Chapter 4

Substance vs. Form

Beginning with this chapter, we turn to the taxation of various transactions between corporations and their investors and between one corporation and another. The taxation of corporate transactions is the principal concern of the subchapter C rules and a core part of most corporate tax practices.

This chapter introduces you to perhaps the most difficult and important question in the taxation of corporate transactions: under what circumstances are the tax consequences of a transaction determined by its "substance" as opposed to its "form"? As you will learn in succeeding chapters, the subchapter C rules are highly form-oriented. The rules often specify in exquisite detail the tax consequences of complying with a particular set of requirements or steps. Yet the courts (and the IRS) repeatedly remind taxpayers that merely following the form and conditions set out in the law may not be enough to qualify for the desired tax consequences. What more is needed? When is literal compliance with the law not enough? Unfortunately, as you might suspect, there are no clear answers to these questions. It is important, however, to begin to think about these matters at the outset. We will return to these issues again and again throughout the rest of this course.

The importance of these issues was heightened in 2010 when Congress, after more than a decade of debate, codified the "economic substance" doctrine in section 7701(o). This doctrine has been one of the principal tools enabling a court to look beyond the form of a transaction to its substance. In addition to clarifying the meaning of the common law doctrine, Congress enacted a sizable, strict liability penalty on any underpayment attributable to a violation of the doctrine.

Part A of this chapter introduces you to some of the general principles the courts have laid out in this area, often in response to government efforts to prevent tax avoidance. Part B then reviews the principal additional steps the government has taken outside of litigation to combat tax avoidance. Part C concludes with a discussion of the new legislative provision.

A. Judicial Principles

As we will see throughout this book, courts have articulated and applied a "substance-over-form" principle in a variety of different ways. Unfortunately, the

courts have not always been consistent in their formulations. Confusingly, even the terminology varies—courts sometimes use different labels when referring to the same approach and use the same label when referring to different approaches. Courts also employ different tests to determine whether to uphold a particular substance-over-form argument, and apply the tests to the facts in different ways.

One common term used by the courts is to conclude that a particular transaction is a "sham." This conclusion sometimes results from a court's finding that a particular set of facts didn't really happen, or didn't happen in the manner claimed by the parties. In this sense, the claimed facts and purported transaction are "fake." In his dissent in Knetsch v. U.S., 364 U.S. 361, 370 (1960), Justice Douglas seemed to be thinking of this type of case when he referred to a court not respecting a transaction that is "hocus-pocus." Other courts sometimes refer to this type of case as a "sham in fact." If a court determines that a transaction didn't really happen, then, not surprisingly, it refuses to allow the tax consequences that would have arisen if the transaction had taken place.

An example of a fake transaction occurred during the late 1970s when some taxpayers, in order to obtain tax savings, began investing in year-end "straddle transactions" designed to produce offsetting gain and loss positions. The strategy was for the taxpayer to sell the loss position in the current year but to hold the gain position into the succeeding year before selling. The taxpayer claimed that this strategy resulted in a deferral of tax and conversion of ordinary income into capital gain. In some cases, taxpayers appear to have claimed the purported tax benefits from the transactions without actually doing them, presumably to avoid incurring the transaction costs for what were essentially meaningless investments. Not surprisingly, the tax benefits in these cases were disallowed. See Forseth v. Comm'r, 85 T.C. 127, 164-66 (1985), aff'd, 845 F.2d 746 (7th Cir. 1988); cf. Dewees v. Comm'r, 870 F.2d 21, 28-29 (1st Cir. 1989).

The term "sham," however, is not used only in this limited sense. In *Knetsch*, the taxpayer purchased long-term annuity bonds from an insurance company with the proceeds of debt borrowed from that company and secured by the bonds. Much of the interest paid on the debt was also borrowed from the insurance company. Because the taxpayer prepaid the interest and was not taxed currently on the return from the bonds, he claimed that his net out-of-pocket expenses of about $90,000 from the transactions produced interest deductions of almost $300,000 and tax savings of over $230,000. The majority agreed with the lower court's conclusion that the circular flow of funds between the taxpayer and insurance company made the claimed payment of interest a "sham," and therefore denied the tax consequences asserted by the taxpayer. The interest, in effect, was not really paid by the taxpayer because most of it had been loaned to him by the same party that purportedly received the interest. Justice Douglas disagreed, arguing that in contrast to "hocus-pocus," the taxpayer's steps had actually taken place—there were real borrowings and real purchases with the proceeds—and therefore the taxpayer's position should have been respected. The tax consequences of a "sham transaction" in the sense used in *Knetsch* are sometimes determined through application of the

121

"step-transaction doctrine." This principle permits a court to collapse the formally independent steps of a transaction in order to determine what really happened and, therefore, what tax consequences are appropriate.

