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> All judges follow a simple rule: when the statute is clear, apply it. But people rarely come to court with clear cases. Why waste time and money?
>
> —Judge Frank Easterbrook,
> U.S. Court of Appeals, Seventh Circuit[1]

I. INTRODUCTION

The above quotation from Judge Easterbrook illustrates how the law works when the parties can rely on the text of a statute. In tax law, such reliance is often not available. While the Supreme Court has been taking a more textualist approach to interpreting statutes[2]—i.e., applying the clear text of a stat-

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1. Frank H. Easterbrook, *Text, History, and Structure in Statutory Interpretation*, 17 HARV. J.L. & PUB. POL'Y 61, 61 (1994).

2. According to a former judge of the Court of Appeals for the D.C. Circuit, "true believers" in textualism include Justices Antonin Scalia and Anthony Kennedy, with Justices William Rehnquist, Sandra Day O'Connor, and Byron White becoming more supportive of the textualist approach. *See* Patricia M. Wald, *The Sizzling Sleeper: The Use of Legislative History in Construing Statutes in the 1988-89 Term of the United States Supreme Court*, 39 AM. U. L. REV. 277, 300 (1990). Since that article, Justices Clarence Thomas and Stephen Breyer have joined the Court, and Justice Byron White has departed. Other commentators have also noted Justice Antonin Scalia's influence. *See* EDWARD LAZARUS, CLOSED CHAMBERS—THE RISE, FALL, AND FUTURE OF THE MODERN SUPREME COURT 311 (1999) (noting that Justice Anthony Kennedy is a self-proclaimed textualist); Michael H. Koby, *The Supreme*

ute[3]—the current state of tax law in the lower courts is distinctively non-textualist. The approach the lower courts take to tax cases can be described as non-textualist because it permits courts to ignore or override the text of a statute, in certain instances, by applying judicially-developed doctrines that incorporate substance-over-form principles. Judge Learned Hand introduced these substance-over-form principles into tax law in 1934 in *Helvering v. Gregory*.[4] In *Gregory*, Judge Hand held that a taxpayer who has jumped through the textual hoops in the Internal Revenue Code is not necessarily entitled to the tax benefit the text of the Code provides if the transaction or activities of the taxpayer appear questionable.[5]

Textualism and substance-over-form as applied in tax law are polar opposites.[6] Under textualism, statutes should be inter-

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Court's Declining Reliance on Legislative History: The Impact of Justice Scalia's Critique, 36 HARV. J. ON LEGIS. 369 (1999); Fritz Snyder, *Legislative History and Statutory Interpretation: The Supreme Court and the Tenth Circuit*, 49 OKLA. L. REV. 573, 592-94 (1996) (noting less reliance on non-textual sources between 1981 and 1995); Nicholas S. Zeppos, *Justice Scalia's Textualism: The "New" New Legal Process*, 12 CARDOZO L. REV. 1597, 1598 n.9 (1991) (noting that Justice Anthony Kennedy has supported textualism in Pub. Citizen v. United States Dep't of Justice, 491 U.S. 440, 467 PG (1990) (Kennedy, J., concurring)).

3. *See, e.g.*, Gitlitz v. Comm'r, 531 U.S. 206 (2001); United States v. Brockamp, 519 U.S. 347 (1997).

4. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). Many courts and commentators attribute the genesis of the substance-over-form doctrines to the Supreme Court's opinion in *Gregory*, which affirmed Judge Hand's opinion. *See* Horn v. Comm'r, 968 F.2d 1229, 1236 (D.C. Cir. 1992) ("The initial and seminal case for the sham transaction doctrine is *Gregory v. Helvering* . . . ."); Alexandra M. Walsh, Note, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 STAN. L. REV. 1541, 1554 (2001); Karen Nelson Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FL. L. REV. 659, 660 (1989) ("Modern sham transaction jurisprudence draws heavily from three Supreme Court cases, decided over a forty-three-year period, beginning with *Gregory v. Helvering* in 1935."). Another commentator has noted that Judge Hand wrestled with substance-over-form issues as early as 1918 in *United States v. Oregon-Washington Railroad & Navigation Co.*, 251 F. 211 (2d Cir. 1918). *See generally* Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

5. *See Gregory*, 69 F.2d at 809-11.

6. The tension might be accurately described as Justice Scalia does in *Walton v. Arizona*, 497 U.S. 639, 664 (1990) (Scalia, J., concurring), while he is criticizing the majority:

> To acknowledge that "there perhaps is an inherent tension" between this line of cases and the line stemming from *Furman* . . . is rather like saying that there was perhaps an inherent tension between the Allies and the Axis Powers in World War II. And to refer to the two lines as pursuing "twin objectives" . . . is rather like referring to the twin objectives of good and evil. They cannot be reconciled.

preted on the basis of what the text means.[7] Under the substance-over-form doctrines, courts are permitted to ignore or disregard the text of the Internal Revenue Code on the basis of economic principles or taxpayer motivation or both.[8]

Some commentators have suggested that Justice Scalia has brought about a trend in the Supreme Court in favor of textualism. The Supreme Court has not decided a case on substance-over-form grounds since the appointment of Justice Scalia in 1986. If the Court hears a tax case involving substance-over-form while Justice Scalia remains on the Court,[9] it will be interesting to see if the approach of the lower courts will survive textualist scrutiny. The last case the Supreme Court decided a case involving substance-over-form was *Frank Lyon Co. v. United States* in 1978.[10] One case the Supreme Court decided after 1986, *Cottage Savings Ass'n v. Commissioner*, had substance-over-form issues, but the Court did not decide the case on that basis.[11] Both of the lower courts that issued opinions in *Cottage Savings*—the Tax Court and the Sixth Circuit Court of Appeals—decided the case on the economic substance doctrine, which arose from *Gregory's* progeny.[12] The Supreme Court's opinion, however, sidestepped the issue.[13] Another case the Court decided since 1986 mentions one of the substance-over-form doctrines, but

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Id. (citations omitted).

7. *See* Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253-54 (1992). *See also* William N. Eskridge, Jr., *Textualism, the Unknown Ideal?*, 96 MICH. L. REV. 1509 (1998). *See generally* Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, *in* A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW (Amy Gutmann ed., 1997) [hereinafter Scalia, Role of Federal Courts]; Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175 (1989) [hereinafter Scalia, Rule of Law].

8. *See* discussion *infra* Part III.

9. *See* Jeffrey Birnbaum, *Is Justice Antonin Scalia Frustrated Enough to Retire in 2001?*, FORTUNE, Nov. 22, 1999, at 80.

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

11. *See* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991).

12. *See* Cottage Sav. Ass'n v. Comm'r, 890 F.2d 848 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991); Cottage Sav. Ass'n v. Comm'r, 90 T.C. 372 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991). The economic substance doctrine is a subset of substance-over-form principles.

13. Although the Court mentioned a substance-over-form doctrine, the Court dismissed it on the basis of bad lawyering. The Court stated:

> The Commissioner contends that the losses were not sustained because they lacked "economic substance," by which the Commissioner seems to mean that the losses were not bona fide. We say "seems" because the Commissioner states the position in one sentence in a footnote in his brief without offering further explanation.

Cottage Sav., 499 U.S. at 567-68.

does not treat the doctrine as more important than the statute's text.[14] There have been other opportunities for the Court to address the tension between textualism and substance-over-form since Justice Scalia's arrival, but the Court has chosen not to do so.[15]

This article first discusses textualism[16] and the standard substance-over-form doctrines applied in tax cases,[17] and then analyzes the tension between the two.[18] This analysis examines developments in the Supreme Court, congressional action regarding the Internal Revenue Code, and activities of the tax policy and tax enforcement agencies. The article concludes from this analysis that the substance-over-form doctrines discussed here are no longer appropriate in tax cases.[19]

II. TEXTUALISM

There are two basic viewpoints as to how courts should interpret statutes: textualist and non-textualist.[20] According to Professor William N. Eskridge, Jr., some textualists believe that a judge should interpret a statute by examining "the text, the whole text, and nothing but the text."[21] Under this theory, a textualist searches for the meaning of the words used in a statute.[22]

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14. *See* Comm'r v. Clark, 489 U.S. 726 (1989) (integrating steps of a transaction on the basis of the structure of the applicable Code provisions).

15. *See* Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001) (discussing the sham transaction doctrine), *cert. denied*, 535 U.S. 986 (2002); Del Commercial Props. v. Comm'r, 251 F.3d 210 (D.C. Cir. 2001) (discussing the step-transaction doctrine), *cert. denied*, 534 U.S. 1104 (2002); ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 511 (D.C. Cir. 2000) (discussing the sham transaction doctrine), *cert. denied*, 531 U.S. 871 (2000); ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998) (discussing the sham transaction doctrine), *cert. denied*, 526 U.S. 1017 (1999); Herrington v. Comm'r, 854 F.2d 755 (5th Cir. 1988) (discussing the sham transaction doctrine), *cert. denied*, 490 U.S. 1065 (1989); Gardner v. Comm'r, 954 F.2d 836 (2d Cir. 1992) (discussing the sham transaction doctrine), *cert. denied sub nom.* Falk v. Comm'r, 504 U.S. 910 (1992); Cook v. Comm'r, 941 F.2d 734 (9th Cir. 1991) (discussing the sham transaction doctrine), *cert. denied*, 502 U.S. 857 (1991); Lerman v. Comm'r, 939 F.2d 44 (3d Cir. 1991) (discussing the sham transaction doctrine), *cert. denied*, 502 U.S. 984 (1991).

16. *See* discussion *infra* Part II.

17. *See* discussion *infra* Part III.

18. *See* discussion *infra* Part IV.

19. *See* discussion *infra* Part V.

20. *See* Scalia, Role of Federal Courts, *supra* note 7, at 23. Some commentators further subdivide the non-textualists, but those subdivisions have no relevance to this discussion.

21. Eskridge, Jr., *supra* note 7, at 1514.

22. *See* Scalia, Role of Federal Courts, *supra* note 7, at 16.

The basis for textualist interpretation rests on a theory of separation of powers inherent in American democracy.[23] The legislature enacts the laws, the executive branch enforces the laws, and the courts interpret the laws.[24] Thus, the argument goes that the text of a statute enacted pursuant to the bicameralism and presentment clauses of Article I of the Constitution controls,[25] not the unstated intent of Congress.

In contrast, non-textualists attempt to give effect to the legislature's intent by looking beyond the text of the statute for evidence of that intent.[26] From a practical standpoint, textualists point out that legislatures have no collective intent.[27] Each of the chambers of Congress, and specifically, each of the members in each chamber, may have had different reasons for wanting certain words in the statute, but it is only the words that both chambers passed, and the President signed, that became law.[28]

A. *Justice Scalia's Textualism*

Justice Scalia has not hidden his views on judicial interpretation of statutes. He has published various works discussing his philosophies.[29] He has set forth the foundations for a textualist approach, given justifications for a textualist approach, and criticized other approaches.[30] If one read only Justice Scalia's writings on statutory interpretation, one would wonder what other approaches could possibly exist. His approach has an attractive logic to it that gives it great force and persuasive power.

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23. *See id.* at 9.

24. *See* U.S. CONST. arts. I-III; O'Donoghue v. United States, 289 U.S. 516 (1933). The Court stated:

> The Constitution, in distributing the powers of government, creates three distinct and separate departments—the legislative, the executive, and the judicial. This separation is not merely a matter of convenience or of governmental mechanism. Its object is basic and vital .... [N]amely, [its object is] to preclude a commingling of these essentially different powers of government in the same hands.

Id.

25. *See* Chadha v. INS, 462 U.S. 919 (1983); U.S. CONST. art. I, § 1, cls. 2-3.

26. *See* Scalia, Role of Federal Courts, *supra* note 7, at 16-18.

27. *See* William Robert Bishin, *The Law Finders: An Essay in Statutory Interpretation*, 38 S. CAL. L. REV. 1, 14 (1965); Max Radin, *Statutory Interpretation*, 43 HARV. L. REV. 863 (1930).

28. *See* Bishin, *supra* note 27, at 14; Radin, *supra* note 27.

29. *See generally* Scalia, Role of Federal Courts, *supra* note 7; Antonin Scalia, *Assorted Canards of Contemporary Legal Analysis*, 40 CASE W. RES. L. REV. 581 (1990) [hereinafter Scalia, Canards]; Scalia, Rule of Law, *supra* note 7.

30. *See generally* Scalia, Role of Federal Courts, *supra* note 7.

1. *Foundations*

Although Justice Scalia sets forth democracy as the foundation and justification for textualism, it appears that the foundation for his own views rests in part on the modern reliance of federal courts on statutes rather than on common law.[31] Judges developed the common law piecemeal, case-by-case, according to what the judge in the particular case thought was appropriate for the set of facts before it.[32] This approach is no longer appropriate where statutes have, for the most part, replaced the common law.[33] The law as developed under statutes should not develop piecemeal according to the whims of the judiciary.[34] Even vague statutes should not give rise to a "facts and circumstances" test.[35] According to Justice Scalia, abandoning the common law in favor of clear rules restrains judicial biases and provides predictable and legitimate rules of law.[36]

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31. *See id.* (laying the groundwork for Justice Scalia's textualist discussion by noting that "in the federal courts, where, with a qualification so small it does not bear mentioning, there is no such thing as common law" and that "[e]very issue of law resolved by a federal judge involves interpretation of text—the text of a regulation, or a statute, or of the Constitution"). *See also* Swift v. Tyson, 41 U.S. 1 (1842) (holding that federal courts should only apply state statutes and not the common law as developed in each state); 1 NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 1.03 (5th ed. 1994 & Supp. 2002) ("[S]ociety has placed progressively greater reliance on legislative bodies and attempted to withdraw from the courts more of the function of determining the character of society and the principles under which individuals must live."). Other commentators have concluded that Justice Scalia rests his views somewhat on the need for clear rules as a way of restraining judges. *See* Zeppos, *supra* note 2, at 1619 ("[Justice Scalia's] textualism in statutory interpretation as a means of restraining judges is but a part of his repeated calls for clear, bright-line rules to cabin judicial discretion."); *see also* William D. Popkin, *An "Internal" Critique of Justice Scalia's Theory of Statutory Interpretation*, 76 MINN. L. REV. 1133, 1186 (1992) ("[Justice Scalia's textualist] position rests . . . on conceptions of legitimacy, in the normative sense of the rule of law . . . ."). Like the chicken and the egg, it is difficult to tell if Justice Scalia adheres to text because he believes a common law approach is inappropriate, or if he eschews common law methodology because he believes in the virtues of textualism. Regardless, the two ideas are interrelated.

