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Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*

BY
BORIS I. BITTKER**

A. INTRODUCTION

During the nineteenth century, the practice of construing taxing statutes strictly against the government was said to be "founded so firmly upon principles of equity and natural justice as not to admit reasonable doubt."1 As explained by Mr. Justice Story in 1842:

In every case . . . of doubt, [taxing] statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import. Revenue statutes are in no just sense either remedial laws or laws founded upon any permanent public policy, and therefore are not to be liberally construed.2

This approach, which bracketed taxing statutes with laws imposing criminal penalties or forfeitures, was not without challenge even in its heyday,3 and by now has been largely abandoned.

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3. For an extended nineteenth century discussion of this subject, see COOLEY, A TREATISE ON THE LAW OF TAXATION (2d ed. 1886), 265-275, who favored (at 272) a middle road:

Construction is not to assume either that the taxpayer, who raises the legal question of his liability under the laws, is necessarily seeking to avoid a duty to the state which protects him, nor, on the other hand, that the government, in demanding its dues, is a tyrant, which, while too powerful to be resisted, may justifiably be obstructed and defeated by any subtle device or ingenious sophism whatsoever . . . . All construction . . . which assumes either the one or the other, is likely to be mis-
Contemporary courts apply tax laws with greater tolerance—some would say enthusiasm—and if strict construction is still a watchword, it is more likely to be used against the taxpayer in cases deciding the scope of statutory exceptions, deductions, and similar allowances than against the government. Often, however, what one taxpayer loses from the strict construction of a statutory provision, another taxpayer gains. Thus, if the term "capital asset" is narrowly defined to deny the benefit of the lower tax rate for capital gains to a taxpayer who sells his property at a profit, the same narrow construction will inure to the benefit of other taxpayers who have incurred losses on the sale of similar property, since they will not be subjected to the special limitations on the deductibility of capital losses.

Quite aside from the possibility that a court's effort to help out the Treasury in a close case may give the government a pyrrhic victory, however, it is far from clear why the Internal Revenue Code should be construed strictly against either the taxpayer or the government. A more salutary attitude was advocated by Mr. Justice Holmes, responding to the once-popular adage that statutes in derogation of the common law should be strictly construed:

The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however, indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of chievous, and to take one-sided views, not only of the laws, but of personal and official conduct.

The trend away from strict construction has been strengthened by frequent inclusion in state laws of a directive to interpret the law with a view to accomplishing its objectives. 2A Sands, Statutes and Statutory Construction (4th ed. 1973), Sec. 58.03, n.14.

4. See, e.g., Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) (strict construction of term "capital assets" in order to reduce "preferential treatment" for capital gains); Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943) (income tax deductions are a "matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer").

See generally Griswold, An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943).

Despite the popularity of the theory that many tax allowances are the equivalent of subsidies and constitute a program of "welfare for the rich" (see Bittker, Income Tax "Loopholes" and Political Rhetoric, 71 Mich. L. Rev. 1099 (1973)), it has evidently not been suggested that these provisions should be liberally construed in favor of the taxpayer, in the spirit of Cox v. Roth, 348 U.S. 207 (1955) (welfare legislation is to be liberally construed in favor of its intended beneficiaries).

5. Of course, the taxpayer has the burden of proof in litigated cases as respects factual issues; the discussion in the text is concerned with the resolution of legal questions.
policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.  

In applying the Internal Revenue Code to particular transactions, the courts frequently distinguish between "tax avoidance" and "tax evasion" and between "form" and "substance," assert that transactions are to be taken at face value for tax purposes only if they are imbued with a "business purpose" or reflect "economic reality," and integrate all steps in a prearranged plan rather than give effect to each step as though it were a separate transaction. These presuppositions or criteria are so pervasive that, in combination, they resemble a preamble to the Code, describing the framework within which all statutory provisions are to function. Like the canons of statutory construction, however, these judicial presuppositions are more successful in establishing an attitude or mood than in supplying crisp answers to specific questions.  