The difference between an entirely fabricated transaction and one whose steps are actually undertaken but completely circular may be fairly small. In either case, it is quite easy to see how a fact-finder might conclude that because "nothing really happened" or "no transaction really occurred," the tax consequences flowing from the purported transaction should be disallowed. But courts apply substance-over-form principles, and sometimes use the term "sham" very loosely in this context, to disallow tax claims in circumstances outside these two narrow situations.

For example, in Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), in order to shelter income from winning the Irish Sweepstakes, the taxpayer undertook the same basic transactions as the ones involved in *Knetsch*. The transactions, however, were not carried out with the same counterparty; because the taxpayer borrowed money from two commercial banks to purchase some Treasury notes, there was no circular flow of funds. The Second Circuit respected as real the borrowing of money, the purchase of Treasury notes, and the prepayment of interest. Nevertheless, it denied the taxpayer's claimed interest deduction because the transaction had "no substance or purpose aside from the taxpayer's desire to obtain the tax benefit." The court indicated that an interest deduction should be permitted only where funds are borrowed for a "purposive activity," meaning an activity whose purpose is not merely tax avoidance. Id. at 741. Other explanations offered by courts to deny a taxpayer's position even when a transaction really occurs include the taxpayer's failure to have a profit motive, bear a sufficient level of risk, or have a realistic chance of earning a pre-tax profit. When "sham" is used loosely to refer to these types of transactions (sometimes also described as a "sham in substance"), the sham analysis may overlap with other doctrines resting on substance-over-form principles, such as "economic substance" or "business purpose." Thus, a transaction found to lack "economic substance" and/or a sufficient "business purpose" may also sometimes be termed a "sham" or "sham in substance," with the result that the claimed tax consequences are not respected.

The following case, Gregory v. Helvering, remains the most influential decision in the tax law of substance versus form. As the note following the case indicates, there were actually three very interesting opinions in the case. The trial court (Board of Tax Appeals) held for the taxpayer based on an approach suggesting a limited role of courts to find the facts and apply the literal terms of the tax statute to those facts. This decision was reversed on appeal, and Judge Learned Hand's majority statute to these facts. This decision was reversed on appeal, and Judge Learned Hand's majority opinion for the Second Circuit ultimately became the blueprint for the Supreme Court's holding in favor of the government.

At the time of the *Gregory* case, Congress had determined that a particular transaction, now considered a "divisive reorganization," should not result in any immediate tax consequences to the participants in the transaction. We will take up in chapter twelve the current law of divisive reorganizations and the theory behind their tax treatment. For now, simply examine closely the rather crude

122

statutory language that Congress used at that time to define the covered transaction, and then consider the transaction undertaken by Mrs. Gregory. Why did she not receive the tax consequences specified in the statute?

Gregory v. Helvering
293 U.S. 465 (1935)

Mr. Justice SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under section 112(g) of the Revenue Act of 1928. …To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation, as capital net gain, the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the latter decision, the Circuit Court of Appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F.(2d) 809.…

Section 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

> Sec. 112(g). Distribution of Stock on Reorganization. If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the

123

> reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock of securities shall be recognized.…
>
> (i) Definition of Reorganization. As used in this section…
>
> (1) The term "reorganization" means…(B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred.…

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.…But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the

124

situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

NOTES AND QUESTIONS

1. *The lower court opinions*. The Board of Tax Appeals thought the issue in the case was whether Averill's existence should be respected, given the purpose it served and its short life. The Board refused to ignore the corporation, and held for the taxpayer:

> As long as corporations are recognized before the law as if they were creatures of substance, there is nothing to distinguish this corporation from innumerable others, whether they be devised to achieve temporary tax reduction or some other legitimate end. 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. [27 B.T.A. 223, 225 (1932).]