32. *See* Scalia, Role of Federal Courts, *supra* note 7, at 3-9; Scalia, Rule of Law, *supra* note 7.

33. *See* Scalia, Role of Federal Courts, *supra* note 7, at 13.

34. *See id.*

35. The "facts and circumstances" test is an approach to deciding cases that embraces traditional common-law principles where courts take into account the totality of the circumstances to decide the outcome of a case rather than relying exclusively on the strict wording of a particular statute. *See* Scalia, Rule of Law, *supra* note 7, at 1180-81 (describing the "facts and circumstances" test, although labeling the test as a "totality of the circumstances" test).

36. *See* Scalia, Rule of Law, *supra* note 7, at 1180; *see also* Alex Kozinski, *My*

In the case of a vague statute, Justice Scalia has articulated that an appellate court should craft a general rule rather than decide cases under a "facts and circumstances" test.[37] The application of a "facts and circumstances" test by an appellate court becomes a fact-finding exercise by that court, which is not the appellate court's role.[38] A "facts and circumstances" test is inappropriate unless so provided by the statute, as in the Voting Rights Act.[39] Even cases involving the Sherman Act, a vague antitrust statute,[40] are not decided on a case-by-case basis.[41] Rather, courts have applied clear rules anchored in the Sherman Act's text.[42]

Justice Scalia does not discuss whether a judge sitting as a trier of fact, as do judges for tax cases in the Tax Court and Court of Federal Claims, should apply a "facts and circumstances" test. It seems that they should not, however. In the abstract, the judicial application of a "facts and circumstances" test, in which the application of a statute's text resolves an issue, seems to obviate the statute.

Justice Scalia finds support for his textualist approach in American democracy.[43] He writes that the common-law ap-

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Pizza with Ninò, 12 CARDOZO L. REV. 1583, 1589 (1991). Justice Scalia expressed this concern in *Webster v. Reproductive Health Services*, in which he urged the Court to reconsider *Roe v. Wade*:

> We can now look forward to at least another Term with carts full of mail from the public, and streets full of demonstrators, urging us—their unelected and lifetenured judges who have been awarded those extraordinary, undemocratic characteristics precisely in order that we might follow the law despite the popular will—to follow the popular will.

Webster v. Reprod. Health Services, 492 U.S. 490, 535 (Scalia, J., dissenting).

37. Scalia, Rule of Law, *supra* note 7, at 1180-81 (discussing a totality of the circumstances test).

38. *See id.* at 1182.

39. *See id.* at 1183; *see also* 42 U.S.C. § 1973(b) (1982) ("A violation of subsection (a) is established if, based on the totality of circumstances, it is shown that the political processes leading to nomination or election . . . are not equally open to participation by members of a class of citizens protected by subsection (a) . . . ."). Another recent example in tax law is in the regulations under I.R.C. § 355(e) (2002), which have adopted an explicit "facts and circumstances" test in determining the existence of agreements, understandings, and arrangements. Treas. Reg. § 1.355-7T(h)(1)(i) (2002).

40. 15 U.S.C. § 1 (2002) ("Every contract, combination . . . , or conspiracy, in restraint of trade . . . is declared to be illegal.").

41. *See* Scalia, Rule of Law, *supra* note 7, at 1183.

42. *See id.*

43. *See* Scalia, Role of Federal Courts, *supra* note 7, at 10. Justice Scalia discusses democracy as it relates to statutory construction. *See* K-Mart Corp. v. Cartier, 486 U.S. 281, 325 (1988) (Scalia, J., concurring in part and dissenting in part) ("The prin-

proach "would be an unqualified good, were it not for a trend in government that has developed in recent centuries, called democracy."[44] Under the separation of powers doctrine inherent in American democracy, Congress enacts the laws and the courts interpret the laws in light of Congress' expressed intent.[45] It is not the subjective or actual intent that interpreters look for, but an "objectified" intent.[46] This objectified intent is the law of the land. Under this approach, it does not make sense and it is not fair to inquire into what was intended rather than what was enacted.[47] It is respect for the enacted text that makes America "a government of laws, not of men."[48] When a judge inquires into the actual intent of the legislature, she is left with deciding what the law ought to mean instead of what the text actually means.[49]

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ciple of our democratic system is not that each legislature enacts a purpose, independent of the language in a statute, which the courts must then perpetuate, assuring that it is fully achieved but never overshot by expanding or ignoring the statutory language as changing circumstances require.").

44. Scalia, Role of Federal Courts, *supra* note 7, at 9.

45. *See* O'Donoghue v. United States, 289 U.S. 516 (1933) (discussing the separation of powers); Scalia, Role of Federal Courts, *supra* note 7, at 16-18 (discussing legislative intent).

46. Scalia, Role of Federal Courts, *supra* note 7, at 17. Justice Scalia also makes this point in his concurrence in *Green v. Bock Laundry Machinery Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring), in which he states:

> The meaning of terms on the statute books ought to be determined, not on the basis of which meaning can be shown to have been understood by a larger handful of the Members of Congress; but rather on the basis of which meaning is (1) most in accord with context and ordinary usage, and thus most likely to have been understood by the *whole* Congress which voted on the words of the statute (not to mention the citizens subject to it), and (2) most compatible with the surrounding body of law into which the provision must be integrated—a compatibility which, by a benign fiction, we assume Congress always has in mind.

Id. at 528.

47. *See* Scalia, Role of Federal Courts, *supra* note 7, at 16-17 ("Why not accept, as proper material for the court to consider . . . , a sworn affidavit signed by the majority of the each house, for example, as to what they *really* meant.").

48. *Id.* at 17. Justice Scalia writes further, "men may intend what they will; but it is only the laws that they enact that bind us." *Id.* Justice Scalia criticizes the majority opinion in *Morrison v. Olson* for eschewing the text of the Constitution in favor of resort to a common law approach. There he stated:

> Evidently, the governing standard is to be what might be called the unfettered wisdom of a majority of this Court, revealed to an obedient people on a case-by-case basis. This is not only not the government of laws that the Constitution established; it is not a government of laws at all.

Morrison v. Olson, 487 U.S. 654, 712 (1988).

49. *See* Scalia, Rule of Law, *supra* note 7, at 18 ("When you are told to decide, not on the basis of what the legislature said, but on the basis of what it *meant*, and are assured that there is no necessary connection between the two, your best shot at

This inquiry was appropriate in common-law times, when the law developed one case at a time and judges decided what the law should be.[50] Now, however, the authority to decide what the law should be resides in the purview of Congress.[51] Congress has the authority to consider the broad implications of statutes it enacts and the authority to change the laws with the changing world,[52] not the judiciary.[53]

2. *Method*

Justice Scalia has identified principles that he claims to follow in deciding cases. He notes that he is not a strict constructionist, and he is not a lenient constructionist.[54] Rather, he believes statutes should receive a reasonable interpretation.[55] A reasonable construction of a statute, however, does not permit words to be interpreted outside of their limited range of meanings.[56] His practice of deferring to the ordinary meaning of the words of a statute appears consistent with the claim that he is a reasonable constructionist.[57] In *Chisom v. Roemer*, he even cited *Webster's Dictionary* to show that the word "representatives"

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figuring out what the legislature meant is to ask yourself what a wise and intelligent person *should* have meant; and it will surely bring you to the conclusion that the law means what you think it *ought* to mean—which is precisely how decide things under the common law."). *See also* Zeppos, *supra* note 2, at 1619 ("Once text is abandoned, answers to statutory cases are not found in the 'law' but the judge's own views of justice, fairness, or social welfare") (citing Johnson v. Transp. Agency, 480 U.S. 616, 672 (1987) (Scalia, J., dissenting)).

50. *See* Scalia, Rule of Law, *supra* note 7, at 1183.

51. *See* U.S. CONST. art. I, § 1.

52. *See* Scalia, Role of Federal Courts, *supra* note 7, at 136. One of Justice Scalia's points is that judges are not elected by popular vote. Many commentators agree on the basis that judges have not accepted the responsibility to follow the wishes of the people. *See* Cornelius J. Peck, *Comments on Judicial Creativity*, 69 IOWA L. REV. 1, 31-45 (1983); Michael J. Dittoe, *Statutory Revision by Common Law Courts and the Nature of Legislative Decision Making—A Response to Professor Calabresi*, 28 ST. LOUIS U. L.J. 235 (1984); Ernst Freund, *Prolegomena to a Science of Legislation*, 13 U. ILL. L. REV. 364 (1918).

53. Other commentators discussing textualism have quoted a Justice Oliver Wendell Holmes statement embodying these principles. When commenting on a statute he disagreed with, Justice Holmes stated: "[I]f my fellow citizens want to go to Hell I will help them. It's my job." *See, e.g.*, Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 407 (1989) (quoting 1 OLIVER WENDELL HOLMES, HOLMES-LASKI LETTERS 249 (Mark DeWulfe Howe ed., 1953)).

54. Scalia, Role of Federal Courts, *supra* note 7, at 23.

55. *See id.*

56. *See id.* at 24.

57. *See id.* at 23.

does not refer to judges.[58]

Commentators have criticized Justice Scalia's use of dictionaries. For example, Professor Nicholas S. Zeppos[59] believes that it is more realistic to speculate as to the collective intent of Congress than "to assume that Congress enacts statutes with the care of a lexicographer."[60] It does not seem that Professor Zeppos' criticism considers the public that must live by the laws Congress enacts. Statutes communicate Congress' will to the public, and judges preside over any controversy that arises.[61] The law assumes that the public understands the words Congress uses.[62] It makes sense for courts to expect the same from Congress as they do from those governed by its laws.

Justice Scalia acknowledges that it is permissible for judges to take into account "scrivener's error" when interpreting a statute. This view appears to fit within his theoretical parameters because he views it as a "mistake of expression" rather than a mistake of "legislative wisdom."[63] As an example of sound use of context to make sense of scrivener's error, Justice Scalia describes a statute that uses the word "defendant" when it is clear that the statute refers to a "criminal defendant" rather than a "civil defendant."[64]

Justice Scalia agrees with his critics that textualism is formalistic rather than pragmatic.[65] It separates the law from its underlying policies.[66] His response to this objection to separation is the following: "[O]*f course it's formalistic*! The rule of law is *about* form."[67]

With respect to canons of and presumptions for statutory construction, Justice Scalia is vague about canons but opposes

58. *See* Chisom v. Roemer, 501 U.S. 380, 410 (1991) (Scalia, J., dissenting).

59. Professor Zeppos was one of numerous participants in a symposium discussing Justice Scalia's methodology. *See* Zeppos, *supra* note 2.

60. Id. at 1619.

61. *See* SINGER, *supra* note 31, § 1.03 ("The statute is merely a structural device through which the determined principle is communicated for the regulation of private conduct and for the limitation of governmental activity.").

62. It is unlikely that a judge would have sympathy for a criminal defendant that thought what he did was legal because he did not understand a word used in a statute.

63. *See* Scalia, Role of Federal Courts, *supra* note 7, at 20.

64. *See id.* This issue arose in *Green v. Bock Laundry Machinery Co.*, 490 U.S. 504 (1989) (Scalia, J., concurring).

65. *See* Scalia, Role of Federal Courts, *supra* note 7, at 25.

66. *See* Zeppos, *supra* note 2, at 1623.

67. Scalia, Role of Federal Courts, *supra* note 7, at 25.

presumptions.[68] He describes true canons of construction as common sense and beyond criticism, aside from the fact that they are often expressed in Latin.[69] The use of canons of construction, he acknowledges, has its limits.[70] According to Justice Scalia, they are merely evidence of meaning, and thus not conclusive.[71] One interpretation is that he might believe that resort to canons for interpretation is better than resort to common law or legislative history. Common-law presumptions, on the other hand, "are a lot of trouble."[72] Justice Scalia thinks that instead of clarifying the language of a statute, presumptions add vagueness.[73] For example, consider the presumption that statutes in derogation of the common law are to be read narrowly.[74] How narrowly are they to be read?[75] This inquiry produces no clear answer.

Although Justice Scalia believes that the text of a statute should be followed, he also believes in stare decisis.[76] He has difficulty finding a textual basis for certain rights that are engrained in American law, such as some First Amendment rights.[77] But the Supreme Court "has developed long-standing and well-accepted principles . . . that are effectively irreversible."[78] On the other hand, Justice Scalia recognizes that, in some cases, the legal system may be better served by the reversal of bad precedent.[79]

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68. *See id.* at 25-27.
69. *See id.* at 25.
70. *See id.* at 27.
71. *See id.*
72. *Id.* at 28.
73. *See* Scalia, Role of Federal Courts, *supra* note 7, at 28.
74. *See id.* at 27.
75. *See id.* at 28.
76. *See id.* at 139-40.
77. *See id.* at 138.
78. *Id.*
79. *See* Scalia, Canards, *supra* note 29, at 589-90. In a lecture at Case Western Reserve School of Law, Justice Scalia stated:

> Sometimes, of course, the highest court in the judicial system may come to the conclusion that the result inescapably produced by the binding abstractions is simply wrong—which means a return to the drawing board and the construction of a superseding scheme that leads to the right result. Such overrulings, I must acknowledge, involve a sacrifice of consistency. Yet even while abandoning consistency in the particular case, the court will affirm its enduring value for the system as a whole. For even as the old rationale is abandoned, a new one is announced, which forms the basis for a new scheme that is to be consistently followed.

Id.