In decisions dealing with particular practical problems, however, these pervasive judicial doctrines are extremely important despite their vagueness. Indeed, in some areas they are influential primarily because they are vague; when the meaning of a tax provision is veiled by fog, taxpayers usually tread more warily than when the landmarks are clearly visible. As Mr. Justice Brandeis observed in a similar context:

If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone, you may slip, and go over; but anybody can tell you where you can walk perfectly safely within convenient distance of that precipice.

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6. Johnson v. United States, 163 F. 30, 32 (1st Cir. 1908) (Mr. Justice Holmes on circuit). For a similar comment by Mr. Justice Stone in a tax case, see White v. United States, 305 U.S. 281, 292 (1938) (duty of courts, in tax cases as in other litigation, is to decide "what [the] construction fairly should be"), quoted with approval by Griswold, supra note 4, at 1144-45; see also Cooley's earlier support for the same principle of even-handedness, supra note 3.

7. Thus, Paul's monumental effort to provide a "restatement of the law" of tax avoidance, infra note 11, contains few generalizations and demonstrates that the subject is "exquisitely uncertain," as Judge Jerome Frank points out in his introduction (at p. 2) to the Paul essay. See generally, Rice, Judicial Techniques in Combating Tax Avoidance, 51 MICH. L. REV. 1021 (1953).

See also the Australian and Canadian statutory catch-all prohibitions on tax avoidance transactions, described by Blum, Motive, Intent and Purpose in Federal Income Taxation, 34 U. CHI. L. REV. 485, 524-25, p.107 (1967).

Mr. Justice Holmes did not object to the *in terrorem* effect of uncertainty even in criminal law:

Whenever the law draws a line there will be cases very near each other on opposite sides. The precise course of the line may be uncertain, but no one can come near it without knowing that he does so, if he thinks, and if he does so it is familiar to the criminal law to make him take the risk.9

In point of fact, the layman is far more inclined than the expert to trust paperwork as a shield against tax liability. Tax lawyers are bombarded at cocktail parties with tax schemes, offered as proof positive of the speaker’s astute sophistication, that would not convince the most inexperienced revenue agent or that teeter on the brink of fraud. Randolph Paul’s comments on this subject cannot be improved:

Above all things, a tax attorney must be an indefatigable skeptic; he must discount everything he hears and reads. The market place abounds with unsound avoidance schemes which will not stand the test of objective analysis and litigation. The escaped tax, a favorite topic of conversation at the best clubs and the most sumptuous pleasure resorts, expands with repetition into fantastic legends. But clients want opinions with happy endings, and he smiles best who smiles last. It is wiser to state misgivings at the beginning than to have to acknowledge them ungracefully at the end. The tax adviser has, therefore, to spend a large part of his time advising against schemes of this character. I sometimes think that the most important word in his vocabulary is “No” . . . .10

B. Tax Avoidance vs. Tax Evasion

Although the terms are occasionally used interchangeably,11 it is more common to contrast “tax avoidance” with “tax evasion,” the former phrase denoting lawful modes of minimizing or avoiding tax liability, while the latter implies fraudulent behavior. The line be-

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11. See Paul, Restatement of the Law of Tax Avoidance, STUDIES IN FEDERAL TAXATION (1937) 9, at 12 et seq.; Justice Holmes’ observation, infra note 14; § 482, which uses the term “evasion” but is applicable to a broad spectrum of “tax avoidance” transactions having no fraudulent overtones whatsoever.
between lawful conduct (which, of course, may or may not achieve its
tax reduction objective) and fraudulent or criminal misconduct is ex­
amined at length in specialized works;¹² for present purposes, the
term "tax evasion" can be reserved for conduct that entails decep­
tion, concealment, destruction of records, and the like, while "tax
avoidance" refers to behavior that the taxpayer hopes will serve to
reduce his tax liability but that he is prepared to disclose fully to the
Internal Revenue Service.

