 (1960). In *Knetsch*, the taxpayer purportedly borrowed money to purchase an annuity. He pledged the annuity as security for the loan and consistently borrowed against any appreciation in the annuity. In holding that the "substance" was not a loan, the Court referred to the "transaction" as the entire *series* of events rather than the borrowing alone; but nowhere does it appear that the Court considered itself to be actually applying the step transaction doctrine.

1. *Business Purpose*

The business purpose test originated in *Gregory v. Helvering*.⁵⁸ Ms. Gregory owned all the stock of United Mortgage Company, which in turn owned, *inter alia*, 1,000 shares of Monitor Securities Corporation. Gregory sought to have the Monitor shares sold and to have the proceeds of the sale inure to her personal account. To accomplish these results with a minimum of tax liability, Gregory caused United Mortgage to transfer the Monitor shares to a newly formed subsidiary (Averill) which was distributed to Gregory and then immediately liquidated, leaving Gregory in possession of the Monitor shares, which she then sold. Gregory contended that the formation of Averill and the subsequent distribution of the Averill stock to her was a tax-free reorganization, and that the only tax-significant transaction was the liquidation of Averill, which resulted in a relatively small capital gains tax to Gregory.

Despite the fact that the transfer of Averill appeared to meet the statutory language defining a reorganization,⁵⁹ the Court held that the distribution of Averill was *not* a reorganization, and that Gregory should be taxed as if she had instead received a dividend taxable at the substantially higher ordinary income rates. The Court explained that the reorganization provision, which speaks of a transfer of assets by one corporation to another, refers only to a transfer made “ ‘in pursuance of a plan of reorganization’ of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either”⁶⁰ It went on to state that the transaction which had occurred was “[s]imply an operation having no business or corporate purpose” and as such “the transaction upon its face lies outside the plain intent of the statute.”⁶¹ The apparent instruction to be gained from the Court’s language is that a transaction which has no business or corporate purpose is not a “reorganization.”⁶²

58. 293 U.S. 465 (1935).

59. The pertinent statutory language the *Gregory* court relied upon defined a tax-free reorganization to include “a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. . . .” 293 U.S. at 468 (quoting § 112(g)(1)(i)(B) of the Revenue Act of 1928).

60. 293 U.S. at 469 (citations omitted).

61. 293 U.S. at 469.

62. Some commentators have suggested that, in fact, the Court’s opinion means only that corporations must carry on some business to be recognized as corporations for tax purposes. *E.g.*, Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 739 n.21 (1978). This view would seem to be dispelled by the Court’s assertion in *Gregory* that “No doubt, a new and valid corporation was created.” 293 U.S. at 469. Most of the commentators are of the opinion that *Gregory* “lays down

The same business purpose test has been integrated by the Treasury not only as a requirement of other corporate reorganization provisions,⁶³ but also as a requirement to achieve tax-free status on the formation of corporations;⁶⁴ and cases have found the business purpose requirement to apply as well to dividends,⁶⁵ and to a broad array of other kinds of transactions. Indeed, Judge Learned Hand explained that *Gregory* generally has been taken to mean that "in construing words of a tax statute which describes [any] commercial or industrial transaction we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."⁶⁶ Indeed, *Gregory* has been broadened even further, and a form of the test which purported to require business reasons for commercial transactions has been applied to admittedly *noncommercial* transactions.⁶⁷

Before further exploring what the doctrine *does* mean, it is important to emphasize what it does *not* mean. In order to avoid application of the doctrine, a taxpayer need not show that the transaction engaged in is one which she would have entered into in a tax-free world.⁶⁸ In-

a general principle of tax law that in order to fit within a particular provision of the statute a transaction must comply not only with the letter of the section, but must have a business purpose, (other than a desire to avoid taxes)" B. BITTKER & J. EUSTICE, *supra* note 34, ¶ 14.51 at 14-170.

63. See Treas. Reg. § 1.368-1(b) (as amended in 1980), which describes reorganizations as relating to "readjustments . . . required by business exigencies"; and Treas. Reg. § 1.368-1(c) (as amended in 1980), which excludes from its definition of a plan of reorganization "a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character . . . the object . . . of which is the consummation of a preconceived plan having no business or corporate purpose"

64. See Rev. Proc. 73-10, 1973-1C.B. 760, 762.

65. See *Basic Inc. v. United States*, 549 F.2d 740 (Ct. Cl. 1977).

66. *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950).

67. *E.g.*, *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). In *Goldstein*, the taxpayer borrowed funds at 4% interest, prepaid the interest, and invested the same funds at less than 2%, solely to lower her taxes for the year in which she prepaid the interest. The court held the business purpose test sufficient to deny the sought-after interest deduction "when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction" 364 F.2d at 741-42.

68. It is only appropriate to note some of the well-known comments that courts seem to recite in almost every case decided against the would-be tax-avoiding citizen:

[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 [sic] 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.

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

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced

deed, if such were the case, it is likely that very few tax-free exchanges could satisfy the test, because many of these exchanges have both substantive and technical requirements which few transactions would meet without intentional advance planning. For example, a fairly simple and straightforward transaction which might not be entered into in a tax-free world could be the kind of reorganization defined in section 368(a)(1)(B). That section grants nonrecognition to shareholders of a company (*T*) who exchange their shares for shares of an acquiring company (*P*) if immediately after the exchange *P* has more than 80% control of *T* and if in the exchange *P* acquires the *T* stock solely for *P* voting stock. Assume that (1) *P*, a publicly held company, offers cash to the *T* shareholders in exchange for all of the stock and that, tax consequences aside, the *T* shareholders would prefer cash to *P* stock; (2) nonetheless, simply in order to avoid the imposition of tax on the exchange, the *T* shareholders decide to sell to *P* only if *P* acquires the *T* stock solely for *P* voting stock. The transaction will qualify as a tax-free "B" reorganization despite the fact that it was engineered solely for tax savings.

Rather than applying when the taxpayer structures an exchange in a certain way in order to achieve tax benefits, the business purpose doctrine has been said to apply only when there is no business reason at all for engaging in a particular transaction — "[a] transaction . . . lacks business purpose if its *raison d'être* is tax reduction."⁶⁹ But despite the wide array of cases which cite to the business purpose doctrine for support, there are very few sales, exchanges or other tax-significant transactions which could reasonably be said to exist entirely for tax savings; and of those that do exist, none has yet been subjected to a "business purpose" analysis.

The easiest way to avoid taxation of accrued appreciation in property is to hold the property. Because simply failing to engage in any transaction with respect to an appreciated asset will result in a zero rate of tax,⁷⁰ it would appear that a transaction might exist *solely* for

exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting), *cert. denied*, 331 U.S. 859 (1947).

69. Bittker, *What Is "Business Purpose" in Reorganizations?*, 8 N.Y.U. INST. ON FED. TAXN. 134, 137 (1950).

70. Congress is apparently not unaware that taxpayers may avoid realizing gains for the sole purpose of tax avoidance; as early as 1913 it enacted legislation which at times makes realization mandatory. Additionally, the accumulated earnings tax applies only to certain corporations "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." I.R.C. § 532(a) (1982). Essentially, if shareholders control a corporation that has earnings and profits above and beyond those needed for the conduct of business, those shareholders must

tax purposes only if that transaction produces a rate of tax which is less than zero. The most obvious single transaction that produces a rate of tax below zero is the sale of property which has *declined* in value. If *A* has investment property with a basis of \$100 and a value of \$10, sale of that property will result in a \$90 tax deduction, while retention of the property will produce no tax consequences. *A* might sell the property solely in order to recognize that \$90 loss; and indeed *A* might be so tempted even at a price below market value, because the tax savings would likely outweigh the economic loss.⁷¹ Nonetheless, no one has ever suggested that the business purpose doctrine should be applied so as to convert that sale into a "nonsale."⁷²

In addition to a sale, *purchase* of property can, in some circumstances, also produce a tax rate below zero. Between 1981 and 1984, the combination of accelerated cost recovery and the investment tax credit available to the purchaser of equipment could produce tax savings which, in present value terms, exceeded the tax that would be imposed on the income generated by the equipment. The result was, in effect, a negative rate of tax on income earned on certain investments.⁷³ Despite the fact that taxpayers might purchase property that was an admittedly uneconomic investment and that might be expected to produce a pretax return of zero or less, never did the Internal Revenue Service or a court assert that such an investment lacked a "business purpose" and was therefore not a "purchase" for tax purposes.⁷⁴

Other provisions capable of producing negative tax are referred to

realize their gains, by having the corporation distribute them as dividends, in order to avoid the accumulated earnings tax. By preventing shareholders from deferring realization and its accompanying tax burdens solely for tax avoidance purposes in only very limited circumstances, Congress seems to have made it clear that in all other circumstances, holding property and deferring realization in order to avoid tax is perfectly acceptable. See Paul, *Motive and Intent in Federal Tax Law*, in *SELECTED STUDIES IN FEDERAL TAXATION* 255, 277 (1938).

71. Assuming a marginal tax rate of 30%, the savings would be 30% of \$90, or \$27.

72. Nor has anyone suggested how such a "nonsale" might be taxed. *But see infra* Part III.D.2.

73. See Steines, *Income Tax Allowances for Cost Recovery*, 40 *TAX L. REV.* 483, 506-07, 540 (1985).

74. Often the Internal Revenue Service and courts *did* attack such investments when the property was acquired with borrowed funds and was leased back to the seller. *E.g.*, *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976); *cf.* *Swift Dodge v. Commissioner*, 692 F.2d 651 (9th Cir. 1982) (taxpayer, an automobile dealer, borrowed funds to purchase cars for lease; court held arrangement to be a conditional sale). In these cases, however, the courts were careful to point out that it was not merely the acquisition of the property, but the *combination* of the borrowing, purchase, and lease, that caused the taxpayer to lose purported tax benefits. In any event, the taxpayer who spent \$100 cash to buy property which he intended to rent out for amounts with a total present value of \$99 would, after taxes, have a positive return on his investment only because of tax savings. That taxpayer's rights to deductions were never questioned on "business purpose" grounds.

as "rollovers."⁷⁵ Unlike a like-kind exchange,⁷⁶ which allows for a tax-neutral choice between continuation or conversion of an investment,⁷⁷ these rollover provisions give tax preference to *spending* the receipts on similar property *over* simply retaining the property received. Nonetheless, no court has ever seen fit even to inquire into the presence of a business purpose as a condition for receiving the statute's benefits.

In addition to these few exchanges which, by application of a single beneficial provision, can produce a negative tax rate, there are several exchanges which, because of the application of more than a single kind of tax benefit, can offer tax savings sufficient to motivate action without any corresponding economic (nontax) benefit. While the act of engaging in a tax-free incorporation does not reduce the taxpayer's taxes, the effect is to allow continued operation of a business, but in a form which can be subject to lower rates of tax. As a result, the incorporation may well be entered into for no reason other than to reduce taxes.⁷⁸ Nonetheless, the courts have not seen fit to require a taxpayer to demonstrate that he had a business purpose or a profit motive in order to receive nonrecognition for an incorporation transaction.⁷⁹

75. See I.R.C. §§ 1033, 1034 (1982). These provisions work generally as follows: Assume that Taxpayer owns an apartment building with a basis of zero and a value of \$1,000,000. The building is destroyed by fire in 1987 and Taxpayer receives \$1,000,000 in insurance proceeds in the same year. If Taxpayer retains her \$1,000,000 during 1987 and 1988, she will be taxed on \$1,000,000, the excess of her amount realized over her basis in the building. However, if Taxpayer invests her \$1,000,000 in another apartment building during 1987 or 1988, she will not be taxed on that money.

76. *E.g.*, I.R.C. § 1031 (1982).

77. Because the tax consequences of both are identical — no tax.

78. Compare I.R.C. § 11(b) (1982) with I.R.C. § 1 (1982).

79. Rev. Proc. 73-10, 1973-1 C.B. 760, 762, purports to require an explanation of the business reasons for incorporating in order to receive a ruling from the Internal Revenue Service to the effect that the incorporation transaction will qualify for nonrecognition under § 351. The author is unaware of any case in which a ruling has been denied on that basis (excepting certain step transactions, see *infra* Part II.B.2), and almost any asserted nondescript "business purpose" will do. See *Gunn, supra* note 62, at 744. Even were the Internal Revenue Service to contest the application of § 351 to incorporations undertaken solely to achieve lower tax rates, it would be bound to fail. The Supreme Court stated over 30 years ago that a corporation will be respected as a separate entity (and, presumably, the incorporation will be respected as a transaction governed by § 351) if there is *either* a business purpose for organizing the corporation *or* if the incorporation is followed by the carrying on of any business. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943).

Along similar lines, a corporation with substantial earnings (the "profit" company) might acquire (or cause itself to be acquired by) a corporation with substantial net operating loss carryovers (the "loss" company) in either a taxable or a tax-free reorganization. Prior to 1987, the acquisition might have proven beneficial after taxes even if the loss company could be expected to continue to lose money from its business operations. Within limits, after the acquisition, the profit company could use the loss company's pre-acquisition net operating losses to offset its own post-acquisition income. Prior to 1987, the limitations on the use of pre-acquisition net operating losses were both substantial and complex. Their specifics are not germane to this article, but for the curious, they are well described in B. BITTKER & J. EUSTICE, *supra* note 34, at ch. 16. The

It would appear from the above that business purpose is generally *not* a requirement for the tax characterization of many commercial transactions described in the Code. In fact, in many situations, to hold otherwise might lead to results which could be not just unwarranted, but completely absurd. For example, one of the reasons for the enactment of what is now section 351, which grants nonrecognition to individuals who form a corporation, was to "increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."⁸⁰ Prior to section 351's existence one could imagine two taxpayers, each of whom owned depreciated property of equal value. They could arguably simply transfer their properties to a new corporation⁸¹ in exchange for one half of the shares of that corporation.⁸² A taxable sale or exchange would have occurred, and each taxpayer would enjoy a deductible loss on the transfer of his depreciated property to the newly formed company.

Section 351 was enacted partially to combat this technique by providing that on such exchanges no gain or loss is recognized to the contributing shareholder(s). To read a business purpose requirement into the section would be to prevent taxpayers from deducting realized losses on the formation of a corporation *only* when they had some business purpose for establishing that corporation, and to *allow* the deduction of such losses *only* where the taxpayers incorporated for the

Tax Reform Act of 1986 added new I.R.C. § 382 to these limitations. The implications and effects of that section are set forth in S. LIND, S. SCHWARZ, D. LATHROPE & J. ROSENBERG, *supra* note 34, at 520, 525-39. New § 384, enacted in 1987, also limits the ability of an acquiring corporation to use *its* pre-acquisition losses to shelter "built in gains" of an acquired corporation. I.R.C. § 384 (West Supp. 1988). Because the loss company had no income, these losses would otherwise be unusable, so that the acquisition could be used to breathe life into what were often substantial amounts of otherwise useless deductions.

Congress was well aware of this possible reason for combining profit and loss corporations. Indeed, in response to these attempts it enacted, *inter alia*, § 269. That section applies to acquisitions of the stock or assets of one corporation by another for "the principal purpose . . . [of] securing the benefit of a deduction . . . which such . . . corporation would not otherwise enjoy" I.R.C. § 269(a) (1982). When it applies, § 269 acts to disallow the desired deduction. Even where the section has applied, however, no one has suggested that the lack of business purpose for the combination of the profit and loss corporations could make the acquisition itself a taxable event (assuming it would otherwise qualify as a tax-free reorganization). Instead, application of § 269 to cases where there was no purpose to the combination other than to generate a use for the net operating losses seems to make clear that it is § 269, and *not* any kind of business purpose test applicable to reorganizations, that provides the appropriate tool to combat this kind of tax avoidance. *E.g.*, *Scroll, Inc. v. Commissioner*, 447 F.2d 612 (5th Cir. 1971) (§ 269 applied to disallow postmerger tax benefits, but merger was still not taxable).

80. S. REP. NO. 275, 67th Cong., 1st Sess., 11-12 (1921).

81. Alternatively, they could transfer their property to an existing corporation of which they were already equal shareholders. The transfer to a pre-existing corporation would serve to defeat any possible contention that the very existence of the corporation as a separate entity should be disregarded.

82. The text suggests two equal shareholders so that the loss disallowance provision of § 267 will not apply.

sole purpose of deducting the losses (because in such a case, the taxpayers would have no "business purpose" for incorporating and would therefore fail to satisfy that implicit requirement for the application of section 351).

A similarly counter-intuitive result could arise from across-the-board application of the business purpose test in the very area in which the test was born — corporate reorganizations. In *Survaunt v. Commissioner*,⁸³ the taxpayer was a 50% shareholder of a corporation. Several steps were taken in order for the shareholders to pay off certain personal obligations: (1) the corporation was liquidated; (2) a new corporation, owned by the same shareholders in the same proportions, was formed; (3) the shareholders each contributed to the new corporation all but \$30,000 worth of the assets received upon liquidation of the old corporation; and (4) the shareholders sold to the new corporation the remaining \$30,000 worth of the assets received on liquidation of the old company.

The Internal Revenue Service argued that the entire series of events constituted a reorganization, with the result, under the provisions applicable to corporate reorganizations, that the shareholder should be taxed as if he had received a \$30,000 dividend.⁸⁴ The shareholder's response was that the entire transaction had no business purpose and was instead motivated by his own desire to receive \$30,000 from his corporation without incurring any tax liability.⁸⁵

Since *Gregory v. Helvering*⁸⁶ appeared to make it clear that one of the essential elements of classification as a corporate reorganization was a business purpose, it was claimed that the transaction at issue, lacking that essential purpose, could not be so characterized. The court rejected this contention,⁸⁷ holding that the only relevant ques-

83. 162 F.2d 753 (8th Cir. 1947), *modifying* 5 T.C. 665 (1945).

84. 162 F.2d at 755.

85. The taxpayer asserted that (1) the liquidation was tax-free to the old corporation and resulted in a capital loss to the shareholder (because his basis in the stock surrendered exceeded his amount realized); (2) the formation of the new corporation was tax-free; (3) the contribution of property to the new corporation was tax-free to all parties; and (4) the sale of \$30,000 worth of property to the new corporation, though a taxable sale, resulted in no gain because the shareholder's basis in the assets sold equaled his amount realized. 162 F.2d at 756.

86. 293 U.S. 465 (1935).

87. *Survaunt*, 162 F.2d at 757. One commentator has suggested that "[b]usiness purpose or the absence thereof is too readily manufactured in corporate counsel's office to be available as a basis for reclassification of transactions to avoid unpleasant tax consequences," so that the doctrine "is a weapon only for the taxing sovereign, a sword that cuts only one way." Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 *TUL. L. REV.* 355, 365 (1963). This approach suggests that the issue is merely one of proof, and that some sort of unstated but irrebuttable presumption exists to the effect that whenever business purpose is raised as an issue by the taxpayer, the taxpayer is unable to carry his burden. No court has ever adopted this approach and while perhaps consistent with some uses of the doc-

tion raised by *Gregory* was *what* was done rather than *why* anything was done, and that what was done in this case qualified as a reorganization.

The net result of these cases is that a doctrine which originated as an implicit requirement of statutory provisions describing corporate reorganizations has in some ways grown well beyond that role, so that courts feel comfortable imposing a "business purpose" requirement as an adjunct to almost *any* kind of transaction. On the other hand, the same requirement is at other times dysfunctional, and disregarded, in the characterization of transactions including the very ones (corporate reorganizations) that gave birth to the doctrine. As a result, the doctrine is often not applied to so-called commercial transactions totally lacking in business purpose,⁸⁸ yet it is not only alive but also growing

trine, this interpretation does not explain the Internal Revenue Service's own failure to apply the test to a large number of transactions that clearly lack any business purpose. See *supra* text at notes 79-84. Moreover, in cases like *Survaunt*, even stipulated facts could not change the court's determination that the business purpose test was inapplicable.

88. Professor Gunn has suggested that the business purpose test "is sensible to the extent that it means, as it seems to have meant in *Gregory*, that corporations must actually carry on business activities to be recognized as corporations under the reorganization provisions." Gunn, *supra* note 62, at 739. Such interpretation, if confined to the reorganization provisions, seems somewhat more consistent with the actual usage of the business purpose test than does a broader view of the scope of the doctrine. It could explain why the courts do not appear to apply the test to the incorporation provisions (*i.e.*, because they are not reorganizations) and could explain the result in *Survaunt* — the transaction was a reorganization because the new corporation which was formed did survive and carry on business, so it could be recognized as having a "business purpose."

This interpretation of the business purpose doctrine, however, achieves its consistency by viewing the doctrine in an essentially different light than do most scholars and courts. If the business purpose test is a requirement that a corporation carry on some business or, presumably, be created for the *purpose* of carrying on some business, see *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), then Judge Hand's explanation that the test ascribes some commercial or industrial purpose to commercial transactions that are described in the Code is a fundamental misconception of the doctrine's function. Rather than viewing the doctrine as a nonstatutory requirement of certain "transactions," Professor Gunn would view it as nothing more than part of the tax definition of a corporation — a corporation is an entity with certain definite characteristics, one of which is either the carrying on of business or the existence of some purpose to carry on business in the mind(s) of those organizing the purported corporation. The inevitable result of so limiting the doctrine's role is to rule out the relevance of a taxpayer's state of mind (unless specifically referred to in the Code, see *supra* note 39) for all purposes other than to breathe life (or death) into a "corporation" which does no actual business. This is simply not something that anyone other than Professor Gunn has been willing to do.

In any event, a seemingly undeniable implication of this characterization is that Ms. Gregory was denied her tax benefits not because the transaction was engaged in for no business purpose, but only because she did it the wrong way. Presumably, when her wholly owned corporation formed and distributed Averill, the distribution could not have been a reorganization because Averill, which was immediately liquidated by Ms. Gregory, had no business purpose, carried on no business, and therefore could not be recognized as a corporation for tax purposes. When so viewed, the "distribution" must have been of the shares of Monitor stock *outside* of corporate solution, and it was therefore not a reorganization. Had she been well advised after the adoption of the "business purpose" test suggested by Professor Gunn, Ms. Gregory might have simply kept Averill intact and sold the Averill stock instead of liquidating Averill and selling the Monitor stock received in that liquidation. Because Averill would have continued in existence in the hands of the purchaser, Averill would presumably qualify as a corporation, and the transaction

in a wide array of different kinds of cases.

would have qualified as a reorganization. Because Gregory's gain on the sale of Averill would have been capital gain, she would have achieved her hoped-for tax benefits.

One might argue, in support of a limited business purpose test, that it could apply to disallow Ms. Gregory her tax breaks even in the above scenario; but any potential arguments to support application of a limited business purpose test to this fact pattern do more to raise questions than to provide answers. First, one might suggest that even if not immediately liquidated by Ms. Gregory, Averill would not be a corporation (and the transaction therefore not a tax-free reorganization) because it still carried on no business and was formed without an intention to carry on business. If by this it were meant that merely holding stock (the Monitor shares), collecting dividends, and, presumably, eventually selling the Monitor shares and buying other shares was not the carrying on of business, but was merely investment, then the clear implication would be that mere investment companies do not carry on business and are therefore not corporations. This is patently false. Indeed, the Code explicitly contemplates the existence of "mere holding or investment compan[ies]." Section 533(b) states that the fact that a corporation is a mere holding or investment company is evidence of the kind of tax avoidance purpose which may lead to imposition of the accumulated earnings tax on the corporation. See I.R.C. § 533(b) (1982). This necessarily implies the existence, for tax purposes, of that corporation.

One might alternatively argue that investment companies are corporations for tax purposes only if they invest extensively; but could it really be contended that if Mr. Rich and Mr. Poor each forms a holding company to which each transfers all of his investments (\$10,000,000 for Mr. Rich, \$10,000 for Mr. Poor), Mr. Rich's corporation will be respected and Mr. Poor's will not? Such is doubtful, but it would be the inevitable result of conditioning corporate recognition on the number and kinds of investments made.

In any event, if such were the case, Gregory could have transferred to Averill some small amount of other business assets (*i.e.*, inventory) which Averill could have sold, thereby engaging in actual noninvestment "business." While the amount of business conducted could have been quite small compared to the value of the Monitor stock held by Averill, it could easily have exceeded the amount of business done by some very small closely held corporations which have been consistently recognized for tax purposes. The amount of business might be compared to either the incorporated investment assets or to the tax savings generated by the incorporation-reorganization, and that comparison would be a good indicator of some tax-avoidance motive. But if one were to accept that the carrying on of business is enough to establish the tax existence of a corporation, and that existence is in turn enough to satisfy the business purpose test, comparisons of the *amount* of business with the amount of tax saved, and the resulting conclusions, would be irrelevant.

One might finally suggest that this reformed version of *Gregory* would fail to satisfy the narrow business purpose test for corporate existence, at least if Averill were liquidated by the purchaser immediately after its sale by Gregory. To this, one might suggest that (1) Averill might *not* be immediately liquidated (if the purchaser were a corporation, there would be little need for Averill to be liquidated because the consolidated return regulations for affiliated corporations could provide results similar to those which would result from liquidation of Averill); and (2) if Averill were liquidated, it could be made to conduct some small amount of business prior to liquidation, as suggested above.

Indeed, even if Averill *were* immediately liquidated by the purchaser prior to the conduct of any business or investment function (*i.e.*, without so much as the collection of dividends on the Monitor stock), disregard of the corporate entity would not necessarily be proper. Since the corporation was formed by Gregory, it would appear to satisfy the business purpose test if Gregory believed that the purchaser would continue the corporate existence after the sale. To condition corporate "existence," and Ms. Gregory's tax liability, on post-sale decisions made by a third party seems inappropriate.

For example, assume that Averill has been formed with a legitimate expectation that it would engage in active business. Assume also for purposes of this example that Averill had been formed with substantial business assets and had been distributed to Gregory in anticipation of conducting that business. Assume that legitimate business reasons existed for separating Averill from its parent corporation. If Ms. Gregory had been approached by a purchaser *after* the distribution, but just before the conduct of business, Gregory's tax liability for the preceding distribution ought not to depend on whether or not the purchaser decides to liquidate Averill or operate it as is. Indeed, Gregory might have no way of knowing the purchaser's plan. To make her

This inconsistency and apparent random application of the business purpose doctrine is an unavoidable consequence of viewing the doctrine as a requirement for classification of a given exchange as a specific type of transaction. The doctrine is fundamentally premised on an unspoken assumption that at least certain kinds of tax-motivated behavior (as opposed to business-motivated behavior) ought not to be rewarded; and it proceeds from that assumption to a conclusion that certain transactions require a business purpose. Unfortunately, for every tax-motivated taxpayer who would be *hindered* by classification of an exchange as other than some specific kind of transaction, there is another taxpayer who would be *benefited* by that same classification. As a result, the doctrine as originally explained must be either arbitrarily applied or self-defeating.

To the extent that there may be consistency in the application of the business purpose doctrine in all of the situations discussed above, it simply does not lie in a view of the doctrine as an extra-statutory requirement of certain transactions otherwise defined in the Code, as suggested by Judge Hand.⁸⁹ Instead, the doctrine seems to have consistent meaning only when seen as a test for application of the step transaction doctrine. The results of the cases purporting to deny tax benefits because of a lack of a business purpose seem reconcilable if one takes the business purpose test to mean that if an action has no business purpose, then that action is not entitled to be taxed as a distinct exchange, but is deemed to be part of a larger transaction. In other words, the business purpose test is no part of the definition of any commercial *transaction* described in the Code, but is a part of the determination of what *facts* should be considered as having occurred together. Viewed this way, the test, whether or not it is appropriate, at least produces results consistent with many of the relevant court decisions.

When the business purpose doctrine as so interpreted is applied to *Gregory*, the absence of business purpose for the formation of Averill becomes a reason for treating the formation, distribution, and immediate liquidation as a single integrated transaction. The substance versus form doctrine can then be applied, resulting in treatment of the transaction as a taxable distribution.⁹⁰

liability depend on actions she neither anticipated nor even considered is somehow off the mark. The only difference between this situation and the reformed *Gregory* facts, mentioned above, is the intent to have Averill carry on a more active business than investments. Since either one constitutes enough to assure corporate existence, however, this difference is irrelevant.

89. Nor as a part of the definition of a corporation, as suggested by Professor Gunn.

90. All of this is not to suggest that, when so applied, the business purpose test and the substance versus form doctrine combine to give sensible results. Many results of this combined

Similarly, while the broader business purpose test fails to account for apparently contradictory results in simple incorporation transactions and in reorganization cases such as *Survaunt*,⁹¹ application of the business purpose doctrine *qua* step transaction doctrine generates results which are, if nothing else, at least consistent. For example, despite a reference in certain rulings to a business purpose as a necessary prerequisite to the grant of tax-free status to a corporate formation,⁹² courts have declined to apply a business purpose test to a straightforward incorporation. One might instead suggest that application of the business purpose test to corporate formation followed only by operation of the corporation could result in viewing the formation and operation as an integrated series of events; but because application of the substance versus form doctrine to that series of events would nonetheless result in characterization of the events as nothing other than an incorporation followed by the conduct of corporate business, the doctrine, though in fact applicable, does not change the tax consequences.⁹³

In *Survaunt*, where the taxpayer argued that a liquidation followed by an incorporation could not be classified as a reorganization because the series of exchanges lacked a business purpose, application of this reformulated business purpose test results in the apparently more appropriate conclusion that the liquidation and subsequent reincorporation should be viewed as part of a single transaction — that transaction being, as the court found, a reorganization.

This view of the role of the business purpose test is consistent with

approach are logically strained. See *infra* Part II.B.3. The suggestion made here is only that, whether or not they know it, what courts seem to be doing is applying this kind of sequential analysis.

Somewhat at odds with this conclusion are regulations which explain that, regardless of the sequence of events, the kind of reorganization attempted in *Gregory* will *not* be found to have occurred unless carried out for real and substantial nontax reasons common to the business of the corporations. See Treas. Reg. § 1.355-2(c) (1987). The regulation is essentially an attempt to incorporate what Treasury saw as the holding of *Gregory*. The cases and rulings tend to point out the kind of reasons that meet the requirement. See generally B. BITTKER & J. EUSTICE, *supra* note 34, ¶ 13.09. What is more significant is that those times when courts or the Internal Revenue Service find a *lack* of business purpose are when the transaction has the *potential* to be combined with another exchange to form a low-tax road to what would otherwise be a higher taxable destination. E.g., *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971) (no "business purpose" for distribution because it was part of larger plan which contemplated disposition (as bequest) of distributed stock).

91. See *supra* text at note 83.

92. Rev. Proc. 73-10, 1973-1 C.B. 760, 762 (requires a statement of the business reasons for a tax-free incorporation as a prerequisite to receipt of a favorable ruling with respect to qualification for tax-free incorporation under I.R.C. § 351 (1982)). See *supra* note 79.

93. Compare application of the step transaction doctrine to an incorporation followed by a stock for stock exchange, where unification of the seemingly separate exchanges *does* result in different tax consequences. See *infra* Part II.B.2.

other facets of its current use as well. Generally, where some purported transaction is found to have no business purpose, the transaction will be held to be *not* what it is purported to be. However, the business purpose test alone does not purport to provide a way to determine exactly what the transaction *is*, as opposed to what it is not. Whether a purportedly tax-free exchange is simply characterized as a nontax-free exchange or whether it is characterized as some different kind of transaction by application of the substance versus form doctrine seems not to have been discussed in the cases; but if the business purpose doctrine is something other than a version of the test for application of the step transaction doctrine, what it is, is, to say the least, unclear.

2. *Step Transaction Doctrine*

a. Step transaction tests. While perhaps encompassing some sort of business purpose test, the step transaction doctrine at least *appears* to focus on the opposite side of the coin from that given attention by the "business purpose" analysis. Rather than a nonstatutory element of the definition of certain tax-favored transactions, the step transaction doctrine is one which purports to be applied to certain *facts* prior to and independent of the application of a specific transactional label to those facts. The doctrine is simply a way to determine "what was done"; the thing found to have been done then awaits characterization through application of a substance versus form analysis.

Nonetheless, the doctrine can still trace its roots to the same opinion which gave birth to the business purpose test.⁹⁴ In discussing Ms. Gregory's predicament in *Gregory v. Helvering*, the Court explained that it was doing no more than "[p]utting aside . . . the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred."⁹⁵ This determination that what actually occurred can be different from what is represented to have occurred is the essence of the step transaction doctrine.

A fairly typical application of the step transaction doctrine can serve as an example. Assume that *T* owns several low basis assets that she has been using in an ongoing sole proprietorship, and Publicly Held Company seeks to acquire the entire business. If *T* trades her

94. Professor Bittker has traced the doctrine's seeds back as far as 1932, three years prior to *Gregory*. B. BITTKER, *supra* note 48, § 4.3.5, n.74. On the presumption that it is the Supreme Court that *plants* the possibly pre-existing seeds, it is not inappropriate to trace its *roots* only back to *Gregory*.

95. 293 U.S. at 469.

business to Publicly Held in exchange for either cash or Publicly Held stock, the exchange will be fully taxable.⁹⁶ However, *T* might be tempted to suggest a somewhat more complex, but nonetheless apparently less taxing arrangement. If *T* exchanges her business for all of the shares of newly formed Newco, the transaction would appear to qualify as a tax-free incorporation.⁹⁷ If Publicly Held then acquires all of the assets of Newco in exchange for Publicly Held stock, and Newco liquidates, distributing the Publicly Held stock to *T*, that exchange would appear to qualify as a tax-free⁹⁸ reorganization under section 368(a)(1)(C).⁹⁹ If the separate actions are respected, *T* will have converted a single taxable exchange (assets for Publicly Held stock) into two separate nontaxable exchanges. In such a situation, the step transaction doctrine will be applied; and the "transaction" will be defined as a taxable exchange by *T* of her business assets for Publicly Held stock.¹⁰⁰

The utility of some sort of objective determination of the facts of a transaction seems apparent. Nor does this need arise merely from the possibility of a transaction in which the documentation retained by the taxpayer or submitted to the Internal Revenue Service does not represent the actual legal rights and liabilities of the parties to the transaction.¹⁰¹ Such cases fall clearly within the confines of the "sham" transaction principles. Instead, the step transaction doctrine is applied where the written documentation accurately reflects the legal rights and liabilities of the signatories thereto, but those legal rights do not fully reflect the underlying economic realities or the expectations of the parties.