B. *Criticisms of Textualism*

Justice Scalia has undergone possibly the closest methodological scrutiny of any jurist in recent history. It is no surprise, then, that some have criticized him with their criticism of textualism as a whole. Commentators on textualism have set forth various hypothetical situations as platforms for discussing textualism. Two of these platforms are the following: *Church of the Holy Trinity*[80] and the wandering basketball player.[81]

1. Church of the Holy Trinity

In his book on interpretation of federal laws, Justice Scalia discusses a case, *Church of the Holy Trinity v. United States*, as an example of the danger of searching for the collective intent of the legislature.[82] In 1892, a federal law criminalized helping an "alien" immigrate to the United States to "perform[] labor or service of any kind."[83] The Church of the Holy Trinity helped a man, "an alien residing in England," immigrate to the United States to serve as the church's rector and priest.[84] The Supreme Court held that the priest was not an "alien" brought to the United States to "perform[] labor or service of any kind" for purposes of the statute.[85] The rationale the Court proffered for departing from the text of the statute was that the statute was only intended to reach manual laborers, not Christian ministers or "brain-toilers."[86] The Court held that the legislature could not have intended to say what it did. It stated:

> It must be conceded that the act of the [church] is within the letter of this section, for the relation of rector to his church is one of service, and implies labor on the one side with compensation on the other . . . . It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers . . . .[87]
>
> It is the duty of the courts under [certain] circumstances to say that . . . the act, although within the letter, is not within

80. Church of the Holy Trinity v. United States, 143 U.S. 457 (1892).
81. *See* Eskridge, Jr., *supra* note 7, at 1553-56.
82. *See* Scalia, Role of Federal Courts, *supra* note 7, at 18-23.
83. Church of the Holy Trinity v. United States, 143 U.S. 457, 458 (1892).
84. *Id.* at 458.
85. *See id.* at 472.
86. *See id.* at 458.
87. *Id.* at 458-59.

> the intention of the legislature, and therefore cannot be within the statute.[88]

In Justice Scalia's view, the Court was not justified in searching for meaning beyond the statute.[89] According to Justice Scalia, the Court's exception in *Church of the Holy Trinity* for manual laborers did not make sense in light of the specific exceptions for actors, artists, lecturers, and singers.[90] The priest was from England and thus met the statutory definition of an "alien."[91] The priest obviously performed "labor or service of any kind."[92] Thus, "[t]he defendant's act was within the letter of the statute, and therefore within the statute: end of case."[93]

Professor William Eskridge has criticized Justice Scalia's approach to *Church of the Holy Trinity*.[94] In Professor Eskridge's opinion, a plain meaning interpretation of a statute, such as the statute in *Church of the Holy Trinity*, should take into account Congress' unexpressed values, goals, and beliefs.[95] He describes Justice Scalia's approach as unreasonable because it does not take these items into account.[96] It is interesting, perhaps contradictory, that Professor Eskridge reaches the same result as the Court by applying the rule of lenity rather than solely from the plain meaning.[97]

Professor Eskridge also sees the difference between Justice Scalia's approach to the interpretation of statutes and his approach to interpretation of the Constitution as irreconcilable.[98] To illustrate, Professor Eskridge compares Justice Scalia's analysis[99] of *Church of the Holy Trinity* to Justice Scalia's approach in the majority opinion in *Printz v. United States*.[100] Professor Eskridge describes Justice Scalia's approach to the Constitution as a determination of the original meaning of the text as "histori-

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88. *Id.* at 472.
89. *See* Scalia, Role of Federal Courts, *supra* note 7, at 20.
90. *See id.*
91. *See id.*
92. *See id.*
93. *Id.*
94. *See* Eskridge, Jr., *supra* note 7.
95. *See id.* at 1549.
96. *See id.*
97. *See id.* at 1553. According to the rule of lenity, any ambiguity in a criminal statute is resolved in favor of the defendant. *See id.* at 1534.
98. *See* Eskridge, Jr., *supra* note 7, at 1516.
99. *See id.* at 1517.
100. Printz v. United States, 521 U.S. 898 (1997).

cist."[101] In contrast, Professor Eskridge describes Justice Scalia's approach to statutes as a determination of what the words mean as "linguistic."[102] In other words, Professor Eskridge questions Justice Scalia's willingness to look at the history of the Constitution but not the legislative history of a statute. In noting this perceived contrast, Professor Eskridge misses the point Justice Scalia makes–that the inquiry is the same. In Justice Scalia's own words: "What I look for in the Constitution is precisely what I look for in a statute: the original meaning of the text, not what the original draftsmen intended."[103]

In *Printz*, Congress enacted a statute requiring states, on a temporary basis, to operate certain aspects of a gun control program for the federal government.[104] Local governments challenged the federal government's commandeering of their resources.[105] The federal government's position was that early statutes enacted by the first Congress required state courts to resolve certain federal controversies.[106] Justice Scalia authored the Supreme Court opinion deciding in favor of the states.[107] He noted state courts originally could act within their judicial power to resolve federal controversies pursuant to the Full Faith and Credit Clause and the Supremacy Clause of the Constitution.[108] In contrast, these provisions of the Constitution did not authorize the federal government to command state executives to administer federal laws.[109] Finding no authorization in the Constitution for the federal government to commandeer state resources, the Court invalidated the statute.[110]

A close look at *Printz* and *Church of the Holy Trinity* reveals that the cases are so different that a comparison does not support an inference of a separate approach to constitutional versus statutory cases. In *Printz*, Justice Scalia's reading of the text did not answer the question at hand.[111] Thus, Justice Scalia exam-

101. *See* Eskridge, Jr., *supra* note 7, at 1516 (citing Scalia, Role of Federal Courts, *supra* note 7, at 45).

102. *See id.* at 1516.

103. Scalia, Role of Federal Courts, *supra* note 7, at 38.

104. *See* Printz v. United States, 521 U.S. 898, 902-04 (1997).

105. *See id.* at 905.

106. *See id.* at 905-06.

107. *See id.* at 943.

108. *See id.* at 907.

109. *See id.* at 907-09.

110. *See Printz*, 521 U.S. at 907-09.

111. *See id.* at 905 ("[T]here is no constitutional text speaking to this precise question.").

ined the Constitution for text authorizing the federal government to commandeer state resources but found none. In *Church of the Holy Trinity*, his reading of the text led to an obvious conclusion.[112] The statute provided a rule for him to follow. Absent a text-based rule in *Printz*, it is no surprise that Justice Scalia would fashion a concrete rule on the basis of the history of the Constitution.

Professor Eskridge criticizes the approach in *Printz* as being in tension with Justice Scalia's "belief that the Constitution should not evolve to fulfill abstract principles, and his view that judicial discretion must be limited by confining judges to the application of plain meanings, not spongy spirits."[113] A rule that the federal government shall not control state governments does not scream of abstraction. Professor Eskridge's criticism would make more sense if Justice Scalia had reached a result on the basis that guns are good. By not saying something abstract such as guns are good, Justice Scalia's approach in *Printz* illustrates his mistrust of the "facts and circumstances" tests under common law.[114] The text did not support the federal government's position. If we know that the federal government shall not control state governments, it is not necessary to attempt to figure out when guns are good and when guns are bad on a case-by-case basis.

Suppose Professor Eskridge is correct that Justice Scalia's judicial opinions take a different approach to statutes than to the Constitution. This disparity could be explained by the fact that the statutes that Justice Scalia interprets are usually those that were enacted during his lifetime. In other words, it would make sense for him to feel more comfortable determining the original meaning of words used in a contemporary statute as opposed to the original meaning of words used in a more ancient document such as the Constitution. This criticism of Justice Scalia's approach is unfounded.

2. *The Wandering Basketball Player*

Professor Eskridge uses an example from professional sports to make a point about Justice Scalia's theory in relation to Justice Scalia's practice.[115] During the 1997 National Basketball

112. *See* Church of the Holy Trinity v. United States, 143 U.S. 457 (1892).
113. Eskridge, Jr., *supra* note 7, at 1517.
114. *See* Scalia, Rule of Law, *supra* note 7, at 1180-82.
115. *See* Eskridge, Jr., *supra* note 7, at 1553-56.

Association (NBA) playoffs in which New York played Miami, a fight broke out.[116] Mr. Patrick Ewing left the bench and paced around at center court during the fight.[117] The NBA suspended him pursuant to its rule that players may not leave the bench during a fight.[118] Professor Eskridge does not appear to have a problem with Mr. Ewing's suspension. Rather, he believes that Justice Scalia's methodology applied to variations on Mr. Ewing's fact pattern yields indeterminate results that must be based on subjectivity.[119] Professor Eskridge sets forth the following six scenarios and his conclusions regarding each one:

1. The player jumps off the bench and joins the fight-clear violation
2. The player jumps off the bench and runs over to the fight without joining in-clear violation
3. The player leaves the bench and wanders in mid-court, not getting any closer to the fight-violation after consideration of what the drafters intended to prevent
4. The player leaves the bench and moves as far away from the fight as possible-unclear
5. Player leaves the bench to go to the bathroom-no violation
6. The fight spreads, and two players end up brawling in front of the bench; a player leaves the bench to stop a second player from choking a third player-no violation[120]

Professor Eskridge says the first two scenarios are easy.[121] Both acts are within both the letter and spirit of the rule, and suspension is warranted.[122] The last two are within the letter of the law but outside the spirit, and suspension is not warranted.[123] Professor Eskridge believes that Justice Scalia would not suspend the player under these two scenarios because one would be a de minimus violation (scenario 5) and the other

116. *See id.* at 1509.
117. *See id.*
118. Rule 12A, § IX(c), of the NBA Rules provided: "During an altercation, all players not participating in the game must remain in the immediate vicinity of their bench. Violators will be suspended, without pay, for a minimum of one game . . . ." *Id.* at 1509 n.1.
119. *See id.* at 1555.
120. *Id.* at 1553-55.
121. *See* Eskridge, Jr., *supra* note 7, at 1553-55.
122. *See id.*
123. *See id.*

would be an absurd application of the rule (scenario 6).[124] According to Professor Eskridge, situations 3 and 4 involve judgment.[125] Professor Eskridge's point is that Justice Scalia represents his theory of textualism as mechanical and as a restraint on judges, i.e., free from normativity.[126] But Professor Eskridge believes the application of textualism in practice still requires normative judgment, contrary to Justice Scalia's alleged representations.[127] But normativity does not necessarily follow from a requirement of judgment. Textualism represents a formalist ideal. No formal system answers every question, and eventually some problems require human judgment.[128] This fact does not infuse textualism with "spirit" and normativity.

In his section on normativity, Professor Eskridge finishes as though he has shot down Justice Scalia's views with a silver bullet. He quotes a passage Justice Scalia wrote as evidence of Justice Scalia's normative approach:

> I am not so naive (nor do I think our forbears were) as to be unaware that judges in a real sense 'make' law. But they make it as judges make it, which is to say as though they were 'finding' it - discerning what the law is, rather than decreeing what it is today changed to, or what it will tomorrow be.[129]

This statement is hardly evidence of a normative approach. The making of law referred to in the passage Professor Eskridge quotes is not an admission of normativity. On the contrary, Justice Scalia refers to the role of the judge as the finder of law rather than a maker of law. If a judge determines what the law is though it was previously unexpressed, she has just made law, but in a positive sense rather than a normative sense. Thus, the quote is consistent with Justice Scalia's mistrust of common-law normative methods.

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124. *See id.*

125. *See id.*

126. *See id.* at 1555. Others have pointed out that Justice Scalia's version of textualism separates interpretation from policy. *See* Zeppos, *supra* note 2, at 1619-20 & n.145.

127. *See* Eskridge, Jr., *supra* note 7, at 1555.

128. *See generally* Mark R. Brown & Andrew C. Greenberg, *On Formally Undecidable Propositions of Law: Legal Indeterminacy and the Implications of Metamathematics*, 43 HASTINGS L.J. 1439, 1487 (1992) (concluding that Gödel's Incompleteness Theorem applies to the law).

129. Eskridge, Jr., *supra* note 7, at 1556 (alteration in original) (quoting James B. Beam Distilling Co. v. Georgia, 501 U.S. 529, 549 (1991) (Scalia, J., concurring)).

III. SUBSTANCE-OVER-FORM

Tax law is complicated.[130] The Commerce Clearinghouse (CCH) soft-cover version of the Internal Revenue Code currently takes up two volumes of statutory provisions, with six volumes of accompanying regulations (which includes proposed regulations). A proper tax library also includes the Cumulative Bulletin, which contains countless rulings, procedures, and announcements published by the Department of Treasury and the Internal Revenue Service (IRS). If these statutory provisions, regulations, rulings, procedures, and announcements were the sole bases for tax law, it would still be complicated. Predictable, but complicated. With these statutory provisions, regulations, rulings, procedures, and announcements, it would seem that Congress, the Department of Treasury, and the IRS have communicated to taxpayers exactly what they need to know to plan their affairs and determine the precise amount of tax to pay the government each year. This is not so. These detailed statutory provisions, regulations, rulings, procedures, and announcements commingle with another dimension of vague, complex judicial doctrines, the most pervasive of which come from the substance-over-form family of doctrines.[131] With a little help

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130. Judge Learned Hand has commented on the complexity:

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most ordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.

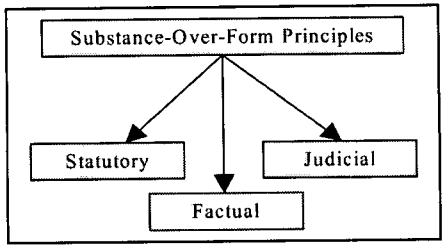
Learned Hand, *Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947). *See also* Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 OHIO ST. L.J. 1037, 1078-80 (1995); Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusion of Tax Simplification*, 2 GEO. MASON INDEP. L. REV. 319 (1994).

131. *See generally* Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982) (reviewing BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (1981)) ("It is from these cases that the basic weapons in the Commissioner's arsenal are derived—the business purpose doctrine, the step transaction doctrine, 'substance over form,' and others. The effect of these doctrines is the existence alongside the Internal Revenue Code of an additional (and somewhat autonomous) set of principles for deciding tax disputes."). *See generally* Boris

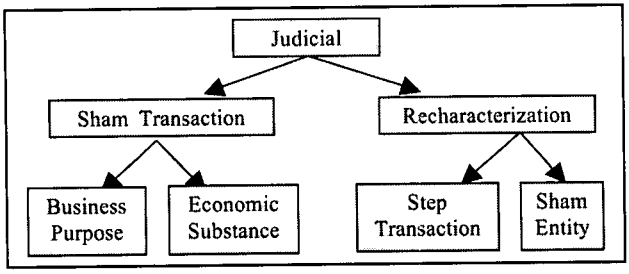
from the Supreme Court, Judge Learned Hand gave birth to these doctrines in *Helvering v. Gregory* by applying substance-over-form principles to the Code.[132]

A. *Substance-Over-Form Doctrines*

Substance-over-form principles can override a result achieved by a technical reading of the text of the Internal Revenue Code.[133] These principles are not solely judicial.[134] Statutory and factual principles can also override the text of the Code. The family tree of substance-over-form principles might look something like this:



This section focuses mainly on the judicial doctrines, but the analysis section of this article discusses factual and statutory substance-over-form principles. Because of overlapping principles, a family tree of judicial doctrines is difficult to set forth in graphic form. It might look something like this:



I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 695 (1978). It is also notable that the IRS has issued guidance proclaiming that the sham transaction doctrine applies to almost any transaction where the anticipated pre-tax profit is not significant in relation to the anticipated tax benefits. *See* Rev. Rul. 99-14, 1999-1 C.B. 835 (1999).