Furthermore, the Board justified a limited judicial role in interpreting the tax statute:

> 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. [Id. at 225-26.]

Writing for the Second Circuit, Judge Learned Hand agreed with the Board in respecting Averill's existence:

> We do not…agree fully with the way in which the Commissioner treated the transaction; we cannot treat as inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill

> inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill Corporation of its own shares to the taxpayer, and her acquisition of the Monitor shares by winding up that company. The Averill Corporation held a juristic personality, whatever the purpose of its organization; the transfer passed title to the Monitor shares and the taxpayer

125

> became a shareholder in the transferee. All these steps were real.…[69 F.2d 809, 811 (2d Cir. 1934).]

Nevertheless, the court reversed the Board and held for the government:

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.…Therefore, if what was done here, was what was intended by section 112(i)(1)(B),[*] it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the 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. The purpose of the section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as "realizing" any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations." [Id. at 810-11.]

As we have seen, the Supreme Court affirmed the Second Circuit and, in the process, tracked much of Judge Hand's opinion.

2. *The Court's holding*. In finding for the government, does the Supreme Court respect or reject the form of the taxpayer's transaction? If form was respected, what was the basis for the Court's holding?

3. *Business purpose*. Was there a nontax business purpose for the taxpayer's transaction? Does your answer depend upon how one describes her transaction? Why was a business purpose needed in the first place?

4. *Role of tax avoidance purpose or motive*. Both appellate court opinions make clear that the existence of a tax avoidance purpose or motive on the part of the taxpayer is not by itself damning. As Judge Hand put it, "there is not even a patriotic duty to increase one's taxes." These words and the similar ones used by the Supreme Court are recited over and over again by taxpayers in defense of their tax positions (as well as by courts when they uphold a taxpayer's claim) even though, as we have seen, the principle stated in the appellate court opinions was pure dicta. At the end of the

126

day, Mrs. Gregory lost her case. Moreover, despite the principle articulated by both courts, is it so clear that her tax avoidance purpose was irrelevant to the outcome?

5. *Role of legislative intent*. *Gregory* is sometimes viewed as a case that turned on legislative intent. The Court initially says "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended" and then answers its question, "the transaction upon its face lies outside the plain intent of the statute." Unfortunately, the Court does not provide guidance regarding how such intent was (or should be) determined. Textualists question the propriety of "looking behind the words of the statute" in part because of the difficulty of ascertaining the true intent of the legislature. Legislators don't vote on Committee Reports and rarely read or write them; should such legislative material therefore be given any special effect? More broadly, some are skeptical about a court's reliance upon legislative intent because of concern that, in the guise of judicial interpretation, a court may simply substitute its judgment for that of the legislature.

The counterargument is that the bare words in a statute are necessarily an imperfect way for a legislature to convey the rule it wishes to impose in a particular situation. Thus, the "law" is more than such words; they must be interpreted in the context in which they were intended. Under this view, when application of a statute to a particular set of facts is clear, a court should not resort to nonstatutory guidance. But if application of a statute to a set of facts is ambiguous and Congressional intention is guidance. But if application of a statute to a set of facts is ambiguous and Congressional intention is clear, a court should interpret the statute consistent with that intention. Almost 25 years after his majority opinion for the Second Circuit in *Gregory*, Judge Hand was still supportive of the use of nonstatutory sources to aid in the interpretation of statutes:

> The literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their "interpretation" demands the projections of their expressed purpose upon occasions not present in the minds of those who enacted them. [Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir. 1957).]

6. *Mrs. Gregory's transaction today*. Because dividend income and long-term capital gain of individuals are both currently taxed at the same preferential tax rate, Mrs. Gregory would not need to undertake the same tax planning today to have her income taxed favorably. On the other hand, current law might give rise to an issue that did not exist at the time of Mrs. Gregory's case—namely, the possible taxation of United upon its distribution of the Averill stock to her. We discuss this possibility in chapter twelve.

7. *The fruits of* Gregory. *Gregory* has been used as authority in virtually all substance versus form cases in which a taxpayer's claimed tax consequences are denied. It has been used, for example, to support all of the different ways in which courts have concluded that a transaction is a "sham," and is generally viewed as the source of the "business purpose" and "economic substance" doctrines. As noted