The substantial difference which can exist between legal rights and economic expectations, and the occasional relative insignificance of legal rights when compared to the underlying economics, is apparent in situations such as that described above. If, after receiving an offer from Publicly Held, *T* transfers her business to Newco in exchange for all of the Newco stock in contemplation of Newco's transfer of those same assets to Publicly Held, the transfer of those assets to Newco in

96. I.R.C. § 1001 (1982).

97. I.R.C. § 351(a) (1982).

98. Both to *T*, under I.R.C. § 354 (1982 & Supp. IV 1986), and to Newco, under I.R.C. § 361 (1982 & Supp. IV 1986).

99. I.R.C. § 368(a)(1)(C) (1982) (The term reorganization means "the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of substantially all of the properties of another corporation.").

100. *E.g.*, *West Coast Mktg. Corp. v. Commissioner*, 46 T.C. 32 (1966) (same facts as in text); *Rev. Rul. 70-140*, 1970-1 C.B. 73.

101. *I.e.*, because there is a legally binding verbal agreement that supersedes the written documentation.

exchange for Newco stock clearly has independent legal significance.¹⁰² There was a legal obligation on the part of *T* to transfer assets, in consideration of which there was a corresponding obligation on the part of Newco to transfer stock. The obligations were legally interdependent on each other and independent of any other rights or obligations of either party. The problem is that where there is an identity of interest between *T* and Newco, the very concept of legally binding commitments seems irrelevant — if legal commitments exist they can be mutually abrogated; and if they do not, *T* can still just as easily see that her goals are accomplished.¹⁰³

While the problem caused by focusing on legal commitments is most *obvious* in situations where there is an identity of interests between the parties, it is by no means limited to such situations. It is not within the province of the tax laws to enforce legal agreements made among taxpayers, but only to use those agreements to evaluate the relationships and exchanges of the taxpayers *inter se*. Thus, it is arguable that legal relationships ought to have significance within the tax system only to the extent that they describe relationships or exchanges more accurately than do nonlegal descriptions.

To say that an exchange of assets for stock has independent legal consequences is to say nothing more than that if one party fails to perform its contractual obligations, the aggrieved party may seek redress in a court of law (or, perhaps, equity) upon proof of the existence and breach of the legally binding agreement. Essentially, legal rights merely give one party the ability to incur some expenses (*i.e.*, legal fees and court costs) in order either to compel the other party to act in accordance with the agreement (in those few situations where injunctive relief might be available), or to punish the other party (and reap some financial reward for itself) for failing to act accordingly.

Without demeaning the judicial system, it must be acknowledged that in many situations the free marketplace provides the economically powerful and astute actor with the same kinds of ability to provoke or to prevent actions of others. Especially within the context of ongoing economic (and, often, social) relationships, one party can enforce its will by the threat of cutting off or somehow altering a relationship that has previously proved mutually productive. While such enforcement may involve costs to the enforcing party, such as requiring it to seek

102. This statement assumes that at the time of the incorporation *T* is not *legally obligated* to see to it that the assets are transferred, directly or indirectly, to Publicly Held.

103. It may be that, for certain purposes, fiduciary obligations of directors, and, in some cases, controlling shareholders, could be invoked to support an argument that there is less than full identity of economic interest between a corporation and its sole shareholder. To the extent that there is a divergence in interest, it is negligible.

another outlet or source of supply for goods, these costs are not necessarily always greater than the costs involved in prosecuting a legal action; and in many situations the actual cost of producing behavioral changes by way of economic, rather than judicial, force is nothing more than that involved in merely *threatening* to take, rather than taking, any action. To the extent that the tax system is attempting to measure the relatedness and interdependence of purportedly separate exchanges, the economic power of one party over another would appear no less significant than potential resort to judicial enforcement.

If reliance on *legal* relationships is not a prerequisite to accurate measurement of actual economic relationships, the question then becomes by what means *can* the interrelationship of purportedly separate exchanges be determined? Because the step transaction doctrine is neither a method of statutory interpretation nor a nonstatutory requirement of certain Code provisions, but merely a means of determining the *facts* to which the Code should be applied, it would seem that the method arrived at for determining those facts ought to be of general applicability and should not be subject to variation dependent on the law to be applied to those facts.

The courts have generally set forth three different tests for determining whether several exchanges should be treated as a single transaction: (1) the binding commitment test; (2) the end result, or intention test; and (3) the interdependence test.¹⁰⁴ Each term is basically self-descriptive. Under the binding commitment test, different actions by a taxpayer are not treated as a single transaction on his part unless at the time he takes the first step he is under a binding commitment to proceed with the next step.¹⁰⁵ The end result, or intention test, links actions together if they are "component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."¹⁰⁶ Finally, the interdependence test will unify actions for tax purposes if the steps "are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."¹⁰⁷ As will be seen, each of these three tests will often lead to the intuitively correct result. But, because none of these tests has a valid conceptual foundation, none of them

104. See generally Paul & Zimet, *Step Transactions*, in SELECTED STUDIES IN FEDERAL TAXATION 200 (1938); Mintz & Plumb, *supra* note 56; Note, *Evolution of the Step Transaction Doctrine*, 11 WASHBURN L.J. 84 (1971); Note, *Step Transactions*, *supra* note 56.

105. Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

106. King Enters., Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

107. Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981).

will *always* do so.¹⁰⁸

The first of these tests, which joins actions if they are taken pursuant to a binding commitment, is the most straightforward and the least followed. The Supreme Court first applied the test in *Commissioner v. Gordon*.¹⁰⁹ There, a corporation distributed to its shareholders in 1961 about 57% of the stock of a wholly owned subsidiary. At the time, the corporation notified its shareholders that it expected to distribute the remainder of the subsidiary stock within about three years. The remaining 43% of the subsidiary stock was distributed about two years later, in 1963. The taxpayer claimed that receipt of his share of the initial distribution in 1961 was tax-free because that distribution was merely one of a series of steps which, taken together, qualified as a nontaxable distribution pursuant to section 355, which grants tax-free status to certain distributions of the stock of a subsidiary if the amount of stock distributed exceeds 80% of all outstanding shares of the subsidiary.¹¹⁰

If the 1961 and 1963 distributions had been treated as a single transaction, that transaction would have qualified for nonrecognition. The Court held that the step transaction doctrine did not apply, however, and that instead there was a taxable distribution in 1961 and a second, separate, taxable distribution in 1963. In so holding, the Court expressed concern that if it held otherwise, the Internal Revenue Service and the courts could have been required to wait for an indefinite period to determine the tax consequences arising out of the 1961 distribution. It refused to apply the step transaction doctrine when to do so would mean that "the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen."¹¹¹ The Court concluded that "[t]his requirement that the character of a transaction be determinable does not mean that the entire divestiture must necessarily occur within a single tax year. It does, however, mean that if one transaction is to be characterized as a 'first step' there must be a binding commitment

108. One commentator has suggested that all three of these tests can be integrated into a single test of "purposive analysis," requiring each court to "first, characterize the parties' intent . . . second, construe the purpose of the relevant Code provision[s]; and third, determine whether the parties' intent is consistent with the purpose of the statute." Comment, Redding v. Commissioner: *Step Transaction Doctrine Applied to Distribution of Stock Warrants in a Section 355 Spin-Off*, 35 TAX LAW. 257, 267 (1981). This "test" more than anything else appears to focus on statutory interpretation: Are the parties acting in the way Congress wanted?

109. 391 U.S. 83 (1968).

110. I.R.C. § 355(a)(1)(D) (1982).

111. 391 U.S. at 96.

to take the later steps.”¹¹²

Essentially, because tax must be determined and imposed each year, the Internal Revenue Service and courts must be able to judge the “substance” of a transaction at the time it occurs. Similarly, because taxation depends on the occurrence of classifiable and discrete events, the “substance” of an event or exchange must exist at the time the event occurs. The problem raised in *Gordon* was that neither the Internal Revenue Service nor the trial court was able to know, in the year of the first distribution, the “real” relationship between that distribution and a subsequent transaction.

The problem caused by uncertainty regarding the relationship among several events in a system dependent upon characterizing transactions *based* on the interrelatedness of those events is not new. Including the approach taken in *Gordon*, the Internal Revenue Service and the courts have traveled along at least three different avenues in addressing it: (1) if we are uncertain of the facts, take our best guess; if we are subsequently proven wrong, take steps in that subsequent year to redress that previous wrong;¹¹³ (2) if we are unsure of the facts at the actual time of the transaction, wait till the facts become clear before characterizing the transaction;¹¹⁴ and (3) if we are unsure of the

112. 391 U.S. at 96.

113. This approach has its foundation in the Court's opinion in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). There, a taxpayer had lost money under a particular contract during four consecutive years, and in the fifth year sued under the contract and recovered his prior losses. In holding the recovered damages to be taxable income when received, the Court explained that transactions must be taxed in the year in which they occur, rather than on completion of an entire business relationship:

It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required . . . to adopt such a system

282 U.S. at 365.

The principle that transactions must be determined as accurately as possible each year and that subsequent events are to be accounted for when they occur is also at the heart of the tax benefit rule, which specifically allows for such later accounting. *See, e.g., Hillsboro-National Bank v. Commissioner*, 460 U.S. 370 (1983). The tax benefit rule applies to deductions later proven to have been based on erroneous propositions. A similar rule acts to “undo” income which is properly reported when received and later required to be returned by the taxpayer. *See United States v. Lewis*, 340 U.S. 590 (1951); *see also I.R.C. § 1341* (1982). For an in-depth analysis of other ways to undo or change transactions to conform to subsequent events, see Banoff, *Unwinding or Rescinding Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942 (1984).

114. This was the case with respect to the “open transaction” method of reporting gain on installment sales. Where in exchange for property, the taxpayer was to receive a series of payments of uncertain amount or length, the taxpayer was, in certain situations, allowed to recover his basis in the exchanged asset prior to reporting any of the amount realized as gain. *See Burnet v. Logan*, 283 U.S. 404 (1931); *but see Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975) (open transaction reporting no longer available after amendments to I.R.C. § 453 absent indication that payments to be received have no currently ascertainable fair market value).

facts, rule against the taxpayer. This last approach is the one chosen in *Gordon*.

The *Gordon* Court's concern with establishing the taxability of an event in the year it occurs rather than waiting to see what happens in subsequent years is warranted. Unfortunately, however, this concern is fundamentally different from the previously enunciated concerns which have given rise to the step transaction doctrine; and the result in *Gordon* is necessarily of limited applicability.

Whatever else can be said for or against the particular approach to the problems of unknown future events which was adopted in *Gordon*, it is clear that the Court was describing a way to deal with cases where the facts could not be known at the time of the supposed "transaction." Whether the rule which it adopted gains in administrative convenience what it may sacrifice in fairness or accuracy is not as significant as the fact that the rule adopted *was* one of administrative and judicial convenience. Rather than propose a method for determining what the "facts" *were*, the Court explained that where the facts could *not* be known they should be held against the taxpayer. While the Court and scholars have looked at the opinion as a test for application of the step transaction doctrine, to the extent that the doctrine represents a way of determining *what* the significant facts were, rather than a way of determining what to do when the significant facts are unknown, the "binding commitment" test is simply not relevant.

Indeed, although often failing to explain their grounds for doing so, courts, commentators, and the Internal Revenue Service have generally rejected the use of the binding commitment test. While courts and commentators often list it as an alternative formulation for application of the step transaction doctrine,¹¹⁵ after such listing they generally proceed to explain either that it does not apply to the case at hand,¹¹⁶ that it is only one "factor to consider,"¹¹⁷ that it applies only to the specific facts of *Gordon*,¹¹⁸ or that it applies only when the taxpayer rather than the Internal Revenue Service is attempting to integrate several steps into a single transaction. In any event, few if any individuals subscribe to the binding commitment test as worthy of

115. *E.g.*, *McDonald's Restaurants v. Commissioner*, 688 F.2d 520, 530 (7th Cir. 1982). *But see* McMahon, *Defining the "Acquisition" in B Reorganizations Through the Step Transaction Doctrine*, 67 IOWA L. REV. 31, 68 (1981) (excluding binding commitment test as even an alternative test).

116. *See McDonald's Restaurants*, 688 F.2d at 531.

117. *Redding v. Commissioner*, 630 F.2d 1169, 1178 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981).

118. *See McMahon, supra* note 115, at 70-80.

general application.¹¹⁹

A more commonly applied test for implementation of the step transaction doctrine is the “end result” or “intention” test, pursuant to which legally independent actions will be linked together if they are parts of a single scheme or plan taken for the purpose of reaching a given end result. As applied to the taxpayer discussed above, who incorporates assets in order to exchange them indirectly, and tax free, for stock of Publicly Held Company, this test would treat the legally separate exchanges as a single transaction — an exchange of assets for Publicly Held stock — because the exchanges were part of a preconceived plan to reach that result.¹²⁰

A problem with this test is that while it provides a ready means to support an allegation that two legally independent exchanges are actually parts of a single, integrated transaction, it provides almost no basis whatsoever to support an allegation that two actions are ever separate. If all that is required to join two separate exchanges together is that at the time the first is engaged in, the taxpayer also intends to engage in the second, this test could treat as a “transaction” every single exchange intended by a taxpayer at the time he engages in any other, seemingly unrelated, exchange. For example, imagine that *A* forms a corporation in 1987. At the time, *A* intends to make the corporation successful and to have it go public in 1990. *A* also intends to purchase Treasury bonds in 1988 and to sell short some stock in an unrelated enterprise in 1987. All of these purchases and sales are planned to maximize *A*’s profit potential and to minimize his risk; yet to suggest that these events are a single “transaction” would be absurd.

One could suggest that all of the above exchanges, though planned and intended simultaneously,¹²¹ are not part of a plan to reach a *single* intended result and thus should not be integrated under the end result test (*i.e.*, because each exchange has its own independently anticipated economic result). To suggest this, however, is to do no more than to suggest that there is some *other* means to determine when a taxpayer’s plans and intentions are separate and when they are part of a single plan. If there is a means to make that determination, then that means, rather than the taxpayer’s intention or plan, must be the appropriate test for application of the step transaction doctrine. No such test has

119. But see Note, *Step Transactions in “A” Reorganizations: A Proposal for a Binding Commitment Test*, 56 VA. L. REV. 255 (1970).

120. See *King Enters., Inc. v. United States*, 418 F.2d 511, 517 (Ct. Cl. 1969).

121. This means that the taxpayer’s intentions exist simultaneously, not that the taxpayer intends to perform all the actions at the same time.

been proposed.¹²²

122. One author has suggested that focusing on the plans of any single taxpayer is inappropriate and that this intention test necessarily rests on the establishment of some sort of *mutuality* of intention — that is, that the transferor and the transferee jointly intend to perform a given series of exchanges. McMahon, *supra* note 115, at 70-80. The question of mutuality of intent and of the requirement of transactionally consistent remedies is also discussed in Faber, *The Use and Misuse of the Plan of Reorganization Concept*, 38 TAX L. REV. 515, 528-30 (1983).

A requirement of mutuality of intention would solve the problem suggested immediately above — that all of a taxpayer's intended actions over the entire course of life could be treated as a single transaction; but it would also result in treating as *separate* the few kinds of exchanges which both the courts and the Internal Revenue Service, as well as scholars, have long unanimously agreed upon as examples of when the step transaction doctrine should be applied to join exchanges together. For example, in cases typified by *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), and Rev. Rul. 75-447, 1975-2 C.B. 113, a shareholder has some of his shares of stock redeemed by the corporation, and shortly thereafter, as part of the same plan, sells his remaining shares. It is universally acknowledged that the redemption and subsequent sale will be treated as a single transaction resulting in the complete termination of the shareholder's interest in the corporation, and the excess of the taxpayer's amount realized over his stock basis will be treated as capital gain. See generally B. BITTKER & J. EUSTICE, *supra* note 34, ¶ 9.25. Nonetheless, especially where the corporation's stock is publicly traded, the redeemed shareholder will likely be unable to establish any kind of *mutual* intention, in that he will not be able to point to any person who (at the time of the prior redemption) had an intention to purchase his remaining shares subsequently. See also *McWilliams v. Commissioner*, 331 U.S. 694 (1947) (Court treated as a single transaction husband's brokered sale of publicly traded stock and wife's immediate purchase, through a different broker, of an equal number of shares of the same stock; neither husband's purchaser nor wife's seller had plans to participate in exchange with either spouse, so that mutuality of intention was at least implicitly found to be irrelevant).

Without explaining exactly what they are doing, some other cases and rulings point to the idea that it is not "mutuality" of intention but the likelihood that the taxpayer will be able to carry out her plan that is the necessary adjunct of intention. Such a requirement would consistently account for the results in the above situations: where a taxpayer is assured of being able to carry out a planned purchase or sale because the asset sought is publicly traded, mutual intent is unnecessary; but where such mutual intent is necessary to allow the taxpayer to carry out her plans (because those plans require the cooperation of a specific third party), it is a prerequisite to integration of otherwise legally independent exchanges. See, e.g., Rev. Rul. 78-197, 1978-1 C.B. 83; *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd.*, 523 F.2d 1308 (8th Cir. 1975).

Such a "likelihood of success" test in conjunction with intent might also explain other kinds of seemingly inconsistent results arising from application of a pure intent test. There are several fact patterns, aside from *McWilliams*, in which a taxpayer transfers (by sale or exchange) a specific asset with the intention of reacquiring that asset, and shortly thereafter does reacquire the asset. Even in those cases in which the taxpayer has an ongoing relationship with the purchaser (and subsequent reseller) of the asset, the results differ. Sometimes the sale and repurchase are treated as an integrated transaction, and sometimes they are separated. Compare *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (sale and repurchase integrated), and *Davant v. Commissioner*, 366 F.2d 874 (5th Cir.), *cert. denied*, 386 U.S. 1022 (1966) (same), with Rev. Rul. 72-354, 1972-2 C.B. 276 (sale and repurchase of stock in a stock-for-stock exchange not integrated — acquisition qualifies as valid reorganization under § 368(a)(1)(B)). For a discussion of *Reef* and *Davant* see *infra* notes 185, 189. The facts of *Reef* and *Davant* are strikingly similar to those in the ruling; but an overview of the facts would reveal that, whatever the legal commitments, the taxpayer in the ruling was, on the whole, somewhat less likely to be able to accomplish his aim than were the taxpayers in either *Reef* or *Davant*, and perhaps the taxpayer's ability (or lack of ability) to accomplish his goal can account for the different results in the two cases.

Unfortunately, while a step transaction test combining intent and likelihood can cure some of the inconsistencies arising from application of a pure intent test, the combination has its own shortcomings. Even such a modified intent test would result in occasional integration of admittedly separate transactions and occasional separation of admittedly integrated ones. Inappropriate integration of independent exchanges would arise when a person was dealing with a controlled corporation. For example, if *T* formed a company with the intention of having it

A test which has become more popular than either binding commitment or intent is the "interdependent" test. This test essentially converts the business purpose doctrine¹²³ into a test for application of the step transaction doctrine.¹²⁴ Elsewhere described as asking whether "the initial steps would be fruitless in the context of the [taxpayer's] particular purpose without completing the plan,"¹²⁵ this test incorporates the business purpose doctrine by segregating actions where each step was motivated by a business purpose existing independent of the other contemplated steps, and integrating steps where several "unnecessary" steps were taken only in contemplation of the others and without any independent business purpose.¹²⁶

operate and pay a \$1,000 dividend every year, *T* could assure herself of receipt of that dividend beginning in year one. Nonetheless, the company's payment of the dividend would not, without more, be treated as a part of the incorporation transaction. The problem here is that the intent test generally provides a means to integrate rather than to differentiate transactions. Use of a "likelihood" test as a supplement to intent allows one to separate out *some* exchanges, but the implication that all exchanges planned or intended by a taxpayer are a single exchange as long as they are all likely to happen is still overbroad.

On the other hand, the Treasury Regulations themselves at times integrate different planned exchanges even *absent* any indication at the occurrence of the first exchange that the subsequent exchanges are likely to occur. See Treas. Reg. § 1.368-2(c) (as amended in 1985) (integrates transactions to find a type "B" reorganization, absent any certainty or likelihood that the planned transactions will occur; the mere existence of an open offer, or attempt, on the part of the taxpayer will be enough to unify the exchanges if that attempt simply proves in the end to be successful).

123. See *supra* Part II.B.1.

124. Under the test as initially proposed by professors Paul and Zimet, a series of actions or exchanges is treated as a single transaction if each part of the transaction is undertaken only as part of a "general prearranged plan or program." Paul & Zimet, *supra* note 104, at 245. While this statement appears to connote a sort of contractual interdependence — that steps are integrated only where they are legally interdependent — it is not meant to do so. Instead, "[t]he question . . . is whether the nominally separate steps of the series are mutually interdependent in the sense that while each such separate step might in another context stand independently on its own feet and be an integrated transaction, it has no substantial effect upon the rest of the series, and all the steps are component parts of another different transaction constituting a whole of which each step in question is a part." *Id.* at 245.

125. Hobbet, *The Step Transaction Doctrine and Its Effect on Corporate Transactions*, 19 TUL. TAX INST. 102, 111 (1970) (emphasis omitted).

126. The use of a business purpose test for application of the step transaction doctrine has found its way into many different areas. In *Knetsch v. United States*, 364 U.S. 361 (1960), the taxpayer borrowed funds from an insurance company, used those same funds to purchase a deferred annuity contract from that company, and pledged the annuity as security for the loan, which was otherwise nonrecourse. Each year as the annuity increased in value, Knetsch borrowed from the issuer against that increased value and used the borrowed funds to pay interest on the original loan. The tax result was a substantial current deduction for interest paid, which would be offset by income when the annuity was sold or forfeited in payment of the debt. Knetsch was out-of-pocket about \$15,000, but because of current ordinary deductions and income which was both deferred and taxed at low capital gains rates, the tax savings more than made up that cost.

The Court treated the loans and the annuity purchase as a single transaction and held that the "substance" of that transaction was different from the form in which it had been cast. While the Court did not acknowledge that it was applying the step transaction doctrine, its decision clearly implies that the taxpayer's lack of an independent business purpose provided a basis for refusing to segregate the borrowings and the annuity purchase. Only by viewing these actions as

Essentially, this test views certain transactions as having at least two effects: (1) changing the taxpayer's legal rights and liabilities; and (2) changing the taxpayer's tax status. When the purpose of the exchange is only to affect the taxpayer's tax status, and the economic effects are undone or redone by way of another contemplated exchange, the steps will be integrated.

This interdependence test has been popular in large part because it can be used to integrate transactions in the absence of a binding commitment but, unlike the intent test, it provides a basis for *segregation* of intuitively separate actions as well as for integration of intuitively connected ones. Applying the test to some of the cases discussed earlier reveals results in line with those reached by courts and the Internal Revenue Service. Indeed, in *Gregory* the Court apparently did no more than apply the step transaction doctrine to integrate the formation of, a distribution by, and subsequent liquidation of, a corporation because none of the transactions had an independent business purpose. The act of incorporation was engaged in only as a prelude to the corporation's own undoing by way of liquidation; and, as a result, the actions, being self-cancelling, were ignored.

In another application of the test, if a taxpayer incorporates assets in order to operate a business as a corporation, whether or not operation as a corporation is chosen because of its tax benefits, that incorporation is recognized as a separate transaction for tax purposes because it has a lasting impact on the taxpayer's legal rights. On the other hand, if the taxpayer incorporates assets solely for the purpose of being able to transfer those assets to some other company in a tax-free reorganization, the incorporation, having no independent business purpose and no lasting effect on the taxpayer's legal rights, is not

a unified transaction could the Court justify its holding that legally binding loans and purchases were other than what they appeared to be.

Implicit use of the business purpose, or interdependent, test for application of the step transaction doctrine also arises in cases involving sales and leasebacks. Assume that *A* owns property, sells it to *B*, and leases the property back from *B* under a net lease for a substantial period of time (with or without a purchase option). If the steps are treated as separate, the tax consequences are clear: there is a sale by *A* to *B* and a lease from *B* to *A*. If the steps are integrated, the substance of the transaction becomes somewhat less clear: (1) the transaction may still be characterized as a sale followed by a lease; (2) it may be treated as a sale by *A* of a future interest only; or (3) if *A* has a purchase option, the transaction may most closely resemble a mere financing arrangement with *A*'s property simply serving to secure a loan from *B*. See generally Joyce & Del Cotto, *The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests*, 31 TAX L. REV. 121 (1976). While the characterization of an integrated exchange is a question of substance versus form, see *infra* Part II.B.3, the fact of integration is prerequisite even to asking the question of substance versus form. Thus, while courts seem to be somewhat fuzzy in explaining their approach, it *must* result from application of the step transaction doctrine to the purportedly separate sale and lease.

treated as separate and the incorporation and purported reorganization will be taxed as a single unified exchange.

This interdependence test, unlike the other tests for application of the step transaction doctrine, even has a degree of internal consistency and reasonableness: If an action viewed independently achieves some purpose, be it a change in economic circumstances or even a tax savings, that action is independently motivated and ought to be independently taxed. If an action, when viewed independently, serves no taxpayer purpose, either that action will not be taken at all, or, if taken, it must not be independent.

Application of this test to nonrecognition exchanges is fairly straightforward. Most exchanges, and almost all nonrecognition transactions, generate no tax savings.¹²⁷ A nonrecognition exchange merely results in no current taxation of accrued appreciation in the exchanged assets, a result identical to that imposed upon simple retention of the asset. As a result, the tax savings generated by a single nonrecognition transaction could never entirely motivate that transaction. The taxpayer must either have some business purpose (*i.e.*, the desire to exchange assets), some other tax goal which will be accomplished by the nonrecognition exchange,¹²⁸ or some tax purpose which can be accomplished only by combining the first nonrecognition exchange with a second exchange. In the last case, the two (or more) exchanges necessary to achieve the single tax purpose will be integrated and treated as a single transaction.

Despite the frequent utility of the interdependent test, its fundamental flaw was first noticed by its greatest proponent even at the time that the test was initially suggested: "It will not do for all the cases."¹²⁹ Instead, there are a great many cases in which this test will not "do" at all; and the problem with the test is not lessened by the fact that its failures are balanced: Sometimes exchanges can be *unified* despite the *existence* of separate business purposes, and other times they can be *separated* despite the *lack* of such independent purposes.

There are numerous examples of unified characterization of multiple exchanges having independent purposes. The shareholder who has some of her stock redeemed and plans to and does shortly thereafter sell the remaining shares will be entitled to treat the two exchanges as

127. See *supra* text accompanying notes 31-32.

128. For example, the taxpayer in a 33% marginal tax bracket might incorporate assets in order to take advantage of lower corporate rates on the first \$50,000 of the corporation's taxable income (assuming the corporation would not be a personal service corporation, see I.R.C. § 11(b)(2) (1982)).

129. Paul & Zimet, *supra* note 104, at 252.

a single transaction resulting in a complete termination of her stock interest (and therefore taxable at capital gains rates).¹³⁰ Neither cases nor rulings imply that this tax benefit could be denied if it could be established that the taxpayer would have redeemed the shares even absent a later sale of the remaining stock. As long as that subsequent sale is part of a unified "plan," the benefits of integration of the planned exchanges are available.

Similarly, the corporation that acquires stock of another corporation solely in exchange for its voting stock over a relatively short time, such as twelve months, will be entitled to treat all of the stock so acquired as obtained in a single transaction for purposes of qualifying the series of exchanges as a tax-free reorganization.¹³¹ Evidence that the acquiring company would have made the initial stock acquisitions even absent the later acquisitions would show that the series of exchanges were not mutually interdependent. It would not, however, cause those exchanges to be separated for tax purposes.

On the other hand are cases in which different exchanges would not have been made but for the taxpayer's expectation of undoing them, but which are nonetheless treated as separate, despite their interdependency and lack of separate business purpose. The corporation that sells stock with the hope of reacquiring that same stock in a subsequent reorganization may be entitled to treat the sale and reacquisition as separate exchanges even if the sale is made for no purpose other than to allow the reacquisition to qualify as a tax-free exchange.¹³² And indeed it appears that the taxpayer who sells stock at a loss only in order to be able to deduct that loss and only because he will "undo" the sale by a later repurchase of the same stock is entitled to treat the sale and repurchase as separate despite the lack of any independent motive, so long as he waits long enough before making the repurchase.¹³³ Similar separation of interdependent exchanges is allowed for taxpayers who sell (or purchase) stock in a liquidating corporation solely for the purpose of reducing (or increasing) their stockholdings prior to liquidation and solely in order to qualify for favorable treatment on that liquidation.¹³⁴ In all of these cases, mutual interdepen-

130. See B. BITTKER & J. EUSTICE, *supra* note 34, ¶ 9.06; *infra* notes 218-19.

131. Treas. Reg. § 1.368-2(c) (as amended in 1962).

132. Cf. *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980).

133. See I.R.C. § 1091(a) (1982) (disallowing the loss on the first such sale if the repurchase is made within 30 days before or after the sale).

134. See, e.g., *George L. Riggs, Inc. v. Commissioner*, 64 T.C. 474 (1975), *acq.* 1976-2 C.B. 2 (minority shareholder sold to majority shareholder in order to allow majority shareholder to reach 80% ownership and qualify for tax-free liquidation under § 332); Rev. Rul. 75-521, 1975-2 C.B. 120 (same).

dence of the series of exchanges seems to give way to the fact that the taxpayer is taking a "risk" which justifies separation of the exchanges.¹³⁵

Indeed, it should not be surprising that the business purpose, or interdependence, test does not provide a satisfactory measuring rod for determining the "true" facts of a series of exchanges. The very enunciation of the test is enough to reveal that its focus lies not on determining "what" happened, but on determining "why" it happened — what was the taxpayer's motive for entering into a given exchange? While an examination of motive may have relevance for purposes of determining how a taxpayer should be treated, it provides no more than an explanation of *why* she did what was done, and cannot logically be a tool for determining *what* it was that was done.

b. Summary of the step transaction tests. None of the three tests which are generally used to determine what exchanges ought to be treated as unified are capable of doing so: one test is nothing more than an allocation of burden of proof; the second is incapable of ever separating any concurrently contemplated transactions, no matter how separate legally or functionally; and the third examines the taxpayer's *purpose* for doing what he did rather than explaining what it *was* that was done.

The result is compromise: sometimes courts use the binding commitment test; sometimes they use versions of the intent test; and sometimes they use the interdependent/business purpose test. While reasoned compromise is certainly worthwhile, there is at least some question regarding the reasoning behind this compromise. Acceptable grounds for choosing different tests at different times might include: (1) different courts take different approaches; (2) different statutes suggest different levels of necessary integration; or (3) different relationships require various tests to determine objective facts. Unfortunately, none of these possible bases for differentiating among the different tests offers an adequate explanation of what has been done.

First of all, the existence of three different tests for application of the step transaction doctrine is clearly not the result of mere disagreement among different courts as to which of the tests represents the single proper standard. The Supreme Court has led the way by using all three of the tests without ever explicitly overruling one or the other; instead, the Court's opinions reflect the unspoken assumption

135. For further discussion of the concept of "risk" as it relates to step transactions, see Rosenberg, *The Step Transaction Doctrine in Corporate Tax*, 1986 N.Y.U. INST. ON CORP. TAX PLAN. 280, 290-91.

that sometimes one standard is appropriate and at other times another standard "works" better.¹³⁶ This pattern of choosing a different test for different cases seems to be generally followed by the Internal Revenue Service as well as lower courts.

Professor Bittker has suggested that different tests may be appropriate where different statutory provisions apply.¹³⁷ However, Professor Bittker himself points out that "if the courts have been significantly influenced by considerations of this type, they have not explicitly said so."¹³⁸ Indeed, one would be hard pressed to find even an implicit acknowledgment that different statutory provisions require different standards for integration. In interpreting a single Code section (the reorganization provisions¹³⁹) the courts and Internal Revenue Service have at times used each of the three different tests: in determining whether a series of acquisitions is a single "B" reorganization, the intent test is generally applied;¹⁴⁰ at other times, determination of whether a purportedly separate "B" reorganization should be so treated has seemed to warrant application of the interdependent/business purpose test;¹⁴¹ and at still other times, determining whether a "B" reorganization has occurred has apparently mandated application of the binding commitment test.¹⁴² The Supreme Court has at times applied the binding commitment test and the interdependent/business purpose test to the same kind of reorganization.¹⁴³ Indeed, it has been suggested that two different tests can be applied at the same time to a single transaction!¹⁴⁴

Nor do the courts choose a specific test based upon the relationship

136. In *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968), the Court enunciated the "binding commitment" test. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the same court applied the "business purpose" test. In *McWilliams v. Commissioner*, 331 U.S. 694, 697-702 (1947), the Court appeared to apply the "intent" test. In none of the cases did the Court feel a need to differentiate the case before it from the other situations. The Internal Revenue Service agreed with the Court in all three cases and continues to use the three different tests without explaining its choices.

137. B. BITTKER, *supra* note 48, ¶ 4.3.5.

138. *Id.* at ¶ 4.3.5, at 4-50.

139. I.R.C. § 368 (1982).

140. Treas. Reg. § 1.368-2(c) (as amended in 1986).

141. See *Weikel v. Commissioner*, 51 T.C.M. (CCH) 432 (1986); *West Coast Mktg. v. Commissioner*, 46 T.C. 32 (1966) (§ 351 transfer followed by purported "B" reorganization held taxable because there was no independent business purpose for incorporation).