132. *See* Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

133. *See* David P. Hariton, *Sorting out the Tangle of Economic Substance*, 52 Tax Law. 235, 237-41 (1999); U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS-DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 46-58 (1999) [hereinafter TAX SHELTER WHITE PAPER].

134. Hariton, *supra* note 133, at 238; *see* TAX SHELTER WHITE PAPER, *supra* note 133, at 35-46.

Three of the above doctrines arose directly from the language the Supreme Court used in *Gregory v. Helvering*.[135] Some of the factual and statutory principles probably also arose from the same substance-over-form principles created by Judge Learned Hand in the Court of Appeals for the Second Circuit. It is interesting to note that the jurisprudence of sham entities overlaps with factual substance-over-form principles.[136] In addition, the sham transaction doctrine[137] is often called the economic substance doctrine,[138] and transactions discussed in the context of either the sham transaction doctrine or the economic substance doctrine are often called economic or substantive shams[139] (to be distinguished from factual shams).

B. Gregory v. Helvering

Mrs. Evelyn Gregory owned a company, United Mortgage Corporation (United Mortgage), which in turn owned another corporation, Monitor Securities Corporation (Monitor).[140] United Mortgage stood to make a large profit on the sale of its shares in Monitor.[141] It appears that Mrs. Gregory sought to put the gain on the sale in her pocket while incurring as little tax as possible. To do so, she created another corporation, called Averill, with herself as the sole shareholder.[142] United Mortgage transferred Monitor to Averill, then Mrs. Gregory sold Averill.[143]

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135. *See* Moore, *supra* note 4, at 660-62. Judge Moore referred to the step-transaction doctrine as the substance-over-form doctrine. *See id.* at 662. This is probably because the first two Supreme Court cases after *Gregory* applying the step-transaction doctrine held that substance controlled over form without mentioning "step transactions." *See* Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945); Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). The Supreme Court in *Commissioner v. Clark*, 489 U.S. 726 (1989), however, acknowledged that it was the step-transaction doctrine that was applied in *Court Holding* and *Minnesota Tea*. Judge Moore's article and *Clark* were published around the same time.

136. In this article, references to "substance-over-form doctrines" are to the judicial doctrines other than the sham entity doctrine.

137. *See infra* notes 156-220 and accompanying text.

138. *See* United Parcel Serv. of America v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001).

139. *See* Appellant's Opening Brief, United Parcel Serv. of America v. Comm'r, 254 F.3d 1014 (11th Cir. 2001) (No. 00-12720) (referring to the substantive sham doctrine).

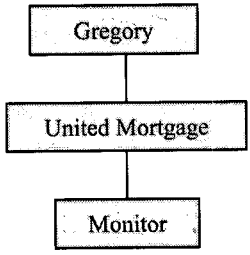
140. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *see* Gregory v. Comm'r, 27 B.T.A. 223, 223 (1932).

141. *Gregory*, 69 F.2d at 810.

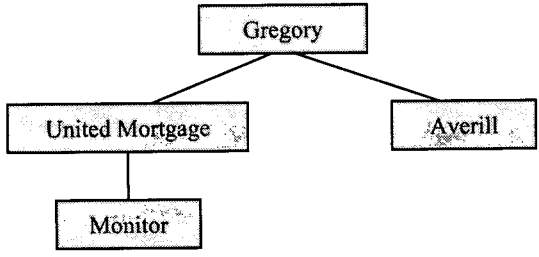
142. *See id.*

143. *See id.*

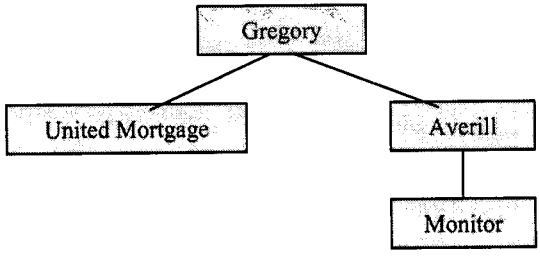
Graphically, it looked like this.



Then, Mrs. Gregory created Averill, resulting in this structure:



Then, United Mortgage sold Monitor to Averill, which resulted in the following:



Then, Mrs. Gregory liquidated Averill, causing her to receive the shares in Monitor, which she subsequently sold.[144] After the transaction, she remained the sole owner of United Mortgage and had pocketed the gain on the Monitor shares.[145] She reported capital gain income on the gain inherent in the Monitor shares.[146]

The Board of Tax Appeals, the predecessor to the Tax Court,

144. *See id.*
145. *See id.*
146. *See id.*

found that the Internal Revenue Code provided for tax-free treatment for the sale of Monitor to Averill as a reorganization.[147] Further, Mrs. Gregory was entitled to pay the lower capital gain tax rate on the sale of Averill (and therefore the Monitor shares) rather than the ordinary income tax rate she would have paid had she received the Monitor shares directly from United Mortgage.[148] The Board of Tax Appeals found that the Internal Revenue Code provided that Mrs. Gregory was entitled to these tax benefits.[149] The Board stated that the Commissioner could not argue in contradiction of the tax statutes:

> Congress has not left it to the Commissioner to say, in the absence of fraud or other compelling circumstance, that the corporate form may be ignored in some cases and recognized in others. Whatever can be said of the wisdom of recognizing the corporate device, the taxing statutes have so plainly accepted it and provided the detailed methods of taxing its transactions, that to disregard it in a case like this would vary the time, method and amount of tax which the statute imposes.[150]

In addition to the Commissioner's hands being tied, the Board of Tax Appeals believed that the Code bound the courts to the following conclusion based on a textual reading of the Code:

> [T]he incidence of the statute may be as favorable to the Government in one case as it is unfavorable in another. A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration. The general legislative plan apparently was to recognize the corporate entity and, in view of such recognition, to specify when the gains or losses would be recognized and upon what basis they should be measured. We may not destroy the effectiveness of this statutory plan by denying recognition to the corporation and thus preventing consideration of its transactions.[151]

The IRS appealed to the Court of Appeals for the Second Circuit. Judge Learned Hand wrote for the panel. First, he agreed with the taxpayer and the Board of Tax Appeals that a tax avoidance motive is irrelevant, noting that:

147. *See* Gregory v. Comm'r, 27 B.T.A. 223, 226 (1932).
148. *See id.*
149. *See id.* at 225.
150. *Id.*
151. *Id.* at 225-26.

> [A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not even bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[152]

Courts have often quoted this passage when holding that a transaction that 'smells bad' is entitled to tax benefits.[153] After acknowledging the right to plan one's own taxes, Judge Hand did an about-face, voicing his disagreement that the transaction fit within what Congress intended:

> [I]t does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition . . . [T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.[154]

On the basis of the above, Judge Hand concluded that the transactions at issue did not fit within the meaning of the reorganization statutes.

> All these steps were real, and their only defect was that they were not what the statute means by a "reorganization," because the transactions were no part of the conduct of the business of either or both companies; so viewed, they were a sham, though all the proceedings had their usual effect.[155]

Appearing persuaded by Judge Hand's prose, the Supreme Court adopted the Second Circuit's blueprint. Justice Suther-

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152. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). This idea has been expressed in other ways. Justice Holmes stated, "[t]he fact that [the taxpayer] desired to [escape taxation] is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930). In another case, Judge Hand observed that "there is nothing [more] sinister in so arranging one's affairs as to keep taxes as low as possible . . . nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions." Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting).

153. *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001); Estate of Stranahan v. Comm'r, 472 F.2d 867, 869 n.2 (6th Cir. 1973); Hariton, *supra* note 133, at 242 (noting that this quote is "now quoted verbatim in almost every recharacterization case which finds for the taxpayer").

154. *Gregory*, 69 F.2d at 810-11.

155. *Id.* at 811.

land tried to use his own prose to express a similar rationale, but Judge Hand's language was far more eloquent.[156] An interesting aspect of the opinion is that the Supreme Court did not use the term "sham," whereas Judge Hand did.[157]

C. *The Standard Formulations of the Substance-Over-Form Doctrines*

Rather than overriding the Internal Revenue Code with an explicit "facts and circumstances" test, lower courts have attempted to develop a common-law approach to tax avoidance through the substance-over-form doctrines. These attempts have resulted in chaos. The various courts of appeals have not agreed on which substance-over-form doctrines apply, how the doctrines apply, or when the doctrines apply. This section discusses the standard formulations of the substance-over-form doctrines, the Supreme Court cases giving rise to the doctrines, and the confusion dividing the courts.

1. *The Sham Transaction Doctrine*

Of all the substance-over-form judicial doctrines, the sham transaction doctrine probably has attracted the most debate.[158] Under the standard sham transaction doctrine, a court may deny the tax benefits of a transaction depending on the presence or absence of two factors, economic substance and business pur-

156. *See generally* Helvering v. Gregory, 293 U.S. 465 (1935).

157. *Compare Gregory*, 69 F.2d at 811, *with Gregory*, 293 U.S. at 465-70.

158. *See generally* Thomas C. Durham et al., *Mrs. Gregory's Great-Grandchildren: The Lost Generation*, 2 J. TAX'N OF GLOBAL TRANSACTIONS 25 (2002) (discussing the sham transaction doctrine, though calling it the economic substance doctrine); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2001); David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73 (2001); Lee A. Sheppard, *Why the IRS Should Argue the Statute First*, 92 TAX NOTES 465 (2001) (discussing UPS, a sham transaction case, though calling it an economic substance case); Lee Sheppard, *Economic Substance Abuse*, 89 TAX NOTES 1095 (2000) (discussing the sham transaction doctrine, though calling it the economic substance doctrine); Hariton, *supra* note 133 (discussing the sham transaction doctrine, though calling it the economic substance doctrine); Richard M. Lipton, *Brush Up Your Planning – More Lessons from the Colgate Case*, 90 J. TAX'N 89 (1999) (discussing ACM, a sham transaction case that called the doctrine the economic substance doctrine); Paul J. Donahue, *The Rule of* Sheldon v. Commissioner: *Is It an Economically Efficient Evolution of the Sham Transaction Doctrine?*, 13 VA. TAX REV. 165 (1993); Moore, *supra* note 4; Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 (1981) (discussing sham transactions); Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978).

pose.[159] Not all circuits that apply this doctrine agree whether a lack of both business purpose and economic substance is required for denying the tax benefits, or if the lack of one or the other suffices.[160] In other words, the circuits do not agree whether a taxpayer attempting to show entitlement to tax benefits in court must demonstrate that a transaction had a business purpose and economic substance or if it is sufficient to show that the transaction had one or the other.

Another example of the sham transaction doctrine involves *Rice's Toyota World, Inc. v. Commissioner*.[161] The taxpayer therein bought a used computer, paid with credit from a leasing company consisting of approximately 80% non-recourse and 20% full recourse debt.[162] After the purchase of the computer, the taxpayer leased the computer back to the leasing company.[163] Prior to entering into these transactions, the leasing company had already subleased the computer.[164] The taxpayer relied on literature regarding the sale-leaseback arrangement highlighting the tax benefits of the transaction, which included interest expense and accelerated depreciation deductions.[165]

In affirming the Tax Court, the Court of Appeals for the Third Circuit held that the sale-leaseback transaction was a sham for tax purposes, because the transaction lacked both business purpose and economic substance.[166] Regarding business purpose, the court affirmed the lower court's finding that the taxpayer's sole motivation for entering the transaction was tax

159. *See* Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983), *aff'd in part and rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

160. *See* United Parcel Serv. of America v Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001) (discussing the notion that a transaction is a sham if it lacks either economic substance or business purpose); Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992) (discussing the notion that a transaction is a sham if it lacks both economic substance and business purpose); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89 (4th Cir. 1985) (discussing the notion that a transaction is a sham if it lacks both economic substance and business purpose).

161. *See* Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983), *aff'd in part and rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

162. *See* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985). A nonrecourse loan is one where the creditor has no right to sue to collect the loan. *See, e.g.*, Comm'r v. Tufts, 461 U.S. 300 (1983). Such loans are common when there is an asset, such as a house, securing the loan. *See id.*

163. *See Rice's Toyota World*, 752 F.2d at 91.

164. *See id.* at 92.

165. *See id.* at 92 n.3, 93.

166. *See id.* at 95.

avoidance.[167] This finding rested on the taxpayer's failure to evaluate the sufficiency of residual value in the computer to make a profit.[168] With respect to economic substance, the court held that the taxpayer could not realize any economic value from the transaction.[169] This finding rested on the court's acceptance of the conclusion of the court below as to the credibility of the government's expert witnesses with respect to estimated residual value of the computer.[170] Because the transaction was a sham, the court disallowed the taxpayer's interest expense deductions.[171]

The two main Supreme Court cases since *Gregory* involving the sham transaction doctrine are *Knetsch v. United States*[172] and *Frank Lyon Co. v. United States*.[173] The Court decided *Gregory* and *Knetsch* in favor of the government, and *Frank Lyon* in favor of the taxpayer.[174] Of the Justices that decided these three cases, only one remains on the Court, Justice John Paul Stevens, the author of the dissenting opinion in *Frank Lyon*.[175] Nevertheless, deriving the sham transaction doctrine from these three Supreme Court cases is a stretch. The Supreme Court has never provided a clear formulation of the doctrine. The Supreme Court in *Gregory* relied on the meaning of the word "reorganization" under the statute.[176] There is no indication that the Court in *Gregory* expected its pronouncement to apply to transactions outside the Code's reorganization provisions.