Used in this sense, "tax avoidance" embraces a virtually unlim­
ited spectrum of personal, financial, and business transactions. Tax­
payers often organize corporations, establish trusts, make gifts, sell
property, and borrow money—to mention only a few obvious ar­
-eas—in ways or at times calculated to reduce their tax liabilities. In
many cases, the tax saving is so clearly granted by the statute that
even the most severe moralist would direct any criticism at Congress
rather than at the taxpayer. Thus, when the Internal Revenue Code
requires one of several options to be chosen (e.g., cash or accrual
accounting; straight line or accelerated depreciation; etc.), it would
be quixotic to gladden the heart of the Commissioner of Internal
Revenue by picking the most costly. Citizens who want to make a
voluntary contribution to the Treasury can do so by sending in their
checks at any time; there is no reason to use the tax return as a vehi­
cle for such generosity. A fortiori, it is hard to fault a taxpayer who
engages in a transaction with significant nontax results (e.g., operat­
ing a business as a proprietorship rather than in corporate form, or
selling property rather than continuing to hold it), even though his
decision is motivated more by the tax saving to be achieved than by
the transaction's other consequences. Even Mr. Justice Holmes, who
allegedly said that "I like to pay taxes; with them I buy civilization,"
did not give his money to the Treasury until his death.¹³

In any event, the issue for consideration here is not whether tax­
payers who seek to minimize their taxes by engaging in transactions
of the types just described should be condemned as tight-fisted, but
whether the courts—staffed not by moral philosophers, but by ju­
rists—will uphold their legal claims. An affirmative answer is so self-

¹². See, for example, BALTER, TAX FRAUD AND EVASION (4th ed., 1976), Chapter 2.
¹³. The original location of this widely-quoted remark has eluded me. In Compania
General de Tabacos de Filipinas v. Collector, 275 U.S. 87, 100 (1927), Holmes, dissenting,
said, "Taxes are what we pay for civilized society. . . ."
evident that the transactions themselves would not be challenged by the Internal Revenue Service, except in quite special circumstances.

The Code bristles with elections, options, and statutory incentives, and it is perfectly clear that Congress expects, and often hopes, that they will be used. It may, indeed, be confusing to apply the tax avoidance label to behavior so clearly sanctioned by Congress as the use of these statutory opportunities. In common parlance, that term often conjures up a transaction whose success depends on a debatable interpretation of an ambiguous statutory provision, or on an inadvertent loophole in the law that will probably be closed if and when it comes to public attention. Used in this sense, “tax avoidance” implies risk; and this in turn raises the question: If the taxpayer is trying to take advantage of an ambiguous provision, should it be construed against him in order to discourage tax avoidance, at least if that was his sole or principal motive?

It is clear that the courts do not regard themselves as invested with a roving commission to extirpate tax avoidance. There are three classic statements justifying judicial disregard of the taxpayer’s motive if, though close to the dividing line, he has stayed on the taxable side—all quoted so frequently that experienced tax lawyers know them by heart. One is a 1930 observation by Mr. Justice Holmes:

The only purpose of the [taxpayer] was to escape taxation . . . .
The fact that it desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you may intentionally go as close to it as you can if you do not pass it. 14

The second statement is by Judge Learned Hand:

We agree with the [Board of Tax Appeals, the predecessor of the United States Tax Court] 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, of one choose, to evade, taxation. Any one may so arrange his affairs that


We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law.
The term “evade” is used by Mr. Justice Holmes in both cases to denote an unsuccessful attempt to avoid taxation, not as synonymous with fraud. See supra note 11.
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.\footnote{15}

The third, described as "the most eloquent short defense ever to appear of the state of being tax-conscious and, by implication, of the art of tax planning,"\footnote{16} is also by Judge Learned Hand:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.\footnote{17}

The statements that tax avoidance is practiced by rich and poor alike must be taken as exaggeration, since wage-earners have few opportunities to "arrange [their] affairs" so as to reduce their taxes and it is not clear why Judge Hand felt impelled to commend persons engaged in tax avoidance for "doing right," rather than merely upholding their privilege to do so. These reservations aside, his central message—"the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it"\footnote{18}—is widely accepted.