142. Rev. Rul. 72-354, 1972-2 C.B. 216 (sale of target stock followed by reacquisition as part of "B" reorganization separate transactions because purchaser not under binding commitment to retransfer).

143. *Commissioner v. Gordon*, 391 U.S. 83, and *Gregory v. Helvering*, 293 U.S. 465, both involved tax-free "spin-offs," now described in I.R.C. § 355 (1982).

144. Note, *Step Transactions in "A" Reorganizations: A Proposal for a Binding Commitment Test*, *supra* note 119, at 265 (current case law seems to suggest that for purposes of determining whether purportedly separate exchanges, one of which is a tax-free reorganization under

of the parties involved. *Gregory* applied the business purpose test to related parties; *Gordon* applied the binding commitment test to related parties; and in other situations the intent test has been applied to related parties.¹⁴⁵ In sum, the step transaction doctrine simply provides no consistent method for determining the "facts" of a specific exchange.

A closer look at what the doctrine purports to do reveals why *no* test can serve its purpose. The transaction-based nature of the tax system requires correlating each receipt with one or more specific payments. Only when each payment is linked to a particular receipt and each receipt to a particular payment can the two (or more) events be treated as an "exchange," which can then be characterized as a particular type of "transaction," depending on other circumstances surrounding the exchange. If "what was done" means something other than a determination of the purely legal rights and liabilities that existed, it would appear that it must mean "what was exchanged for what?" Unfortunately, as suggested earlier,¹⁴⁶ that question is one which simply cannot be answered.

But the fact that the kind of reciprocal causation which the step transaction doctrine seeks to identify often does not exist is only one of the problems with application of the doctrine. Even where such reciprocal causation *does* exist, the doctrine attempts to go further and to provide a means for determining when reciprocal exchanges should be separated and when they should be treated as part of some still *larger* reciprocal "exchange." For example, assume that *A* transfers her business assets to Newco in exchange for all of the Newco stock, and that *A* does so for the purpose (and with the intention) of transferring the Newco stock to Publicly Held in exchange for Publicly Held stock in a tax-free "B" reorganization.¹⁴⁷ One might suggest that there are two reciprocal exchanges: assets for Newco stock, and Newco stock for Publicly Held stock. Using the tests applied by the courts, the facts of these exchanges may be proved by each party's purpose, intentions or binding legal commitments: *A*'s purpose in transferring the assets was to receive the Newco stock, which *A* wanted so that she could trade with Publicly Held; Newco's purpose, intention, and legal commitment in transferring its stock to *A* was to receive *A*'s assets. *A*'s pur-

§ 368(a)(1)(A), should be integrated, one step transaction test applies for determining the question of "control" and a different test applies to the question of continuity of interest).

145. For example, in Rev. Rul. 85-139, 1985-2 C.B. 123, acquisitions by a parent and its subsidiary were integrated because of their combined intent. See also Rev. Rul. 85-138, 1985-2 C.B. 122.

146. See *supra* Part I.B.1.

147. I.R.C. § 368(a)(1)(B) (1982).

pose, intention, and obligation in transferring the Newco stock is to receive Publicly Held stock; and Publicly Held acts to receive *A*'s Newco stock. Each party in turn makes its transfer for the purpose of receiving the property it gets; and mutually interdependent purposes, expectations, and obligations establish reciprocal causation.

Unfortunately, the step transaction doctrine is *not* used to establish exchanges such as the ones above, but instead provides a rationale for explaining that in "reality" those two exchanges did *not* occur — that there was only a single exchange in which *A* transferred assets to Newco and Publicly Held transferred stock to *A*. The result is that when the traditional step transaction tests of intent and purpose do have a legitimate role in determining reciprocal causation, the exchanges which they describe are *not* the exchanges found by the courts.

The problem is that there are innumerable levels of reciprocal effect: *A*'s action can affect *B*, whose resultant action can affect *C*, whose action can affect *D*, whose action can in turn affect *C*, *B*, and eventually *A*. That one might choose to describe each relationship as independent or all as parts of a whole "transaction" seems clear. It may be that the further away the two ends of the defined transaction, the less primary are the reciprocal causes, but the difference in primacy of causation is only one of degree; and the relationship between *A* and *D* will in some cases be stronger than the relationship between *A* and *B* in others.

If one chooses to look beyond each individual "exchange," the more appropriate issue is the basis for doing so. Taxpayer intention or purpose may serve to establish a connection between *A* and *D*, but it does not establish a basis for determining when *that* connection should be more significant than the connection between *A* and *B*. Perhaps the *degree* of reciprocal effect between actions might establish a basis for determining when to integrate those purportedly separate actions, but no test for determining the degree of reciprocal effect has ever been suggested. In any event, it is difficult to imagine *any* situation where the reciprocal effect between more distant actions could be stronger than that between the direct "intermediary" exchanges; but at the same time it is easy to imagine *several* transactions where the degree of reciprocal causation in even a *single* direct exchange is minimal.¹⁴⁸

Another problem with the doctrine and the way it has been applied is that to the extent that the traditional tests of intent or purpose are relevant, they are relevant because they tend to establish reciprocal

148. See *supra* text accompanying note 122.

causation. However, when intent or purpose is referred to in application of the doctrine, it is *not* reciprocal causation, but the intention or purpose of a single party that seems to carry the day. How a single party's intent or purpose could establish a reciprocal "exchange" beyond the legal one reported by the parties is unclear.

Given the impossibility of any consistent standard for application of the step transaction doctrine, it would appear that while the doctrine may serve some purpose, that purpose is something other than determining "what was exchanged for what." Use of three different standards, each to be applied where "appropriate," has the same effect as would administration of any other single test with a series of standards which can be applied by the test administrator as he sees fit. It allows the test administrator to discriminate among the test-takers by using some other, unexpressed, subjective criteria. For example, assume that *A*, *B*, and *C* each take a test, and *A* gets a grade of 60, *B* gets a grade of 70, and *C* gets an 80. Further assume that a passing grade is sometimes a 50%, sometimes 75%, and sometimes 90%, depending on which standard the administrator applies. To suggest that whether or not one of the takers passes the test is a determination of the "facts" with respect to that person, rather than a determination of whether the administrator made a predetermination of whether that person should pass, and then chose to apply the standard which brought about the desired result, is simply naive. Similarly, to suggest that the step transaction doctrine represents a method to determine the "facts" of an exchange, rather than an *ex post* rationale for decisions made on some other ground, is simply wrong.

3. *Substance Versus Form*

a. Step transaction cases. Even were there a principled rationale for determining when a series of exchanges ought to be treated as a single, integrated exchange, classification of that exchange as a particular transaction requires one more step. That step, of determining the "substance" of the redefined exchange, generally replaces some inappropriate transactional label with a different one that more accurately describes the facts surrounding a given exchange or series of exchanges.

At the heart of the substance versus form doctrine is the search for some label that can appropriately account for the economic consequences which result from a given set of exchanges. As applied to step transaction cases, the doctrine would ideally be applied to whatever "steps" make up the completed "transaction" and would label that

transaction as one that accurately describes the economic impact on every party thereto. Unfortunately, there are three problems with the application of the substance versus form doctrine to these cases: (1) there is often no single transactional label that accurately describes the "exchange" from even one party's point of view (instead, steps that have been "integrated" by application of the step transaction doctrine must, as often as not, be immediately disintegrated by the substance versus form doctrine in order to permit accurate description of the economic consequences for the parties involved); (2) where some label does accurately describe the economic consequences to one party, that label is often inconsistent with the economic results to the other parties to the same exchange; and (3) in those cases where labels can be found that accurately describe the series of exchanges, there is generally a *variety* of applicable labels, each with different tax consequences, and no apparent basis for choosing any one label over the others.

Several cases have made it clear that the system depends on the "discovery" of a *single* transactional label that accurately describes an exchange from *all* viewpoints, rather than on different labels for different parties. One of the more recent of these is *McDonald's Restaurants v. Commissioner*.¹⁴⁹ There, McDonald's transferred its newly issued stock to the shareholders of *X*, and *X* was merged into McDonald's. Shortly after the merger, the *X* shareholders, who had indicated a desire for cash, sold their McDonald's stock.¹⁵⁰ The court held that the step transaction doctrine should be applied and that the merger and the subsequent sale of the McDonald's stock should be treated as an integrated series of exchanges. As a result, the substance of the exchange did not qualify as a tax-free reorganization because the *X* shareholders did not have the type of continuing interest in McDonald's (because of their stock sale) required for such characterization.¹⁵¹

What makes this decision interesting is that the *X* shareholders, whose actions and intentions served to disqualify the transaction from nonrecognition treatment, were not before the court and were unaffected by the outcome of the case. Instead, it was McDonald's which was before the court, arguing that the transaction was not a reorgani-

149. 688 F.2d 520 (7th Cir. 1982).

150. The agreement between McDonald's and the *X* shareholders provided that the newly issued McDonald's stock would be included in an upcoming SEC registration, so that it could be easily traded by the *X* shareholders. 688 F.2d at 521-22.

151. In so holding, the court noted the Internal Revenue Service's ruling that the continuity of shareholder interest requirement would not be met if the shareholders receiving stock in the purported reorganization had a "'plan or intention . . . to [reduce their new holdings] to a number of shares having, in the aggregate, a value of less than 50 percent of the total value of the acquired stock outstanding immediately prior to the proposed transaction.'" 688 F.2d at 528 (citation omitted).

zation and that its basis in the acquired assets was therefore its cost for those assets¹⁵² rather than a transferred basis.¹⁵³ Indeed, the result to the *X* shareholders would have remained unchanged regardless of the characterization of the transaction.¹⁵⁴ Not only did the court search for a single transactionally consistent label for the exchange, but it was only this requirement of transactional consistency that allowed McDonald's even to raise the question of application of the step transaction doctrine in the first place.¹⁵⁵

152. I.R.C. § 1011 (1982).

153. I.R.C. § 362 (1982).

154. If the transaction had been a reorganization, the reorganization would have been tax-free (I.R.C. § 354 (1982)), but the shareholders would have been taxed on the subsequent sale of the McDonald's stock (which would have first taken a basis equal to the shareholders basis in the exchanged *X* Corp. stock under I.R.C. § 358 (1982)). If the exchange were instead a taxable sale, the shareholders would have been taxed at the time of that exchange, but would have taken a cost basis in the McDonald's stock, so that no further tax would have been imposed on their sale of that stock.

155. Another case in which the only party before the court was the party who had *not* engaged in a series of unified exchanges, but who was nonetheless affected by an implicit transactional consistency requirement, was *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd.*, 491 F.2d 749 (3d Cir. 1974). The taxpayer had traded her shares of *A* to Track Company, pursuant to the merger of *A* into Track; and the issue before the court was again whether the merger qualified as a tax-free reorganization, I.R.C. § 368(a)(1)(A) (1982). Although the exchanges appeared to meet the requirements of § 368(a)(1)(A), the court determined that the transaction failed to qualify because there was, as in *McDonald's*, no continuity of shareholder interest. Prior to the merger, Track had purchased, for cash, a substantial amount of *A* stock. Immediately after the merger, the pre-merger shareholders of *A*, including Track, owned enough Track stock to meet the continuity requirement. The court, however, held that Track's pre-merger stock purchase should be integrated with the merger for tax purposes. As a result, the shareholders required to have a continuing interest in Track did not include Track itself, but instead included the former *A* shareholders who had made the pre-merger cash sale to Track. So viewed, the relevant group failed the requirement. As a result, the substance of the taxpayer's exchange depended on the plans and actions of a party (Track) that was neither subject to her control nor responsive to her wishes. The court explained: "We realize that in one sense petitioner was not privy to the plans of the [other parties]. In another sense — in the same way that all shareholders in a corporation play a part in major corporate decisions — she was a party to the choice of steps taken." 60 T.C. at 225 n.15. Because the corporation took these steps in part because they allowed it to circumvent the taxpayer's desires, 60 T.C. at 219-20, the taxpayer's role in making this choice was minimal.

The general requirement of transactionally consistent treatment of exchanges is also well illustrated by comparison of two other Tax Court cases. In *Crenshaw v. United States*, 450 F.2d 472 (5th Cir. 1971), *cert. denied*, 408 U.S. 923 (1972), the taxpayer received an interest in a building, pursuant to the purported liquidation of her interest in a partnership. She traded this to her husband's estate in exchange for different real estate, and the husband's estate then sold the building to Corporation, which was owned by the continuing partners and which contributed the building back to the partnership. The taxpayer contended that both the liquidation of her partnership interest and her subsequent exchange of real estate were tax-free under I.R.C. §§ 736(b), 1031 (1982). The court determined that the exchanges should be integrated and treated as if the taxpayer had exchanged her partnership interest with *X* in a taxable sale and then used the cash to purchase the real estate.

In *Harris v. United States*, 356 F.2d 582 (5th Cir. 1966), the facts were similar to *Crenshaw*, except that the building was not recontributed to the partnership. Although that last step was admittedly of no concern to the taxpayer, the court found that the substance of the exchange could not be recharacterized because to do so in the absence of that last step was inconsistent with the consequences of the transaction to a party *other* than the taxpayer.

Even a cursory review of the cases reveals, however, that often there simply is no transaction which accurately describes a given set of exchanges for all parties involved. For example, if *A* transfers assets to Newco for stock, in contemplation of trading the Newco stock to Publicly Held for Publicly Held stock, and the series of exchanges is integrated, the "exchange" will be treated as one involving *A*'s assets for Publicly Held stock. If Newco is liquidated by Publicly Held prior to engaging in any economic transactions, its transitory existence will have had no long term economic effect and can easily be ignored. However, if Publicly Held decides not to liquidate Newco upon its acquisition, the single "exchange" (as characterized by the step transaction doctrine) will have had effects on at least three different entities: *A* will have "exchanged" assets for Publicly Held stock; Newco will have "exchanged" its newly issued stock for assets; and Publicly Held will have "exchanged" its stock for the stock of Newco. If one looks at any one of the taxpayers individually, characterization of its exchange seems apparent: *A* has engaged in a taxable exchange of assets for Publicly Held stock; Newco has engaged in a tax-free exchange of stock for assets;¹⁵⁶ and Publicly Held has engaged in a tax-free exchange of stock for stock.¹⁵⁷ However, if tax consequences are based on characterization of the actions of *all* parties to a single transaction, it is not enough to state that, for example, *A* transferred assets and received Publicly Held stock. Instead, determination of *A*'s tax consequences would seem to require explanation of the entire transaction in which *A* engaged — to whom did *A* transfer assets, and what did that person transfer to *A* in exchange for those assets? In our example, *A* has transferred assets to Newco and received stock from Publicly Held; there is no such transaction described in the Code.

There have generally been two kinds of responses to this problem. Courts have either (1) recharacterized step transactions by defining them *not* as a single, integrated exchange, but as a series of separate exchanges whose net economic effect mirrors the actual impact on the parties involved; or (2) recharacterized transactions differently with respect to each of the different parties to the exchange. Neither of these actions is without its own problems.

One problem with redefining the substance of step transaction cases as a different *series* of exchanges rather than as a single transaction is that, while such treatment might allow consistent treatment of all parties to a series of exchanges, it would also undo exactly what the

156. See I.R.C. §§ 351, 1032 (1982).

157. See I.R.C. § 1032 (1982).

step transaction doctrine was supposed to have done in the first place. Why application of the step transaction doctrine to "integrate" a series of exchanges into a single transaction should be followed by application of the substance versus form doctrine to resegment those exchanges into a different series of transactions is unclear and perhaps nonsensical. It is not, however, without precedent. In *Commissioner v. Court Holding Co.*,¹⁵⁸ Court Holding had discussed the sale of its only asset to Purchaser. Prior to signing a contract of sale, however, the company realized that it could save taxes by distributing its asset to its two shareholders in complete liquidation, and having them then sell the asset to Purchaser. The company proceeded to liquidate, and the shareholders then sold the asset to Purchaser. The Court determined that the series of steps should be treated as a single transaction. Surprisingly, its next step was to impose tax as if the company had sold the asset and then in a separate exchange distributed the sales proceeds in liquidation.¹⁵⁹

Similarly, in *Idol v. Commissioner*,¹⁶⁰ the taxpayer sold some of the stock of his otherwise wholly owned corporation to Purchaser, and subsequently caused the corporation to distribute some assets to Purchaser in redemption of that stock. After concluding that the exchanges should be integrated and that the same net result could have been reached (with greater tax liability) by the corporation's first selling some assets to Purchaser and then distributing the cash to Idol, the Tax Court decided to tax the exchanges as if they had occurred in the latter order.¹⁶¹

158. 324 U.S. 331 (1945).

159. It has been suggested that the decision in *Court Holding Co.* was actually based on the Court's restructuring of the entire series of events to comport with the real negotiations between the parties, on the assumption that the negotiations represented the true substance of the transaction. Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861 (1976). While Mr. Kingson's article makes many excellent points, the suggestion that negotiations can represent the true "substance" of a transaction is not one of them. Whatever form is ultimately agreed on by the parties is itself the end product of their negotiation. If negotiations could provide evidence of a *different* substance, it would have to be the product of only *some* of the negotiations — not including the set of negotiations which finally brought about the final structure of the agreement. Unfortunately, there is no logical way to determine *which* negotiations represent the "substance," and which of the negotiations should be disregarded.

160. 38 T.C. 444 (1962), *affd.*, 319 F.2d 647 (8th Cir. 1963).

161. An example of a more recent case where the Tax Court followed the Supreme Court's lead in integrating and resegmenting exchanges is *Estate of Schneider v. Commissioner*, 80 T.C. 906 (1987). Schneider was the major stockholder of Transport Co. Transport offered employees the right to purchase stock from Schneider. If the employees opted to do so, they were given (in exchange for services) a check issued with a restrictive endorsement to Schneider. Upon the employee's endorsing the check to Schneider, Schneider would transfer some of his Transport stock to the employee. The Tax Court determined that the exchanges were all parts of an *integrated* transaction. It then proceeded to impose tax as if *separate* exchanges had occurred, but in reverse order. The parties were treated as if Transport had paid Schneider for his stock and then issued the stock to the employees.

Finally, in a case decided only this year, the Tax Court seems to have realized the folly inherent in integrating steps only to resegment them in reverse order. In *Esmark, Inc. v. Commissioner*,¹⁶² Purchaser acquired approximately 50% of the outstanding stock of Esmark, and Esmark subsequently distributed the stock of Subsidiary to Purchaser in redemption of Purchaser's newly acquired Esmark stock. In refusing to adopt the Internal Revenue Service's argument that Esmark should be taxed as if it had first sold the Subsidiary stock to Purchaser for cash and then used the cash to redeem its own shares, the Tax Court stated that "[t]his [proposed] recharacterization does not simply combine steps; it invents new ones. Courts have refused to apply the step-transaction doctrine in this manner."¹⁶³

What is perhaps more surprising than the court's belated acknowledgement of this inconsistency in the application of the step transaction doctrine is the ease with which the court was able to reconcile its insight with previous cases in which it had done exactly what it found so offensive in *Esmark*. Indeed, even in the very case in which it voiced its antipathy to the concept of inventing new steps, the court appeared to reconfirm its holding in *Idol*,¹⁶⁴ where it had done exactly that. Rather than overrule *Idol*, the *Esmark* court merely found it "factually distinguishable"¹⁶⁵ because in *Idol* the percentage of shares redeemed was smaller. If the implication is that a court can invent new steps only in certain kinds of cases and not in others, then the court was somewhat lax in its explanation of what separates those different kinds of cases. If the court simply decided to proceed slowly along a more rational path, then there are many steps along the path of irrationality that eventually need to be undone.

Aside from its own inherent inconsistency, another problem with this integration-reverse-disintegration approach is that reversing the order of exchanges would appear to have sometimes significant effects on other parties to the redefined transaction.

In *Kimbell-Diamond Milling Co. v. Commissioner*,¹⁶⁶ the taxpayer-corporation sought to acquire the assets of Seller. Rather than simply purchase the assets, Kimbell-Diamond decided to purchase the stock of Seller and immediately liquidate the company because that se-

162. 90 T.C. 171 (1988).

163. 90 T.C. at 196.

164. 38 T.C. at 444. See *supra* text accompanying note 161.

165. 90 T.C. at 190.

166. 14 T.C. 74 (1950), *aff'd.*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 347 U.S. 827 (1951). For a discussion of this case and its implications, see Pugh, *Combining Acquired and Acquiring Corporations and Their Subsidiaries Following a Purchase of Stock: Some Anomalies of Form and Substance*, 35 TAX L. REV. 359 (1980).

quence of events would leave it with a higher basis in the newly acquired assets.¹⁶⁷ The court, realizing that the stock purchase and liquidation were parts of a single pre-arranged plan by Kimbell-Diamond, decided to treat the actions as a unified exchange. It determined that Kimbell-Diamond paid to acquire the assets and should be treated as if it had acquired those assets directly. Essentially, Kimbell-Diamond was taxed as if the liquidation of Seller had preceded, rather than followed, the taxpayer's purchase.

As a result, the court disallowed Kimbell-Diamond's planned transferred basis and determined that the company's asset basis was simply its cost for each asset. Seller was not before the court in that case, but the court's opinion clearly implied that its presence would not have changed the result and, moreover, that the result did not change the consequences to Seller. In other words, the court looked only to Kimbell-Diamond's actions to determine whether to treat the purchase-liquidation as a direct purchase, and it was satisfied with simply changing the consequences to that taxpayer.

The implication, then, is that the substance versus form analysis may provide a method for redetermining the tax consequences to one party to a multiparty exchange without affecting the other parties. Aside from the obvious and direct conflict between this single party approach and cases such as *McDonald's*,¹⁶⁸ which appear specifically to require interparty transactional consistency, neither the courts nor the Internal Revenue Service would be likely to be content with this approach for several other reasons.

Some of the problems with inconsistent treatment of the parties to an exchange can be made apparent by putting Kimbell-Diamond in a post-1986 setting. In the original case, the court (and the Internal Revenue Service) disregarded the tax consequences of its own liquidation to Seller. Since at that time, liquidation carried no tax consequences to the liquidating corporation, and the tax consequences of a liquidation to the owner of the "liquidated" company would not have differed from those of a stock sale, disregarding the consequences to Seller was not problematical.¹⁶⁹ Under current law, liquidation of a

167. A corporation owning at least 80% of the stock of a subsidiary could assume the subsidiary's asset basis upon its liquidation under former I.R.C. §§ 332-334(b)(1) (1982) (now I.R.C. § 337 (Supp. IV 1986)). Because Seller's asset basis exceeded the value of those assets, Kimbell-Diamond hoped to have the assets retain that high basis.

168. 688 F.2d 520 (7th Cir. 1982). See *supra* text accompanying notes 149-55. For a discussion of cases rejecting this doctrine see *Broadview Lumber Co. v. United States*, 561 F.2d 698, 710-12 (7th Cir. 1977) (holding that *Kimbell-Diamond* was superseded by I.R.C. § 334(b)(2) (1982)).

169. See 14 T.C. at 79. Seller would have been treated basically the same whether it had liquidated and sold the assets under the pre-1987 version of I.R.C. § 336 (1982), amended by

corporation results in recognition by that company of all gain inherent in all of its assets.¹⁷⁰ It is doubtful that either the Internal Revenue Service or any court would now be content to allow Seller's gain to go unrecognized simply because the liquidation occurred immediately after the acquisition of its stock and as part of the purchaser's plan to acquire its assets.

Another case that illustrates the same problem is *Basic Inc. v. United States*.¹⁷¹ In *Basic*, Parent company owned Child company, which in turn owned Grandchild company. Purchaser sought to acquire the assets of Child and Grandchild. Prior to the sale, Child distributed all of the Grandchild stock to Parent, which then sold the stock of both companies to Purchaser. Parent reported its receipt of the Grandchild stock from Child as a dividend. This characterization was essentially tax-free to all parties¹⁷² and gave Parent a basis in the Grandchild stock which served to reduce Parent's gain on the sale to Purchaser. The court, referring to its actions as being based upon a "business purpose" or "substance versus form" approach, treated the distribution and sale as a single transaction, and then held that the "substance" of the distribution was not a dividend. Instead, it explained that "the whole transaction was a foregone conclusion that might just as well have been carried out in reverse order without changing the attendant risks or final result to the slightest degree."¹⁷³ Apparently, the court believed that this justified disintegrating the "whole" transaction and treating it *as if* it had been carried out in reverse order. Parent was taxed as if it had not received any distribu-

I.R.C. § 336 (Supp. IV 1986), or first sold its assets pursuant to a plan of liquidation and then distributed the receipts of that sale under "old" I.R.C. § 337 (1982), *amended by* I.R.C. § 337 (Supp. IV 1986). (Query whether old § 337 would apply if no plan of liquidation had been formally adopted prior to a "deemed" liquidation. See former I.R.C. § 337(a) (1982), *amended by* I.R.C. § 337 (Supp. IV 1986); *Virginia Ice & Freezing Corp. v. Commissioner*, 30 T.C. 1251 (1958) (§ 337 applies only to sales after formal adoption of plan of liquidation).) Even during most of that period, however, there would have been different treatment if part of the purchase price were an installment obligation, since some of the shareholders' gain could be deferred on an asset sale followed by liquidation (I.R.C. § 453(h) (1982)), but not on a liquidation followed by an asset sale (I.R.C. § 331 (1982)). Under current law, the difference in result to Seller if it were deemed to have liquidated prior to sale would be substantial, because that liquidation would result in current (pre-sale) corporate-level income equal to all accrued appreciation in the company's assets under the current version of I.R.C. § 336 (Supp. IV 1986).

170. I.R.C. § 336 (1986). This assumes that the transition rules of the 1986 Act are inapplicable and that the liquidating corporation is not at least 80% owned by another corporation and thus would not qualify for deferred recognition under I.R.C. § 337 (Supp. IV 1986).

171. 549 F.2d 740 (Ct. Cl. 1977).

172. Parent would receive the distribution tax-free under I.R.C. § 243 (1982); Child would have escaped recognition of gain under the version of I.R.C. § 311 in effect at that time. See I.R.C. § 311 (1982), *amended by* I.R.C. § 311 (Supp. IV 1986).

173. 549 F.2d at 746.

tion but had sold the Child stock while Child still owned the stock of Grandchild.

To complete the picture, Purchaser acquired stock of two companies, Child and Grandchild. If the "real" facts were that Parent sold the stock of Child, which, at the time of sale, owned the stock of Grandchild, it would appear that subsequent to the sale, Child must have distributed the stock of Grandchild to Purchaser. In *Basic*, Purchaser was not before the court, so that Purchaser's tax consequences were not at issue. Nonetheless, it would not be exaggerating to suggest that Purchaser might have been surprised to learn, after purchasing the stock of two separate corporations, that it had "really" purchased only the stock of Child and that Child distributed the Grandchild stock as a dividend immediately after the purchase.

The court in fact treated the seller as if there had been no pre-sale dividend without any apparent need to treat Purchaser as if there had been a post-sale dividend, with the result that the distribution of the Grandchild stock was essentially ignored. At the time the case arose, the tax result of the distribution, had it not been ignored, would have been simply to increase Parent's basis in the stock it sold, thereby reducing its taxable gain.¹⁷⁴ Under current law, however, a dividend distribution by Child could result in that company recognizing as gain all the accrued appreciation on its Grandchild stock.¹⁷⁵ A transactionally inconsistent recharacterization of the exchanges which disregarded the dividend would allow substantial and unwarranted tax savings; and it is highly unlikely that taxpayers who sought that savings could find it by simply making the dividend distribution without any business purpose and as part of a broader plan of tax avoidance.¹⁷⁶

174. At the time of the transaction, reordering of the exchanges would have had *some* effect on Purchaser, such as changing its current earnings and profits under I.R.C. § 312 (1982); but the effect would not have been substantial.

175. See I.R.C. § 311(b) (Supp. IV 1986). This would be true unless the distribution would qualify as a tax-free reorganization under § 355 (it apparently would not, because of the absence of any business purpose). The consequences of reordering to Purchaser might be of even more interest if Purchaser were an individual, so that the deemed distribution to it of the Grandchild stock would be fully taxable (because the § 243 deduction for dividends received is available only to corporate shareholders).

176. *Waterman S.S. Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971), is another typical case in which a transaction was restructured with respect to one party without any perceived need for logically consistent restructuring of the transaction from the perspective of the other parties. For a discussion of *Waterman* and related cases, and a suggestion that in these cases the form of the transaction ought to be determinative, see Lang, *Dividends Essentially Equivalent to Redemptions: The Taxation of Bootstrap Stock Acquisitions*, 41 TAX L. REV. 309 (1986). In *Waterman*, a case not unlike *Basic, Inc.*, the taxpayer planned to sell the stock of its wholly owned subsidiary. Just prior to the sale, the subsidiary purported to distribute a substantial dividend (tax-free to Waterman under § 243 and to the distributee under the pre-1984 version of § 311) in the form of a note. The subsidiary's liability on the dividend note substantially reduced its net worth, so that the sales price, and Waterman's taxable gain,

The conclusions to be drawn from analysis of the above cases are that (1) sometimes inter-party transactional consistency is crucial to a determination of whether and how an integrated series of exchanges will be recharacterized; (2) other times such consistency is irrelevant; and (3) no basis has ever been enunciated for distinguishing between the two possibilities or for determining which aspect (importance or irrelevance) will rule in any particular case.

There are many substance versus form cases, however, where inter-party consistency is not a problem. Courts can often simply ignore self-cancelling steps or telescope two or more steps into a single, less complex, transaction;¹⁷⁷ in these cases, deciding that the "substance"

were minimal. Shortly after the sale, the purchaser lent to its newly acquired subsidiary enough cash to pay off its note to Waterman, and the subsidiary did so. The court, treating all of the actions as an integrated series, determined that the "substance" of the series was that Waterman had *not* received a dividend but had instead "sold" the subsidiary stock for an amount equal to its actual sales price plus the pre-sale dividend. 430 F.2d at 1191. Transactional consistency would seem to require treating the parties as if the following order of events had occurred: (1) Waterman sold the subsidiary stock for cash; and (2) the subsidiary distributed a dividend note to its new purchaser. Nonetheless, reference to a post-sale dividend was never made, and the tax consequences of such a dividend were not explored.

Consideration of the effects on third parties would have been of even greater interest in a similar case following *Waterman*. In *TSN Liquidating Corp. v. United States*, 624 F.2d 1328 (5th Cir. 1980), the pre-sale dividend consisted of appreciated securities, and the post-purchase transfer from the purchasing company to its newly acquired subsidiary was a cash contribution. Consistent restructuring of the transaction seemingly would have resulted in treating the exchanges as (1) a cash sale of the subsidiary; and (2) a post-sale purchase of the subsidiary's appreciated securities by the original seller. Because the court determined that the exchanges should not be integrated in that case, the reordering did not occur. Had the court found that the actions were a single scheme worthy of reordering, however, the proper result to the subsidiary would be unclear. Apparently, the subsidiary should have been taxed as if it had *sold* the appreciated securities, in spite of the fact that either a pre-sale or post-sale *distribution* of those securities would have been tax-free under the version of § 311(a) then in effect. Whether the court would have taxed the subsidiary on a sale that did not occur, simply because of its parent's attempted tax savings, is doubtful; but a failure to do so would have been inconsistent with a restructuring of the transaction with respect to the other parties. This dilemma was avoided by the court's finding that the distribution and sale were independent. A series of cases and rulings in this area seems to indicate that the intended end result is in fact generally reached not by the application of a substance versus form approach, but by a decision of what "test" to use for integration. Compare Rev. Rul. 75-493, 1975-2 C.B. 109 (binding commitment) and *Waterman*, 430 F.2d at 1194-95 (business purpose), with *Casner v. Commissioner*, 450 F.2d 379, 389 (5th Cir. 1971) (plan). It is also possible that the basis for choosing a certain test (and achieving a given end result) depends on facts such as whether the subsidiary distributes its own assets (*TSN*), borrowed funds, a note (*Waterman*), or some other asset. See Bowen, *Structuring Leveraged Buyouts—Selected Tax Problems*, 63 TAXES 935 (1985); Kingson, *supra* note 159. Why that *should* be determinative, as opposed to whether or not it *is* so, is unclear.

177. Both kinds of transactions are plentiful. Self-cancelling steps, such as a transfer from one person to a second person and then back to the first, come in many forms. Examples include a sale of property followed by resale of the same property back to the seller and a loan followed by a transfer of the same amount by the borrower back to the lender. In *Battelstein v. Commissioner*, 611 F.2d 1033 (5th Cir. 1980), Taxpayer owed interest to Creditor. He borrowed more money from Creditor to pay the interest, and the court integrated the series of actions into a single "nonpayment" of the interest. Cf. *Hauer v. United States*, 85-2 T.C.M. (CCH) ¶ 9447, at 89,005 (*S* corporation distributed cash to shareholders, who lent it back to corporation. Dividend respected as long as not *dependent* on subsequent shareholder loan.).

Application of a substance versus form approach to telescope two or more exchanges into a

of the exchanges differs from the characterization chosen by the taxpayer seems more straightforward. Even these seemingly straightforward cases leave room for concern, however. They necessarily advance from a determination that a series of exchanges should be integrated to a conclusion that integration means characterization as a single transaction — or, in the case of self-cancelling steps, characterization as a “nontransaction” — is a more appropriate description of the “substance” of the exchanges. The problem is that when the “substance” of an exchange is so defined, all that can be meant by “substance” is “a more convenient way of achieving a given result.” Unfortunately, in most areas of tax law, a more convenient way of doing something is only a more convenient way of doing something; it is not necessarily the “substance” of actions that are done less conveniently.