In *Knetsch*, Mr. Karl F. Knetsch purchased $4 million of deferred savings annuities bonds from an insurance company financed with notes he issued at a higher rate to the same company.[177] He then borrowed back on his annuity to pay the

167. *See id.* at 95-96.
168. *See id.* at 94.
169. *See Rice's Toyota World*, 752 F.2d at 95.
170. *See id.* at 94-95.
171. *See id.* at 95.
172. Knetsch v. United States, 364 U.S. 361 (1960).
173. Frank Lyon Co. v. United States, 435 U.S. 561 (1978).
174. *See* Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. United States, 364 U.S. 361 (1960); Frank Lyon Co. v. United States, 435 U.S. 561 (1978).
175. *See Frank Lyon*, 435 U.S. at 584-88 (Stevens, J., dissenting).
176. *See Gregory*, 293 U.S. at 468-69.
177. *See Knetsch*, 364 U.S. at 362. Mr. Knetsch obtained the tax benefit as follows: He purchased deferred savings annuities bonds with a face value of $4,000,000 from an insurance company that yielded 2.5% for a price of $4,004,000. *See id.* He paid $4,000 of the purchase price by check and issued nonrecourse notes to the company for the remaining $4,000,000, secured by the bonds that required him to pay the insurance company 3.5%. *See id.* at 362-63. He then prepaid his interest payments

interest on the larger amount he owed.[178] In other words, he loaned money to an insurance company with money he borrowed from that company at a higher interest rate. Then, he borrowed back the money he loaned. At the termination of the annuities contract he purchased, Mr. Knetsch was to receive a monthly annuity of approximately $90,000.[179] After borrowing against the annuity and obtaining huge tax benefits, however, all that would have been left was enough for a monthly annuity of less than $50.[180]

Under the Supreme Court's analysis, Mr. Knetsch's motive or intent to reduce his tax burden was unimportant to the outcome of the case. Instead, the Court examined "whether what was done, apart from the tax motive, was the thing which the statute intended."[181] It held "that there was nothing of substance to be realized by [the taxpayer] from [the] transaction beyond a tax deduction."[182] The Court concluded that it was clear that "Knetsch's transaction . . . did 'not appreciably affect his beneficial interest except to reduce his tax.'"[183] Accordingly, the Court held that the transaction was a sham.[184]

Justice Douglas' dissenting opinion acknowledged that the transaction was tax motivated, but pointed out that many transactions are tax motivated.[185] He stated that the transactions should be recognized for tax purposes unless Congress dictates otherwise: "The remedy is legislative. Evils or abuses can be particularized by Congress."[186] Further, he noted that Congress

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every year deducting the entire amount even though he borrowed approximately the amount of the interest accrued on his annuity bond from the insurance company (the amount he prepaid for interest is excluded in order to simplify by keeping the numbers round). *See id.* at 362. In other words, he paid the insurance company about $140,000 and received back about $100,000, leaving a net outflow of about $40,000. *See id.* But he deducted the entire $140,000. *Knetsch*, 364 U.S. at 362. Assuming a tax rate of 90% for simplicity, he received a tax benefit of approximately $126,000 ($140,000 x .90) for which he paid approximately $40,000. *See id.* at 362-364. Thus he obtained a net tax benefit of approximately $86,000. *See id.*

178. *See id.* at 363.

179. *See id.*

180. *See id.*

181. *Knetsch*, 364 U.S. at 365 (quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935)).

182. *Id.* at 366.

183. *Id.* (citation omitted).

184. *See id.*

185. *See id.* at 371 (Douglas, J., dissenting).

186. *Id.*

did change the law for tax years after the transactions at issue.[187]

Although on its face *Knetsch* looks like an override of the statutory text with the judicial economic substance doctrine, commentators have described *Knetsch* as a factual sham.[188] Examination of the case reveals that it involved a lot of paper shuffling. A dissenting opinion in a case with identical facts supports this proposition. In *United States v. Bond*, the Court of Appeals for the Fifth Circuit held in favor of a taxpayer in the same situation as Mr. Knetsch.[189] The dissenting judge observed, however, that interest is a payment for use of money, and that the insurance company did not actually give the taxpayer any money or economic benefit on which to make a payment of interest.[190] This analysis indicates that *Knetsch* was resolvable by looking at whether the debt was actual or not, rather than whether the text of the statute should be overridden by a judicial doctrine.

Frank Lyon also involved a factual analysis. In that case, the Supreme Court found for the taxpayer.[191] The Worthen Bank & Trust Company (Worthen) originally purchased the site for a building, but the bank's regulators would not approve the proposed financing for constructing it.[192] After considering various options, Frank Lyon Company (Lyon), the taxpayer, offered to purchase and lease the building back to the bank.[193] Lyon purchased the building from Worthen with financing from First National City Bank and New York Life Insurance Company and leased it back to Worthen.[194] Lyon, as owner of the building, took depreciation deductions on the building.[195]

The Commissioner challenged the deductions on the ground that in substance Worthen owned the building, not Lyon.[196] The Supreme Court rejected the Commissioner's argument that the sale-and-leaseback arrangement was a sham.[197]

187. *See Knetsch*, 364 U.S. at 370.

188. *See* Hariton, *supra* note 133, at 246 ("The Supreme Court held, fairly enough, that there was no interest deduction because there was no borrowing at all—just a net payment to the insurance company in exchange for purported tax benefits.").

189. *See* United States v. Bond, 258 F.2d 577, 580, 584 (5th Cir. 1958).

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

191. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978).

192. *See id.* at 563-64.

193. *See id.* at 564.

194. *See id.* at 564-65.

195. *See id.* at 568.

196. *See id.* at 568-69.

197. *See Frank Lyon*, 435 U.S. at 583-84.

The taxpayer convinced the Court that it had a business purpose and would likely attain economic benefits.[198] The Court stated that a transaction should be respected for tax purposes if it 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 not shaped solely by tax avoidance features."[199] In holding for the taxpayer, the Court stated: "[S]o long as [a party to a transaction] retains significant and genuine attributes of the traditional [type of party to the transaction], the form of the transaction adopted by the parties governs for tax purposes."[200] In reaching its holding, the Court did not rely on *Gregory* or *Knetsch*. Instead of providing a clear formulation of the rule it applied, the Court listed a number of factors as to why the taxpayer was the owner of the building at issue.[201]

The requirement of economic substance may exist independent of the requirement of business purpose. In the Sixth and the Eleventh Circuit Courts of Appeals, for example, a lack of economic substance is sufficient to find that a transaction is a sham without mentioning business purpose.[202] The D.C. Circuit Court of Appeals found a lack of business purpose fatal to a taxpayer's claimed tax benefits without a discussion of economic substance.[203] Interestingly, an earlier case in the same circuit had concluded that both factors were necessary to a sham analysis.[204]

A transaction has economic substance if it provides an economic benefit of some consequence to the taxpayer separate and apart from tax savings.[205] Some courts have found that a trans-

198. *See id.*

199. *Id.*

200. *Id.*

201. *See id.* (listing factors such as the competition Worthen Bank faced, undercapitalization of Worthen, legal restraints on Worthen, advice from regulators, the presence of an independent third party, the presence of potential financial organizations, the bargaining process, the independence of Lyon Bank, Worthen's motivation, risk, the absence of family involvement, and the various legal relationships found).

202. *See, e.g.*, United Parcel Serv. of America v. Comm'r, 254 F.3d 1014 (11th Cir. 2001); Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001); Pasternak v. Comm'r, 990 F.2d 893, 898 (6th Cir. 1993) ("If the transaction lacks economic substance, then the deduction must be disallowed without regard to the niceties of the taxpayer's intent."); Mahoney v. Comm'r, 808 F.2d 1219, 1220 (6th Cir. 1987).

203. *See* ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 514 (D.C. Cir. 2000).

204. *See* Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992).

205. *See* Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Comm'r, 364 F.2d 734, 737-38 (2d Cir. 1966); Hariton, *supra* note 133, at 249.

action has economic substance if the transaction earned an actual pretax profit.[206] Sometimes a nominal profit suffices,[207] sometimes it does not.[208]

The business purpose factor is somewhat less straightforward compared to the economic substance factor. At least three formulations of business purpose have percolated through the courts. First, Judge Hand found that if the purpose of a transaction contradicts or defeats the purported form of the transaction then courts may sometimes deny tax benefits sought by using that form.[209] Commentators refer to this particular formulation as one of statutory interpretation because courts applying this formulation inquire as to whether the form prescribed by Congress was intended to permit the particular transaction to go untaxed.[210] An example of a case applying the economic substance doctrine cast as an inquiry into congressional intent is *Horn v. Commissioner*.[211]

Second, courts sometimes apply a pure subjective business purpose test. *Rice's Toyota World* is an example of this version of business purpose.[212] In that case, the Court of Appeals for the Fourth Circuit found that the transaction lacked business purpose.[213] The court found one of the subsidiary findings of the Tax Court relevant: the level of inquiry into certain aspects of the transaction.[214] The court also found support for the taxpayer's lack of business purpose in the literature the taxpayer had available to evaluate the transaction.[215] The literature distributed to the taxpayer regarding the transaction "emphasized the large

206. *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 786 (5th Cir. 2001) (reversing the Tax Court's finding that the transaction lacked economic substance on the basis that the Tax Court had miscalculated by finding that there was no pretax profit).

207. *See id.* (stating that profit of $1.7 million was sufficient for economic substance even though the transactions at issue involved more than $800 million in shares of stock in Royal Dutch Shell).

208. *See* Sheldon v. Comm'r, 94 T.C. 738, 768-69 (1990) (stating that the transaction lacked economic substance even though the taxpayer earned a nominal profit).

209. *See* Chisholm v. Comm'r, 79 F.2d 14, 15 (2d Cir. 1935).

210. *See* Durham et al., *supra* note 158, at 25.

211. *See* Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992). The D.C. Circuit appeared to abandon this statutory interpretation approach in *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 513 (D.C. Cir. 2000) and *Del Commercial Properties v. Commissioner*, 251 F.3d 210, 213 (D.C. Cir. 2001).

212. *See* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 92 (4th Cir. 1985).

213. *See id.* at 94.

214. *See id.* at 92.

215. *See id.* at 93.

tax deductions the transaction would produce, not the potential for profit."[216]

Third, courts sometimes apply a business purpose or ongoing business test. An example of this version is *United Parcel Service v. Commissioner*.[217] In that case, the court reversed the Tax Court's application of the sham transaction doctrine.[218] United Parcel Service (UPS) sought tax savings by restructuring its excess value business as insurance provided by an overseas company.[219] There, the fact that UPS sought tax savings did not negate business purpose.[220] "[A] transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business."[221] The court added, "This concept of 'business purpose' is a necessary corollary to the venerable axiom that tax-planning is permissible."[222]

2. *The Recharacterization Doctrines*

Another set of substance-over-form doctrines in tax law is recharacterization doctrines. The IRS often invokes the power to recharacterize transactions in certain instances.[223] According to at least one commentator, the judicial versions of this power are limitless and are much more problematic than the sham transac-

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216. *Id.* The court of appeals appears somewhat impressionable in this regard. What if the taxpayer had read books such as ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776)? Or what if the IRS had provided evidence that the taxpayer had read periodicals such as THE WALL STREET JOURNAL or PLAYBOY?

217. *See* United Parcel Serv. of America v. Comm'r, 254 F.3d 1014 (11th Cir. 2001).

218. *See id.* at 1020.

219. *See id.* at 1016.

220. *See id.* at 1020.

221. *Id.* at 1019.

222. *Id.* The outcome in *United Parcel Service* contrasts with the outcome in *Winn-Dixie*, decided eight days later in the same circuit. *See* Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001). The Court of Appeals for the Eleventh Circuit—even though it found that UPS's arrangement was fine because it was a continuation of the taxpayer's business—disallowed the tax benefits that Winn-Dixie reported from entering into a company-owned life insurance program (commonly referred to as a COLI program). *See id.* at 1316-17. The distinguishing feature between these cases can best be put the way Mr. Mark P. Gergen described *ACM*: "The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it." . Gergen, *supra* note 158, at 140.

223. *See* Hariton, *supra* note 133, at 238-39.

tion doctrine.[224] An often-invoked manifestation of the recharacterization power is the step-transaction doctrine.[225] Under the standard step-transaction doctrine, a series of formally independent steps is treated as a single, integrated transaction if the steps satisfy one of three tests.[226]

First, a series of transactions may be integrated into one if, at the time of entering into the series of prearranged transactions, the taxpayer intended the end result.[227] This is commonly known as the "end result" test.[228] Application of this test requires examination of the actual intent of the taxpayer, regardless of the purported form of chosen transactions.[229] The Court of Appeals for the Sixth Circuit appears to have invoked this test exclusively.[230]

Second, a series of transactions may be integrated into one if each of the steps is interdependent.[231] This is commonly known as the "interdependence" test.[232] To describe this test another way, a taxpayer may see a series of her transactions integrated if one of the transactions would have been pointless without the completion of the entire series of transactions.[233] Courts have examined both the intent and the chosen forms of the transactions in applying this test.[234]

Third, a series of transactions may be integrated into one if there was a binding commitment to complete the entire series.[235] This is commonly known as the "binding commitment" test.[236] Application of this test requires examination of the form of the transaction or transactions at issue.[237] Intent is irrelevant.[238] An

224. *See id.* at 239.

225. *See* Gaw v. Comm'r, 70 T.C.M. (CCH) 1196, 1226-28 (T.C. 1995), *aff'd*, 111 F.3d 962 (D.C. Cir. 1997); Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1521 (10th Cir. 1991); Penrod v. Comm'r, 88 T.C. 1415, 1428-30 (1987); King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969).

226. *See Gaw*, 70 T.C.M. (CCH) at 1226-28; *Penrod*, 88 T.C. at 1428-30.

227. *See id.*

228. *See id.*

229. *See id.*

230. *See* Brown v. United States, 782 F.2d 559, 564 (6th Cir. 1986) (explaining Davis v. Comm'r, 746 F.2d 357 (6th Cir. 1984)); *see also* Russell v. Comm'r, 832 F.2d 349, 352 (6th Cir. 1987).

231. *See Gaw*, 70 T.C.M. (CCH) at 1226-28; *Penrod*, 88 T.C. at 1430.

232. *See id.*

233. *See id.*

234. *See id.*

235. *See id.* at 1429.

236. *See id.*

237. *See Gaw*, 70 T.C.M. (CCH) at 1226-28; *Penrod*, 88 T.C. at 1429.

interesting aspect of this test is that taxpayers and the government alike have had success invoking it.[239] When a corporate taxpayer invokes it, he or she can qualify for certain types of tax benefits, such as non-recognition of gain in a merger context.[240]

Courts and commentators mention *Gregory, Commissioner v. Court Holding*, and *United States v. Cumberland Public Services Co.* when discussing this doctrine.[241] None of these cases, nor any other Supreme Court cases, have applied the end result, interdependence, or binding commitment test.