Judicial reluctance to decide tax cases on the basis of the taxpayer's state of mind is understandable. Given high rates and the divergent tax burdens imposed on alternative ways of accomplishing similar nontax results, "tax planning" is as American as apple pie. If as a general rule of tax administration, doubts were routinely resolved against persons harboring a motive, purpose or intent\footnote{19} to reduce their tax liability, scrupulous taxpayers would pay a heavy price for candor in responding to the Internal Revenue Service's questions about their state of mind. At the same time, disingenuous taxpayers and persuasive liars would go scot-free, unless revenue

19. For distinctions among these terms, see Blum, supra note 7; Paul, \textit{Motive and Intent in Federal Tax Law}, \textit{Selected Studies in Federal Taxation} (2d series 1938) 255, at 271-304.}
agents, judges, and juries came to reject disavowals of any tax avoidance intent as too bizarre to be believed. In that event, however, taxpayers who were in fact too ignorant, naive, or open-handed to inquire into the tax effect of their transactions would be penalized along with the others. An intermediate approach, under which a tainted purpose would not automatically count against the taxpayer but would be fatal if it met a specified standard (e.g., "principal," "major factor," "proximate cause," etc.), would be at least as difficult to apply in practice as a blanket rule, and would probably to be as erratic in its results was the concept of "contemplation of death" in estate taxation until its repeal in 1976.20

It would be a mistake, however, to conclude that the flavor of a stew is never impaired by a generous infusion of tax avoidance. After asserting that the taxpayer's purpose was a neutral circumstance, both Holmes and Hand in the first two opinions quoted above went on to resolve the tax question in favor of the government, and it is hard to escape the conclusion that the aroma of tax avoidance contributed to the outcome.21 Even if the taxpayer's purpose was wholly irrelevant in these cases, however, there are other circumstances in which it cannot be disregarded.

First, the Code contains many statutory provisions that explicitly make tax avoidance an operative factor in determining tax liability. Thus, § 532 imposes a special tax on "every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders"; § 357(b)(1), involving the treatment of an assumption of debt in certain transfers to a controlled corporation, requires a determination of whether "the principal purpose of the taxpayer . . . was a purpose to avoid Federal income tax"; and § 306(b)(4) exempts certain sales and redemptions from unfavorable


21. In the Superior Oil Co., the court said that a crucial document (relied on by the taxpayer to establish that a transaction was in interstate commerce and immune to a state sales tax) "seems to have had no other use than . . . to try to convert a domestic transaction into one of interstate commerce"; in Gregory, 69 F.2d 809 (2d Cir. 1934), the taxpayer created a transitory corporation that was promptly, and pursuant to plan, liquidated. On the significance of tax avoidance in Gregory, see Chirelstein, supra note 16, concluding (at 464) that Judge Hand favored "an interpretative rule of general application . . . that ambiguous transactions were to be characterized in the Commissioner's favor, unless the taxpayer could dispel the ambiguity by showing that the form which he had chosen carried with it, or was expected to carry with it, some appreciable economic effect beyond tax savings."
tax treatment "if it is established to the satisfaction of the Internal Revenue Service that the transaction was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." The difficulty of administering a statutory distinction between transactions that are, and those that are not, dominated by tax avoidance objectives has more than once led Congress to impose a disability on all transactions in the suspect category, whether guilty or not.

Second, in deciding whether to accept the form in which a transaction was cast by the taxpayer or to probe beneath the surface in search of its substance or net effect, revenue agents and courts sometimes respond to the aroma of tax avoidance like hounds to the scent of foxes. They are likely to suspect that the form adopted by the taxpayer is a self-serving declaration—"motive is a persuasive interpreter of equivocal conduct"—if the Internal Revenue Code seems to be more influential in shaping a transaction than its nontax results. Used as a divining rod, however, the taxpayer's tax avoidance purpose serves only the preliminary purpose of advising the Internal Revenue Service and courts where to dig; it does not help in deciding whether what is actually found falls on the taxable or the nontaxable side of the statutory line. Conversely, even if a transaction serves no tax avoidance purpose, it may deserve closer inspection; appearances do not always correspond to reality. But the percentage of false scents will probably be greater among these "innocent" transactions than among those characterized by tax avoidance objectives. In the words of Randolph Paul:

In deciding a fact issue the courts will analyze and scrutinize with special zeal where tax avoidance appears as a motive. But that motive will be immaterial except as an eye-opening mechanism or interpreter of equivocal conduct; it will not negative the effect of a transaction which has really occurred.