The difference between “convenience” and “substance” is well established. For example, tax-free reorganizations are only those exchanges which meet certain statutory requirements.¹⁷⁸ If *X* acquires all of the stock of *Y* in exchange solely for *X* voting stock, the exchange would qualify as a reorganization.¹⁷⁹ If *X* does not want reorganization treatment, it could intentionally fail to meet some of the statutory requirements, perhaps by acquiring some of the stock for cash or for *X* nonvoting stock. Similarly, if *X* had wanted to acquire some of the *Y* stock for cash, but went to the trouble of issuing *X* voting stock instead, it could qualify the exchange as a reorganization. In either case, *X* could manipulate the status of the transaction (as a tax-free reorganization or as a taxable sale) by simply acting in a somewhat less convenient way than it had at first anticipated.

One might be tempted to point out that in the above context, unlike in other substance versus form cases, characterization as a reorganization or a sale is dependent on real economic distinctions — the quality of consideration (some cash or all equity) makes for a substan-

single, direct transfer is also common. A person who performs services for a partnership or corporation in exchange for a right to payment and then exchanges that right to payment for partial ownership of the enterprise will be treated for tax purposes as if she performed services in return for that partial ownership (resulting in a single, taxable transaction instead of two tax-free exchanges). See W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 4.02[3] (1977). Or, a person who advances cash or property as a loan and, pursuant to a plan, cancels the loan, may be treated as if she had made the initial transfer free of any repayment obligation. See Rev. Rul. 77-299, 1977-2 C.B. 343 (installment sale followed by pre-planned cancellation of payments when they became due treated as gift of entire property in year of purported sale). But see *Kelley's Estate v. Commissioner*, 63 T.C. 321 (1974), and *Haygood v. Commissioner*, 42 T.C. 936 (1964) (reaching conclusion opposite of Rev. Rul. 77-299).

178. I.R.C. § 368 (1982).

179. I.R.C. § 368(a)(1)(B) (1982).

tive economic difference, which in turn governs the tax characterization of the exchange. The point, while superficially appearing persuasive, is irrelevant. The Code is full of other provisions which make tax characterization wholly independent of economic substance.¹⁸⁰ Nonetheless, no court has been tempted to hold the "substance" of these actions to be different from their form.¹⁸¹ Even more telling, the Code often makes determination of the tax "substance" of transactions *explicitly* dependent on nothing more than the taxpayer's own stated choice of form.¹⁸²

On the other hand, there often *is* economic effect to actions which *are* disregarded in even the most straightforward cases. When a taxpayer simply takes two steps to achieve a single result, there often is some effect on legal rights during the interim between the two steps. If *A* lends *B* \$100 on Monday and forgives the debt on Tuesday, the "transaction" puts *A* and *B* in a different legal and economic position for 24 hours than had *A* simply given *B* \$100 on Monday (or on Tuesday). While in cases such as this the economic consequences of two steps may differ only minutely from what would have been the case if only a single step had been taken, the *degree* of economic consequence would appear to be of little concern. Indeed, the economic consequences of a corporation paying \$1,000 to a single shareholder (in addition to transferring, say \$1,000,000 worth of its voting stock to other shareholders) to avoid characterization of a stock acquisition as a "B" reorganization, or the consequences of a taxpayer waiting two days (until the next tax year) to sell an asset in a fixed market, are themselves almost meaningless.

In addition to some perhaps insignificant economic consequence inherent in almost all step transaction and substance versus form cases, many such cases which are found to have a substance different from their form can actually involve *substantial* economic consequences which are simply disregarded. For example, in *Knetsch v. United States*,¹⁸³ the Supreme Court collapsed a loan and transfer of the same proceeds into essentially a "nontransaction," despite the taxpayer's out-of-pocket costs of over \$90,000.

180. For example, a decision to operate as a corporation rather than as a sole proprietorship may have no real consequences aside from tax considerations; a year-end decision to defer the sale of an asset for a few days, until the next taxable year, may have no consequences aside from deferring tax liability; or the distribution of a stock dividend to one shareholder may have economic consequences identical to those of a redemption of a different shareholder.

181. See generally Kingson, *supra* note 159.

182. *E.g.*, I.R.C. § 71(b)(1)(B) (1982) (treatment of alimony payments); I.R.C. § 152(e)(2) (1982) (determination of which parent gets personal exemption for dependent); I.R.C. § 1361 (1982) (consolidated returns).

183. 364 U.S. 361 (1960).

The problem with attempting to redefine the substance of a transaction based upon its ultimate economic effect is that transactions are simply not defined by reference to their economic effect, but by reference to facts such as the items exchanged and other similar attributes.¹⁸⁴ While the substance of a series of exchanges might be seen as the overall change in economic status of the taxpayer involved, tax transactions are always defined by reference to the *means* (i.e., exchanges) used to reach the ends (economic changes) rather than by the ends themselves.¹⁸⁵

When courts do tax individuals by looking to the change in their overall economic circumstances and determining what transaction(s) *might* have achieved those economic results, their actions do not seem

184. See *supra* Part I.B.

185. One consequence of looking to economic result, rather than the means of achieving that result, to define a transaction is that often the "substance" of the redefined exchange is held to be a transaction defined by the Code as consisting of one or more specific exchanges when those exchanges which define the transaction have, quite simply, not occurred. For example, in *Davant v. Commissioner*, 366 F.2d 874 (5th Cir.), *cert. denied*, 386 U.S. 1022 (1966), shareholders owned all the stock of *X* Co. and *Y* Co. They decided to combine the operating assets of both in a single corporation and to withdraw \$900,000 cash from the combined company. Pursuant to the advice of Attorney, the following steps were taken: Shareholders sold the *X* stock to Attorney's Son for \$900,000, which amount Son had borrowed from Bank. Son caused *X* to sell its operating assets to *Y* for \$700,000. *X* distributed this \$700,000, plus \$215,000 cash which it had, to Son in complete liquidation. Son used \$900,000 to repay Bank and kept \$15,000 as his profit.

The court determined that this series of exchanges should be treated as a unified transaction, and that, when so viewed, the transaction which had occurred was a reorganization under § 368(a)(1)(D). That section defined a "D" reorganization as a transfer by one corporation (*X*) of all or part of its assets to another corporation controlled by the same shareholders (*Y*) "only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred [*Y*] are distributed in a transaction which qualifies under section 354, 355 or 356 . . ." I.R.C. § 368(a)(1)(D) (1982). The court noted that although *no* stock of *Y* was distributed to Shareholders, the "substance" of the exchange had the same result as if it had been (because Shareholders owned all of the *Y* stock in any event) and in light of that, the actual statutory requirement was irrelevant.

The *Davant* court has had plenty of company in holding that it could disregard an unmet statutory requirement for characterization of an exchange as a particular transaction when that statutory requirement would have been, in effect, a meaningless gesture. See, e.g., *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); *James Armour Inc. v. Commissioner*, 43 T.C. 295 (1964); *Grubbs v. Commissioner*, 39 T.C. 42 (1962). The concept has been used by courts to justify holding that taxpayers have met the requirements for tax-free incorporations despite their failure to meet the requirement that they maintain, after the transfer of assets, 80% control of the newly formed corporation. E.g., *D'Angelo Assocs. v. Commissioner*, 70 T.C. 121 (1978); *Florida Mach. & Foundry Co. v. Fahs*, 168 F.2d 957 (5th Cir. 1948) (shares distributed directly to third party held to have been distributed to taxpayer). It has been used to justify taxing individuals on funds they never received, see, e.g., *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), and has been said to have provided the basis for the entire assignment of income doctrine. See *Gunn, supra* note 62, at 760-65. The doctrine taxes a person on money earned but never received. The doctrine might well be justified by the fact that the taxpayer who earned the funds was enriched by them to the extent he could direct them, because to that extent he enjoyed consumption of that amount (i.e., by making a gift and "consuming" the amount gifted). Such justification of the doctrine has never been offered, however. Instead, courts simply explain that the "substance" was that money was transferred to the earner and then to the eventual recipient.

unreasonable; but the problem in most cases is simply that there is *not* just a single transaction that could have achieved the actual economic results. Instead, there are usually *several* different kinds of transactions by which those results could have been reached: for some, the formal statutory requirements have been met; for others, they have not. Typically, in these cases, the court will choose only the *latter* as accurately describing the "substance" of the transaction.

Indeed, in those few situations where there *is* a single economic substance that appears more accurate than other choices, courts nevertheless will frequently characterize the situations as constituting a transaction that, according to the Code, has requirements that are unmet by the exchange, even as recast, and that also *fails* to reflect the economic substance of the exchange. For example, in *Higgins v. Smith*,¹⁸⁶ a shareholder sold property to his wholly owned company, and the Court simply disregarded the sale, despite the fact that property previously owned by the shareholder was afterwards owned by the corporation.¹⁸⁷ Similarly, in Revenue Ruling 60-133¹⁸⁸ the taxpayer transferred stock of one wholly owned corporation (*X*) to another wholly owned corporation (*Y*) just prior to *X*'s payment of a dividend. The Internal Revenue Service simply ignored the transfer and treated the taxpayer as if he had personally received the dividend. Again, the recharacterized transaction was further from the economic substance (and from its statutory definition) than was the taxpayer's original characterization of the exchange.¹⁸⁹

186. 308 U.S. 473 (1940).

187. The transfer *might* have been treated as a contribution to capital followed by a dividend, which would have been *consistent* with the economic substance, if not *more* consistent than characterization as a sale. The Court did not characterize the transaction as such.

188. 1960-1 C.B. 189.

189. Another case where the recharacterized economic "substance" was further from a reflection of reality than was the taxpayer's initial characterization is *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967). In that case, Old Co. was owned by two groups, *A* and *B*, each of which owned approximately half of the outstanding shares. Pursuant to a plan, *A* formed Newco by transferring to it some of *A*'s Old Co. stock. *A*, *B*, and Newco then sold all of their Old stock to Attorney for notes and some cash borrowed from Old. Attorney caused Old Co. to sell all its assets to Newco in exchange for Newco notes. Old Co. was then liquidated, distributing to Attorney \$1,000,000 cash on hand and the Newco notes, which Attorney transferred to *A*, *B*, and Newco to pay off his obligations to them. The net result of all this was that Newco had the Old Co. operating assets; *A* owned all the stock of Newco and some Newco notes; and *B* had some cash and some Newco notes.

The court integrated the exchanges and held that the transaction was a reorganization under § 368(a)(1)(F). That section applied to exchanges which were a "mere change in form" and did not apply when there was a shift in proprietary interest. As a result, the *substance* of the transaction, in which there was an ownership change of approximately 50% (because *B* no longer owned any stock), was treated as a transaction which caused *no* shift in proprietary interest. The court explained that it viewed the ownership change as a redemption which occurred *prior* to the reorganization. It noted that this redemption should not be treated as part of the overall reorganization because it was "functionally unrelated." This explanation, however, is weak. If by

b. Summary of substance versus form in step transaction cases. To the extent that the "substance" of a series of exchanges for a single taxpayer can be determined, that substance represents an overall change in the taxpayer's economic position. For example, she may have begun with stock of *X* and may end up with stock of *Y*, which owns the former operating assets of *X*, so that the "substance" from her point of view is an exchange of *X* stock for *Y* stock. This change in substantive rights might have been accomplished by some tax-free transaction, but it might also have been accomplished by a fully taxable exchange. The problem is that the Code does not impose taxes based on changes in economic rights; it imposes taxes based on certain *transactions*, and transactions are not defined as any actions which work certain changes in economic rights. They are defined as very specific sets of *exchanges*.

While it would not be "wrong" to impose tax on net economic "substance" rather than on the objective determinants listed in the Code, the substance versus form doctrine provides no framework for determining either when or how such should be done. Even were there guidelines for determining *when* substance should rule over form, because the Code specifies transactions only by reference to formal characteristics, there often is no true substance that describes a taxpayer's exchanges, but only a choice of potentially applicable forms, one of which was chosen by the taxpayer accurately, and a different one of which may be chosen by a court. Finally, even if a single transaction could be said to describe the substance of the actions of one taxpayer accurately, it is just as likely as not that that transaction would misdescribe the actions of all the other parties to the exchange.

The overwhelming contradictions in both the theory and the application of substance versus form analysis to step transaction cases can be understood only when it is also understood that the doctrine is simply not what it purports to be. When it is acknowledged that the doc-

"functionally unrelated" the court meant that the so-called "redemption" had an independent effect, its statement is meaningless: *every step, looked at individually*, has an independent effect. It is *only* when steps are looked at together that they may be recharacterized. The buyout of *B* was a contemplated part of the transaction; and indeed there was no evidence that any exchange would have occurred absent that step. If the court meant something else by its "functionally unrelated" language, it is not clear what that was.

Professor Manning had suggested earlier that two parts of a legally interdependent transaction may be treated as separate if one, and not the other, is pursuant to the "plan of reorganization," thus focusing on the "plan" rather than on whether some exchange is functionally independent. See Manning, "In Pursuance of the Plan of Reorganization": *The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881, 890-91 (1958). This does not adequately address the problem. If all the actions were planned together, and if taken together they do not constitute a reorganization, then it may be that the "plan" is simply *not* a plan of reorganization. Reliance on a "plan" provides no basis for determining what should and should not be included as parts of the plan.

trine is aimed at preventing tax-motivated behavior, a court's conclusion that the parties *could* have achieved their goals by different means, so they should be taxed *as if* they did so becomes understandable. All of a sudden, questions such as whether and when transactional consistency should be required and *which* sequence of exchanges more "accurately" reflects the substance become readily answerable. Unfortunately, at the same time, any appearance of judicial honesty disappears.

c. *Substance versus form in defining relationships.* In some cases, the substance versus form issue appears to have a fundamentally different role from that discussed above: rather than seeking to recharacterize transactions by focusing on the order of exchanges or by defining transactions by reference to their economic effect, the issue raised by these cases has to do initially with characterizing ongoing *relationships*. If *A* simply sells property to *B*, the exchange is obviously a sale. But what if *A* transfers some, but less than all, of his rights in that property? Depending on the extent of the rights transferred, the exchange may be characterized as a sale, a lease, a financing agreement, or any of numerous other transactions. Proper characterization, it seems, depends on the relationship between *A* and *B* and the property. If *B* "owns" the property after the exchange, the exchange is a sale. If *A* "owns" the property, then whatever the transaction is, it is not a sale. Essentially, rather than attempting to redefine what rights are exchanged for what other rights, these cases focus on defining the *relationship*¹⁹⁰ caused by transfers which are acknowledged to have occurred.¹⁹¹ Unlike transactions, relationships *do* vary based on

190. While it is suggested that these cases determine relationships such as ownership and do not characterize transactions, the two are admittedly not quite so readily distinguishable. Many cases attempt to determine ownership because the person in the relationship of "owner" is entitled to depreciation. However, one could point out that even depreciation is not relationship-oriented, but is transaction-dependent. While depreciation is intended to account for the gradual decline in value of property over its useful life, current depreciation provisions allow one to determine exactly when and what those deductions will be by reference to a single transaction — the placing of the property in service. See I.R.C. § 168 (1982). Nonetheless, one must be the owner of property in order to place that property in service; hence, the significance of the person's relationship to the property.

191. Although these cases do not explicitly acknowledge that they are applying the step transaction doctrine in conjunction with, or, more accurately, precedent to, determining the "substance" of the relationships involved, they are doing so. The transactions are most frequently structured by the taxpayers as sales and leasebacks. If the Internal Revenue Service and courts acknowledged that there were two separate exchanges, a sale and a later lease, they could not proceed to determine that the purported seller was still the owner and that no sale had ever occurred. Often the sale and leaseback are parts of a unified contractual arrangement, so that integration of the steps is beyond dispute. Even when that is not the case, however, the only issue seriously considered is the substance versus form question, not whether integration of the steps is initially appropriate.

actual economic substance, so that an analysis of the substance seems not only possible, but appropriate. Analysis of these cases reveals interesting results.

In *Helvering v. F. & R. Lazarus & Co.*¹⁹² the taxpayer transferred legal title in some buildings to a bank as trustee for land-trust certificate holders. Pursuant to the same contract, the taxpayer leased the buildings for 99 years with an option to repurchase. The annual rental was five percent of the amount that had been paid to the taxpayer by the bank. The agreement provided for additional payments that would, over 49 years, equal the principal amount paid by the bank. Upon completion of those payments, the taxpayer could retain possession of the building without further cost. The Court explained that "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding."¹⁹³ It held that the substance of the agreement was more like a mortgage than a sale and leaseback, and that the taxpayer should be treated as the tax "owner" of the buildings.

The Supreme Court's most recent and best known foray into the sale-leaseback issue took place in *Frank Lyon Co. v. United States*.¹⁹⁴ Worthen Bank & Trust Co. owned land on which it wanted to build an office building. State and federal banking laws made that direct course impossible. Instead, Frank Lyon Co. leased the land from Worthen for 76 years, at an annual rent of \$50 for the first 26 years, and higher amounts in later years. Lyon purchased the building from Worthen piece by piece as it was constructed, but the building was leased back to Worthen under a net lease. Worthen's rent to Lyon equaled Lyon's mortgage payments on the building. At all times, Worthen could acquire ownership of the building by paying to Lyon an amount equal to Lyon's original down payment plus 6% interest, in addition to the unpaid balance of Lyon's mortgage. The government argued that the transaction was not a sale and leaseback, but that in substance Worthen continued to be the owner of the building and Lyon was simply a conduit for Worthen's own mortgage payments. The Court treated Lyon as the owner of the property, stating that

[w]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is

192. 308 U.S. 252 (1939).

193. 308 U.S. at 255.

194. 435 U.S. 561 (1978). See also Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 (1981).

not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.¹⁹⁵

Lyon has been often cited, but for different propositions by different courts.¹⁹⁶ The Tax Court has recently found it to stand for "the principle that, in a sale-leaseback context, a nonuser-owner recipient of tax benefits must prove that his entry into the transaction was motivated by a business purpose sufficient to justify the form of the transaction."¹⁹⁷ While the court did not hold that business purpose alone is *sufficient* to determine whether a specific party is the owner of property, it implied that if the form of a business transaction does *not* meet a minimum threshold of business purpose or economic objective, ownership of property may be determined according to what an objective observer may determine to be its substance.¹⁹⁸

One principle clearly established by *Lyon*, then, is that the same rights may be deemed ownership in one case and mere tenancy in another, depending on the presence of business purpose. In these cases, no party is "the owner . . . in any simple sense."¹⁹⁹ Each of the parties has some rights; none of the parties has all; and looking to a business purpose at least avoids requiring a weighing of these rights against one another in all cases.

Unfortunately, focusing on whether or not parties had a business purpose for structuring a transaction a certain way in order to determine the substance of the relationships created thereby does create some problems. If nothing else, the focus suggested by the Court makes the parties' relative economic rights and liabilities of only sec-

195. 435 U.S. at 583-84. There are several other situations where transactions were encouraged by regulatory realities. In Rev. Rul. 83-142, 1983-2 C.B. 68, a foreign corporation incorporated, and then liquidated, a subsidiary in order to accomplish an exchange that could not have been accomplished more directly because of local law problems. Despite the business purpose for, and economic realities of, its creation, the transitory subsidiary was disregarded (at the taxpayer's request). In Rev. Rul. 85-133, 1985-2 C.B. 192, banking law made technical compliance with the installment sales provisions impossible. The Internal Revenue Service rejected the taxpayer's argument that the step transaction doctrine should apply and that, as in Rev. Rul. 83-142, 1983-2 C.B. 68, the steps required by local law should be disregarded. The differences in the rulings appear to be irreconcilable.

196. See Simonson, *Determining Tax Ownership of Leased Property*, 38 TAX LAW. 1, 18 (1984) ("Despite the frequency with which the *Lyon* case is cited, the only enduring principles that can be derived from the majority opinion are that no single test is determinative of ownership and that each case must be decided on its own complex and numerous facts and circumstances.").

197. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 201 (1983), *aff'd. in part, revd. in part*, 752 F.2d 89 (4th Cir. 1985).

198. The attempt to determine who is, in substance, the owner then would appear to depend on facts such as which party has what benefits and liabilities and who has what investment in the property. See generally Simonson, *supra* note 196.

199. 435 U.S. at 581.

ondary importance. The crux of Justice Stevens' lone dissent in *Lyon* is apparent in his first sentence: "In my judgment the controlling issue in this case is the economic relationship between [the parties];"²⁰⁰ and the majority opinion itself explained that generally "[i]n applying this doctrine of substance over form [we have] looked to the objective economic realities of a transaction rather than to the particular form the parties employed."²⁰¹ Nonetheless, when the *Lyon* majority looked at the "economic realities," those to which it gave the most significance were the objective legal factors that mandated the *choice* of a specific form rather than the economic rights which arose out of the arrangement between the parties.²⁰² The implication is that the transaction has the "substance" assigned to it by the taxpayer because it was engaged in for some nontax reasons (business purpose). Thus, in one of the few situations where there may be ongoing economic relationships which may be characterized by terms (owner or lessee) which actually reflect different economic relationships, those economic relationships would seem to become irrelevant (or only marginally relevant).

Another problem with *Lyon* is that it gives little guidance for determining how ownership should be determined in the *absence* of a business purpose for the structure adopted by the parties. If parties are free to structure a transaction as either a sale-leaseback or as a financing transaction, and can achieve identical economic results from either structure, when will the parties' chosen form be respected for tax purposes? Unless *Lyon* also means that lack of business purpose is enough to justify *rejecting* the taxpayer's form (which would *completely* eliminate economic relationships from the equation), there must be some way to evaluate objectively the economic relationships

200. 435 U.S. at 584.

201. 435 U.S. at 573.

202. The Court stated that

[w]e, however, as did the District Court, find [these] . . . economic realities of the transaction: the competitive situation as it existed between Worthen and Union National Bank in 1965 and the years immediately following; Worthen's undercapitalization; Worthen's consequent inability, as a matter of legal restraint, to carry its building plans into effect by a conventional mortgage and other borrowing; the additional barriers imposed by the state and federal regulators; the suggestion, forthcoming from the state regulator, that Worthen possess an option to purchase; the requirement, from the federal regulator, that the building be owned by an independent third party; the presence of several finance organizations seriously interested in participating in the transaction and in the resolution of Worthen's problem; the submission of formal proposals by several of those organizations; the bargaining process and period that ensued; the competitiveness of the bidding; the bona fide character of the negotiations; the three-party aspect of the transaction; Lyon's substantiality and its independence from Worthen; the fact that diversification was Lyon's principal motivation

435 U.S. at 582. Note the extent to which these economic realities prove *motive* and do not describe the actual resultant *relationship*. This problem has not escaped the attention of other scholars. See, e.g., Del Cotto, *Sale and Leaseback: A Hollow Sound When Tapped?*, 37 TAX L. REV. 1, 30-31, 41-47 (1981).

growing out of a transaction so that one of the parties can be labeled "owner." Unfortunately, no one has yet been able to enunciate exactly how that determination can be made. Some suggest that ownership means a "realistic hope of profit."²⁰³ Others believe that it means a realistic possibility of loss.²⁰⁴ Most simply acknowledge that there is no accurate test.²⁰⁵

This inability to articulate a means of determining the "substance" of ownership says more about the shortcomings of ownership as a concept than it does about any shortcomings of tax attorneys.²⁰⁶ The problem is that the cases are generally concerned with determining which of two (or more) parties is the "owner" of a specific depreciable asset. But to the extent that the concept of ownership has any real meaning (outside of tax law), it relates not to an asset as a whole, but to certain rights to act with respect to that asset. While people often casually refer to "ownership" of property, "what one owns is properly *not* the [asset], but rather [certain] rights" with respect to the asset, such as current or future possession or use of the asset.²⁰⁷ At least under commonly accepted principles of property law, "[o]ne having a lesser estate [such as tenancy] may be an owner, and, indeed, there may be different estates in the same property, vested in different persons, and each be an owner thereof."²⁰⁸

Where one of the parties is the owner of certain property, in the sense that she owns *all* of the possible rights to possession and enjoyment of that property, no court will be asked to determine ownership; when a court *is* asked to determine "ownership" of a particular asset, no such thing exists. To the extent that courts are attempting to ascribe to one party a relationship (ownership of the *asset*) that does not exist in the cases before them, it is understandable that they have a hard time getting it right.²⁰⁹

Another common situation in which tax consequences explicitly

203. See *Dunlap v. Commissioner*, 74 T.C. 1377 (1980), *revd. and remanded on other grounds*, 670 F.2d 785 (8th Cir. 1982); Marsh, *Tax Ownership of Real Estate*, 39 TAX LAW. 563 (1986) (suggesting that potential for appreciation should be the most significant determinant of ownership).

204. See Simonson, *supra* note 196, at 20-24.

205. *Id.* at 31. See also Cliff & Levine, *Reflections on Ownership — Sales and Pledges of Installment Obligations*, 39 TAX LAW. 37 (1985) (concept of ownership is necessarily imprecise, and no single test can be relied upon).

206. In general, a group with very few, if any, shortcomings at all. For example, talk to my friend David Gerson.

207. See 1 H. TIFFANY, *LAW OF REAL PROPERTY* 4 (3d ed. 1939).

208. *Baltimore & Ohio R.R. v. Walker*, 45 Ohio St. 577, 16 N.E. 475, 480 (1888).

209. One could imagine fairly straightforward ways of determining who is the "owner" of property, such as simply stating that the owner is the one with the most valuable rights in the property. Among the effects of such a rule would be that most property would be found to be

depend on characterization of the relationships created by an exchange, rather than on identification of the items exchanged, arises when courts and the Internal Revenue Service attempt to define corporate obligations as debt or equity. If the obligations represent ownership of the corporation (equity), corresponding corporate payments are either dividends²¹⁰ or stock redemptions.²¹¹ Neither is deductible by the paying corporation. If the obligations are debt instruments, payments are either interest (deductible to the payor under section 163(a)) or tax-free payments of principal. Significant tax consequences thus depend on whether the relationship established by the shareholder's transfer is ownership of the corporation.

Generally, the difference between debt and equity is that equity represents an investment in the company, while the return on debt is more secure and not dependent on the company's performance. In those cases hard enough to attract attention, the obligations sought to be characterized have significant elements of both debt and equity but all of the elements of neither. Sometimes the obligations on their face have more risk (perhaps because they may be subordinated to other

"owned" either by long-term tenants or by mortgagees; and no one connected with the tax law is willing even to contemplate the confusion and consternation that would follow.

Even if a satisfactory test of ownership could be developed, it could not be consistently applied. Assuming such a test related to the value of certain rights and the realistic expectation or possibility of future gain or loss, ownership would necessarily be dependent on the value of the entire asset, because a substantial change in the asset's value would affect the relative value of the different rights as well as the different parties' realistic possibilities of gain or loss. Unfortunately, while a determination of ownership is necessarily a determination of the economic relationship between a person and an asset, and while the significant (and defining) aspects of the relationship can vary from day to day (e.g., the value of a deed of trust securing a nonrecourse loan may vary in accordance with the value of the property securing it), determination of ownership in the tax sense *cannot* change along with the changes in the economics that define it. If, under an objective test, *A* were found to be the owner of property on Monday, but on Wednesday substantial market changes made it so that *B* was the objective "owner," for tax purposes, *A* would still have to be considered to be the owner on Thursday morning. For an analysis of how and why courts could account for ownership changes even absent some observable exchange, see Rosenberg, *Better To Burn Out Than To Fade Away? The Consequences of the Disposition of a Tax Shelter*, 71 CALIF. L. REV. 87, 119 (1983).

Arguably, tests for determining "ownership" could be enunciated if one takes into account the reasons for making the determination; and the above problems could be said to be nothing more than the result of removing the term "ownership" from context. By placing "ownership" in its appropriate context, one could simply ask questions such as: "Given all the facts, who should be entitled to the depreciation deductions for the decline in value of the property?" Unfortunately, merely rephrasing the question provides no answer. Perhaps the depreciation deductions should go to the person who bears the loss from the property's decline in value; but in many situations risk of loss is divided among two or more parties. In many others, depreciation is not based on the property's decline in value in any event. Real property is depreciable despite the likelihood in some cases that it will *increase* in value, and personal property is depreciable at a rate which often bears little relationship to the rate at which its value actually declines. See Steines, *supra* note 73, at 535-45. Nor does looking to congressional intent provide assistance. In these, as in most hard cases, Congress simply did not foresee the problems.

210. I.R.C. §§ 301, 316 (1982).

211. I.R.C. § 302 (1982).

creditors or because the corporation is thinly capitalized) and more upside potential (perhaps because of high interest conditioned on the company's performance) than "debt," but have less risk (because of priority over other shareholders and because payment is dependent not on profits but on simply avoiding bankruptcy) and upside potential than equity. Other times obligations appear to be straight debt, but the relationship between the corporation and the shareholder is such that the parties are unlikely to treat it as such.²¹²

Judicial attempts to determine whether obligations are debt or equity have been summarized by professors Bittker and Eustice: "[I]t is well established that the formal terms [of the instrument] are not decisive On the other hand, no alternative standards can be distilled from the viper's tangle of cases, which commonly refer to such general principles as . . . 'substance over form,' 'business purpose,' 'tax avoidance,' and the like."²¹³ Neither legislative nor administrative action has resulted in a more reasoned or logical approach to the problem, however. After failing in an earlier attempt to codify definitions of debt and equity,²¹⁴ Congress in 1969 enacted section 385, which authorized the Treasury to draw up workable definitions. Treasury has tried to do so three different times and has yet to approach success.

To some extent, the problems in determining whether certain obligations are debt or equity mirror problems found in several other areas of tax law: Exchanges (*i.e.*, payments) must be classified as a certain kind of transaction (*e.g.*, interest payment or dividend distribution or rent). Such classification requires a particularized labeling of relationships (*e.g.*, owner or creditor or tenant) when *none* of the possible labels describe the relationships that actually exist.

Another example of the same problem involves determining whether transfers from one person to another are gifts or compensation: The answer depends on whether the payments are compensation for past or future services by the recipient (or someone else), or whether they are made out of detached and disinterested generosity.²¹⁵ But in fact, when cases come up, the truth lies somewhere in the middle. Similarly, whether payments from a corporation to a shareholder

212. For example, a sole shareholder is unlikely to enforce the terms of a debt instrument against her own corporation. *See, e.g.*, *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408 (1954), *aff'd.*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957) (notes were not debt because controlling shareholder would not enforce them to corporation's detriment).

213. B. BITTKER & J. EUSTICE, *supra* note 34, ¶ 4.04.

214. Definitions were passed by the House and rejected by the Senate in 1954. *See* H.R. 8300, 83d Cong., 2d Sess. §§ 312(b)-312(d) (1954); S. REP. NO. 1622, 83d Cong., 2d Sess., 42 (1954).

215. *See Duberstein v. Commissioner*, 363 U.S. 278 (1960).

are dividends or compensation for services depends on establishing which extreme is the case when the reality is simply somewhere between the two.

The result is that when there are easy cases, description of the substance is simple. When there are hard cases, all available descriptions of the substance are simply wrong.

4. *The Real Basis for the Doctrines*

At this point, one might question the validity of much of the judicial analyses of tax cases. "Business purpose" is supposedly a requirement of certain *statutes*, but it appears to be relevant only as a means of determining whether the *facts* of a case are different from those alleged by the taxpayer. The relevant facts must be determined so that the appropriate law can be applied; but there is no way to determine what those facts (the "real" exchanges) are, so that a court's view of the "facts" depends more on what law it wants to apply than on any kind of objective observation of facts. Transactions are to be characterized as those which reflect the "substance" of the facts; but the facts often have different substance for the different taxpayers involved. Other times *none* of the potentially applicable characterizations accurately reflect the substance from *anyone's* point of view. Still other times, several *different* provisions, with very different tax consequences, can describe a single exchange equally well. Citizens may do whatever they wish to avoid taxes; but if actions are seen as motivated by tax avoidance rather than by a business purpose, the desired tax consequences may not be available. Then again, maybe they will be.

All of these inconsistencies flow from the same basic systemic flaws: (1) the system attempts to force precise transactional definitions on imprecise relationships; (2) even where the facts of a case accurately reflect the precise statutory requirements for certain tax-favored exchanges, they may *not* reflect the behavior that Congress sought to encourage (or to avoid discouraging) because the statutory *requirements* simply do not mirror the statutory *objectives*; and (3) in any system where a person's taxable income and ultimate liability depend on his transactions rather than on accurate measurement of economic income, taxpayers will be encouraged to engage in tax-favored transactions rather than in the most economically productive activities. As a result, the system is inherently inaccurate both in defining transactions and in defining income by way of transactions. Left unchecked, these problems would allow taxpayers to avoid taxes through economically meaningless (or worse) activity.

Those charged with administering and enforcing the tax laws have

responded to the flaws caused by the system's transaction focus by enunciating and applying all of the doctrines discussed above — business purpose, step transaction, and substance versus form. None of these doctrines adequately addresses the problems, however, because these doctrines are children of the same system that created the problems. The problems are the result of basing taxation on transactions. The purported solutions are all simply *ex post* justifications for recharacterizing one transaction as some different one, resulting in neither accuracy nor consistency.

While courts have made a point of explaining that tax minimization is not “bad,”²¹⁶ the truth is that some tax minimization *is* bad and *is* condemned by the courts. All of the above doctrines were designed essentially to combat it. The problem is that when doctrines address tax minimization only within the context of determining whether some implicit statutory requirement is met (business purpose), whether the “facts” are different from those embodied in legal contracts (step transactions), or whether the “substance” of a transaction is different from its form, the response seems to be simply that tax minimization becomes “bad” only when the taxpayer's exchanges can somehow be recharacterized as a different transaction from that posited by the taxpayer. In the law of tax avoidance, the remedy determines the rights. Sometimes courts will hold that the “facts” are different from those alleged by the taxpayer; other times they will instead hold that the substance of the exchange is different from its form. In either case, the unexpressed reasoning behind the decision is the same: If the transaction can be recharacterized, tax minimization becomes tax avoidance and is bad. If the taxpayer was motivated by tax avoidance but there is no other label we can readily put on her exchanges, her behavior is only tax minimization and is good.