Court Holding involved a real estate deal,[242] whereby a corporation with two shareholders entered into an oral agreement to sell an apartment building to a potential buyer.[243] The corporation's tax lawyer called the transaction to a halt before the buyer and seller inked the deal.[244] He advised that the participants could remove some of the tax burden if the shareholders, rather than the corporation, sold the property.[245] As a result, the corporation liquidated the property to the shareholders, who in turn sold the property to the buyer.[246] The Supreme Court affirmed the Tax Court's finding that, in substance, no liquidation of the corporation had occurred.[247] Instead, the Court held that the corporation-not the shareholders-had sold the property to the buyer.[248]

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238. *See id.*

239. *See, e.g.*, McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982) (sustaining taxpayer's invocation of the step-transaction doctrine); King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) (sustaining taxpayer's invocation of the step-transaction doctrine); Heintz v. Comm'r, 25 T.C. 132 (1955) (sustaining taxpayer's invocation of the step-transaction doctrine); True v. United States, 190 F.3d 1165 (10th Cir. 1999) (sustaining the IRS's invocation of the step-transaction doctrine); Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991) (sustaining the IRS's invocation of the step-transaction doctrine); Davis v. Comm'r, 746 F.2d 357 (6th Cir. 1984) (sustaining the IRS's invocation of the step-transaction doctrine).

240. *See King Enters.*, 418 F.2d at 511 (discussing a taxpayer who relied on the interdependence test to qualify as reorganization receiving non-recognition treatment on stock received when it had received stock, notes, and cash just prior to a statutory merger).

241. *See* Kluener v. Comm'r, 154 F.3d 630, 634-35 (6th Cir. 1998); Esmark v. Comm'r, 90 T.C. 171, 194 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989).

242. *See* Comm'r v. Court Holding Co., 324 U.S. 331, 332-33 (1945).

243. *Se id.*

244. *See id.* at 333.

245. *See id.*

246. *See id.*

247. *See id.*

248. *See Court Holding*, 324 U.S. at 334.

This case illustrates nicely the step-transaction doctrine because it contained a series of transactions. First, the corporation liquidated the apartment to the shareholders. Next, the shareholders sold the apartment to the buyer. Viewing the series of transactions as an integrated whole, the Supreme Court ignored the participation of the shareholders in the sale and the liquidation of the corporation. Accordingly, the Court held the corporation, rather than the shareholders, sold the property to the buyer.

On the other hand, the holding of the case seems artificial. It appears that the Supreme Court focused on what could have happened rather than what actually happened. One commentator has noted that a liquidation such as the one in *Court Holding* is a creature of statute, not dependent on who negotiated the subsequent transaction.[249] This view is supported by the fact that the Supreme Court decided differently *Cumberland Public Services* on almost the same facts when the evidence showed that it was the shareholders who negotiated the deal from the start rather than the corporation.[250] The commentator called the focus on negotiations "baffling."[251]

A close cousin to the step-transaction doctrine is the sham entity doctrine. Many cases can be characterized as sham entity cases, although they are not often described as such. In a sham entity case, the court disregards the participation of an entity that acts as a mere conduit.[252] Usually something about the entity merits such treatment. For example, in *Aiken Industries v. Commissioner*, the court disregarded the participation of a corporation created for the sole purpose of borrowing money from one related corporation and then loaning the same money to another related corporation on the same terms.[253] At first glance, it seems ridiculous for one company to serve as an intermediary between two companies borrowing and lending the money on the same terms. This scenario conjures up images of the First Citiwide Exchange Bank portrayed on Saturday Night Live, which existed for the sole purpose of providing change to its

249. *See* Isenbergh, *supra* note 131, at 873.

250. *See* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950).

251. *See* Isenbergh, *supra* note 131, at 872 & n.56 (discussing Court Holding Co. and noting that the decision was corrected in Cumberland Pub. Serv.).

252. *See, e.g.*, N. Ind. Pub. Serv. Co. v. Comm'r, 115 F.3d 506 (7th Cir. 1997); Aiken Indus. v. Comm'r, 56 T.C. 925 (1971).

253. *See Aiken Indus.*, 56 T.C. at 934.

customers.[254] Borrowing and lending on the same terms is as likely to yield profit as exchanging a $10 bill for ten $1 bills. Both are senseless transactions, seeming to exist only for entertainment value.

The taxpayer in *Aiken Industries* probably did not have entertainment in mind. The taxpayer was a United States company that was a subsidiary of a Bahamian parent.[255] The taxpayer had borrowed money from its parent corporation, and had to pay withholding tax on the interest on the loan paid back to the parent corporation in the Bahamas.[256] To avoid this withholding tax, a corporation was formed in Honduras, where a treaty was in place exempting interest from withholding tax paid on interest from a United States borrower to a Honduran noteholder.[257] The parent corporation transferred its note to the Honduran corporation, and claimed an exemption from withholding tax under the treaty.[258] The court held that this Honduran corporation deserved no respect for tax purposes because all it did was interpose itself between a loan from the Bahamian parent and the United States borrower.[259] It engaged in no other business.[260]

In contrast, courts will respect a related intermediary between a corporation and a third party that engaged in business. *Northern Indiana Public Service Co. v. Commissioner* (*NIPSCO*) in-

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254. *See Saturday Night Live: First Citiwide Exchange Bank II* (NBC television broadcast, Oct. 8, 1988), *available at* http://snltranscripts.jt.org/88/88achangebank2.phtml (last visited Mar. 27, 2003). The following is an excerpt from the mock commercial:

> Bank Representative: A lot of people don't realize that change is a two-way street. You can come in with sixteen quarters, eight dimes, and four nickels-we can give you a five-dollar bill. Or we can give you five singles. Or two singles, eight quarters, and ten dimes. You'd be amazed at the variety of the options you have.
>
> . . . .
>
> Bank Representative: All the time, our customers ask us, "How do you make money doing this?" The answer is simple: Volume. That's what we do.

Id.

255. *See Aiken Indus.*, 56 T.C. at 926.

256. *See id.* at 930.

257. *See id.*

258. *See id.* at 931.

259. *See id.* at 934 ("In effect, Industrias, while a valid Honduran corporation, was a collection agent with respect to the interest it received from MPI. Industrias was merely a conduit for the passage of interest payments from MPI to ECL, and it cannot be said to have received the interest as its own.").

260. *See id.* at 926 ("During the years 1964 and 1965, the only income received by Industrias was interest income in the amounts of 232,500 lempiras and 350,000 lempiras, respectively . . . .").

volved such an arrangement.[261] The taxpayer needed to borrow money and found it could borrow from lenders in the Eurobond market at a cheaper interest rate than it could domestically.[262] The taxpayer set up a subsidiary in a treaty country to avoid paying withholding tax on interest paid back to the lenders.[263] The subsidiary borrowed money from the Eurobond market and then loaned the same money at a higher interest rate to the parent corporation in the United States.[264] When the parent corporation paid the subsidiary, the subsidiary invested the profit it made on the transaction.[265] Even though the subsidiary was formed solely to trigger the withholding exemption provisions of the treaty, the Tax Court and the Court of Appeals for the Seventh Circuit both respected the entity for tax purposes.[266]

The Supreme Court cases that form the basis for deciding "conduit" cases are *Higgins v. Smith*[267] and *Moline Properties v. Commissioner*.[268] In *Smith*, Mr. Smith formed a corporation to buy and sell securities, allowing him to control the timing of the realization of gains and losses on the purchases and sales of the securities for tax purposes.[269] The wholly-owned corporation did not engage in any business beyond serving Mr. Smith's individual tax needs.[270] The Supreme Court saw the issue as how to tax transactions between a taxpayer and a wholly-owned corporation.[271] The Court disregarded the corporate form and found in favor of the revenue collector.[272]

Soon after deciding *Smith*, the Supreme Court decided *Moline Properties*.[273] *Moline Properties* involved a taxpayer-corporation organized by an individual who sought to have the taxpayer-corporation disregarded for tax purposes.[274] A lender had requested that the individual form the corporation to hold

261. *See* N. Ind. Pub. Serv. Co. v. Comm'r, 115 F.3d 506, 506, 514 (7th Cir. 1997).
262. *See id.* at 508.
263. N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341, 347 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).
264. *See id.* at 355.
265. *N. Ind. Pub. Serv. Co.*, 115 F.3d at 514.
266. *See id.*; *N. Ind. Pub. Serv. Co.*, 105 T.C. at 356.
267. *See* Higgins v. Smith, 308 U.S. 473 (1940).
268. *See* Moline Props., Inc. v. Comm'r, 319 U.S. 436 (1943).
269. *See Smith*, 308 U.S. at 474-75.
270. *See id.* at 474.
271. *See id.* at 482 (Roberts, J., dissenting).
272. *See id.* at 480.
273. *See Moline Props.*, 319 U.S. at 436.
274. *See id.* at 436.

mortgage and title to certain property for security purposes.[275] As holder of title, the taxpayer-corporation litigated on behalf of, refinanced, and leased out portions of the property.[276] On the sale of part of the property, the individual reported the gain on his own returns rather than the taxpayer-corporation's returns.[277] For the sale of another part, the taxpayer-corporation reported the gain but the owner filed for a tax refund.[278] The Court refused to disregard the taxpayer-corporation. It stated:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[279]

With some exceptions, courts have read *Moline* as prohibiting the disregard of an entity or its participation in a series of transactions if the entity had a business purpose or carried on business activity. For example, the Tax Court and Court of Appeals for the Seventh Circuit followed *Moline* in *NIPSCO*, discussed above.[280] In that case, the Court of Appeals for the Seventh Circuit upheld the Tax Court's reliance on *Moline* for the proposition that the IRS could not disregard a particular subsidiary corporation if it conducted "substantive business activity—even minimal activity."[281]

Taxpayers should beware that courts might ignore *Moline*, regardless of whether the taxpayer brings it to the court's attention. In *Del Commercial Properties v. Commissioner*, for example, the Tax Court made a factual finding that a subsidiary indistinguishable from the subsidiary in *NIPSCO* carried on "minimal business activity."[282] The taxpayer argued on appeal that *Moline*,

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275. *See id.* at 437-38.

276. *See id.* at 437-38.

277. *See id.* at 438.

278. *See id.*

279. *Moline Props.*, 319 U.S. at 438-39 (footnotes omitted).

280. *See* N. Ind. Pub. Serv. Co. v. Comm'r, 115 F.3d 506, 511 (7th Cir. 1997); N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341, 347-48 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).

281. *See N. Ind. Pub. Serv. Co.*, 115 F.3d at 511.

282. *See* Del Commercial Props. v. Comm'r, 78 T.C.M. (CCH) 1183, 1184 (1999), *aff'd*, 251 F.3d 210 (D.C. Cir. 2001). The author represented the taxpayer in this case in its appeal and in petitioning the Supreme Court for certiorari.

as interpreted by the Seventh Circuit in *NIPSCO*, prevented tax law from disregarding the subsidiary in *Del Commercial*.[283] The Court of Appeals for the D.C. Circuit failed to mention *Moline*-binding Supreme Court precedent-at all.[284]

The confusing nature of these doctrines can be further illustrated by the Court of Appeals for the D.C. Circuit addition to the step-transaction doctrine. As discussed, the standard step-transaction formulation included three tests—interdependence, binding commitment, and end result.[285] In *Del Commercial*, the Court of Appeals for the D.C. Circuit added a fourth test, which other circuits have said is irrelevant to a step-transaction analysis: business purpose.[286] At various points in the Court of Appeals opinion in *Del Commercial*, the court refers to *ASA Investerings* for guidance as to how to analyze step-transaction cases.[287] This reference is curious because *ASA Investerings* was not a step-transaction case; rather, it was a sham entity case.[288] In *Del Commercial*, the Court of Appeals for the D.C. Circuit appears to have assumed that *ASA Investerings* was a step-transaction case.[289] However, the *ASA Investerings* opinion did not use the term "step transaction," nor does it use language one would have associated with step transaction cases, such as "integration," "series of steps," or "series of transactions."[290]

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283. *See* Brief for Appellant at 29-30, Del Commercial Props. v. Comm'r, 251 F.3d 210 (D.C. Cir. 2001) (No. 00-1313).

284. *See id.* at iv, 22-33.

285. *See* discussion *supra* notes 226-40 and accompanying text.

286. *See* Del Commercial Props. v. Comm'r, 251 F.3d 210, 215 (D.C. Cir. 2001); *see also* True v. United States, 190 F.3d 1156, 1177 (10th Cir. 1999) (holding that the presence of a business purpose in a step-transaction case was not dispositive); Associated Wholesale Grocers v. United States, 927 F.2d 1517, 1526-27 (10th Cir. 1991) (holding that the presence of a business purpose in a step transaction case was not dispositive); Reef Corp. v. Comm'r, 368 F.2d 125, 133 (5th Cir. 1996) (holding that the presence of a business purpose in a step transaction case was not dispositive).

287. *See Del Commercial*, 251 F.3d at 213-15.

288. *See* ASA Investerings P'ship v. Comm'r, 76 T.C.M. (CCH) 325 (1998) ("The primary issue for decision is whether these corporations formed a valid partnership for Federal income tax purposes."), *aff'd*, 201 F.3d 505, 512 (D.C. Cir. 2000) ("Getting to the controlling issue, petitioner argues that under the standard established in *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1943), the partnership cannot be regarded as a sham.").

289. The court cited *ASA Investerings v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000), for the proposition that, "[i]n step-transaction cases, 'the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive.'" *Del Commercial*, 251 F.3d at 214.

290. *See ASA Investerings*, 201 F.3d 505 (D.C. Cir. 2000).

D. *Indeterminacy*

Recent cases illustrate the indeterminacy of these doctrines. A number of courts of appeals disagreed with the conclusion the courts below reached in applying these doctrines. Examples of these are *Compaq Computer Corporation v. Commissioner*,[291] *IES Industries v. United States*,[292] *United Parcel Service*,[293] and *Boca Investerings v. United States*.[294]

In the descriptions of the standard substance-over-form cases above, it should be apparent that aside from the sham entity or factual sham doctrine, the text of the Internal Revenue Code does not authorize the above applications of the standard formulations of the substance-over-form doctrines.[295] This lack of statutory authority does not mean the cases are wrong. Such applications could follow from the Code from a non-textualist perspective.