Viewing these doctrines as mere devices to combat tax avoidance when the recharacterization remedy is available also serves to explain why the business purpose test for either doctrine does not always “work.” If the doctrines are nothing more than justifications for punishing certain transactions fraught with tax avoidance, it would make sense that when taxpayers engage in transactions that have a legitimate business purpose and are not motivated by tax avoidance those taxpayers should not be punished. It should not be surprising that the business purpose test does not “work” only in those cases in which its

216. “[A] man's motive to avoid taxation will not establish his liability if the transaction does not do so without it.” *Chisholm v. Commissioner*, 79 F.2d 14, 15 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1936). See generally Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

application might do something *other* than punish tax avoidance. In cases such as *Zenz v. Quinlivan*²¹⁷ and Revenue Ruling 83-142²¹⁸ the taxpayer *had* a business purpose for his actions, but those actions were nonetheless integrated *for the taxpayer's benefit*. If viewed as exceptions to a general rule that determines "facts" by reference to business purpose, these cases do not make sense. When viewed from the perspective of a doctrine which is addressed to punishing tax avoidance and rewarding economically motivated behavior, they make perfect sense.²¹⁹

Use of these doctrines to combat tax avoidance does have some benefits. It allows the courts and the Internal Revenue Service to counter abuses, and it allows them to do so in a manner that appears (to some) to be consistent with the system and with the rule of law. Rather than stating that tax avoidance is wrong but our weapons against it are weak, we can explain that tax minimization is not tax avoidance and is not therefore wrong; sometimes the taxpayer simply "did" something other than what she thought she had done. Courts and the Internal Revenue Service can enforce equity under the guise of determining "facts" or "substance," thus protecting the image of precision while fighting some of its untoward consequences.²²⁰

But use of the business purpose, step transaction, and substance versus form rationales for punishing tax avoidance does have some flaws. Essentially, there are three problems with this approach: (1) it is misunderstood; (2) it is inaccurate; and (3) it is misdirected.

If the courts and Internal Revenue Service acknowledged the true role of the step transaction and substance versus form doctrines as ex

217. 213 F.2d 914 (6th Cir. 1954).

218. 1983-2 C.B. 68.

219. Analysis of the few substance versus form cases which have resulted in recharacterization of the "substance" in the taxpayer's favor reveals that the taxpayer has "merited" relief from the purported substance by acting without a tax avoidance motive. See, e.g., Rev. Rul. 83-142, *supra* note 218; *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (taxpayer was obligor of debt in substance, even though in form her corporation was debtor).

220. For a discussion of the value of this image, see P. NONET & P. SELZNICK, *LAW AND SOCIETY IN TRANSITION: TOWARD RESPONSIVE LAW* 68-70 (1978). Adoption of "equitable" principles in these cases is probably more common than might appear. A kind of perceived equitable estoppel might be behind situations such as that in Rev. Rul. 72-354, 1972-2 C.B. 216 (sale and reacquisition of stock held separate) and cases such as *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973), and *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd.*, 523 F.2d 1308 (8th Cir. 1975) (charitable contributions and repurchases of the contributed property from the charity held separate). In these situations, taxpayers who disposed of property for tax purposes and with the intention of reacquiring the transferred property were *not* subjected to having their transactions recharacterized. Cf. *McWilliams v. Commissioner*, 331 U.S. 694 (1947) (denied losses on stock sales where sales by one spouse matched by identical purchases by other spouse). Very possibly, it was believed that because the taxpayers incurred a risk of not reacquiring the sought after property and because that risk was incurred in reliance on express statutory provisions, some sort of equitable estoppel against the government was in order.

post justifications for punishing tax avoidance when the facts are close enough to some other transaction so that either the “facts” or the “substance” of the exchange can be said to be described by that other transaction, at least everyone would understand both the principles to be applied and the relevant facts. Because the doctrines are instead supposed to be objective observations of fact or law, however, their roles are often fundamentally misconceived. Courts may be convinced that they are reaching an objective determination of an exchange when there is no such thing. While tort scholars long ago realized that proximate cause is merely identifying circumstances where “the law is justified in imposing liability”²²¹ and that liability must therefore be rooted in fairness at least as much as in causation, tax lawyers and courts are still attempting to figure out objective causation — a task which is not only fruitless but also misleading. As a result, a court may cling to a test such as business purpose, intent, or binding commitment, or to a concept such as transactional consistency, because that court, or one by whose decision it is bound, used that test in a previous decision. By so doing, it may reach an inappropriate result in the case before it, because it fails to understand that *really* the proper test is a function of the desired result rather than vice versa.

III. ALTERNATIVE APPROACHES

Because the current doctrines aimed at countervailing the inherent flaws of a transaction-based system of taxation are misdirected, the question becomes whether there is any more rational way to deal with these problems. The problems will not disappear, and, unless some alternative approach is available, it may be that misdirected solutions are better than none at all. What follows is the outline of a way of viewing and solving these problems which, while not without its own drawbacks, may provide the foundation for a more reasoned and justified approach to the problems.

A. Introduction

1. Defining the Problem

Because it measures income and imposes liability by reference to exchanges and transactions, our system impacts on every transaction (and every failure to engage in a transaction) in which a person might otherwise take part. Some transactions result in tax liability in excess

221. W. PROSSER & R. KEETON, *supra* note 39, at 264.

of the income generated by the tax-significant exchange;²²² others may result in accurate taxation of accrued income; and, indeed, some transactions may even result in a negative rate of tax on accrued income.²²³

Because every taxpayer has a potentially infinite number of alternative transactions available, each with different tax consequences, every taxpayer's choice will theoretically be impacted by the applicable tax consequences. To the extent that some transaction generates more tax liability than would some alternative behavior, the tax laws will tend to discourage it when compared with that favorably taxed alternative. To the extent that a certain transaction generates *less* tax than some other alternative, the tax laws will tend to encourage it, as opposed to the more highly taxed avenue. On the other hand, *no* choice will be governed *entirely* by tax consequences: no taxpayer would enter into a transaction that generates even \$1,000,000 in tax savings if the transaction will also result in a \$1,500,000 economic loss. Unless the economics are sufficiently acceptable so that the *net* after-tax result, taking into account *both* economic and tax consequences, is positive, the transaction will be foregone. As a result, to condition tax benefits on the presence of some "business purpose" is, in reality, to do nothing at all.²²⁴

Nor is conditioning tax benefits on the taxpayer's pursuit of some *pre-tax* profit, either in gross-dollar or present-value terms, an acceptable alternative. Congress has specifically enacted many tax benefits *expressly* to encourage taxpayers to engage in transactions which would be economically unproductive absent the tax incentive. In addition, the worst tax abuses would not be made more tolerable by the presence of some minimal pre-tax profit.

Similarly, to withdraw tax benefits where the taxpayer fails to take some economic risk, as the law seems to do in many situations, appears to lack any reasoned justification. Many risk-free investments are motivated by a desire to avoid risk, not by a desire to avoid taxes; and the absence of risk itself indicates nothing about tax avoidance. As a corollary, the presence of economic risk is no indication of the absence of tax avoidance. If someone is avoiding taxes that she ought

222. Any sale or exchange of appreciated property results in taxation of gain accrued prior to the sale, even if the sale or exchange itself is a losing proposition. See *supra* text at note 32.

223. Any sale or exchange of property that had declined in value prior to the sale results in such a negative tax.

224. One might suggest that there are certain activities that result in tax savings but that have no economic effect at all, and taxpayers may at least engage in these kinds of activities solely for their tax consequences. Such a suggestion misses the point. *Every* action necessarily has some economic effect — even an action that simply maintains the *status quo* (e.g., if a taxpayer refrains from selling an asset).

to pay, the fact that her plan requires her to engage in some economically risky (or even counterproductive) activity does not itself make that plan any more productive or desirable. At most, the presence of economic risk might make a taxpayer less inclined to engage in some activity, but it cannot make the activity itself less inclined towards tax avoidance. One might analogize tax avoidance to robbery from the public fisc. The presence of economic risk, like the presence of a dangerous neighborhood surrounding a vault that houses some public funds, may make that robbery less likely to occur, but it does not make the taking of funds from that dangerous vault any less of a robbery when it does occur; nor does it make that robbery any more acceptable than, for example, robbery of a smaller amount from a less dangerous vault.

Many have responded to this apparent dilemma by claiming that tax avoidance ought to be irrelevant to the determination of tax liability.²²⁵ But the fact remains that the system *is* subject to abuse and that avoidance-motivated taxpayers *do* abuse the system.²²⁶ Because the system focuses on transactions rather than on income, and because those transactions themselves are not always defined in a way that correlates with their underlying purpose, the system is easily subject to manipulation. Taxpayers can tailor their conduct in ways that increase the distortions in the system, decrease their share of tax liability, and produce results that are economically either meaningless, or worse, undesirable. Unfortunately, purely legislative correction of the mismeasurements that create the problems is sometimes impossible, and is always too late. As long as many of the country's best lawyers continue to be so well paid for finding and maximizing the mismeasurements that lead to abuse, it is likely that the lawyers and their clients will almost always remain at least a year or two ahead of legislators' attempts to close down the mines.

Nor does the fact that current approaches to tax avoidance are irrational imply that tax avoidance cannot be dealt with reasonably. It

225. See, e.g., Gunn, *supra* note 62, at 743; Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982); Summers, *A Critique of the Business-Purpose Doctrine*, 41 OR. L. REV. 38 (1961). But see Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021, 1052 (1953) (admitting that the current judicial approaches to tax avoidance are not necessarily logically consistent, but upholding the need to protect the federal revenues from tax avoidance, hoping that somehow "legal principles will emerge").

Professor Blum has suggested that these problems make any unifying theory of the role of form or substance simply unattainable. See Blum, *The Importance of Form in the Taxation of Corporate Transactions*, 54 TAXES 613, 621 (1976).

226. See Cohen, *Tax Avoidance Purpose as a Statutory Text* [sic] in *Tax Legislation*, 9 TUL. TAX INST. 229 (1960) (concluding that statutory tests that refer to tax-avoidance motive are the result of Congress' inability to deal adequately with the problems before it).

means only that it has not been so dealt with yet. The remainder of this article suggests and explores some consistent and workable alternatives to current judicial analysis.

2. *Defining Tax Avoidance*

Any reasoned approach to tax avoidance ought to begin with a question that, surprisingly, has generally been ignored to date: What *is* tax avoidance? Because some tax-motivated behavior is not only sanctioned, but also encouraged and relied on by Congress, while other such behavior is clearly frowned upon, it must be apparent that tax-motivated behavior is not *per se* tax avoidance. The first step is thus to determine when tax-motivated behavior *becomes* tax avoidance — what distinguishes acceptable tax-motivated behavior from abusive tax-motivated behavior.

Obviously, any transaction that results in the accurate measurement of accrued income cannot realistically be said to result in the “avoidance” of any tax, regardless of the taxpayer’s motive; and any statutory *provision* that accurately measures the taxpayer’s accrued income cannot really be subject to abuse. There can be no tax avoidance absent some provision that undermeasures the taxpayer’s economic income.

Equally obvious is the fact that many provisions that result in mismeasurement of economic income have been enacted with the knowledge and expectation that they will do so, and that this undermeasurement of economic income will encourage certain desirable taxpayer behavior, which will in turn promote some desired congressional goal. A tax incentive that achieves a congressional purpose by rewarding the taxpayer who acts in the manner sought to be encouraged by Congress is not bad, nor is the taxpayer who carries out the intended legislative purpose and who is rewarded accordingly engaging in tax avoidance. The result of these fairly obvious statements is that there can be tax avoidance only when (1) some Code provision mismeasures economic income; and (2) that mismeasurement accompanies behavior that fails to implement the congressional purpose underlying that Code provision.

Essentially, there are two different ways that a provision might reward behavior that is in fact inconsistent with the provision’s underlying aim: (1) a statute may fail to encourage the specifically desired exchanges or transactions at which it is aimed; or (2) a desired transaction may fail to further the general legislative goals which it was intended to implement. Both of these possibilities are necessary conse-

quences of any transaction-based system, and both merit further analysis.

Because the tax system imposes taxation on transactions and exchanges, the specific taxpayer conduct at the foundation of *any* incentive will usually be the taxpayer's engaging in some exchange. For administrative purposes, these exchanges must at least in the first instance be defined in terms of objectively verifiable criteria. As previously noted, nonrecognition treatment is generally given to exchanges that meet certain numerical requirements rather than to exchanges that work no change in substance. Accelerated depreciation may have been enacted to assist the *user* of depreciable property but, for administrative purposes, the benefits go to the "owner," a term that, unlike "user," is generally easily and objectively represented by possession of legal title. Congress meant to allow corporations to deduct payments that were necessary costs of doing business, and to disallow any deduction for payments that represent mere distributions of profits. In order to create some certainty as to specific payments, however, it allows deduction for payments on "debt" and not for payments on "equity." The reason is that, at least initially, the distinction between debt and equity, unlike that between costs of doing business and distribution of profits, is objectively determinable by reference to existing documents.

In all of these examples, transactions are defined by, and tax consequences are conditioned on, criteria which are objectively verifiable but which do not always coincide with the activity or relationship sought to be encouraged. When a taxpayer takes actions to fit within some objective statutory definition, while failing actually to engage in the underlying behavior for which that definition is intended to substitute, he is engaging in tax avoidance.

Even if a taxpayer engages in the very transaction encouraged by Congress, the potential for abuse exists. Although tax benefits are usually conditioned on a taxpayer engaging (or failing to engage) in certain transactions, the congressional goals which underlie those benefits are rarely fulfilled by the mere completion of those transactions. Instead, those goals often relate to the taxpayer's achievement of some desirable status, and the favored transaction is generally one which may tend to, but does not always, produce that desired ultimate result or status. Again, examples are numerous. Congress allows the accrued value of annuities²²⁷ and of life insurance²²⁸ to escape current taxation primarily in order to encourage taxpayers to save; and gener-

227. I.R.C. § 72 (1982).

228. I.R.C. § 101 (1982).

ally the purchase of annuities and insurance has the intended result. But the purchase of an annuity or insurance policy does not *guarantee* savings. Where that purchase is accompanied by some other activity that *reduces* the purchaser's net worth (such as incurring a debt), the terms (*i.e.*, purchase of an annuity), but not the goal (*i.e.*, increased savings), of the incentive provisions have been met.

Similarly, to the extent that the exemption from taxation of unrealized gains is premised on considerations aside from administrative convenience, at least one such consideration is that the taxpayer who has not yet realized her gain has no cash to pay tax. Where nonrealization is accompanied by other transactions, such as borrowing, which generate cash without tax liability, at least one purpose of the realization requirement remains unfulfilled.

What the above implies is that the converse of tax avoidance is not some generalized "business purpose." Instead, tax avoidance exists only when there is a convergence of undermeasurement of economic income with a failure to achieve the specific goals underlying the provision that allows for that undermeasurement. If any provision *accurately* measures income, that provision is inherently not subject to abuse. If any provision *undermeasures* income, that provision *is* being abused unless both (1) the taxpayer engages in the actual exchange (or lack of exchange) whose concept underlies the objective statutory definition, and (2) the taxpayer does *not* engage in any other behavior whose effect tends to cancel the desired impact of the tax-favored transaction.

3. *Remedying Tax Avoidance*

When tax avoidance is so defined, an appropriate remedy becomes apparent: to the extent that the purpose of some provision that undermeasures economic income is being defeated, the benefit afforded by that provision ought to be removed. To the extent that the undermeasurement benefit of any provision *is* removed, the taxpayer's income will be measured accurately, so that no opportunity for tax avoidance exists.

While this definition of, and suggested remedy for, tax avoidance does not alone solve all of the problems discussed above, it does at least provide a firm conceptual foundation upon which solutions can be built. What follows is a logical and workable framework for those solutions.

B. *Defining the Transaction*

The approach to tax avoidance suggested above and explored here-

after suggests that tax avoidance can *exist* even when the facts indicate that the statutory requirements of some provision have been met, and that tax avoidance can be *remedied* without holding that either the facts or any particular statutory provision are something different from what they are. Acknowledgement of these possibilities would have significant implications for tax cases. Once a redetermination of the "facts" of an exchange is no longer seen as the major remedy for undesirable tax-motivated behavior, administrators and courts charged with determining the facts surrounding a given transaction will no longer need to *precede* that "factual" determination with an analysis of whether there has been "tax avoidance" and will no longer need to *premise* that "factual" determination on an unspoken predetermination *with respect* to tax avoidance. Instead, courts and the Internal Revenue Service could view tax cases as potentially raising two sequential, but fundamentally *different*, inquiries: (1) What is the transaction that has occurred? and (2) To what extent has the taxpayer engaged in tax avoidance?

While new to tax cases, this two-level inquiry has deep roots in many other areas of the law. Tort cases, for example, always require that a determination of the facts precede a judgment as to whether there has been negligence. Similarly, the initial inquiry suggested above is essentially a factual one; the second issue, like a finding of negligence, is a mixed question of law and fact.

Of course, merely segregating the appropriate inquiries without more does not solve all problems; as with tort cases, each of the two inquiries must be defined with sufficient precision to allow it to be directly addressed. But segregation of the inquiries does allow for a *degree* of precision within each issue that may be new to tax law. Because the first inquiry suggested above is a determination of the relevant "facts," the first step towards more precise definition of that inquiry is a determination of which facts to look for; if the ultimate "factual" finding is a decision that some specified relationship exists or that some transaction has occurred, how does one reach that decision?

In line with both the above approach and with generally applicable principles of tax law, a determination of what transaction has occurred ought to rest only on the legal relationships among the parties.²²⁹ A significant reason for basing taxation on transactions rather than on economic income is that economic relationships are simply too difficult to measure; on the other hand, legal relationships are generally

229. See, e.g., *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) (it is state law as determined by the federal court that determines real legal rights).

clear-cut and readily determinable. Indeed, with respect to relationships such as "ownership," the reasonableness of basing the relationship on legal rights ought to be self-evident. As previously explained, there is no "fact" of ownership at all. Almost the first thing any first-year law student learns in her property class is that property does not have some natural "owner," but that "ownership" is merely a *legal* term applied to describe a certain bundle of legal rights which one person has with respect to a certain asset. To assert that "ownership" is a question of "fact" rather than of law is to claim that the existence of some inherently *legal* relationship can be described without reference to the law. It simply makes no sense.

Even aside from relationships that can be explained *only* in terms of their legal foundation, tax consequences generally are dependent in the first instance on a person's legal rights rather than on his economic intentions or expectations. The employee who expects a bonus is not taxed on it until and unless it is received or the employee's legal rights become fixed; the businessperson who establishes good working relationships is not taxed on their value until they translate into receipt of some legal right. Characterization of payments as "alimony,"²³⁰ of transfers as "completed gifts,"²³¹ of relationships as "ownership," or of entities as corporations, partnerships, or trusts²³² has always been based on examination of the parties' legal rights and liabilities. Relationships with some economic benefit which cannot be translated into the receipt or accrual of an actual legal right, while possibly relevant in determining true economic income, are essentially ignored for tax purposes.

Basing the facts on a determination of the legal rights and liabilities created by the parties does not mean that issues such as the intention and purpose of the parties are irrelevant. While it is the federal tax law that *characterizes* relationships based on legal rights, it is relevant state law that *determines* the rights and liabilities on which that characterization depends. The determination of what is a single "exchange" is, as most other facts in tax, ultimately a question of legal relationships, and the legal relationships involved are necessarily those created under the relevant state laws. Whether purportedly separate exchanges should be integrated ought to depend simply on whether the exchanges form an integrated contract under basic principles of contract law. Under those principles, a "contract is entire when by its terms, nature, and purpose it contemplates and intends that each and

230. I.R.C. § 71 (Supp. IV 1986).

231. *E.g., Bosch*, 387 U.S. 456.

232. Treas. Reg. § 301.7701-2 to -4 (as amended in 1986).

all of its parts and considerations shall be common to the other and interdependent.”²³³ Essentially, if one party can enforce one part of an overall agreement (*i.e.*, one exchange) against another, based upon the consideration provided by another part of that overall agreement (*i.e.*, a different, but integrated exchange), then the exchanges are part of an integrated contract and ought to be treated as such. If the exchanges can be separately, and independently, enforced, they should be treated as separate. In determining whether a contract is integrated, Professor Williston suggested that “[t]he essential test . . . can be nothing else than the answer to an inquiry whether the parties assented to all the promises as a single whole, so that there would have been no bargain whatever, if any promise or set of promises were struck out.”²³⁴

Thus, applying state contract law to redetermine what the parties would or would not have assented to might well involve inquiry into their intent and purpose. Nonetheless, the inquiry is fundamentally different from, and more reasonable than, the intent or business purpose test sometimes used for application of the step transaction doctrine. Rather than sometimes basing integration on the intent of only one of the two (or more) parties to a series of exchanges, and other times conditioning integration on mutual intention without providing any reasoned basis for determining when either individual or mutual intention should be the basis for decision, a test that looks to contract law would make clear *what* intention is relevant (mutual intention of the parties) and *why* it is relevant (to determine the understandings reached between or among the parties).

Looking to contracts to determine when exchanges are integrated would not mean always accepting at face value the documents submitted by the parties. Contract law does not always restrict itself to the documents, but can and often must take into account parol evidence to determine the real, rather than merely the written, agreement of the parties. In addition, where a single document (or several simultaneously executed documents) sets out a series of exchanges, whether those exchanges are understood by the parties to be mutually interdependent is simply unascertainable without reference to extrinsic facts. Contracts which purport to establish as separate a sale and leaseback, a sale and nonrecourse (or, for that matter, recourse) loan, a dividend and recontribution, or any number of other possibly interdependent exchanges may well lack the independence asserted therein. Further

233. *First Seattle Dexter Horton Natl. Bank v. Commissioner*, 27 B.T.A. 1242, 1247, *aff'd*, 77 F.2d 45 (9th Cir. 1935). See generally Paul & Zimet, *supra* note 104, at 235-54.

234. 6 S. WILLISTON, WILLISTON ON CONTRACTS § 863 (3d ed. 1957).

factual inquiry will often be necessary, but at least the decisionmaker and the parties will all be inquiring after the same facts.

Conditioning the determination of transactions on legal relationships may not be as "helpful" to the government in some circumstances as is the current approach. If transactions between individuals and their controlled entities are respected as separate in the absence of "mutual" intent sufficient to establish contractual interdependence, much self-dealing will be possible. On the other hand, in a system that generally recognizes as separate taxable entities an individual and her wholly owned corporation, some self-dealing is inevitable. Such potential "abuse" would seem to be best dealt with by provisions which recognize the possibility and address it directly, rather than by artificial restructuring of the "facts" when the government sees fit.

Nor will determination of the facts of an exchange always be as simple as explaining the legal foundation for that determination. Because the government is not a party to the negotiations or to the contracts which it seeks to enforce (either as written or as "intended"), and because the government's interest will usually be adverse to the interests of the other parties, proof will be difficult and collusion between taxpayers will be tempting. Indeed, it may be that certain factual presumptions in the government's favor would be appropriate.

On the other hand, only by consistently using some logical basis for determining contractual integration will the parties know *what* it is they are attempting to prove. And any attempt to apply a standard for integration *other* than that established by contract law must be either nothing more than a rationalization for some other predetermined (but not necessarily predictable) outcome or else inherently doomed to failure.

In addition, confining a determination of "facts" to a finding of legal relationships will force courts to focus with a more critical eye on the substance of those legal relationships. If the judiciary were forced to determine *what* legal relationships exist, it could not so easily find that some legal contract does *not* exist just because it was motivated by tax avoidance; and what would necessarily follow would be an accurate analysis of what the real legal relationships are.²³⁵

235. Cases involving the acquisition of property subject to nonrecourse debt in excess of the property's value provide a good example of what might be gained by requiring courts to focus on existing legal relationships. In these cases, some courts have held that property sold (in the sense, at least, that *legal* title passed to the purchaser) subject to such debt was *not* sold, *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), thereby denying the very existence of legally enforceable agreements. Even in situations where the Internal Revenue Service has acknowledged that a sale *has* occurred, it has asserted that an admittedly enforceable, legally binding obligation was, for tax purposes, not an obligation at all. See Rev. Rul. 77-110, 1977-1 C.B.

By giving credence to blatantly false assertions that legal relationships simply do not exist, current doctrines allow decisionmakers to avoid determining what these relationships really are. On the other hand, admitting the existence of what is, and then determining *what* it is, could result in decisions that are both more accurate and more effective in combatting tax avoidance.²³⁶

58 (nonrecourse debt in excess of property's fair market value not included in the purchaser's basis because unlikely that it would be paid).

236. For example, assume that *P* purchases a building from *S* for \$10,000 cash and takes the building subject to a nonrecourse debt of \$190,000, payable in full, with all accumulated interest, at the end of 30 years. Further assume that the building is worth only \$10,000 at the time of the purchase. A straightforward analysis of the legal situation created by this sale would be that *P* becomes the owner of the building upon taking legal title thereto, and that *P*'s cost for the building consists of two parts: (1) a current payment of \$10,000 cash, and (2) an obligation to transfer to *S* in 30 years the lesser of \$190,000 plus accumulated interest or the building. (One might suggest that to require a court, or the Internal Revenue Service, to determine what the building will be worth at the end of 30 years would be too burdensome. It is not. Current valuation of any asset is based, in large part, on the asset's predicted income stream. As a result, under this model, the step from current to future valuation involves taking the present value of the property and decreasing that amount by the predicted economic depreciation. Because the economic depreciation of any particular asset may be difficult to determine, the process might be simplified by applying the alternative depreciation schedule of I.R.C. § 168(g) (1982), which at least roughly approximates economic depreciation, to the present value of the asset in question. The possible use of the § 168(g) schedule to approximate, or, perhaps more accurately, substitute for, economic depreciation, is suggested by Cunningham & Schenk, *How To Tax the House That Jack Built*, 43 TAX L. REV. (forthcoming).

If the building had a predicted future value of, for example, \$500 (the predicted future value of any depreciable property would *always* be less than its current value under the approach suggested above), *P*'s real cost for the building would be \$10,000 plus the lesser of (1) the present value of \$190,000 plus interest payable in 30 years or (2) the present value of an obligation to transfer property worth \$500 at the end of 30 years, or a total of about \$10,040. (Of course, the exact present value of a future obligation would depend on the discount rate used. The simplest rate to use would be the applicable federal rate on instruments of similar term, because that rate is published monthly by the Internal Revenue Service.) By *focusing* on the legal relationships rather than denying their existence, the legal sale could be accurately characterized as a sale, the legal debt could be accurately characterized as a debt, and the highly inflated basis sought by the taxpayer would nonetheless be disallowed. As Freud suggested, denial of reality, and the problems that accompany that denial, is simply unnecessary. See generally S. FREUD, *THE PROBLEM OF ANXIETY* (H. Bunker trans. 1936); S. FREUD, *THE INTERPRETATION OF DREAMS* (A. Brill trans. 3d ed. 1933). (It may be that cases such as *Franklin* are aimed at the *transfer* of depreciation deductions from Seller to Buyer as much as at the inflation of the amount of those deductions. To the extent that free transferability of tax benefits is undesirable, the problem can be best addressed by the method suggested *infra* in the text at note 317.)

If the sale discussed above occurred in conjunction with a lease from *P* to *S* for "rent" of \$20,000 per year, and if \$20,000 "interest" were payable annually (rather than compounding until due in year 30), the "facts" would more closely resemble those of the *Franklin* case; determining the actual legal relationships might be somewhat more difficult but it would not be any less appropriate. In truth, it is doubtful that such documents would accurately reflect the legal relationships between the parties. Instead, it is likely that the contracts would be integrated under state law (indeed, it is almost impossible to imagine why *S* would lease property worth \$20,000 for \$20,000 per year if he could separately enforce *P*'s obligation to pay \$20,000 per year interest). If the sale and leaseback were treated as an integrated contract, then even though the legal obligations created by that contract might require *P* and *S* to exchange checks for \$20,000 per year, it is doubtful that those amounts would be legally characterized as "rent" and "interest," respectively. The amount of the payment from *S* to *P* that would be characterized as rent would *not* exceed the property's fair rental value, and the excess would be found to be nothing more than consideration for *P*'s excessive annual payments to *S*. More importantly, if the sale

Finally, reliance on legal relationships to establish the facts of any purported transaction would prevent one taxpayer from taking advantage of someone *else's* tax avoidance to implement her *own* tax avoidance goals. If *A* enters into a binding legal agreement with *B*, there is no apparent reason why *A's* tax liability ought to depend on *B's* motive for entering into the agreement. Nonetheless, under cases like *McDonald's*,²³⁷ *Kass*,²³⁸ and *Lyon*,²³⁹ the court's determination that the *facts* of a transaction can change because of one party's actions or motivation, either prior to or subsequent to that transaction, explicitly allows such manipulation. Limiting a determination of facts to legal relationships logically and consistently prevents the "facts" from being abused.

C. Finding Tax Avoidance

1. Introduction

At its most basic level, the assertion that someone is engaging in tax avoidance necessarily implies that the taxpayer is not paying some tax that she ought to pay. To the extent that the system attempts only to measure economic income, each person ought to pay tax equal to that which would result from applying her own rate to her actual economic income as it accrues.²⁴⁰ Thus, absent some underinclusion of

and leaseback were legally separate transactions, there should be no need to *pretend* that they are not. If, in a legally independent contract, *P* agrees to pay more than actual value to purchase property, it should not matter whether the property is purchased from the property's future tenant or from someone else. Similarly, if, in a legally separate contract, *S* agrees to pay excessive rent for some building, it should not matter whether or not that building is one that she recently sold to *P*. In either case, there may be tax avoidance, and in either case the existence of tax avoidance can be dealt with (*see infra* text at note 295); but in no case does the existence of tax avoidance change the legal relationships that otherwise exist, nor is it necessary to pretend that it does so.

Numerous other well-known tax cases equally demonstrate the validity of reliance on legal relationships to determine "facts" and reliance on principles *other* than a reworking of the "facts" to determine tax avoidance. In *Knetsch v. United States*, 364 U.S. 361 (1960), the Court held that the taxpayer who had purportedly purchased and then borrowed against an annuity from the same company had in "fact" not done so (*i.e.*, that no purchase or loan had occurred). While the decision produced a satisfactory result in that case, its implication is that the taxpayer might have succeeded in avoiding tax by simply borrowing from someone other than the company from which he initially purchased the annuity, so that the Court would have been unable to disavow the occurrences asserted. On the other hand, using legal relationships to determine the facts, and separating that issue from a determination of tax avoidance, could allow a court to defeat tax avoidance even if the taxpayer went through more than just one other party to attempt it. *See infra* Part III.C.

237. *McDonald's Restaurant v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

238. *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd.*, 491 F.2d 749 (3d Cir. 1974).

239. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

240. Sometimes one taxpayer may be required to pay tax on an amount in excess of her economic income as a way of indirectly taxing some other party to the transaction. *See, e.g.*, I.R.C. §§ 83(h), 404(a), and 267 (1982) (deferring one party's accrued deduction pending inclusion of income by the other party). These situations can be viewed either as negative incentives

accrued income, or taxation of accrued income at a rate lower than that specified for the taxpayer to whom the income is accrued, there simply can be no "avoidance" of tax.

Of course, the system does more (and less) than merely measure economic income. It is replete with provisions that do result in either the undertaxation or overtaxation of accrued income.²⁴¹ To the extent that any provision undertaxes accrued income, it is essentially equivalent to the payment of some amount²⁴² to the taxpayer by the government; and to the extent that a provision results in the overtaxation of accrued income, it is essentially equivalent to the exaction of some price for the specified conduct. To the extent that these payments or charges reward the taxpayers at whom they are directed and otherwise accurately impact upon those taxpayers whom they were intended to influence, the system can be said to be working well. Where Congress has acted to provide benefits to assist taxpayers in a certain status,²⁴³ or where it has provided benefits to encourage taxpayers to take certain actions believed to be helpful to society,²⁴⁴ taxpayers who fit the status intended to be benefited, or who take those actions intended to be rewarded, cannot be said to be improperly "avoiding" tax. Ultimately, then, there can be no tax avoidance if the Code distributes benefits accurately.

Unfortunately, while there is often a high correlation between the transactions or legal relationships upon which the Code relies to distribute benefits and the status or economic behavior the transactions are intended to reflect, that correlation is necessarily less than complete. To the extent that the transactions and legal relationships relied on by the Code do not correlate with the activities, statuses, or economic relationships at which the benefits are intended to be directed, the potential for tax avoidance exists. To the extent that a taxpayer intentionally directs her actions towards that potential, she is actually engaging in tax avoidance.

*

or as an indirect payment of some *other* party's tax, rather than as a surcharge on the party whose deduction is deferred.

241. *See supra* Part I.

242. The present value of the exemption or deferral of the tax that would otherwise be payable. *See supra* Part I.A.

243. *See, e.g.*, I.R.C. § 121 (1982) (taxpayers over age 55 entitled to one-time exemption for first \$125,000 of gain on the sale of a principal residence); I.R.C. § 1 (1982) (taxpayers with lower taxable incomes are permitted to pay tax at lower rates). *But see* I.R.C. § 56 (1982) (alternative minimum tax imposed on certain individuals with low taxable incomes resulting from certain tax preference items).

244. *E.g.*, taxpayers are allowed deductions for contributions to charity, I.R.C. § 170(a) (1982).

2. Problems

Because a person can be engaging in tax avoidance only if his behavior (1) is tax motivated and (2) conflicts with the actual goals of the incentive or benefit provision of which he is taking advantage, any examination of tax avoidance must begin with an examination of those provisions that mismeasure economic income and are therefore potentially capable of generating tax-motivated behavior. Essentially, there are five ways in which the system can deviate from "accurate" taxation of accrued economic income: (1) underinclusion;²⁴⁵ (2) deferral;²⁴⁶ (3) bracket differential;²⁴⁷ (4) overinclusion;²⁴⁸ and (5) acceleration.²⁴⁹ At least three of these possible types of mismeasurement may motivate taxpayer behavior. Obviously, any taxpayer would prefer

245. The most obvious of these incentives, underinclusion of income, often results from very deliberate Code provisions which specifically exclude from income certain receipts. See generally I.R.C. §§ 101-34 (1982) for a list of specific exclusions. Other exclusions, such as the exclusion of imputed income from property and services, are the result of tax common law. See, e.g., Bittker, *supra* note 69, at 135. Still other times, underinclusion results from the grant of deductions for certain expenditures that do not decrease a person's income, either because they provide untaxed consumption, see, e.g., I.R.C. § 163 (1982) (allowing taxpayers to deduct home mortgage interest payments); I.R.C. § 213 (1982) (allowing taxpayers to deduct certain medical expenses), or because they do not decrease the payor's net worth, see, e.g., I.R.C. § 164 (1982) (allowing taxpayers to deduct state taxes without any corresponding taxation of state provided services).

246. Deferral may result either from specific Code provisions that defer taxation of accrued gains, see, e.g., I.R.C. § 72 (1982) (deferring taxation of accrued increases in the value of annuities until payments are received or funds borrowed against the annuity), or from tax common law that does the same thing (i.e., the realization requirement, see *supra* note 12). And, like underinclusion, deferral can result from "negative" as well as positive provisions: Code sections that allow for deductions in advance of their economic accrual effectively defer payment of the tax on any income offset by those deductions. See, e.g., I.R.C. § 168 (1982) (providing for accelerated depreciation).

247. Bracket differential occurs when a person's income is taxed at the "wrong" bracket. Basically this could occur under pre-1987 law if ordinary income was improperly taxed as capital gains, which were taxed at a preferential rate. Although some tax theorists describe this concept as "shifting" of income from one taxpayer to a different one in a lower bracket, the problem at which that concept is directed is in truth always either deferral or underinclusion. Unless some taxpayer is undertaxed either by underinclusion or deferral, there can be no "shifting" of income to a lower bracket. When the taxpayer is undertaxed because of underinclusion or deferral, it is that undertaxation that is the source of the problem.

Bracket differential can also occur if a taxpayer is in different tax brackets in different years, and income is taxed in a year other than when it accrued and in which the taxpayer is in a lower tax bracket than in the year of accrual.

248. Overinclusion of income, which, like acceleration of income, can best be described as a "negative" incentive, can take the form of either denied deductions for business expenditures, see, e.g., I.R.C. §§ 280(A), 280(F), 274 (1982 & Supp. IV 1986), or inclusion of income never accrued by the taxpayer. See I.R.C. §§ 362, 1015 (1982) (taxpayers who receive gifts of appreciated property or who receive appreciated property in certain nonrecognition exchanges are required to pay tax on the gain inherent in those assets that accrued to the transferors prior to the transfer). See Kohl, *supra* note 15, for a discussion of this aspect of nonrecognition exchanges.

249. Acceleration of income may be effected by either requiring a taxpayer to include earnings prior to their economic accrual, see, e.g., Schlude v. Commissioner, 372 U.S. 128 (1963), or by deferring deductions until after their accrual. See, e.g., I.R.C. §§ 461(h), 404(a), 83(h) (1982 & Supp. IV 1986).

permanent underinclusion of accrued income or permanent undertaxation of that income by way of bracket differential; and most would also prefer deferral of inclusion, and its accompanying deferral of tax liability.²⁵⁰

Because tax avoidance cannot exist unless these incentives are in some way misdirected, the next problem is to determine whether, and, if so, how they miss their intended marks. There are basically two ways in which provisions that act as incentives (because they either undertax or overtax accrued income) can be misdirected: (1) provisions intended to measure one status or relationship, or intended to reward one behavior, do so only by reference to some *different* status, relationship, or behavior (substituted reference); and (2) provisions that do directly measure the status, relationship, or behavior which they are intended to measure do so only in gross — and inherently inaccurate — increments (gross measurement).

a. Substituted reference. The first of these problems, that of substituted reference, is prevalent throughout the tax system and causes problems in both the measurement of income and the effectiveness of intended tax benefits and incentives. Essentially, whenever economic income or some other status is too difficult to measure directly, Congress substitutes some other, more readily determinable status or behavior that tends to reflect the actual status sought to be

250. It is difficult to imagine ways in which either overinclusion or acceleration may be "abused" by taxpayers. For the most part, these provisions have been enacted in order to *counter* some other provisions that have been abused. For example, §§ 404(a) and 83(h), which defer an employer's deduction for much compensation until the employee's inclusion of a like amount, have been enacted to remedy, albeit indirectly, the drain on the treasury caused by employee use of the cash method of accounting (§ 461), which allows the employee to defer inclusion of accrued earnings. It was thought that deferring the employer's deduction might both generate compensatory revenue and, to a limited extent, encourage the employer to see to it that the employee's (taxable) receipt was not delayed. Indeed, because of this intended impact, these provisions have been described as merely "shifting" the tax payment from the employee to the employer; and the combination of employee deferral and employer acceleration has been referred to as doing little other than allowing the parties effectively to shift the *rate* at which the yield on that deferred payment is taxed from the employee's marginal rate to the employer's marginal rate rather than shift the time at which the principal is taxed. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506, 520 (1986). While these provisions may not always be adequate to counter the abuse (in which some *other* taxpayer is engaging) at which these provisions are aimed (e.g., because they do permit the "shifting" of tax liability from employee to employer, or from donor to donee in the case of a gift), they do nonetheless invariably *increase* the tax burden of the person to whom they apply. That person thus cannot be said to be "abusing" the provision any more than anyone else who willingly pays a higher tax cost for engaging in tax disfavored activity. (Compare the individual who receives cash earnings and elects *not* to contribute to an individual retirement account, savings plan, or contributory pension plan.) To the extent that there is "abuse" in these situations, it arises from the *deferral* accorded to the employee, and not from the inefficiency of some *penalty* that attaches to the employer.

Taxpayers may also attempt to accelerate income into a year in which they are in a lower tax bracket than they will be in in the actual year of accrual, but in such a case it is the lower bracket (bracket differential) rather than the earlier *time* of inclusion that results in a tax savings.

measured. Measurement of this secondary referent then substitutes for actual measurement of the status in question. A common substitute referent used to approximate the measurement of economic income is the system's use of a person's *motive* for engaging in a particular transaction as a substitute measure for the *result* of that transaction. Theoretically, any expenditure that results in consumption equal to the amount expended does not decrease a person's economic income, and ought not to be deductible, while any expenditure that does *not* result in equivalent consumption does decrease a person's income and ought to be deductible. Similarly, to the extent that any investment generates consumption,²⁵¹ any corresponding decline in value of that investment does not reduce the taxpayer's economic income and should not be deductible, while an accrued loss on an investment that does not provide offsetting consumption *should* be deductible. Because of perceived administrative difficulties in measuring the taxpayer's actual consumption from any expenditure or investment, however, the Code forgoes any attempt to make that measurement, and instead requires a determination of whether the taxpayer's motivation for a particular expenditure was "business" or "personal," and whether or not an investment was acquired in (or converted into after acquisition) a transaction for profit.²⁵² The determination of whether or not an expenditure or investment was made for a business or profit-seeking purpose will often correlate with whether or not that expenditure generates consumption equivalent to the expenditure, or to the decline in value of the investment, but it will not always do so. Many "business" expenses, such as business meals and many business-related travel and entertainment expenses, will generate substantial (untaxed) consumption;²⁵³ and many "personal" expenses and investments will fail to generate consumption equal to the (nondeductible) amount expended or to the investment's decline in value.²⁵⁴ The mis-measurement of income in these situations is caused by reference to the person's motive for making an expenditure to measure the consumption generated by that expenditure.²⁵⁵

251. An example of such an investment is the taxpayer's use of her home or other personal use property.

252. I.R.C. § 165(c)(1)(2) (1982).

253. See generally Halperin, *supra* note 250.

254. For example, a taxpayer who purchases a home for \$200,000 and sells it one year later for \$90,000 has probably not received \$110,000 in consumption from that home. To the extent the consumption she enjoyed from the home was less than \$110,000, her economic income has declined, but because the investment was "personal" she is entitled to no deduction.

255. For an excellent discussion of the issue of personal versus business expenses, see generally Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859 (1974).

Another example of the use of motive as a substitute for some other, less readily determinable fact inheres in the Code's definition of capital gains. The special treatment accorded such gains will ideally be granted to the increase in an asset's value that results from appreciation of property independent of the taxpayer's performance of services on, or with respect to, the asset, and will not apply to increases in value that result from the taxpayer's labors.²⁵⁶ The exclusion from capital gains treatment of gain from the sale of property held primarily for sale to customers in the ordinary course of business is intended to effectuate this distinction, but does so by reference to the taxpayer's motive for holding the property, rather than to the actual source of the income. In situations where the taxpayer holds the property for investment, but the increase in the value of the property results from her labors with respect to the property, rather than from unrelated appreciation, this reference to motive misdescribes the character of the gain.²⁵⁷ Similarly, when a taxpayer who regularly sells a particular kind of property in her business purchases an asset and later sells it at a profit due solely to appreciation, the entire gain will nonetheless be characterized as other than capital because the asset was held primarily for sale to customers in the ordinary course of business.²⁵⁸

The above examples of substitute reference deal with mismeasurement of income (business versus personal) and of status (capital gain versus ordinary income) that generates problems of underinclusion and bracket differential, respectively. Not surprisingly, substituted references can also cause undertaxation by way of deferral. One example of this problem is the system's reliance on realization of gain as a substitute for the measurement of accrual of income with respect to any asset. Reference to the time of the sale or exchange of an asset to measure the time of the taxpayer's gain on that asset is without doubt a more convenient measurement tool than is reference to accrual, but it is also necessarily an inaccurate one.

Some have suggested that another justification for the realization

256. See B. BITTKER, *supra* note 48, ¶ 51.1.

257. One example of this is the situation where a taxpayer buys a single asset for \$100,000, makes \$40,000 worth of repairs, and sells it for \$140,000, the profit being due solely to those repairs. While the gain *may* be "capital gain," it *should not* be so. See *id.* ¶ 51.1 (describing the transactions subject to capital gain or loss treatment).

258. It should be pointed out that the characterization of gains as capital, or of expenses as "business," will often suffer from a "gross measurement" problem. All of the examples in the text assume away that problem by dealing with situations where the taxpayer holds an asset either exclusively for investment or exclusively for sale in the ordinary course of business (or where all of an expenditure is either business or personal). Difficulties arising from the presence of mixed motives, rather than from the use of a substitute referent, are problems of gross measurement, and are dealt with in Part III.C.2.b.

requirement is the fact that the taxpayer who has not sold her asset does not yet have cash with which she could pay tax in any event.²⁵⁹ If this is indeed a factor, it is only indicative of another substituted referent problem — in this case, the problem lies in the use of the taxpayer's realization of gain to measure her possession of cash. While it is true that a taxpayer may receive cash on the sale of property, it is not necessarily true that the taxpayer who sells an asset will have more cash than one who refrains from selling. First of all, the one who continues to own a particular asset may have much other cash, while the one who sells may have none. Secondly, the one who sells may do so only because she wants to use the cash for some emergency expenditure or some other investment, so that she will ultimately have no more cash than if she had not sold.²⁶⁰

Another problem with using realization of gain to measure "income" with respect to a particular asset is that a taxpayer may derive income from an asset without realizing any "gain" at all. The person who buys property that generates consumption will have economic income from that property regardless of any realized or even accrued gain. But because the system uses realized gains to measure income, that imputed income from the asset will never be taxed, resulting in underinclusion.²⁶¹

Similarly, making reference to a worker's receipt of cash or property to measure his accrued income, as does the cash method of accounting,²⁶² results in deferral of any earned amounts until that receipt; and making reference to a seller's receipt of cash or property to measure her available cash, as does the installment sale provision of section 453, fails accurately to measure the status at which it is directed.²⁶³

Another example of the potential mismeasurement of income or status caused by substitute reference is the way in which most nonrecognition provisions work. If *A* transfers land to newly formed *X* Corporation in exchange for all the stock of *X*, the exchange is tax-free under section 351. *A* is granted continued deferral of any realized gain

259. See *supra* Part I.B.2.b.

260. Indeed, the need for cash, as where the taxpayer is beset by an extraordinary expense such as a medical bill, may itself have induced the sale of the asset.

261. The above discussion highlights both the merits and the defects of substitute reference: the system can use a single, readily determinable, criterion to measure at least three other factors, each of which might otherwise be difficult to ascertain. On the other hand, by doing so, the system often significantly mismeasures each of those factors.

262. See Treas. Reg. § 1.461-1(a) (as amended in 1967); see generally I.R.C. § 461 (1982).

263. This status being, presumably, the seller's ability to pay tax on realized gain without impacting negatively on her other investments.

on the land because she is now the owner of *X*, and, as a result, she has presumably not substantially changed her interest in the land.²⁶⁴ Obviously, *A*'s ownership of *X* is a substitute for the measurement of her continuing ownership of the transferred land. While this substitution of *A*'s ownership of *X* for her ownership of the land works in the above example, reliance on *A*'s admitted legal and economic ownership of *X* to measure her continuing relationship to the land becomes inaccurate either if *X* owns something other than the land or if stock ownership in some other way differs substantially from ownership of land. In either case, there is no doubt about *A*'s continuing ownership of *X*, but that relationship is an inaccurate means to describe *A*'s relationship to the land.

The system also frequently uses substitute references as a means of effectuating intended incentives. Often, the system bases incentives on a person's ownership of a particular asset when what it seeks to encourage is not the ownership of that asset *per se* but some other characteristic or status which may (but also may not) be *heightened* by that ownership. Typical are those provisions that seek to encourage taxpayers to save in order to provide for themselves, in old age, and for their heirs. These provisions generally reward the taxpayer's ownership of particular assets, when what they seek to encourage is a behavior (saving for retirement) that does not always correlate with ownership of the tax-favored asset. Examples include the deferral granted to contributions to qualified retirement plans,²⁶⁵ individual retirement accounts,²⁶⁶ and accrued annuity gains,²⁶⁷ as well as the exclusion of life insurance proceeds.²⁶⁸ While the taxpayer who contributes to a pension, or who invests in an annuity or in life insurance, may be increasing her savings thereby, it is equally possible that the investment was made in the place of some other investment rather than in the place of consumption. If that is the case, the taxpayer's ownership of the tax-preferred savings vehicle has not increased her savings, and the incentive has been inefficient.²⁶⁹

264. See *supra* text at note 34.

265. I.R.C. §§ 401-03 (1982).

266. I.R.C. § 408 (1982).

267. I.R.C. § 72 (1982).

268. I.R.C. § 101 (1982).

269. To the extent that these various incentives are directed not just at encouraging taxpayers to save, but at encouraging them to save in a particular way, rewarding the acquisition of a particular investment vehicle may be an accurate reference. It will encourage the purchase and retention of the particular investment vehicle at issue, so that the taxpayer who takes money out of a bank and purchases an annuity, while not increasing savings, has necessarily increased her investment in that particular *kind* of savings. But it is somewhat doubtful that encouraging the acquisition and retention of any particular investment vehicle is indeed the real goal that Con-

b. *Gross measurement.* While many Code provisions end up measuring some status (or relationship) by reference to some different status (or relationship), or rewarding some desired behavior by reference to a different behavior, the problem of substituted reference is only one of the two ways in which the system mismeasures taxpayer status. Regardless of whether or not any measurement is subject to a substituted reference problem, that measurement may be inaccurate simply because of imprecision in measuring whatever status it is that is subjected to the measurement. Generally, the system allows for measurement of any status only by way of a determination that the taxpayer either does or does not have that status, when the truth is usually that every taxpayer has the status, but to varying degrees. Problems that spring from the system's use of such gross measurements are numerous.²⁷⁰

An obvious gross measurement problem occurs in the tax treatment of interest and dividends paid by corporations. Interest payments are a cost of doing business and therefore decrease a corporation's net worth and are properly deductible. Dividends are ideally only voluntary distributions of profits, and are not costs of doing business; instead, like gifts made by individuals, they may be properly viewed as generating consumption, in the form of personal satisfaction, equivalent in value to the amount distributed.²⁷¹ Thus, measuring corporate income relating to payments to shareholders and lenders by allowing deductions for interest payments²⁷² and disallow-

gress had in mind when it enacted these provisions. It can be inferred that a particular *type* of savings (such as an annuity) is encouraged over some other type because Congress believed that the favored investment vehicle would encourage more long-term savings than the taxpayer would otherwise have (the *accurate* reference). However, just as generic "savings" are not a necessary result of any particular investment, increased long-term savings are not *necessarily* encouraged by granting tax benefits to a long-term savings *vehicle*. The taxpayer might have decided to make a particular long-term investment without any tax benefit, or the taxpayer may make the investment and take other actions (such as borrowing or selling other long-term investments) that negate the economic impact of the acquisition of the tax-favored investment vehicle. In either case, the taxpayer has no more long-term savings than he would have had absent the incentive, but his tax is nonetheless reduced.

270. The difference between substitute reference and gross measurement may be best illustrated by an example having nothing to do with tax. Assume that a system is designed to measure a person's weight. To the extent that any person's weight is measured by reference to her height, the system has a substitute reference problem. On the other hand, if the system seeks to measure each person's weight but can only determine, with respect to any person, that she is either "heavy" or "light," the system suffers from a gross measurement problem. There can, of course, be combinations of the two problems: *viz*, the system that accurately measures height to determine whether a person is light or heavy, or worse, the system that determines only whether a person is short or tall to determine whether she is light or heavy.

271. If one chooses not to regard a dividend distribution as consumption, one might simply state that a *distribution* of profits cannot *reduce* those profits, so that denial of a deduction for dividends paid accurately measures income.

272. I.R.C. § 163(a) (1982).

ing deductions for dividend payments measures a status —income — by *direct* reference to that status and not by reference to any other, substitute status or relationship.

Nonetheless, the Code often mismeasures the impact of such transfers by corporations. This mismeasurement is a result of the fact that proper measurement of income requires, in the first instance, proper characterization of those payments upon which measurement is based. If a payment from a corporation to a lender represents a distribution of profits, rather than a payment of interest, that payment is not interest, but is a dividend. However, to the extent that the corporation's lenders and shareholders are the same person, payments to that person may be, in fact, *partly* (deductible) interest and partly a (nondeductible) distribution of profits (*i.e.*, dividends). Unfortunately, the system currently provides for no such mixed characterization of payments. The result is that when such payments are made, the corporation's income is necessarily mismeasured. If the payments are characterized as all interest, corporate income is understated; if they are characterized as all dividend, corporate income is overstated. Either way, economic income is not being measured by some other referent, but it is still being mismeasured, because the system simply does not allow for the gradations necessary for accurate measurement.

Problems of gross measurement can also occur side by side with substitute reference problems. When that is the case, the two problems can, and ought to, be distinguished. An example of this combination involves the provisions generally allowing deductions for business expenses and disallowing deductions for personal expenses. As noted above, these provisions can involve a substitute reference problem.²⁷³ But they can also mismeasure income even in the absence of any such problem. Assume, for example, that *A* spends \$1,000 on a meal, that his purpose for the expenditure is 60% business and 40% personal, and that the meal provides consumption worth \$400. The reference to business purpose accurately traces the distinction between consumption and nonconsumption so that there is no problem caused by the acknowledged substitution of referents. However, if *A* deducts the cost of the meal as a business expense, he will nonetheless understate income by \$400.²⁷⁴ If he fails to deduct the cost, he will overstate income by \$600. Because the system requires the gross polar measurement of a factor that is nonpolar, *A*'s income will be mismeasured in either case, regardless of the accuracy of the substituted referent.

273. See *supra* Part III.C.2.a.

274. But see I.R.C. § 274(n) (1982), which would limit *A*'s deduction to \$800 in any event.

Similar potential confluence of gross measurement problems with problems of substituted reference can occur in the characterization of capital gains. If *C* purchases an asset and holds it with mixed motives, for example, 80% for potential appreciation and 20% for possible sale in the ordinary course of business, then even if that mixture accurately reflects the ideal referent of determining the source of gain (labor or appreciation), the character of the gain (which depends on *C*'s relationship to the asset) will necessarily be mismeasured. Because the gain must be *either* capital *or* ordinary, when in truth it is partially each, accurate characterization of *C*'s gain becomes impossible.

Another area where gross measurement has been a problem is the determination of ownership. Assume that Congress seeks to allocate some benefit to a person who will use asset *X*, allocates the benefit to the owner of *X*, and that the ownership of *X* asset correlates with its use.²⁷⁵ Although ownership will be an appropriate referent for such an allocation as long as it correlates with use, the status of ownership simply cannot always be accurately measured. Because any asset can have only one "owner" (or "user," to the extent that there is no substitute referent problem) inaccuracy necessarily results whenever some, but less than all, of the asset is sold. As long as *D* owns (and uses) 100% of *X*, measuring the desired status presents no problem. Because *X* can be divided into accurate gradations along physical lines, if *D* divides *X* into two assets, and sells 20% of *X* to *F*, who then uses that 20%, measurement remains accurate. However, if *D* sells to *F* the ownership (and use) of *X* for two years only, and that current ownership (and use) has a value equal to 20% of the full value of *X*, measurement of the ownership of both *D* and *F* will necessarily be inaccurate because *neither* is the owner of the entire asset.

Finally, and perhaps even more directly related to tax avoidance cases, the question of taxpayer motivation in *any* context, from determination of whether a person was motivated by "tax avoidance" to a determination of whether one asset was actually exchanged for some other asset (because the existence of a particular exchange ultimately depends on reciprocal causation, and the cause of any taxpayer's action is ultimately the motivation behind that action²⁷⁶) is essentially a gross measurement problem. Even assuming that motivation is an appropriate referent (or that it is an adequate substitute), it is doubtful

275. Often the description of ownership results in substitute reference problems as well. If Congress seeks to measure some specific relationship to an asset, such as use of, investment in, or income from the asset, but does so instead by measuring "ownership," there is a substitute reference problem to the extent the owner does not use, or bear that other relationship to, the asset.

276. See *supra* text accompanying notes 122 & 149.

that any taxpayer will ever have only a single motive for taking any action. Thus, where the existence of a single motive is in issue, the issue can never be decided with complete accuracy.

3. *Abusing Mismeasurement Problems*

a. Substitute referents. Of course, the fact that the system may mismeasure a person's status or relationship does not mean that the person has engaged in tax avoidance. Because tax avoidance necessarily implies intentional conduct, it can occur only when a taxpayer abuses or takes advantage of the system; this can be said to happen whenever a person acts in a way that is intended to, and does, *exaggerate* some mismeasurement problem that otherwise exists. To the extent that a person is motivated by a desire to increase the variation between the status, relationship, or behavior that the system seeks to measure and the measurement at which the system ultimately arrives, that person is abusing weaknesses in the system and ought to be deterred.

Unlike current law's reliance on misplaced concepts such as business purpose, or on merely intuitive distinctions between tax avoidance and tax planning, the above model presents a logical basis for analyzing cases and can be used to demonstrate both the existence of, and the rationale for finding, tax avoidance in all cases where it has been found to exist. In addition, this analytical framework avoids the problem of basing the existence of tax avoidance on the taxpayer's engaging in actions that themselves accurately measure income. For example, assume that *K* borrows \$1,000,000 from Insurance Company in order to purchase an annuity in a given year.²⁷⁷ Assume further that each year that the annuity increases in value by \$100,000, *K* borrows an additional \$100,000 secured by the annuity and uses that \$100,000 to pay that year's interest on the original loan. Finally, assume that *K* does all of this because it presents an economically risk-free way to minimize his taxes. Current judicial attitudes would lead to the conclusion that *K* has engaged in tax avoidance, and that the specific activity at the foundation of that tax avoidance is *K*'s borrowing of money.²⁷⁸ A problem with this way of viewing tax avoidance, however, is that the taxation of borrowing transactions can *never* itself cause tax avoidance because borrowing transactions are accurately

277. In order to present a fact situation similar to *Knetsch v. United States*, 364 U.S. 361 (1980), the text disregards the existence of I.R.C. § 264 (1982) for the moment. The justification for § 264 and similar provisions is discussed *infra* in the text accompanying notes 284-88.

278. See *Knetsch*, 364 U.S. 361.

taxed. If *K* borrows \$100,000, his receipt of funds is accompanied by a corresponding liability to repay that same amount. The net economic effect of the borrowing (no change in net worth) is accurately reflected by the net tax consequence that attaches thereto (no change in taxable income) and cannot therefore be the cause of, or the basis for, tax avoidance.

Instead, *K* has engaged in tax avoidance because he has acted in order to exaggerate the potential mismeasurement inherent in the tax treatment of annuities. Congress has granted deferral to the accrued increased value in annuity contracts in order to encourage more long-term savings. Annuity investment is therefore a substitute referent for increased savings. By intentionally acquiring the annuity without increasing his pre-tax savings over what they otherwise would have been (absent that incentive), *K* has exaggerated the difference between the measurement of the real intended referent (*i.e.*, his status of having saved more than he otherwise would have) and the substitute referent of his annuity investment.

Because the proposed approach determines tax avoidance only by reference to the transaction that actually causes the mismeasurement, integration of different exchanges is not a prerequisite to a finding of tax avoidance. If *K* had borrowed the purchase money and the money used to pay the interest from some disinterested lender, his tax avoidance would be no less real, despite the fact that the borrowing and the annuity investment were "separate" transactions.²⁷⁹ Nor would his tax avoidance vanish if Insurance Company guaranteed him a \$1,000 annual profit on the deal by increasing the value of his annuity investment at a rate higher than the rate of interest he paid on his outstanding indebtedness.²⁸⁰ If *K* were still motivated by his ability to defer \$100,000, while at the same time failing to increase his savings over what they otherwise would have been, he would still be engaging in tax avoidance.

On the other hand, in the unlikely event that (1) *K* could borrow the annuity purchase money at a rate that would guarantee him a \$1,000 pre-tax profit, (2) *K* was actually motivated to enter into the transaction entirely by the desire to increase his savings by \$1,000 per year, and (3) *K* was *not* influenced by his ability to generate tax savings of approximately \$28,000 per year,²⁸¹ he has *not* engaged in tax avoid-

279. Compare *Knetsch*, 364 U.S. at 365-66.

280. *I.e.*, if *K* had some general "business purpose" or "profit-seeking motive" for entering into the transaction.

281. This assumes that *K* is in the 28% marginal tax bracket.

ance.²⁸² This is true despite the fact that if *K* entered into the transaction for the *sole* purpose of making this \$1,000 profit from arbitrage, he might *not* be engaging in the behavior that section 72 was intended to encourage.²⁸³ Because tax avoidance exists only when the taxpayer *abuses* some provision by acting intentionally to increase the mismeasurement of the accurate referent, it does *not* exist when the taxpayer just *happens* to reap some benefit from mismeasurement through no intentional act on his part.

Another result of the proposed definition of tax avoidance is that a person such as *K* might be just as "guilty" of tax avoidance even if the original annuity had not been acquired with borrowed funds. Assume that *T* has \$1,000,000 that he has decided to save. *T* has this money in a bank account, but because of section 72, he decides to use this money to purchase an annuity. *T* is intentionally taking advantage of section 72's deferral without having increased his savings over what they otherwise would have been, and he may therefore be said to have engaged in tax avoidance.

Of course, to the extent that the correct referent for section 72 is not only the taxpayer's *increased* savings,²⁸⁴ but also the conversion of savings from one kind, such as bank accounts (short-term investments), to annuities (long-term investments), *T* will have behaved in a way (converting bank savings to annuity savings) that is accurately measured by an appropriate referent when he purchases the annuity. There are, however, two responses to this assertion that *T* is not engaging in tax avoidance. First, it is doubtful that the conversion of savings from bank to annuity is anything more than a substitute referent for long-term savings,²⁸⁵ and whether *T*'s annuity investment will actually result in longer-term investment is unclear. Second, and in this case more significant, is the fact that *if* conversion from bank savings to annuity savings *is* an accurate referent for section 72, then to that extent *K* may not have engaged in tax avoidance even when he acquired the annuity with *borrowed* funds. In either case, the taxpayer has converted \$1,000,000 of bank savings to \$1,000,000 of annuity savings. Whether his bank balance goes from plus \$1,000,000 to zero (*T*) or from zero to minus \$1,000,000 (*K*) does not change that fact. Indeed, it is possible in the above scenario that *K* may be *less* guilty of

282. In most situations of course, *K*'s motives would be mixed. For an appropriate response to the existence of mixed motives, see *infra* Part IV.B.

283. If the section was intended to encourage taxpayers to convert consumption to savings, *K* has not done so. He has only converted one kind of savings into another.

284. In other words, the goal of § 72 is not solely to encourage taxpayers to save rather than to consume.

285. See *supra* text at note 274.

tax avoidance than is *T*. If *T* had money invested in a bank at 10% interest and invests in an annuity that increases at the rate of 9%, he is *decreasing* his net pre-tax savings by making the conversion, while if *K* can borrow at 8.9% for the same investment, he will be *increasing* his pre-tax savings despite his use of borrowed funds.²⁸⁶

To analyze, under the framework suggested above, another example of what is generally considered to be tax avoidance, assume that *G* enters into a forward contract that requires her to purchase an asparagus for \$1,000 on January 15, year two and that she simultaneously enters into a contract to sell an asparagus for \$1,000 on the same date. The net result is that *G* will be required both to purchase and to sell an asparagus for \$1,000 on next January 15. If an asparagus costs more than \$1,000 (e.g., \$1,200) in December, *G* will close out her short position in asparagus at a \$200 tax loss, but will retain her long position, now worth \$200. The net economic result will be that on December 30 *G* will hold a contract worth \$200, and she will have paid out a total of \$200. On the other hand, if an asparagus costs less than \$1,000 (e.g., \$700) on December 30, *G* will close out her long position at a \$300 loss, while retaining her short position and its inherent \$300 gain. Finally, assume that *G* does all of this in order to minimize her tax liability for the year.

Clearly, *G* has engaged in tax avoidance by attempting to exaggerate the difference between accrued income (the real referent) and realized income (the substitute referent). When the price of asparagus rises above \$1,000 and *G* fails to close out her long position, her behavior is the result of her intention to avoid current taxation of that accrued gain.²⁸⁷ When the price of asparagus sinks below \$1,000 and *G* refuses to close out her short position, she is again doing so only in order to defer tax on that accrued gain. Whether or not *G*'s acquisition of the offsetting positions was a single transaction is irrelevant to a determination of whether she is avoiding taxes by refusing to recognize her accrued gain on her gain position. Similarly irrelevant is the question whether or not *G* stood to make some minimal pre-tax profit

286. Having weighed the possible inappropriateness of jumping ahead in this article against the possibility that the reader might regard this approach to tax avoidance as useless because it is unenforceable, the author feels compelled to mention several facts that will be discussed in more depth *infra*. Just as not every immoral act is a crime and not every crime is prosecuted, defining tax avoidance in a logical manner does not mandate prosecuting it whenever it may exist. Indeed, there are several reasons that one might choose to prosecute *K* and not *T* in the above example, *see supra* text at notes 223, 227-28. What is important at this point is that *none* of those reasons is that *K* is more guilty of tax avoidance than is *T*.

287. That her motive is not the accrual of economic income should be obvious from the fact that as long as she holds both the long and the short position, any actual economic gain is impossible.

or to suffer some pre-tax loss from her actions. Finally, because deducting her recognized loss on the loss leg of this straddle resulted in the accurate taxation of accrued loss on that leg, the recognition of that loss cannot be said to result in the "avoidance" of any tax that should have been paid. Instead, it is the intentional abuse of *deferral* by refusing to recognize accrued *gains* that represents tax avoidance.

Obviously, *G*'s acquisition of offsetting positions with respect to asparagus prevents her from realizing any net pre-tax economic income (or loss) from her actions; and this is strong evidence that her motivation for acquiring the long and short positions is tax avoidance rather than economic gain. The difference between the proposed approach and current judicial attitudes, however, is that the proposed approach suggests that the acquisition of offsetting positions is *only evidence* of *G*'s tax-avoidance *motive*, and does not itself establish the presence of tax avoidance. The tax avoidance itself lies not in the acquisition of offsetting positions, but only in *G*'s tax-motivated refusal to recognize her accrued gain. One result of this approach is that one can point to tax avoidance without engaging in the fiction of asserting that two separate transactions (acquisition of a long position and acquisition of a short position) are actually only one transaction, a fiction that becomes difficult to maintain when *G* deals with different parties on different days.