Some vestiges of non-textualism still exist on the Supreme Court. Justice Stevens' method of statutory interpretation stands in stark contrast to Justice Scalia's.[296] Justice Stevens prefers the common-law method that Justice Scalia avoids.[297] Under this method, the substance-over-form doctrines might still be developing. If this statement is true, perhaps in another one-hundred years taxpayers will be able to predict when courts will use one

291. Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999).

292. IES Indus. v. United States, 253 F.3d 350 (8th Cir. 2001), *rev'g* No. C97-206, 1999 U.S. Dist. LEXIS 22610 (N.D. Iowa Sept. 22, 1999).

293. United Parcel Serv. of America v. Comm'r, 254 F.3d 1014 (11th Cir. 2001), *rev'g* 78 T.C.M. (CCH) 262 (1999).

294. Boca Investerings P'ship v. United States, 314 F.3d 625 (D.C. Cir. 2003), *rev'g* 167 F. Supp. 2d 298 (D.D.C. 2001).

295. Courts often admit as much when they note that the law changed after the transaction at issue occurred. *See* Knetsch v. United States, 364 U.S. 361 (1960); Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001); Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001). However, it was not actually necessary to admit that the text did not answer the question when a court could just cite *Gregory* for the proposition that the text is irrelevant because "the meaning of a sentence [in a statute] may be more than that of the separate words, as a melody is more than the notes." Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

296. *See* Popkin, *supra* note 31, at 1134 ("Justice Scalia's main judicial rival is Justice Stevens.").

297. *See* Bose Corp. v. Consumers Union of United States, Inc., 466 U.S. 485, 502 (1984) ("[T]he content of the rule is not revealed simply by its literal text, but rather is given meaning through the evolutionary process of common-law adjudication."). *See also* William D. Popkin, *A Common Law Lawyer on the Supreme Court: The Opinions of Justice Stevens*, 1999 DUKE L.J. 1087, 1105-10 (1989).

of these doctrines and which version. Until then, the substance-over-form doctrines remove hope for certainty in tax planning. If the substance-over-form doctrines still are valid, the IRS and the courts have a choice as to whether or not they want to follow the text of the statute. This leaves a taxpayer to guess whether the IRS or a court will find that a transaction "smells bad"[298] and thus will use one of the doctrines to override the text of the Code.

On the other hand, it seems that the IRS should have some way to combat abusive tax avoidance, whatever that may be.[299] It appears that the Internal Revenue Code and available guidance is intended to answer all questions for taxpayers trying to go about their business. But according to Gödel's Incompleteness Theorem, any formal system must remain either incomplete or inconsistent.[300] Perhaps this theorem explains why it is so difficult to determine exactly what is tax avoidance.[301] Without these doctrines it would seem that taxpayers could always find ways to take advantage of the incompleteness or inconsistency in the tax laws. It remains to be seen whether the Supreme Court will uphold the sham transaction doctrine, business purpose doctrine, economic substance doctrine, or step transaction doctrine.

IV. ANALYSIS

To say that tension exists between textualism and sub-

298. *See* ACM P'ship v. Comm'r, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting) (referring to the majority's conclusion as akin to a "smell test." "If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to 'put one over.'").

299. *See generally* George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 658-60 (1985) (noting the difficulty of defining tax avoidance).

300. *See* Brown & Greenberg, *supra* note 128, at 1466-67.

> Fortunately for mathematicians (lest they be out of work), Kurt Gödel proved in 1931 that Hilbert's proposed formal system does not exist. Specifically, Gödel demonstrated that formal systems powerful enough to express the axioms and propositions of arithmetic cannot be both complete and consistent. Instead, these systems *must* contain either statements that are neither provable nor disprovable within the system, or at least two inconsistent statements that are both provable within the system. In either case, proof or disproof of these statements can only be accomplished with extra-systemic insight.

Id. (footnotes omitted). *See also id.* at 1487 (concluding that Gödel's Incompleteness Theorem applies to the law).

301. *See generally* Cooper, *supra* note 299, at 658-60.

stance-over-form doctrines may state the obvious. The terms themselves reflect the tension. "Form," in essence, refers to formal legal text, what textualism hails as controlling. "Substance over form," in essence, refers to the eschewal of that formal text in favor of substance. Commentators have examined the history of our legal system to identify periods where form controlled and where substance controlled.[302] In periods when form controlled, courts did not depart from formal textual sources of law.[303] In periods when substance controlled, courts did not remain bound by these formal texts.[304] In short, substance and form cannot both control.

The Supreme Court has not commented on any of the standard formulations of substance-over-form judicial doctrines since Justice Scalia joined the Court. But if the Court is becoming more textualist, further inquiry into how the three branches of government have been shaping tax law as well as the characteristics of tax law itself may assist in determining if the Supreme Court would affirm any of the standard formulations today.

A. *The Judicial Branch–Recent Supreme Court Opinions*

The Supreme Court has had numerous opportunities to comment on the efficacy of the substance-over-form doctrines since Justice Scalia's appointment.[305] Perhaps it has denied certiorari in these cases to send the message that a "facts and circumstances" test, even if it infuses the tax laws with undesired uncertainty, is better than allowing people to abuse the tax laws. Perhaps the justices do not realize the chaos and uncertainty imposed under the current regime.

It is also possible that the Supreme Court has commented

302. *See generally* William S. Blatt, *The History of Statutory Interpretation: A Study in Form and Substance*, 6 CARDOZO L. REV. 799 (1985).

303. *See id.*

304. *See id.*

305. *See, e.g.*, Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002); Del Commercial Props. v. Comm'r, 251 F.3d 210 (D.C. Cir. 2001), *cert. denied*, 534 U.S. 1104 (2002); ASA Investerings P'ship v. Comm'r, 201 F.3d 505 (D.C. Cir.), *cert. denied*, 531 U.S. 871 (2000); ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999); Herrington v. Comm'r, 854 F.2d 755 (5th Cir. 1988), *cert. denied*, 490 U.S. 1065 (1989); Gardner v. Comm'r, 954 F.2d 836 (2d Cir. 1991), *cert. denied sub nom.* Falk v. Comm'r, 504 U.S. 910 (1992); Cook v. Comm'r, 941 F.2d 734 (9th Cir. 1991), *cert. denied*, 502 U.S. 857 (1991); Lerman v. Comm'r, 939 F.2d 44 (3d Cir. 1991), *cert. denied*, 502 U.S. 984 (1991).

on whether judicial doctrines can override the text of the Internal Revenue Code through other non-substance-over-form cases. Recent cases have taken a literal interpretation of the Code. For example, in *Gitlitz* the taxpayer received a double tax benefit under a plain reading of the Code.[306] In that case, the taxpayers owned a corporation organized under subchapter S of the Internal Revenue Code.[307] In such a corporation, the Internal Revenue Code taxes the shareholders directly instead of the corporation.[308] The corporation realized an approximately $2 million discharge of indebtedness.[309] Under the Code, a discharge of indebtedness is generally considered income.[310] There is an exception, however, for insolvency.[311] At the same time, subchapter S allowed the taxpayers to increase their cost bases in the corporation, another tax benefit, because it allowed the taxpayers to deduct other losses it could not previously deduct.[312] The IRS denied the double benefit.[313] Indeed, neither the IRS nor the courts have historically allowed double tax benefits even if the text of the Code supported it.[314] Nevertheless, the Supreme Court read the Internal Revenue Code as plainly allowing the double benefit.[315]

In *United States v. Brockamp*, the Supreme Court refused to apply traditional judicially-developed equity principles to certain limitations provisions of the Internal Revenue Code.[316] Taxpayers in two different docketed cases argued in *Brockamp* that the statute of limitations on a refund claim should have been tolled during the time that each taxpayer was disabled under the equitable tolling doctrine.[317] The Supreme Court rejected the taxpayers' arguments on the ground that relevant Internal Revenue Code provisions precluded the application of equitable

306. *See* Gitlitz v. Comm'r, 531 U.S. 206, 219-20 (2001).
307. *See id.* at 209. *See generally* 26 U.S.C. § 1366(a)(1)(A) (1994 & Supp. III 1997).
308. *See Gitlitz*, 531 U.S. at 209.
309. *See id.* at 210.
310. *See* 26 U.S.C. § 61(a)(12) (1994); *Gitlitz*, 531 U.S. at 213.
311. *See* 26 U.S.C. § 108(a)(1) (1994); *Gitlitz*, 531 U.S. at 213.
312. *See Gitlitz*, 531 U.S. at 220.
313. *See id.* at 208.
314. *See* Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934); *see also* United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969) (requiring a "clear declaration of intent by Congress" before allowing a double benefit).
315. *See Gitlitz*, 531 U.S. at 220.
316. *See* United States v. Brockamp, 519 U.S. 347, 350-52 (1997).
317. *See id.* at 348.

tolling.[318] Unlike other limitations tolling provisions, which contain simple language, the refund limitation provision was "unusually emphatic."[319] By emphatic, the Court meant that the refund limitations provisions seemed to state in numerous parts that no exceptions applied.[320] The limitations provisions were "set forth in a highly detailed technical manner that linguistically speaking cannot be read as containing explicit exceptions."[321]

The Supreme Court has mentioned the step transaction doctrine in one case, but did not apply it in a substance-over-form context. *Commissioner v. Clark* addressed the characterization of a cash payment the taxpayer received as a result of a reorganization.[322] The taxpayer treated the payment, often referred to as boot, as a capital gain.[323] The Commissioner recharacterized the payment as a dividend, treating it as ordinary income.[324] Although the Court examined the transaction as a whole, it did not use the doctrine to override the text of the Internal Revenue Code as is done in substance-over-form cases. Rather, the Court found that the language of the statute required the examination of the steps of the transaction as an integrated whole.[325]

In *Cottage Savings Ass'n v. Commissioner*, the Supreme Court read the language of the tax regulations narrowly, allowing the taxpayer a benefit that had been denied on the economic substance doctrine by the Court of Appeals for the Sixth Circuit.[326] In *Cottage Savings*, the taxpayer-banks relied on the plain language of tax regulations to take tax losses on loan portfolios by trading with other banks for economically equivalent loan portfolios.[327] The taxpayers entered into the transactions because the Federal Home Loan Bank Board (FHLBB), the taxpayers' federal regulator, apparently wanted to give the taxpayers a tax break.[328] For a limited period of time, it allowed the taxpayers to exchange loan portfolios without accounting for any losses on

318. *See id.* at 350-52.
319. *Id.* at 350.
320. *See id.* at 351-52.
321. *Id.* at 350.
322. *See* Comm'r v. Clark, 489 U.S. 726 (1989).
323. *See id.* at 732.
324. *Id.*
325. *See id.* at 737-38.
326. *See generally* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991).
327. *See id.* at 567-68.
328. *See id.* at 557.

the books as long as the loan portfolios were the same economically.[329] This process allowed a taxpayer to incur a tax loss before it incurred economic loss.[330] Although the regulations allowed a taxpayer to recognize the tax effect of an exchange for materially different property, the IRS disallowed the losses.[331]

In Tax Court, one of the arguments the IRS made was that the transactions lacked economic substance and business purpose.[332] The Tax Court described the IRS's argument as follows: "[The IRS] contends that [the taxpayer's] claimed losses lack substance and are not allowable under section 165(a) because the transfers were solely tax-motivated and resulted in no significant change in petitioner's economic position."[333]

The Tax Court agreed that the transactions were solely tax-motivated, but held that it nevertheless could not disregard the transactions for tax purposes because they had economic substance.[334] The Tax Court's point was essentially that if one person exchanges an apple for an orange of the same value, the person now sits in an economically different situation because he has an orange rather than an apple, even if both fruits were of the same value and the exchange was tax motivated. The Tax Court seemed uncomfortable in allowing tax benefits for a purely tax-motivated transaction. It stated: "We take the tax law as we find it."[335]

The Court of Appeals for the Sixth Circuit sided with the IRS's invocation of the economic substance doctrine and reversed the Tax Court.[336] Without really addressing the Tax Court's point that an apple and an orange are economically different even if they have the same value, the Sixth Circuit set forth numerous economic substance and substance-over-form cases.[337] On the basis of these cases, the Sixth Circuit decided that the economic value was the most important consideration.[338]

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329. *See id.*
330. *See id.*
331. *See id.* at 558.
332. *See* Cottage Sav. Ass'n v. Comm'r, 90 T.C. 372, 384-85 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991).
333. *Id.* at 384-85.
334. *See id.* at 385, 387, 401.
335. *Id.* at 402.
336. *See* Cottage Sav. Ass'n v. Comm'r, 890 F.2d 848, 855 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991).
337. *See id.* at 853-54.
338. *See id.* at 854-55.

When the case reached the Supreme Court, the IRS did not argue that the economic substance doctrine applied.[339] Rather, the IRS argued that the taxpayer should not be allowed to take losses from a transaction exchanging loan portfolios that were economic substitutes.[340] Under this economic substitute theory, a determination of whether the loan portfolios were materially different required an inquiry into whether "the parties, the relevant market (in this case the secondary mortgage market), and the relevant regulatory body (in this case the FHLBB) would consider them [materially different]."[341]

The Court rejected this test because it was subjective, too complicated, and incompatible with the Internal Revenue Code.[342] It was subjective because it called for a consensus of opinions.[343] It was too complicated because the Court concluded it was unlikely that the relevant Code section required the taxpayer and the IRS to determine the relevant market, the existence of a regulatory agency with an opinion that should be considered, and how these two groups might view the transaction.[344] It was incompatible with the Internal Revenue Code because the relevant provision had exceptions, but these transactions did not fall into one of them.[345]

Although the parties did not raise the economic substance doctrine, the Court noted that the Sixth Circuit's opinion analyzed economic substance in depth.[346] The Court further noted that the IRS did not defend this aspect of the Sixth Circuit's opinion and that the IRS's only comment on the Sixth Circuit's opinion was in a footnote citing *Higgins v. Smith*, which the Court distinguished.[347]

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339. *See generally* Brief for the Respondent, Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991) (No. 89-1965). It should be noted that the IRS argued that to be materially different, the loan portfolios had to differ in "economic substance." *See* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 562 (1991). This was not an invocation of the economic substance doctrine because the IRS was not arguing that the transaction lacked business purpose and economic substance and, therefore, should be denied tax benefits. Rather, the IRS was arguing that the loan portfolios were economic substitutes. *See id.* at 561-62.

340. *See id.* at 562.

341. *Id.* at 565.