In several cases involving taxpayers who acted as has *G*, above, the court did in fact integrate the taxpayer's offsetting positions.²⁸⁸ It then held that the taxpayer lacked a profit motive for entering into "the straddle" and deferred her deduction on the loss leg. While the result in these cases may appear similar to the suggested approach, it is not. First, the court relied not on a finding of tax avoidance but on a purported *absence* of a profit motive. As suggested earlier, however, the restriction in section 165 which allows losses only with regard to transactions entered into for profit is an attempt to separate expenditures that generate consumption (not deductible) from those that do not generate consumption (deductible). It is not intended to substitute for a judicial approach to tax avoidance. Even if one accepted the application of section 165 to these cases, however, integration leads to unwanted results. First of all, it implies that if the taxpayer recognizes her *gain* in year one and defers her loss until year two, she need not be

288. For the current judicial approach to tax straddles, see, e.g., *Fox v. Commissioner*, 82 T.C. 1001 (1984); see also Dailey, *Commodity Straddles in Retrospect: Federal Income Tax Considerations*, 47 BROOKLYN L. REV. 313 (1981) (overview of judicial approaches to tax straddles); Note, *The Tax-Straddle Cases*, 1982 DUKE L.J. 114 (analyzing judicial approaches to tax straddle cases and suggesting use of the step transaction doctrine as the appropriate remedy). By and large, these situations are now governed by statute. See I.R.C. § 1256 (1982 & Supp. IV 1986).

taxed on it because the entire integrated "transaction," including the unrealized loss, shows no profit. This is simply a position that the Internal Revenue Service and courts will not always want to take. On the other hand, if one attempted to use the absence of *G*'s profit motive to disallow a loss *without* integrating her offsetting positions into a single transaction, the result would be *permanent* loss disallowance on the loss leg, accompanied by taxation of the gain leg. This would place an unavoidable but undue hardship on the taxpayer who enters into a straddle for reasons other than tax avoidance. The net result of this analysis is that the proper focus in these cases should be on the presence of a tax avoidance motive rather than on the absence of a profit motive.²⁸⁹

To return to the application of the proposed approach to *G*'s straddle, the assertion that *G*'s tax avoidance lies in her refusal to recognize accrued gain and her attempt thereby to exaggerate the timing mismeasurement caused by the realization requirement has significance for many other transactions. For example, if *M* owns stock with a basis of \$100 and a value of \$1,000, and she refuses to sell the stock solely in order to avoid paying tax on her unrealized gain, *M* is just as guilty of tax avoidance as was *G*.²⁹⁰

On the other hand, assume that *P* has an asset with a basis of \$1,000 and a value of \$100, and that *P* sells the asset on December 31 solely in order to be able to deduct a \$900 loss. Although tax-motivated, that action is *not* tax avoidance because deduction of the loss does not exaggerate or result in any mismeasurement of *P*'s economic income. If *P* has no other property, that tax-motivated sale cannot result in the mismeasurement of *P*'s economic income. If *P* has another asset with a basis of \$200 and a value of \$1,100, *P*'s choice not to sell this other asset will result in a net \$900 mismeasurement of *P*'s income; but the mismeasurement is the result of *P*'s *unrealized gain* rather than of his recognized loss. Thus, if *P* chose not to sell his gain asset (or to sell the loss asset *instead* of the gain asset) in order to avoid realizing his accrued gain, he has engaged in tax avoidance. If *P*'s decision to hold that gain asset was unrelated to an intention to defer tax on that accrued gain, he has not been guilty of tax avoidance.²⁹¹

289. Current case law might suggest that the presence of tax avoidance might provide the *justification* for integrating the transactions and for asserting that the taxpayer had no profit motive, but, as suggested earlier, this approach only makes factual determinations depend on a finding of tax avoidance without explaining what "tax avoidance" is. See *supra* Part II.A.

290. *M*'s motive will, of course, be more difficult to detect, however, and that difficulty might suggest different *treatment* for *M* than for *G*. Nonetheless, the difference between *M* and *G* is *not* that only one is motivated by tax avoidance.

291. Obviously, practicality may demand that we not attempt to find and prosecute all of these cases of tax avoidance. Nonetheless, identifying these cases is important because it allows

Another area similar to the above cases (in that tax avoidance has been misdiagnosed by focusing on an action that results in the *accurate* measurement of economic income as itself being an act of tax avoidance) is that of taxpayers who borrow money in order to pay deductible interest. If a taxpayer who owes \$100 of interest on money that was borrowed for use in business borrows another \$100 to pay that interest, she is not thereby engaging in tax "avoidance"; and, indeed, if that is her only tax-relevant transaction during the year, her \$100 net loss will accurately reflect her economic income. While a taxpayer who has unrealized gains and who borrows money to pay interest may well be borrowing, rather than selling appreciated assets, in order to avoid realizing those accrued gains (and to exaggerate the deferral problem inherent in realization), that taxpayer's "avoidance" would consist only of his abuse of the realization requirement, if any. Unless he has those appreciated assets whose sale he is forgoing, his income will not be inaccurately measured, and he cannot be said to be "avoiding" any tax that he ought to pay.

b. Gross measurement problems. While the above examples illustrate taxpayers acting to enhance the mismeasurement of status or economic income caused by substitute referents, tax avoidance can also exist as a result of gross measurement problems. For example, assume that *X* Corporation desires to raise capital, and, absent tax considerations, would do so by issuing an instrument that bore some resemblance to both equity and debt (e.g., 70% like equity, 30% like debt). Assume further that the instrument, because of its greater resemblance to equity, would be treated as equity for tax purposes. Because *X* wants to be able to deduct the payments it makes on its capital, however, it issues an instrument that bears a 51% resemblance to debt, so that the instrument will be treated completely like debt. By increasing the instrument's resemblance to debt by 21%, *X* has issued an instrument that will be taxed like debt 100% more. Rather than having its income overstated by 30%, *X*'s income will be understated by 49%. Under the proposed definition, this intentional action, taken to enhance distortion of income measurement, is tax avoidance.

c. Combinations. One area that has often been a home to tax avoidance and that involves problems of both substitute reference and gross measurement is that of corporate organizations and reorganizations. For example, assume that *A* owns land with a basis of \$10 and a

one to make a reasoned determination of *both* practicality of enforcement *and* the presence of tax avoidance.

value of \$100 and that, in order to transfer that land to Publicly Held without having to pay tax on his realized gain, *A* transfers the land to Newco in exchange for all the Newco stock, later transferring the Newco stock to Publicly Held in exchange for \$100 worth of Publicly Held stock. The organization of Newco is tax-free because, theoretically, *A*'s investment has remained substantially the same. His ownership of Newco substitutes for his prior ownership of the land. The exchange of Newco stock for Publicly Held stock is tax-free because *A*'s ownership of Publicly Held stock substitutes for his ownership of Newco stock, so that, once again, his investment has theoretically remained substantially the same. *A* has engaged in tax avoidance because he has acted in order to take advantage of the mismeasurement of his relationship to the underlying asset that results from the use of these substitute referents. While the Code grants nonrecognition to these exchanges because it presumes that they measure *A*'s *continuing* relationship to the land, *A* has incorporated solely in order to change his relationship to the land.

Just as a taxpayer abuses the substitution of annuity investment for increased savings when she purchases an annuity in order to receive deferral without increasing savings, *A* has abused the substitution of ownership of Newco stock for ownership of the land by forming Newco in order to receive nonrecognition without continuing substantially the same relationship to the land. Because *A* forms Newco in order to *change* his relationship to the land (by transferring the Newco stock to Publicly Held Co.), rather than to *continue* it, abuse of the substituted referent is apparent. Of course, transfer of Newco to Publicly Held is ample evidence of *A*'s tax avoidance motive; but, as suggested earlier, it is nothing *more* than evidence of motive, and it is not itself a necessary *component* of *A*'s tax avoidance.

Not surprisingly, the view of the tax avoidance involved in the above series of exchanges also has implications for other situations. In the above situation, *A*'s actions were designed to allow him to continue to defer taxation of his accrued gain on the land. But the *reason* for *A*'s abuse of the mismeasurement of his continuing relationship to the land was not as significant as the fact that his tax avoidance *consisted* of his abusing that mismeasurement. Any tax-free incorporation will, to some extent, change the taxpayer's relationship to the incorporated assets and will, to that same extent, undermeasure a change in the relevant taxpayer status (continued asset-ownership). Not every such transaction, however, is abusive, because most incorporations are not intended either to take advantage of or to increase that mismeasurement. Instead, most incorporations are intended to take advantage of

some other factor (e.g., limited liability). The substitution of referents merely allows them to occur. When that substitution of referents, and the resultant mismeasurement of the accurate referent, is the *motivation* for the occurrence, tax avoidance is present.²⁹²

If *A* had incorporated the land so that it would be in corporate form in order to allow him to transfer the land tax-free (by way of a "B" reorganization) at some future undetermined time to some presently unknown person, he would be just as guilty of tax avoidance as he was in the above hypothetical. While the temporal proximity of *A*'s formation of Newco and his exchange of the Newco stock for Publicly Held stock may well be strong evidence of the existence of a tax avoidance motive, it is the existence of that motive,²⁹³ and not of any particular kind of evidence, that is the *sine qua non* of tax avoidance.

Tax avoidance would also be present if *A* had already owned Newco and transferred the Newco stock to Publicly Held in exchange for stock, rather than for cash, in order to qualify for nonrecognition treatment. In that case, *A* would again be taking advantage of the mismeasurement of his continuing relationship to the Newco stock in order to continue the mismeasurement of economic income that would normally result from a change in that relationship.²⁹⁴

In addition to presenting problems of substitute reference, the corporate organization and reorganization provisions also present possible gross measurement problems. Again, assume that *A* transfers appreciated land to newly formed *X* Corporation in exchange for all the *X* stock and then trades the *X* stock to Publicly Held in exchange for 10% of the Publicly Held stock. *A* is entitled to nonrecognition because his interest in the land, represented by his ownership of *X*

292. In this situation, the presence of some nontax "business purpose" would be evidence that the taxpayer is not abusing the substituted referent. The correlation of tax avoidance with the absence of business purpose in these cases, however, does not legitimize the *general* reference to business purpose in other situations. See *supra* Part II.B.1.

293. Determining this motive may be difficult. But see *infra* Part IV.B. (the Internal Revenue Service has discretion to bring deficiency actions against the most egregious violators).

294. The kind of tax avoidance described in the text above also closely resembles the kind of tax avoidance present in *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd.*, 187 F.2d 718 (5th Cir.), *cert. denied*, 47 U.S. 827 (1951). There the taxpayer purchased the stock of *T* corporation, which had high basis assets, and then liquidated *T*. It engaged in these actions in order to acquire the assets in a way that would allow them to retain their high basis rather than the cost basis they would have taken had Kimbell-Diamond simply purchased those assets. By taking these actions, the taxpayer was abusing the fact that its ownership of the newly acquired assets was used as a substitute referent for *T*'s prior ownership of those assets. Given this analysis, tax avoidance would have existed any time one corporation chose to acquire the stock, rather than the assets, of a different company solely in order to avoid the change in basis of the corporate assets that would have accompanied an asset purchase. Because of statutory amendments since *Kimbell-Diamond*, the situation does not arise under current law. See *supra* note 167.

stock, is statutorily deemed to be substantially identical to his prior outright ownership of the land, and because his interest in underlying assets represented by his ownership of Publicly Held stock is statutorily deemed to be substantially the same as the interest in underlying assets represented by his pre-reorganization ownership of *X* stock. In either case, the Code determines that the exchange will result in giving *A* an interest that either *is* "substantially the same" as his prior investment or *is not* "substantially the same" as that prior investment. In truth, even aside from the substitute referent problem, *A*'s interest is only *partially* the same as it was before. When *A* transfers his *X* stock for 10% of the Publicly Held stock, *A*'s indirect investment in the land is reduced from 100% to 10%, and his "continuity of investment" in the substitute referent is mismeasured by 90%. If *A* has acted intentionally to exaggerate this mismeasurement, he has engaged in tax avoidance.

Again, the above highlights the fact that tax avoidance is not limited to those situations in which it has been traditionally found. If, for example, *A* sought to transfer 90% ownership of his land to someone else and did so by joining with one or more persons to form a corporation in which *A* was a 10% stockholder, the exchange would qualify for nonrecognition under section 351. However, if *A* preferred simply to *sell* a 90% interest in his land, and if he consented to the corporate formation in order to take advantage of the mismeasurement of his continuing investment in the land caused by section 351 (which would, when it applies, implicitly describe his investment as remaining at 100%), *A* has again engaged in tax avoidance. While current judicial analysis might apply the step transaction doctrine if this incorporation were followed by a tax-free separation of *A*'s interest,²⁹⁵ that analysis misses the point in viewing the presence of that second transaction as the *essence* of tax avoidance rather than as merely *evidence* of *A*'s tax avoidance *motive*.

D. Addressing Tax Avoidance

Not every attempt to minimize tax liability is tax avoidance. Instead, taxpayers are "avoiding" tax only when they take actions intended to increase distortions in the measurement of economic income or other tax-significant factors. Nonetheless, the necessary result of tax avoidance, either because economic income is unintentionally un-

295. For example, a tax-free split off of stock of a subsidiary to *A* in redemption of his stock under I.R.C. § 355 (1982). *See, e.g.*, Treas. Reg. § 1.355-3(a) (1960); *see also* Prop. Treas. Reg. § 1.355-4, 42 Fed. Reg. 2699 (1977); *Portland Mfg. v. Commissioner*, 56 T.C. 58 (1971), *acq.* 1972-2 C.B. 2, *affd.*, 35 A.F.T.R.2d (P-H) 75-1439 (9th Cir. 1975).

dermeasured, or because intended benefits or incentives are unintentionally overallocated (or misallocated) to the person whose status is mismeasured, is that the tax avoider will pay less than her intended share of tax. There are two basic approaches to the problem: (1) detect and prevent tax avoidance, or (2) find a way to measure status or income more accurately.

This part of the article explores these possible solutions to the problem. It concludes that when tax avoidance is the result of a taxpayer's abusing a problem of gross measurement, any appropriate remedy requires, initially, the more accurate measurement of the status in question. These problems, and the tax avoidance that they engender, can be best solved by demanding that taxpayers make more refined measurements in the first instance, and by the Internal Revenue Service and courts making more refined measurements thereafter. Where the taxpayer's initial *mismeasurement* is significant and tax-avoidance-motivated, penalties should be imposed that relate to the extent of both the mismeasurement and the bad motive.

When the problem results from the use of a substitute referent, any remedy requires focusing, either directly or indirectly, on the existence of tax avoidance rather than on the more accurate measurement of the status sought to be directly measured. In these cases, accurate measurement of the ideal referent will likely be nearly impossible, so that curing tax avoidance will require identifying some behavior that appears to indicate tax avoidance. To the extent that tax avoidance is indicated, courts and the Internal Revenue Service should attempt to strip from the abusive taxpayer the benefits of that tax avoidance and to impose penalties based on the degree of abuse that is found to exist.

1. *Gross Measurement Problems*

a. Judicial and administrative responses. Any time a taxpayer abuses a pure gross measurement problem, her tax avoidance must lie in the fact that either (1) she has made a small change in the factor being measured in order to make a gross change in the resulting measurement of that factor; or (2) she has refrained from making some change in that factor in order to avoid a gross recharacterization of that factor. In either case, the avoidance lies only in the taxpayer's attempt to exaggerate the tax effect of her actual activity. The taxpayer will always have made some movement to bring her closer to the status that is recorded for tax purposes, but the movement she will have made is of a lesser degree than is registered.

As long as the problem is only one of gross measurement, then the taxpayer cannot have engaged in a different kind of behavior or at-

tained a status different in kind from what she would have done absent a tax-avoidance motive. Instead, she has only done more (or less) of that same thing. The mismeasurement is not the result of her achieving a certain status, but only of her not achieving that status to an even greater extent. This is necessarily the case because, as long as the status being measured is not a substitute referent, mismeasurement can only be a matter of degree.

In order to prove that a taxpayer has abused a gross measurement problem, one would have to prove that the taxpayer both attempted to exaggerate, and did exaggerate, the difference between the degree of the status that in fact existed and the status that was reported for tax purposes. Thus, one could not prove tax avoidance without showing both the extent to which the taxpayer actually achieved the status in question and the extent to which that status would (or would not) have been achieved in the absence of the provision being abused. Of course, to the extent that one can accurately measure the degree to which any particular status has in fact been reached, it would make little sense to require any proof in addition to that accurate measurement before taking action to impose accuracy. Because proving tax avoidance would require the additional proof of the extent to which the status would have otherwise been reached, proving such avoidance ought to be unnecessary in cases involving only problems of gross measurement.

An example of the above is the corporate taxpayer that issues an instrument bearing just enough resemblance to debt so that it will be treated like a debt instrument for tax purposes, rather than issuing the equity instrument it would have issued in the absence of the gross measurement problem inherent in classifying instruments as either debt or equity. One might prove tax avoidance by showing that (1) the taxpayer issued an instrument that was, for example, 51% like debt and (2) absent the gross measurement problem involved, it would have issued an instrument that was 70% like equity. Because the first of these facts, standing alone and without regard to the taxpayer's motive, would result in accurate characterization of the instrument (*i.e.*, 51% debt and 49% equity), one could reasonably suggest that no additional proof of motive should be needed to allow implementation of that accurate characterization.

Of course, to the extent that the system seeks to justify punishing the taxpayer rather than simply making an accurate measurement of the status in question, proof of motive should indeed be relevant;²⁹⁶

296. The importance of *mens rea* to the criminal law has long been acknowledged. See W. LAFAVE & A. SCOTT, CRIMINAL LAW § 3.4 (2d ed. 1986). To the extent that a taxpayer may be

and to the extent that review of the taxpayer's case results in something other than the accurate measurement of the status in question, that "something else" often is a punishment, whether or not that label is affirmatively affixed. In debt equity cases, for example, when the taxpayer is found to have improperly classified an instrument as debt, the basic remedy imposed by the court (or Internal Revenue Service) is the reclassification of that instrument as equity. While this new classification will be more representative of the instrument's true nature than was its original characterization by the taxpayer, the new label will nonetheless not accurately describe the instrument's actual economic status. Instead, an instrument that may bear as much as a 49% resemblance to debt will be characterized as equity, and payments that, in large part, are real costs of doing business, will be nondeductible.

To the extent that the systemic goal involved in these cases is to encourage taxpayers to report their income more accurately, the imposition of punishment on those who attempt to maximize the potential mismeasurement that inheres in the system is reasonable. Nonetheless, the process by which the punishment is imposed in these cases is curious. Because the basic punishment consists of the reclassification of the instrument as equity (or as debt if the taxpayer had originally labelled it as equity), that punishment will not be imposed, regardless of the taxpayer's motive, unless the instrument does actually bear some significant relationship to equity. Thus, the taxpayer who avoids tax by issuing an instrument that is 45% like equity rather than one that is zero percent like equity will suffer no untoward consequences, despite the fact that the 45% shift in the economics of the instrument from what they otherwise would have been may have been entirely tax-motivated. On the other hand, the taxpayer who makes only a 10% shift as a result of his tax-avoidance motive (for example, changing an instrument from 45% to 55% like equity and still labeling it as debt in order to be able to deduct that extra 10% of interest) is more likely to have that instrument recharacterized despite the lesser impact of his tax-avoidance motive on his behavior.

In addition to the inappropriate way in which the punishment for tax avoidance is administered in these cases, the amount of the punishment also makes for strange results. Assume that *A* and *B* both seek to have instruments labelled as debt in order to secure an interest deduction with respect to that part of the eventual payments on the instrument that will in reality be distributions of profit. Further assume

punished for her behavior, those same considerations are relevant, regardless of the label placed on that punishment.

that *A* issues an instrument that actually bears a 50% resemblance to debt, while *B* issues an instrument that bears only a 15% resemblance to debt, and that they both initially characterize their respective instruments as debt. If both of the instruments are eventually reclassified as equity, the status of *A*'s instrument will be 50% wrong, while the classification of *B*'s instrument (and the resultant overtaxation of *B*) will be wrong by only 15%. As a result, *A* will be overtaxed by 50% and *B*, who is guilty of far greater deception, will be overtaxed by only 15%.

The above problems are the necessary result of a system that seeks to have taxpayers report their status accurately, forces them to report that status inaccurately (by taking an all-or-nothing position with respect to a status that is really some-and-some), and responds to some of these inaccuracies by imposing a different inaccurate result. The confusion of motive with status, and of measurement with punishment, becomes overwhelming; and little is done to assure the accurate reporting of the status in question.

This analysis of the problem leads to another approach, however, that may have much to recommend it. By distinguishing between problems of measurement and proof of motive, one can approach both problems in a logical and consistent manner. Because the ultimate goal is the accurate reporting of any tax-significant factors, one might begin to address the problems by simply making accurate measurements of the factors in question. Although Justice Brandeis is said to have explained that "[t]o be effective in this world you have to decide which side is probably right; and, once you decide, you must act as if it were one hundred per cent right,"²⁹⁷ with respect to problems of gross measurement, courts and the Internal Revenue Service might simply acknowledge that (1) neither of the alternative classifications currently offered will ever be exactly right, and (2) it is counterproductive to act as if they were.

Since any court that is confronted with a debt equity case will always have in front of it an instrument that is partially debt and partially equity, and since that court must in any event determine the extent to which it is either one prior to making any determination with respect to tax avoidance, the court should, in the first instance, simply make that determination. Rather than substitute one inaccurate measurement for a different one, the court should instead make an accu-

297. Coons, *Compromise as Precise Justice*, 68 CALIF. L. REV. 250, 260 (1980). I borrow the quotation from Professor Coons, who received it from Professor Nathaniel Nathanson, who heard it from Thomas Corcoran, who apparently heard it from Justice Brandeis. See generally Marvin Gaye, *I Heard It Through the Grapevine* (Tamla 1968).

rate measurement of the status in dispute. If an instrument is, say, 35% like debt, the court ought to treat it as 35% debt, and as 65% equity. Payments made with respect to the instrument would then be treated as 35% deductible interest and 65% nondeductible distributions of profits. Retirement of the instrument would be treated as 35% repayment of a debt and 65% redemption of stock. Other aspects of the instrument could similarly be treated in a blended manner. A court need not divide up the instrument into separate parts, but could treat the entire instrument as having the status which it in fact does.²⁹⁸

b. Taxpayer reporting positions. While the above approach does not reject the idea that tax-avoidance motive is a problem, it suggests that it is a problem only to the extent that it causes inaccuracy in the measurement of some tax-significant factors; and that it is that inaccurate measurement, rather than the taxpayer's motive, that is the source of the problem. Because accurate measurement is of paramount concern, however, it would appear not just useless, but positively self-defeating, to wait until a case comes before a court before attempting to engage in such accurate measurement. Rather than requiring taxpayers to mislabel their status intentionally and then searching for an accurate label only if and when that taxpayer is brought before a court, one might instead simply ask taxpayers to apply an accurate label to a given status in the first instance. Only if the taxpayer failed to describe its own status with sufficient accuracy would the case be brought before a court. If a taxpayer engaged in tax avoidance by inaccurately measuring its status, the court could address that problem; but by separating the problem from that of status measurement, a court could look for, and then remedy, true tax avoidance rather than some other mixed, and mixed-up, perceived problem.

Under this proposed regime, a corporation that issued an instrument that was 35% like debt would properly treat that instrument as a blended one, of which each dollar is 35% debt and 65% equity. If the Internal Revenue Service's analysis of the makeup of that instrument differed substantially from the label set forth by the taxpayer, it would make its opinion known, and if the Internal Revenue Service had cause to believe that the inaccurate characterization employed by the

298. Two courts in fact have bifurcated hybrid instruments into separate debt and equity components. See *Richmond R.R. v. Commissioner*, 528 F.2d 917 (4th Cir. 1975); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960). None have attempted to apply anything but an "all or nothing" approach to debt equity problems outside of convertible hybrids, however. See generally Madison, *The Deductibility of "Interest" on Hybrid Securities*, 39 TAX LAW. 465 (1986).

taxpayer was intentional, it would seek to extract a penalty from the taxpayer as punishment for tax avoidance. The result would be a system in which accurate reporting was encouraged and intentional misrepresentation was punished.

Another benefit that would accompany a system in which tax avoidance was directly addressed would be that when it was proved, the punishment that accompanied it could be one that bore an appropriate relationship to the factors that make such action deserving of punishment in the first place. Facts such as the extent of mischaracterization, rather than the overall resemblance of the instrument to either debt or equity, could take their proper place in determining the remedy. While any kind of tax avoidance that was especially difficult to detect, and which was therefore a significant threat to the system's integrity, might carry with it some legislatively imposed stronger potential sanction than would less threatening kinds of avoidance, a court could determine the extent to which that potential sanction should be actually imposed by looking to the degree to which the taxpayer has misrepresented the actual status being determined.

c. Possible problems. Clearly, the suggested approach to gross measurement problems would encourage all those involved (taxpayers, the Internal Revenue Service, and courts) to attempt to describe the status at issue with greater precision than is currently the case; nonetheless, in many situations, *complete* precision might be unattainable. The current approach to these problems, while less accurate, may at least lead to greater predictability; and some may suggest that the loss of that predictability would outweigh the benefits of the more reasoned approach to the problem. It would not. While predictability of measurement is not without some value, in tax cases, that predictability can also be the source of some significant problems. When taxpayers are told that they can even intentionally engage in mismeasurement of status or income with impunity, as long as they do so within fairly clearly delineated boundaries, they inevitably will do so, and they will do so in a way that maximizes the potential mismeasurement in their own favor. The result is not only that taxpayers will pay less tax than they should, but also that they will be encouraged by the tax laws to take uneconomic actions that no one actually intends to encourage. For example, assume that a corporation would, if it sought to act in the most economically efficient manner, issue an instrument that was 48% like debt and 52% like equity. If it wants the instrument to be treated as debt and if it is told that it can be assured of debt status by

making relatively slight changes in the instrument, it will, in all likelihood, make those changes. It will sacrifice economic efficiency for the benefits of tax avoidance.

To the extent that it influences taxpayer conduct, the predictable classification of any instrument as either all debt or all equity, like any gross measurement problem, is simply malfunctioning. Ideally, the function of any measurement is to do just and only that — to measure. While the act of measuring any status may necessarily affect that status to some degree,²⁹⁹ if the goal really *is* purely measurement of that status, then any impact that the act of measurement may have on that status is necessarily dysfunctional.³⁰⁰ To the extent that the function of the system is to measure economic income in a way that does not interfere with economic productivity,³⁰¹ the “best” system would not be the one that was the most predictable, but would instead be one in which no one had *any* idea of how income would be measured, and taxpayers would therefore base their actions only on maximizing their pre-tax economic returns. Once taxpayers learn that certain predictable kinds of economic returns are under- or overtaxed, they will begin to consider tax consequences in planning their activities, and the tax system will have unintentionally gone from merely measuring to actually impacting on taxpayer economic activity. Similarly, mere measurement of some status other than economic income can never be intended to affect the status that is being measured.³⁰²

In any event, the potential degree of uncertainty with respect to any estimate made by a taxpayer would be limited. First of all, if courts were asked to analyze cases and make more precise determinations (and if they were told what it was that they were supposed to be measuring), judicial precedent would become more appropriately focused and, as a result, more exact. Rather than simply listing several factors that indicate that an instrument lies between two extremes, and then characterizing it as being only either extreme, courts would be

299. This was the conclusion of Professor Heisenberg that gave rise to the famous “uncertainty principle” dealing with the laws of physics. See R. LEIGHTON, *PRINCIPLES OF MODERN PHYSICS* 86 (1959).

300. If there is, in these cases, a systemic goal *aside* from measurement of the status in question, then that can only be because there is a substitute reference problem in addition to the gross measurement problem, and that other goal is necessarily not being met. Of course, the system will often want to encourage persons to exhibit the particular factor in question by rewarding them if, or to the extent that, they have achieved that status; but the reward is necessarily separate from, and must always be subsequent to, accurate measurement of the status to be rewarded.

301. As it is in the debt equity cases.

302. One might, of course, affect the extent to which a subject exhibits some status by rewarding (or punishing) the subject in accordance with his exhibition of the status in question; but in such a case it is the application of the reward, and not the mere measurement of the status, that affects behavior.

called upon to explain the relative significance of those different enumerated factors and then to decide where the instrument does in fact lie.

In addition to requiring courts to address gross measurement problems with greater precision, requiring accurate measurement would also (hopefully) trigger significant administrative action. The Internal Revenue Service could issue guidelines and examples for characterization of instruments; and in setting forth the various factors and their relative rights, the Internal Revenue Service would be likely to achieve a much greater degree of success than was the result of its latest struggle to issue guidelines concerning characterization of debt and equity under the current all-or-nothing approach.³⁰³

Of course, there would necessarily be some uncertainty among taxpayers with respect to precise characterization of status, but much could be done to minimize it both in amount and in impact. First of all, to the extent that a transaction involved more than one party,³⁰⁴ the parties would be able to allocate responsibility for any subsequently determined inaccuracy in the asserted measurement to a single participant, who might then act as the "insurer" of the agreed upon position with respect to the other parties by compensating them for any subsequent tax increase. With respect to transactions where one party controlled both the real character and the tax label of a transaction, other parties could consider the extent of the possible inaccuracies in status measurement that inhered in the label affixed to the instrument, and the extent of any warranties behind that label, and could then price the instrument accordingly.³⁰⁵

In cases where there were significant amounts of tax at stake, taxpayers could, as they do now, ask for reassurance from the Internal Revenue Service in the form of advance private rulings. While the number of such requests might increase, any additional burden would be well worth its necessary consequence of more accurate measurement. Of course, the Internal Revenue Service would neither want to, nor be able to, respond to ruling requests from every taxpayer on every status question. Those who could not obtain such rulings would often be unable to predict with exact precision the measurement that the Internal Revenue Service might make of the status in question; and the result might well be some degree of unpredictability of tax conse-

303. See S. LIND, S. SCHWARZ, D. LATHROPE & J. ROSENBERG, *supra* note 34, ch.3.

304. As under current law, all parties to a particular transaction ought to be required to take consistent reporting positions.

305. It is, of course, possible that private "appraisers" and insurers might be used in some situations, but it is hoped the need for them would be minimal.

quences. One response to this possible problem, however, is that not every error (or disagreement with the Internal Revenue Service) in status measurement will lead to imposition of a different measurement by a court. Unless the Internal Revenue Service decides to challenge a taxpayer's proposed status measurement, that measurement will stand despite its imprecision; and unless the taxpayer's label is significantly incorrect, it is not likely to be challenged. Guidelines, presumably related to the degree of misrepresentation, the dollar amount in issue, or both, could be issued explaining when perceived difference between an actual status and the way it is presented by the taxpayer may subject the taxpayer's asserted measurement to challenge, so that, to some extent, safe harbors could exist.

The above might place a greater significance on the Internal Revenue Service's actions than does current law. However, because the problems with the current system are the result of attempts to make a system that is administratively convenient, it seems only appropriate that a determination of whether the potential revenue gains from challenging a measurement outweigh the administrative convenience of letting it go unchallenged ought to be made by the agency charged with administering the system.

d. Applying the approach to other areas. Although the above discussion has focused primarily on the problem of debt-equity classification, its premises are equally applicable to other gross measurement problems.³⁰⁶ If a taxpayer has held an asset for investment (capital gain) purposes and later converts the use of that asset to one that would result in its gain or loss being characterized as ordinary, some of the taxpayer's gain or loss on the asset ought to be "capital" and some ought to be "ordinary," but current law nonetheless requires the taxpayer to report *all* gain as either one or the other. As a result, under the current approach, if *A* and *B* each hold property with mixed motives, and *A*'s motives are 45% "capital" while *B*'s are only 30% "capital," each one's gain will be characterized as entirely ordinary, so that *A* is punished with a reclassification that is 45% inaccurate, while *B*'s punishment is only a 30% inaccuracy. Although *A* has exhibited more of the status sought to be benefited, *A* is subjected to a greater

306. To the extent that it is necessary to determine the ownership of land or other property, such can only be done by reference to the value of each person's rights (or of whatever rights constitute ownership) in that property, so, as explained, *supra*, ownership is a gross measurement question. The article does not explore the application of this approach to ownership, however, because determination of who is the owner of property is likely to be irrelevant unless there is also a substitute reference problem in that "owner" is used to substitute for some other relationship. See *infra* Part III.D.2, where this concept is explored more fully.

punishment. To ask the taxpayer properly to characterize the resultant gain or loss on sale as partly capital and partly ordinary will result in more accurate measurement of the status at issue, less unintended distortion of the taxpayer's behavior, more equity, and a more accurate distribution of intended incentives.³⁰⁷ Similar to the suggested treatment of debt versus equity questions, punishment for the tax-avoiding person could be based on the degree of the taxpayer's misrepresentation, rather than on the arbitrary punishment inherent in reclassifying *all* of the taxpayer's gain as ordinary when, in reality, some portion ought to be treated as capital.

Similarly, asking taxpayers to characterize expenses as partly business and partly personal might assist in the correction of some other lingering measurement problems.³⁰⁸ While difficulties of proof involved in the business-personal distinction might lead to arbitrary classification of certain expenses as 100% personal,³⁰⁹ requesting accurate reporting of expenses now often reported as 100% business would be both fair and fairly straightforward.

Requesting accurate reporting of what are now gross measurements might be simplest in cases of corporate formation and reorganization. In these cases, the taxpayer knows the exact extent to which his interest changes. For example, if *A* transfers property (basis \$100, value \$1000) to *X* Corporation in exchange for 60% of the *X* stock in a tax-free transfer, *A*'s interest has gone from 100% in the land to 60% in the stock, which is a substitute referent for the land. Similarly, if *A*'s interest goes from 60% of *X* to, say, 40% of the stock of *X* because of a subsequent stock issue, or to 40% of the stock of *Y* (a different corporation and substitute referent for the *X* stock) because of a reorganization, the calculations are straightforward. Tax-free treatment is given to these transactions only because the taxpayers purportedly do *not* change their investment. Imposition of the negative incentive that attaches to other realization events (*i.e.*, taxation of previously accrued gains), to the extent that a taxpayer *does* change that investment, seems only reasonable.³¹⁰

307. A similar approach could be taken when the taxpayer held a certain asset with mixed motives (*i.e.*, partly for sale to customers and partly for investment) to the extent that such mixed motive investments are not governed by I.R.C. § 1231 (1982).

308. Legislative recognition of the personal element that results from any business meal is in fact evidenced by I.R.C. § 274(n) (1982), which now limits deductions for such meals to 80% of their cost.

309. See *Pevsner v. Commissioner*, 628 F.2d 467 (5th Cir. 1980), *rehg. denied*, 636 F.2d 1106 (5th Cir. 1981) (clothing is a personal expense unless uniform is not suitable for personal use); see also I.R.C. §§ 280A, 280F (1982) (certain partly business-partly personal expenses made completely nondeductible in certain circumstances, despite business component).

310. Because the negative incentive of a transferred basis attaches to the corporation that

Of course, changing the way in which we ask taxpayers to report, and the way that we view, remedy, and punish tax avoidance would necessarily be gradual and would require some enabling legislation; that legislation need not change the way we deal with *all* of these gross measurement problems, regardless of whether or not the general approach is sensible. Nonetheless, an attempt to pinpoint one or more of these areas and to attempt to apply the approach suggested above would be worthwhile and might well prove sufficiently beneficial to motivate a broad based switch to the replacement of gross measurements with more refined, and more realistic, estimates of tax-significant factors.

2. *Substitute Referent Problems*

Unlike gross measurement problems, substitute referent problems cannot be adequately addressed by demanding more accurate reporting by taxpayers. In these situations, the taxpayers *are* making and reporting precise measurements (unless, of course, there is also a gross measurement problem). Instead, the problem is that the factor that is required to be measured and reported is the wrong one. For example, rather than reporting the amount by which her retirement savings have increased over what they would have without the tax benefit afforded retirement plans, the taxpayer instead reports, with perfect precision, the amount of certain kinds of investments that she has made.

While the most direct cure for substitute referent problems would be for the statute simply to refer to the real status at which it is aimed, the statute's failure to do so is generally the result of real difficulties in measuring the ideal referents. In other words, these cases arise only because it is impossible to measure accurately the real factor sought to be measured. Any approach to these problems, then, should not depend on accurate measurement of the real referent. Instead, because the problem of inaccurate measurement of the ideal referent in these cases is generally acceptable except when it is exacerbated by taxpayers intentionally abusing the substitution of a different referent, these cases can be most efficiently addressed by simply preventing that intentional abuse. Essentially, rather than eliminating tax avoidance by requiring accurate measurement of the real referent, the more workable approach to these problems would focus on minimizing inaccurate measurement of the real referent by eliminating tax avoidance. Where

receives assets in a tax-free organization or reorganization, I.R.C. § 362 (1982 & Supp. IV 1986), to the extent that *A* does not receive tax-free treatment, that correlative negative incentive should, of course, be adjusted (*i.e.*, increased by gain recognized to *A*). See *infra* note 316 (transferee's basis equals transferor's basis plus gain recognized by transferor).

the mismeasurement is merely coincidental, it is also tolerable; where the mismeasurement is intended, it should be corrected. To the extent that the taxpayer is engaging in tax avoidance, she ought to be denied the ability to measure her tax liability by reliance on a substitute referent, and should instead be entitled to the tax benefits in question only to the extent that she would be entitled to them under a system which directly measured the ideal referent.

Examples of how this approach might work are numerous. If *K* invests \$1,000,000 in an annuity that produces \$100,000 of tax deferred income, without actually saving more than he otherwise would have, he might be denied the benefit of all of that deferral. If this investment results in *K* saving, say, \$200,000 more than he would have absent the tax benefit, and the tax benefit he received was based upon the substitution of the purchase of the \$1,000,000 annuity for a \$1,000,000 increase in savings, he might be entitled to retain 20% of the benefit of that deferral.

Similarly, if a taxpayer's refusal to sell an appreciated asset was motivated both by tax avoidance and by other considerations, she might be disallowed part of the deferral of previously accrued gains that generally accompanies a refusal to realize those gains. Thus, if *A*, *B*, and *C* each has property with a basis of zero and a value of \$1,000,000, and each is offered \$1,001,000 for the property, then if *A*'s refusal is based purely on economic grounds, *A* would be entitled to complete deferral, if *B*'s decision was solely tax motivated (e.g., because she wanted to avoid or defer tax on her previously accrued gains), she would be required to recognize her gain in full, and if *C*'s decision took into account both factors equally, he would be required to recognize half of his accrued gains.

In the corporate area, if *D* transferred a highly appreciated asset to newly formed *X* Co. partly in order to take advantage of the substitution of *X* stock as a referent for the asset, then to that extent *D* ought to be denied the benefit of nonrecognition (i.e., freedom from taxation of previously accrued gains) that generally accompanies corporate formations. For example, if *D* incorporated solely to be able to defer recognition of gain while actually changing his ownership rights from direct asset ownership to stock ownership, he should receive no continued deferral of accrued gains. If, on the other hand, the change in his relationship to the transferred asset was only a byproduct of some other goal of *D*'s, such as limiting his potential liability with respect to the asset, and the fact that such change was accomplished without incurring a tax was only incidental, then the use of stock ownership to substitute for asset ownership is *not* being abused, and *D* should re-

ceive complete deferral. If *D*'s motives were mixed, partial deferral would be appropriate.³¹¹

Of course, relying in the first instance on establishing tax avoidance presents several problems. First of all, this approach presents a workable remedy only if the existence and extent of tax avoidance can be identified. Because the presence of tax avoidance is in part a function of the taxpayer's state of mind, proving avoidance requires proving that state of mind; and even accepting that any person's motive is a matter of degree does not explain how that degree can be determined.³¹²

Unfortunately, the proposed approach does little to make proof of tax avoidance any easier. Indeed, proof of tax avoidance might often bear substantial resemblance to the kinds of proof currently offered. If *D* incorporates, a tax-free reorganization in which *D* trades her Newco stock for Publicly Held stock following right on the heels of that initial incorporation would be strong evidence that *D*'s initial incorporation was motivated by a desire to *change* her ownership from that of a tangible asset to stock (because the stock had the attribute of being able to be exchanged tax free in the reorganization). If *A* acquires offsetting positions in a straddle, so that any nontax gain from continued retention of the "gain" leg is impossible, there is strong proof that *A*'s refusal to sell is motivated by tax avoidance. If *K* purchases an annuity with borrowed funds, there is strong evidence that the annuity investment was made to avoid taxes rather than to increase savings. If

311. For the use of compromise in other areas, *see, e.g.*, *Sindell v. Abbott Labs.*, 26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 132, *cert. denied*, 449 U.S. 912 (1980) (Plaintiff could not identify which of several companies manufactured the particular pills that injured the plaintiff. Each defendant had the burden of demonstrating that it did *not* make the pills. If a defendant could not meet that burden, its percentage of liability would be equivalent to its share of the market for the drug.). *Summers v. Tice*, 33 Cal. 2d 80, 199 P.2d 1 (1948) (en banc) (Two hunters negligently fired in plaintiff's direction and were held jointly liable because it was impossible to determine which hunter's bullet had hit plaintiff.); *see also* Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under S.E.C. Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1277 (1981); Delgado, *Beyond Sindell: Relaxation of Cause-In-Fact Rules for Indeterminate Plaintiffs*, 70 CALIF. L. REV. 881, 891 (1982) ("American case and statutory law has not yet changed to accommodate injuries to classes the identity of whose members is unknown."); King, *Causation, Valuation, and Chance in Personal Injury Torts Involving Preexisting Conditions and Future Consequences*, 90 YALE L.J. 1353, 1354 (1981) ("the loss of a chance of achieving a favorable outcome or of avoiding an adverse consequence should be compensable and be valued appropriately, rather than treated as an all-or-nothing proposition").

312. Motives other than tax avoidance are also often relevant in determining tax liability. *See generally* Blum, *Motive, Intent and Purpose in Taxation*, 34 U. CHI. L. REV. 485 (1967). Nonetheless, motive has never been easy to establish. *Id.* at 505-20; *see also* Note, *State of Mind Analysis in Corporate Taxation*, 69 COLUM. L. REV. 1224, 1225-26 (1969) (Even when applying tax statutes that specifically refer to the taxpayer's state of mind, courts "have by and large come to de-emphasize subjectivity and have either substituted more objective criteria or have relied on the wholly mechanical requirements often provided as alternatives by the statutes.").

C retains title to appreciated property but subjects the property to a long-term lease and an option to buy in the future at a price below the asset's predicted value, *C*'s motive to avoid realization becomes evident. Essentially, an action that tends to counteract the *economic* impact that the first action might otherwise have made, without counteracting the *tax* consequences of that first action, evidences a likely tax-avoidance motive.

Although there would be substantial similarities in the proof offered under the suggested approach and the proof offered in current tax-avoidance cases, the approaches nonetheless differ significantly. First of all, while actions such as borrowing money and engaging in straddles and so called step transactions may be strong *evidence* of tax avoidance, these actions are not themselves *the* tax avoidance. If *D* incorporates low basis assets in Newco in order to be able to exchange her Newco stock for stock in some other, publicly held, company at some later date, the existence of tax avoidance does not depend on whether *D* now knows *which* publicly held company she will sell to, or on whether she has completed or even begun negotiations with any company. Similarly, the existence of tax avoidance does not depend on whether a taxpayer borrows money (e.g., in sale-leaseback cases) or sells property that has declined in value (e.g., in straddles): a taxpayer may be engaging in tax avoidance even absent any particular kind of proof. Those factors are all only evidence of *D*'s motive, but it is the motive, and not the kinds of evidence, that the system ought to be seeking to deter.

Among other things, confusing *evidence* of tax avoidance with the tax avoidance itself serves to insulate tax avoidance from administrative and judicial scrutiny as long as the taxpayer engages in tax avoidance in a way that is evidenced differently. The person who holds appreciated property until death in order to avoid tax may be *said* to be engaging in tax "planning" rather than tax "avoidance," but her behavior is no less wrong and no less economically unsound (and no less immoral), than that of the person who engages in tax straddle. The difference is only that her motive is less provable. Along the same lines, the person who borrows from *B* to pay *A* is not less guilty of tax avoidance than is the person who borrows from *A* to pay *A*; ³¹³ the

313. According to the proposed definition, *neither* person is guilty of tax avoidance because neither deducting business interest paid nor excluding borrowed funds from income mismeasures economic income in any event. Nonetheless, many cases deny the deduction where the money used to pay the otherwise deductible interest is borrowed from the ultimate payee. See, e.g., *Cleaver v. Commissioner*, 158 F.2d 342 (7th Cir. 1946), *cert. denied*, 330 U.S. 849 (1947); *Battelle v. Commissioner*, 631 F.2d 1182 (5th Cir. 1980), *cert. denied*, 451 U.S. 938 (1981). Courts may grant the deduction, however, where the money used to pay the deduction is borrowed from

only difference is that it may be easier to prove the second taxpayer's state of mind. While it is only proper to limit judicial intervention to cases that are proved, it is the trier of fact that should determine when the evidence is adequate to prove the facts in question. *What* facts are actually in question should not, in turn, depend upon the evidence that might prove them. Statements to the effect that tax avoidance is generally acceptable, except in step transaction cases, only turn administrative ease (*i.e.*, of proving avoidance) into a moral construct, resulting in decreased confidence in the system, decreased revenue (because some non-step transaction cases of tax avoidance that *are* provable are *not* pursued), and decreased equity.³¹⁴

Where the only remedy for tax avoidance is a restructuring of the entire transaction, the confusion of tax avoidance itself with the *evidence* of that tax avoidance is of little concern. Unless the facts indicate that the taxpayer could have achieved the same economic results by some other means, there is, under current law, no remedy for tax avoidance. In such cases, it may do little harm to suggest that there simply is no tax avoidance at all. On the other hand, the proposed approach does not condition its remedy on a court's ability to suggest

a third party. See, e.g., *Crain v. Commissioner*, 75 F.2d 962 (8th Cir. 1935); *McAdams v. Commissioner*, 15 T.C. 231, 235 (1950), *aff'd.*, 198 F.2d 54 (5th Cir. 1952).

314. Arguably, to the extent that a particular kind of tax avoidance is difficult to prove, it may actually increase taxpayer confidence to assert that that kind of avoidance is not "bad." In that case, the system makes arbitrary distinctions between "good" and "bad," but at least it appears basically able to enforce its prohibition against what it does label "bad." This may be preferable to a system that makes logical laws and distinctions, but that is unable to enforce those laws uniformly. If perceived ability to enforce the law is important, however, it would seem more reasonable to acknowledge that many kinds of tax avoidance are "bad," but that only those more readily subject to proof are "actionable." That would at least provide an understandable basis for drawing distinctions.

In addition, it is not at all clear that the present position of the courts and Internal Revenue Service does result in any kind of increased confidence in the tax laws. Many people have a strongly held belief that other taxpayers (mainly the wealthier and more well-advised) are able to avoid their fair share of taxes. It is doubtful that these people feel *more* confident in the system because they are told that the others are avoiding their taxes *legally*. Indeed, most of these people would likely think more highly of a system that at least shared their outrage at tax avoidance, even if the system was frustrated in its attempt to prosecute its case.

It is true that difficulty of enforcement of specific cases of tax avoidance might result in a relatively small percentage of these avoiders being caught, and one might suggest that enforcement against those who happen to be caught would be unfair when compared to the similarly situated taxpayers who avoid detection as well as taxation. However, if it is admitted that tax avoidance is worthy of deterrence (and punishment), then the truth is that if there is unfairness, it lies not in unfair prosecution of the few who are caught, but in unfair escape for the many who are *not* caught. To refrain from exacting taxes from those who *can* be detected would merely increase the number of people given an undeserved bonus.

In any event, it is clear that *some* instances of tax avoidance outside of step transaction cases could be proved even now. In addition, if all taxpayers were told that more kinds of tax avoidance would be punishable when detected, many of them would avoid engaging in those tax motivated transactions in the first place, and the revenues would thereby be increased without the need to prove anything to anyone.

that what happened did not happen. Instead, the remedy for tax avoidance is the full or partial withdrawal of the tax benefit that would otherwise be improperly granted. As a result, the approach is fully compatible with the possibility that the evidence may be either contradictory or incomplete: mixed motives can result in partial withdrawal of tax benefits, and the fact that the net economic effect of the taxpayer's conduct could not be replicated by some other, less-favored, actions may mean only that achieving the particular net economic consequences was one of several motivating factors. It does *not* mean, and ought not to be taken to mean, that the taxpayer was wholly lacking any tax avoidance motive. Indeed, the truth is that a taxpayer may take a particular action not because she wants to achieve some economic end result, but only because she wants to avoid tax without detection. Under current law, she may do so by taking some economically unproductive or counterproductive steps, so long as those steps cannot be recharacterized as some other transaction. Under the proposed approach, such attempts by a taxpayer to cover her footprints will be seen as nothing more than that.

By choosing to remedy tax avoidance, in the first instance,³¹⁵ by removing an incentive to the extent it is being abused, the suggested approach also does away with the transactional consistency problems that surround current doctrines. If a *purchaser* is engaging in tax avoidance, the remedy need not be to conclude that the *seller* did not make a sale, or that it sold something different; if a *borrower* attempts to avoid tax, the conclusion need not be that the *lender* did not make a loan. One party's tax avoidance ought to affect only that party, and it need no longer be inextricably intertwined with redefining what some *other* party to a transaction actually did.³¹⁶

As with the suggested approach to gross measurement cases, one arguable problem with this approach to substituted referents is the potential uncertainty it may cause. If tax avoidance can be proved

315. As suggested earlier with regard to gross measurement problems, additional penalties could also be imposed. These penalties ought to relate to the degree of abuse rather than to the arbitrary amount of extra tax that might be due if the transaction were recharacterized as some different transaction.

316. When tax avoidance is found to have motivated one party to a corporate reorganization or formation, that finding might still affect at least one other party to the transaction. Because the transferee's basis in these exchanges is generally the basis of the transferor increased by the transferor's gain recognized, if the transferor loses some deferral as a result of tax avoidance, it will recognize additional gain which will in turn increase the transferee's basis. Nonetheless, unlike *McDonald's Restaurants v. Commissioner*, 688 F.2d 520 (7th Cir. 1982), the transferee could not go to court alone and increase its basis by establishing the transferor's tax avoidance. Unless the transferor actually recognized the extra gain (*i.e.*, because it was forced to, in the same or a different judicial proceeding), the transferor's actions would be irrelevant to the transferee's basis.

outside of traditional cases, taxpayers may not know exactly what to do to avoid a finding of tax avoidance. While most of the previous discussion regarding uncertainty as it relates to gross measurement problems is equally applicable to substituted referent problems,³¹⁷ there are some aspects of substitute referent problems that merit additional attention. Substitute referent cases will often involve some intended incentive (e.g., increased savings), and when Congress does want to encourage a certain activity, any incentive will be more effective in motivating action when availability of the incentive is certain. As a result, certainty may be of more significance in these cases than in gross measurement cases.

Perhaps a more serious problem in substitute referent cases is that the *degree* of uncertainty present will be greater than it might be in pure gross measurement cases. Because tax avoidance depends on motive, determination of the extent of that motive presents an initial gross measurement problem. In addition, at issue in these cases will be the extent to which the measurement of the substitute referent accurately measures the *correct* referent. Thus, any problem in determining what that correct referent is can exaggerate any other uncertainty. As uncertainty is increased, the taxpayer who does exactly what Congress intended becomes less certain that he can *prove* that motive, and incentives may become less effective.

While these complicating factors do exist in substitute referent cases, they are not without solution. In fact, the suggested approach may lead to *less* uncertainty than does the current approach to tax avoidance. Under the current regime, a difference between a court's finding the presence of a 49% tax-avoidance motive and a 51% tax-avoidance motive may change the characterization of an exchange by 100%. Especially in a world where conclusions are based on a semi-intuitive application of a long list of generally relevant criteria, the outcome will often be more or less a "crapshoot." While imposing a remedy based on the extent of tax avoidance will not necessarily make proof more precise, at least a 2% difference in the degree of bad motive found would count for a 2%, rather than a 100%, difference in the outcome. Reducing the amount at stake in the judicial "crapshoot"

317. It may appear that some of that discussion might be inapplicable because tax avoidance here relates to only one party while gross measurement problems can often involve two parties. However, if one party to an exchange considers that his participation in that exchange may be found to be motivated at least partially by tax avoidance, he may see the potential removal of a benefit that would otherwise attach to his participation in the transaction, such as nonrecognition, as an added cost of his participation. Presumably, he will take this possibility into account when negotiating the exchange, and may pass some of this cost on to the other party. The result will be that, like debt-equity problems, both parties may be affected, although the effect in substitute referent problems is admittedly less direct.

provides much greater certainty as to the overall result. Clearly there will still be both imprecision and inaccuracy. No court could really tell that a person is motivated by tax avoidance to say, 67%, rather than to 69%. But compromise in remedy will insure that both the extent and the effect of these problems are minimized.

Indeed, the suggested approach would be likely to limit uncertainty in many cases by removing those cases entirely from the judicial arena. When settlements are likely to mirror the actual *results* of court decisions rather than to reflect some considered possibility of the chances of complete success, justifying the costs of litigation will be more and more difficult. This suggested outcome is supported by actual results in those states which have adopted comparative negligence principles.³¹⁸

Of course, while the results of any particular case might be more predictable, predictability would be lost in the determination of *when* cases might be brought. Because the Internal Revenue Service would no longer be required to prove "complete" tax avoidance motive in order to deny any part of an abused tax benefit, the Internal Revenue Service would have substantially increased discretion in deciding what cases to bring. The bright line that insulates the taxpayer who is only half motivated by tax avoidance, or who engages in actions that are not readily subject to recharacterization, would be erased.

This aspect could be especially disheartening to many who engage in what are now accepted methods of tax planning. For example, the person who holds significant amounts of low-basis property until death in order to allow her heirs to take that property with a stepped-up basis may be surprised to learn that she may be denied deferral of some or all of her accrued gains. There are several responses to this, and the first is that the taxpayer's surprise simply may not be a problem at all. Other than the fact that we have permitted taxpayers to engage in this type of abuse in the past, there is little to suggest that we ought to allow them to do so in the future. To the extent that the system encouraged taxpayers to engage in actions that were economi-

318. Some might suggest that because the risks might be lessened (no one will suffer a *total* loss), taxpayers will be more inclined to take those risks. Many taxpayers who would be assured defeat under current law might be able to win something, if less than 100% of what they seek. On the other hand, while the risks of loss are lessened, the benefits of victory are correspondingly decreased. As to the party who might be tempted to choose litigation, and the corresponding guarantee of *some* success, over what people would agree ought to be a holding of pure tax avoidance, the suggested approach need not be carried to extremes. When it is determined that one party's nontax-avoidance motive is sufficiently minimal, that position could simply be denied *in toto*. Indeed, similar ideas are currently reflected in the Internal Revenue Service's own positions with respect to settlement and compromise, in that settlement will not be "made based upon nuisance value of the case to either party." (Statement of Procedural Rules) Treas. Reg. § 601.106(f)(2) (as amended in 1987).

cally productive, rather than in behavior that was productive only of tax benefits, there would be little harm done. In addition, if administrators (or Congress) decided to preserve some of these tax benefits despite their lack of utility, it would be simple to exempt those actions specifically from administrative or judicial scrutiny.

In any event, the assurance with which *most* taxpayers generally act would not be substantially changed. Even assuming that the Internal Revenue Service could prove all its positions in court, it would be unrealistic to assume that it would assess deficiencies against all taxpayers. Instead, it would be likely to pursue only those who were most abusive. While taxpayers who engaged in minimal abuse would have little to fear, the taxpayer who engaged in substantial tax avoidance would stand a significantly greater likelihood of having to pay for her sins.

If the Internal Revenue Service were no longer required to limit its attacks to those who step over a bright line, and to refrain from pursuing those who are sufficiently well advised that they constantly stay just one step behind the line, the result would be that the Internal Revenue Service could attack tax avoiders rather than just those who had not been so cleverly advised. The well-advised would be well advised to expect attacks, and the less well advised would also need to be less well defended. Again, the determination of which taxpayers to pursue could be based on reasoned analysis of the extent of avoidance and the potential impact of that type of avoidance, rather than on the arbitrary factors currently in place. If certain transactions were especially bad (*i.e.*, marketed tax shelters), the Internal Revenue Service could go after all participants ("horizontal equity"). If one taxpayer were more abusive, the Internal Revenue Service could go after him alone on a broader range of transactions ("vertical equity").

Of course, the lack of certainty in the proposed approach may still have some drawbacks. Taxpayers *not* motivated by tax avoidance at all may fear that the Internal Revenue Service and a court may nonetheless mischaracterize their motives and withdraw tax benefits to which they are entitled. Unfortunately, this is a possibility in any situation where motive is at issue: motive is ultimately knowable, if at all, only by the actor; where it is in the actor's economic interest to disguise that motive, the actor's testimony may be wrongly disregarded. In truth, this same problem exists in current law. The difference in the proposed approach is only that, where the truth is unclear or motives are mixed, the end result can accurately reflect that uncertainty.

The greater flexibility provided to the Internal Revenue Service by the suggested approach would, of course, carry with it a greater re-

sponsibility in areas in addition to that of choosing which taxpayers to pursue. Taxpayers would have to be made aware of when transactions set forth in the Code are in fact substitute referents for some other behavior. While sometimes the use of a substitute referent, and what it substitutes for, will be clear, other times that will not be the case. Guidance would have to be provided by the Internal Revenue Service (and by the courts) to supplement the legislative history that now exists. Often, providing that guidance would be simple. Other times it would not. As suggested earlier, provisions such as deferral of taxation until realization can substitute for several very different ideal referents.

Requiring the Internal Revenue Service and courts to analyze the presence of substitute referents coherently may also have significant side benefits. By determining the underlying objectives of any provision, these agencies may come to recognize those provisions with respect to which current judicial and administrative interpretations are misguided. For example, neither the courts nor the Internal Revenue Service allow the tax benefits of accelerated depreciation to go to the legal owner of property unless that titleholder also has certain other rights in the asset. This necessarily implies that legal "ownership" of an asset actually substitutes for some other relationship to the asset which more accurately describes the person to receive the deduction. By examining this other relationship, such as use, for which ownership substitutes, rather than by focusing on some extra legal definition of what "ownership" is, the Internal Revenue Service might make a more properly focused inquiry into who ought to receive the benefit to which the owner otherwise would appear to be entitled.³¹⁹

319. In fact, an attempt to make this inquiry may lead to the conclusion that legal ownership is *not* a substitute referent for anything else at all, but is a perfectly reasonable description of the status that ought to be rewarded. If, as appears to be the case, Congress' objective in allowing accelerated depreciation was to lower the after-tax cost of certain assets, then there is actually *no* relationship to the asset that can describe who should get the deduction. Essentially, the incentive is intended to be *asset-specific* rather than *person-specific*. The system attempts to attach a benefit to an *asset* through a system that applies only to *persons*. If the incentive is successful, then *any* person who holds title, sells, purchases, uses, or manufactures the asset may benefit from the incentive. Regardless of which taxpayer actually takes the accelerated deduction, the lower cost of the asset will be shared by all those involved and the way in which the benefit is shared will be determined by market forces regardless of who takes the actual income tax deduction.

The only substantial impact that limiting the benefit to someone other than the legal titleholders can have is to limit the *amount* of the benefit, because those who bear the "correct" relationship to the asset and who are in lower brackets will get less benefit from the same deduction. If the incentive is intended to lower the cost of the *asset*, then restriction of the *amount* of benefit based on some person's relationship to that asset would appear counterproductive. If the incentive *is* intended to be smaller when some low bracket taxpayer bears a certain relationship, one ought to identify what that relationship is. If it is "user," then no matter how strictly the Internal Revenue Service focuses on defining "owner," it will always be defining the wrong thing.

IV. CONCLUSION

Because of fundamental problems with our tax system, even a detailed and extensive body of law such as the Internal Revenue Code cannot guarantee accuracy in the measurement of economic income or other tax-significant factors. The need to implement a system that both raises revenue from and distributes tax benefits to over 100 million taxpayers justifies a system whereby taxpayers are not asked to measure some unarguably relevant factors simply because those factors are too hard to measure; instead, they may be asked to measure other factors which are more readily subject to measurement and which often, but not always, tend to reflect the factor actually sought to be measured. The same need may also justify asking taxpayers to make gross "all or nothing" appraisals of factors that usually lie between the two extremes.

Not surprisingly, in a system where economic income and factors that result in the allocation of tax benefits are not always measured either accurately or directly, some persons will pay more, and others less, than their intended fair share of tax. Because the provisions which result in this mismeasurement are all public knowledge, it is also not surprising that the well-advised will plan their actions in order to take advantage of this mismeasurement, and will thereby minimize their own tax liability. Indeed, if allowed to proceed without restriction, many wealthy persons might well be able to eliminate tax liability completely while accruing substantial amounts of economic income and failing to engage in the actual behaviors at which tax incentives and tax benefits have been aimed.

In order to deter abuse of the system's inadequacies, the Internal Revenue Service and courts have held that tax avoidance will not be tolerated. This article has attempted, for the first time, to set forth a workable definition of what tax avoidance is. Rather than look to the presence of a *remedy* to determine the presence of tax avoidance, as courts have done in the past, this article has set forth a definition of tax avoidance and suggests that the remedy ought to *follow*, rather than precede, a determination of whether that tax avoidance exists.

Essentially, a person is engaging in tax avoidance if, and to the extent that, she is acting in order to exaggerate the system's mismeasurement of economic income or any other tax-significant factor. Tax avoidance can be best remedied in at least two ways: (1) where the mismeasurement is the result of inaccurate measurement of the relevant factor (gross measurement problems), then, to the extent possible, ask taxpayers to report accurate rather than inaccurate measurements of that factor; and (2) where the mismeasurement is the result

of *accurate* measurement of some factor *other* than the one that is actually relevant (substitute reference problems), then, to the extent that taxpayers attempt to abuse the mismeasurement caused by reference to that substituted referent they ought to be denied whatever benefits might otherwise stem from the resultant mismeasurement. In either case, more abuse ought to result in additional penalties.

The suggested approach has several advantages over current approaches to tax avoidance: (1) unlike current approaches, it is both intellectually honest and internally consistent; (2) it would replace arbitrary results with predictability; (3) it would provide guidance where there now is none; and (4) it would provide remedies to fit the abuse, rather than vice versa. While this approach differs substantially from current law, it does so only to the extent that reasoned logic always differs from random chance. It is hoped that difference will lead to rethinking of current law rather than rejection of more reasoned alternatives.

V. LEGISLATIVE APPROACHES (AN AFTERTHOUGHT)

While this article has focused on judicial approaches to tax avoidance, the ideas are equally applicable to legislative attempts to address the problem. This "afterthought" seeks to analyze legislative attempts to combat tax avoidance from the same perspective.

When tax avoidance is the result of a substitute referent problem, it must be because the real referent, although known, is unworkable.³²⁰ Measuring things like accrued gains, net worth, or a person's decision to increase savings is simply beyond the system's capability. The legislative response can only be to employ a series of substitute referents, either for accurate status measurement or for tax avoidance.

With some success, legislative responses have used one taxpayer's tax liability with respect to some payment or asset as a substitute referent for that of another taxpayer whose income or deduction may be less readily determinable. One example of this approach is deferral of an accrual method taxpayer's deduction until the accrued amount is paid, and therefore taxable, to the cash method recipient,³²¹ which substitutes the acceleration of the payor's income for accrual taxation of the payee. It is simply much more manageable to ask an accrual method taxpayer to use the cash method with respect to some pay-

320. Compare cases involving accrued but unpaid interest, where Congress has determined that the real referent of accrued income rather than paid interest *is* a determinable and workable referent and has been adopted. See I.R.C. §§ 1272-1278 (1982) (requires current inclusion of accrued interest income regardless of payment).

321. See, e.g., I.R.C. §§ 267(a)(2), 404(a) (1982).

ments than vice versa, and substitution of the payor's liability for that of the payee will often result in accurate taxation. Similarly, use of a transferred basis in certain tax deferred exchanges, such as gifts and corporate reorganizations, substitutes the transferee's tax liability with respect to the previously accrued gain on the asset for that of the transferor. Because only the transferee will know the time and amount of such gain, substitution of that taxpayer avoids administrative and reporting nightmares.

As with all substitute referents, the above approaches are necessarily less than 100% effective. If the substituted taxpayer is in a lower bracket than the real referent taxpayer, the tax collected will be too low; and, in the case of transferred basis provisions, if the substituted taxpayer recognizes the gain at a later time than the transferor realizes her profit, tax liability will be deferred.

Where Congress is not able to adopt a true referent and is unwilling or unable to use a different taxpayer's liability as a substitute referent, the problem becomes more difficult. The amount of tax benefits available to any taxpayer depends only on his ability to make and retain certain investments. Because investment assets can be created at will³²² and taxpayers can make and retain investments almost at will (assuming the availability of borrowed funds), the potential for the tax-avoiding taxpayer is almost unlimited.

Because Congress cannot limit the amount or value of intangible assets that can be created, any legislative limitation on tax avoidance must restrict the amount of tax-favored investments that any particular taxpayer can make. Essentially, there are three kinds of such limitations: (1) each taxpayer's potential benefit may be limited to a specified dollar amount;³²³ (2) each taxpayer's potential benefit may be limited to a certain percentage of income;³²⁴ and (3) each taxpayer's potential benefit may be limited to some percentage of his net worth.³²⁵

322. See Rosenberg, Harmon & Lipton, *Taxation of New Financial Instruments*, XIX N.Y.U. Graduate Tax Workshop (Summer, 1988) (forthcoming). This is generally true except when benefits are limited to the value of tangible property (assuming that the benefit is limited to the value of such property and is not based on the cost, which is sometimes used as a substitute referent for value and which is potentially limitless).

323. See, e.g., I.R.C. § 408 (1982).

324. See, e.g., I.R.C. § 170(b) (1982) (limiting charitable contribution deductions). The alternative minimum tax, §§ 55-59 (1982), is, essentially, this kind of limitation. It applies only when certain selected tax benefits exceed a given percentage of taxable income. I.R.C. § 469 (Supp. IV 1986), the passive activity loss restriction, is also this kind of limit, but limits certain combinations of benefits to a percentage (*i.e.*, 100%) of a certain type (*i.e.*, passive) of income.

325. In this last category fall a wide variety of seemingly inconsistent limits, including former I.R.C. § 453C (Supp. IV 1986), which limited deferral for certain installment sales, and I.R.C. § 163(h) (Supp. IV 1986), which limited the interest deduction for personal interest. What

While the first two of these limitations are straightforward, the last is not. If the system were capable of actually measuring net worth, it could simply do so each year and be rid of *all* the problems at which the article is aimed, so that any limitation based on net worth *must* use some substitute referent to measure that net worth. The most direct substitute referent for net worth is generally absence of borrowing. To the extent investments are made or retained without the use of borrowed funds, the taxpayer's total investments, and therefore her total tax benefits, cannot exceed her net worth. While Congress has not characterized its actions as legislatively limiting any person's tax benefits to a percentage of her net worth, it actually has done so in several different, roundabout ways. One example is section 453C.³²⁶ Simply put, that section strips away the deferral granted to certain installment sales to the extent that a taxpayer's assets consist of borrowed funds. In these cases, if, for example, 20% of *A*'s assets consist of borrowed funds, *A* must sacrifice 20% of the deferral he would otherwise be entitled to. Indeed, if this approach were applied across the board, one could simply limit a person's *total* deferral (or some other tax benefit such as deduction or exclusion)³²⁷ to the extent that his assets had been acquired with borrowed funds, so that allowable deferral could not exceed the taxpayer's real net worth. The significant problem with extension of this approach is that the actual amount of deferral which a taxpayer is taking advantage of depends on each asset's appreciation, and outside of certain specific instances such as installment sales, that value may be too difficult to discover. One appropriate solution to this problem, however, may be to substitute the accrued interest on borrowed funds for the "unmeasurable" appreciation on assets, and to then disallow any deduction for that interest.³²⁸ Rather than viewing legislative responses as a series of arbitrary reactions to unrelated problems, the above approach might allow one to view the problems in a more reasoned way and then to formulate responses that generally work consistently toward a single real referent.

makes these limits appear inconsistent is, in fact, nothing more than the substitute referents chosen in each case.

326. This section, enacted in 1986, was repealed by the Revenue Act of 1987, Pub. L. No. 100-203, § 10202(a)(1), 101 Stat. 1330-383 (1987).

327. Cf. I.R.C. § 265 (1982) (denying interest and expense deductions relating to obligations that produce tax-exempt income).

328. To date there have been many different kinds of limitations on the interest deduction, all of which have differing rationales and applications. Compare I.R.C. § 265 (1982) and Rev. Proc. 72-18 (1972) with Treas. Reg. § 1.163-8T (1987).