342. *See id.* at 562-66.

343. *See id.* at 564-565.

344. *See Cottage Sav.*, 499 U.S. at 565-66.

345. *See id.* at 566.

346. *See id.* at 568 (referencing an argument from Brief for United States at 16, Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991) (No. 89-1926)).

347. *See id.* at 568.

These cases show that the Supreme Court may approach an examination of the standard substance-over-form doctrines from a textualist perspective. Some questions remain, however. Did *Gregory* announce one of those "long-standing and well-accepted principles" the Supreme Court has developed "that [is] effectively irreversible," such as the First Amendment principles Justice Scalia described in his book?[348] Or did *Gregory* set forth one of those "binding abstractions" that "the highest court in the judicial system may come to the conclusion that the result inescapably produced . . . is simply wrong?"[349] Perhaps *Gregory* represents something in the middle in that it may limit courts to determining what actually happened.[350] This view seems like the most appropriate use of *Gregory*, although the Supreme Court would not need to rely on *Gregory* to announce such a principle, as it utilizes common sense and proper textualist reasoning.

Another question to ponder is whether *Gregory* is another *Church of the Holy Trinity*. The Court's approach in these cases was almost identical. In both cases the Court justified its failure to apply the statutory text in the name of congressional intent. In *Church of the Holy Trinity*, the Court stated:

> It must be conceded that the act of the [church] is within the letter of this section . . . . It is a familiar rule that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.[351]

Similarly, in *Gregory*, Judge Hand wrote:

> [I]t does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition . . . . [T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes.[352]

As discussed above, Justice Scalia seems somewhat hostile to the approach in *Church of the Holy Trinity*.[353] "The defendant's act

348. *See* Scalia, Role of Federal Courts, *supra* note 7, at 138.

349. Scalia, Canards, *supra* note 29, at 589-90.

350. *See* Moore, *supra* note 4, at 678-79, 719 (suggesting that courts look at the substance of a transaction, i.e., what actually happened, rather than attempting to apply the sham transaction doctrine).

351. Church of the Holy Trinity v. United States, 143 U.S. 457, 458-59 (1892).

352. Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

353. *See* discussion *supra* Part II.B.1.

was within the letter of the statute, and therefore within the statute: end of case."[354] Again, even throwing this aspect of *Gregory* out, the Supreme Court could limit *Gregory* to the principle that courts may examine what actually happened in a transaction.

B. *Legislative Branch–Development of the Code Since* Gregory

The Internal Revenue Code has changed since Mrs. Gregory created Averill to reduce her taxes.[355] In *Gregory*, the Board of Tax Appeals reasoned that the Internal Revenue Code was so detailed that Congress could not have intended judges to look outside the statute to resolve an issue the text of the statute already resolved.[356] It stated: "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration."[357] The Internal Revenue Code was relatively simplistic compared to today's Code. If Congress had not tried to restrain judges at that point, it has likely done so now by narrowing the interstices and including concepts of substance-over-form in the text of the statute itself, making obsolete judicial variations of substance-over-form.

Evidence that the interstices of the Internal Revenue Code have gotten narrower can be found in the size of the tax laws. Around the time of Mrs. Gregory's transaction, 1928, CCH's Code and Regulations occupied a single volume of approximately 400 pages.[358] Now CCH's soft-cover version is eight volumes, spanning about 36,000 pages.[359] The increase in size means, at least in part, increased specificity in the Code's provisions.[360] *Brockamp* also confirmed that the Internal Revenue Code sets forth many provisions in such a "highly detailed technical manner" so as to preclude interference from extratextual doctrines.[361]

In addition, the Internal Revenue Code already gives au-

354. Scalia, Role of Federal Courts, *supra* note 7, at 20.

355. *See supra* text accompanying notes 138-41.

356. *See* Gregory v. Comm'r, 27 B.T.A. 223 (1932), *rev'd sub nom.* Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, Gregory v. Helvering, 293 U.S. 465 (1935).

357. *Id.* at 225-26.

358. Pollack, *supra* note 130, at 320 n.3 (noting that the CCH volume did not expand beyond a little over 400 pages until World War II).

359. *Id.*

360. CCH's current volumes also contain text of repealed sections.

361. *See* United States v. Brockamp, 519 U.S. 347, 350 (1997).

thority to the IRS to override the technical results from the application of Code provisions. Some of these provisions are the following:

1. Section 269—Allows the IRS to deny tax benefits where a taxpayer acquires control or property in a corporation in certain instances where the acquisition has a tax avoidance motive[362]
2. Section 446—Allows the IRS to change a taxpayer's method of accounting to clearly reflect its income[363]
3. Section 482—Allows the IRS to allocate income and deductions between controlled corporations to properly reflect income or prevent tax evasion[364]
4. Section 845—Allows the IRS to allocate, recharacterize, or make other adjustments to tax items related reinsurance agreements to properly reflect income[365]
5. Section 7701(*l*)—Authorizes the IRS to develop regulations to tax cross-border financing arrangements; the IRS exercised this authority when it adopted Treas. Reg. 1.881-3[366]

Further, it is possible that Congress has attempted to preclude the override of the text of any Code provision with judicial substance-over-form doctrines. Congress has incorporated substance-over-form principles into various provisions throughout the Code, similar to the judicial requirement in lower courts of business purpose or economic substance. The requirement in § 269 above, that certain transactions lack a tax avoidance motive, is very similar to a business purpose requirement.[367] Section 183 requires that a taxpayer have a profit motive to obtain certain tax benefits.[368] Section 707 requires that certain transactions between certain related partnerships have a substantial economic effect.[369] Reading the Internal Revenue Code to include principles that override the text make the above code provisions pointless.[370]

362. *See* 26 U.S.C. § 269 (2002).
363. *See id.* § 446.
364. *See id.* § 482.
365. *See id.* § 845.
366. *See id.* § 7701(*l*).
367. *See id.* § 269.
368. *See* 26 U.S.C. § 183 (2002).
369. *See* 26 U.S.C. § 707 (2002).
370. As Justice Scalia stated in *Justice v. Julian*, 486 U.S. 1 (1988) (Scalia, J., dis-

Many Code provisions already have explicit "facts and circumstances" tests.[371] Thus there is no need for an additional "facts and circumstances" test, which essentially is what the substance-over-form doctrines represent. In addition, many legislative Treasury regulations incorporate substance-over-form principles. The new regulations governing spin-offs under § 355(e) provide for step transaction tests to determine whether a taxpayer is entitled to certain tax benefits.[372] Also, the regulations governing partnership transactions subject such transactions to business purpose[373] and substance-over-form principles.[374]

Congress knows how to tax what it wants to tax. A number of the cases discussed in this article involve a transaction that the Code did not explicitly tax or deny tax benefits to at the time of the transaction. However, by the time those cases reached the courts, Congress had already found a way to tax the transactions.[375] For example, Congress reacted to the real estate tax shelter boom in the 1980s with passive activity loss rules.[376]

C. *Executive Branch–Recent Actions by the Treasury and IRS*

The IRS and the U.S. Treasury Department have given the Supreme Court reason to disregard the standard substance-over-form doctrines. Until recently, the IRS tried to handle a perceived corporate tax shelter problem on its own rather than asking Congress for guidance.[377] The IRS succeeded in invoking various substance-over-form doctrines in numerous cases in Tax Court involving so called "tax shelters."[378] The Treasury and the

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senting): "[T]he fundamental judicial function of reading the body of enacted laws in such fashion [is] to cause none of them to be pointless; and [failure] to achieve that [is] sure to engender confusion and litigation." *Id.* at 15.

371. *See* 26 U.S.C. § 280A(d)(2)(C) (2002); 26 U.S.C. § 357(d)(1)(a) (2002); 26 U.S.C. § 704(b) (2002).

372. *See* Treas. Reg. § 1.355-7T(h)(1)(i) (2002).

373. *See* Treas. Reg. § 1.701-2(a)(1) (2002).

374. *See* Treas. Reg. § 1.701-2(a)(2) (2002).

375. *See* Knetsch v. United States, 364 U.S. 361, 362 (1960); Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1315 (11th Cir. 2001); Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001).

376. *See* Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 839 (1991); *see also* Esmark v. Comm'r, 90 T.C. 171, 200 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989) (noting that Comm'r v. Court Holding Co., 324 U.S. 331 (1945), was resolved by statute).

377. *See* B. John Williams, Remarks at Federal Bar Tax Law Conference (Mar. 11, 2002) (reported by Sheryl Stratton, 2002 TNT 48-4).

378. *See* Compaq Computer Corp. v. Comm'r, 78 T.C.M. (CCH) 20 (1999), *rev'd*,

IRS pursued this avenue of regulation through litigation despite the Treasury's admission that the "[a]pplication of these doctrines to a particular set of facts is uncertain."[379] The Treasury testified before Congress that there was a problem more important than revenue loss from "tax shelters": public relations.[380] The Acting Assistant Secretary for Tax Policy to the U.S. Department of Treasury testified that public relations are a bigger problem than the "revenue loss" from "tax shelters."

There is some question as to whether there really is a "tax shelter" problem. Commentators and the government have said that tax shelters have led to revenue loss.[381] This statement, however, presupposes a clear definition of "tax shelter." There isn't one.[382] Maybe it is fair to say that tax fraud has led to revenue loss because it is clear in the case of fraud that the income at issue was meant to be taxed. If the term "tax shelter" includes a transaction that technically meets the standards in the Code but the IRS nevertheless denies a tax benefit, this definition actually provides a tax windfall to the government, not a would-have-been revenue loss.

In addition, the term "revenue loss" assumes that corporate taxpayers already operate on a tax efficient basis. However, the General Accounting Office estimated that in 1998 individual

277 F.3d 778 (5th Cir. 2001); Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684 (1999), *vacated*, 273 F.3d 1135 (D.C. Cir. 2001); Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001); ASA Investerings P'ship v. Comm'r, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000); ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998).

379. TAX SHELTER WHITE PAPER, *supra* note 133, at 46.

380. *See Corporate Tax Shelters: Hearing Before the House Comm. on Ways and Means*, 106th Cong. 25 (1999) (statement of Jonathan Talisman, Acting Assistant Sec'y for Tax Policy, U.S. Dep't of the Treasury). Jonathan Talisman stated:

> [T]he corrosive effect of tax shelters breeds disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm and to follow the lead of other taxpayers who have engaged in tax advantaged transactions. This race to the bottom, if unabated, will have long-term consequences to voluntary compliance, far more important than the short-term revenue loss we are currently experiencing.

Id.

381. *See* TAX SHELTER WHITE PAPER, *supra* note 133, at 3; Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000).

382. *See* TAX SHELTER WHITE PAPER, *supra* note 133, at v ("Because corporate tax shelters take many different forms and utilize many different structures, they are difficult to define with a single formulation."). The Internal Revenue Code provides multiple definitions of a tax shelter. *See* 26 U.S.C. § 448(d)(3) (2002); 26 U.S.C. § 6111(c) (2002); 26 U.S.C. § 6662(d)(2)(C)(iii) (2002).

taxpayers overpaid by $945 million.[383] This estimate resulted from an estimate of the number of taxpayers that elected not to itemize their deductions.[384] Corporate taxpayers may also overpay their taxes.

The new Chief Counsel of the IRS also has committed to relying less on litigation to advance tax policies:

> I firmly believe that litigation should never be the means to advance policy choices. The public is entitled to know and rely on the law and the agency's interpretations before cases are developed. Counsel must make a renewed effort to develop those interpretations through public guidance.[385]

He has also stated that the IRS will stop using the economic substance doctrine as a "silver bullet."[386]

V. CONCLUSION

Under the Supreme Court's recent trend of resolving tax cases using textualist interpretation methods, it is doubtful that the Court would allow the standard sham transaction doctrine, the business purpose doctrine, the economic substance doctrine, or the step-transaction doctrine to stand. Moreover, courts and the IRS have precise texts to which they can refer. The precision of these texts leave little room for the interference of vague, indeterminate judicial doctrines in an area of law where certainty and predictability are crucial. Although it would seem that the IRS should have a way to challenge a transaction it believes Congress meant to tax, the substance-over-form doctrines are not the way to do it. It appears that the IRS and the Treasury Department now recognize this fact, because they have been sprinkling their regulations with tidbits of economic and intent requirements where they deem appropriate. Congress appears to recognize it as well, as evidenced by the fact that it has enacted transparency laws that allow it to react faster with legislation when it decides it should be taxing certain transactions.[387] The transparency laws provide an excellent solution to the po-

383. U.S. GEN. ACCOUNTING OFFICE, PUB. NO. 02-509, TAX DEDUCTIONS: FURTHER ESTIMATES OF TAXPAYERS WHO MAY HAVE OVERPAID FEDERAL TAXES BY NOT ITEMIZING 2-3 (2002).

384. *See id.*

385. *Pending Nominations: Hearing Before Comm on Fin.*, 107th Cong. 9 (2001) (statement of B. John Williams, Chief Counsel, Internal Revenue Service).

386. *See* Williams, *supra* note 377.

387. *See* I.R.C. §§ 6707-6714 (2002).

tential theoretical problem under Gödel's Incompleteness Theorem[388] because they provide feedback to the proper lawmakers.

This article does not suggest that courts should not examine whether a transaction authorized by the Code actually occurred. In other words, if the Code authorizes a taxpayer to take deductions on interest on indebtedness paid for a principal residence, it would make sense to see if the taxpayer actually owns the principal residence and actually borrowed money to pay for it. As Professor Joseph Isenbergh says, otherwise it would be like "someone call[ing] a dog a cow and then seek[ing] a subsidy provided by statute for cows."[389] But this is not what these substance-over-form doctrines do. Instead, they override the text of the Internal Revenue Code.[390]

If the Supreme Court were to overturn the sham transaction doctrine, the business purpose doctrine, the economic substance doctrine, or the step-transaction doctrine, that decision would further the goals of textualism. It would minimize reliance on a slow developing "facts and circumstances" common-law approach. Further, it would import more certainty into our tax laws. Finally, it would empower the trial and appellate courts to stand up against the popular will of demonizing corporate America. If the Supreme Court hears a case while the recent trend in textualism continues, the tension between textualism and substance-over-form will probably be resolved in favor of textualism. Thus, it makes sense for the clear text of the Code to control tax cases.

388. *See supra* text accompanying note 298.
389. Isenbergh, *supra* note 131, at 865.
390. *See supra* note 131 and accompanying text.