22. For other instances and general discussion, see Cohen, Tax Avoidance Purpose as a Statutory Text in Tax Legislation, 9 Tulane Tax Inst. 229 (1960); Fischer, Intent and Taxes, 32 Taxes 303 (1954); Blum, How the Courts, Congress and the IRS Try to Limit Legal Tax Avoidance, 10 J. Tax. 300 (1959).

23. E.g., § 267(a)(1), denying any deduction for losses on sales between related taxpayers, whether at a fair market price or not; and § 166(d)(1), providing that nonbusiness bad debts create capital rather than ordinary losses.


25. Paul, supra note 11, at 152. See also Morsman v. Commissioner, 90 F.2d 18, 22 (8th Cir. 1937), cert. denied, 302 U.S. 701 (1937):
A decision to probe beneath the surface may result from evidence that the taxpayer before the court was in fact actuated by a tax avoidance purpose, but such a purpose may be inferred as frequently from the nature of the transaction as from the nature of the taxpayer. Whatever his state of mind, if he travels into a territory that is much frequented by tax-conscious citizens, revenue agents and courts are likely to subject his papers to searching scrutiny.

Finally, when construing ambiguous statutory language, the courts often reject interpretations that would foster tax avoidance before sanctifying legal forms that do not affect the substance of the transaction. Since the statute as construed will affect all taxpayers, however, the state of mind of the litigant who happens to come before the court (however significant it may be in determining whether the forms he has used correspond to the substance of his transaction) is less important in such cases than the objectives of taxpayers as a group. If the court concludes that they are likely to engage in the particular transaction primarily to reduce taxes rather than to achieve nontax business or personal objectives, the statutory provision will often be construed strictly in favor of the government, and this meaning will be visited upon all taxpayers, even those wholly devoid of a tax avoidance purpose.26 Thus, the following comments in Helvering v. Clifford,27 taxing to the husband-grantor the income of a short-term trust established for the benefit of his wife,

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26. Concluding his exhaustive examination of the "law" of tax avoidance, Randolph Paul offered only two general rules—the one quoted in the text (supra note 25) and the following:

In interpreting a tax statute the courts will, in their natural and perhaps imposed duty to protect the revenue, adopt an attitude of skepticism as to the meaning urged by a tax-avoiding taxpayer...[Supra note 11, at 153.]

refer to the state of mind of the “average” taxpayer, and would not have to be revised on a showing that the litigant’s outlook on life was different:

The broad sweep of [the statutory predecessor of § 61(a)] indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. . . . Hence our construction of the statute should be consonant with that purpose. Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus. . . .

We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact.  

C. Form vs. Substance

When today’s federal income tax was still in its swaddling clothes, the Supreme Court treated the superiority of substance over form as a well-settled principle in tax matters, saying (in 1921):

We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases . . . we have under varying conditions followed the rule.

Almost half a century ago, “form” and “substance” were described as “the most overworked words in the tax vocabulary”, the same

28. Id.

29. United States v. Phellis, 257 U.S. 156, 168 (1921). See also Weiss v. Stearn, 265 U.S. 242, 254 (1924); Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income [tax] laws enacted thereunder we must regard matters of substance and not mere form.

30. Underwood, Form and Substance in Tax Cases, 16 VA. L. REV. 327, 341 (1930). The
verdict would probably be reached today if there were a new trial on more recent evidence.

Despite all this, there are times when form—and form alone—determines the tax consequences of a transaction. The numerous accounting elections that are authorized by the Code, for example, drastically affect tax liabilities, but rarely alter the taxpayer's relations with the outside world. Yet it is perfectly clear that the taxpayer's right to report income on the cash rather than the accrual method, to elect accelerated rather than straight-line depreciation, to use a fiscal or calendar year, and to exercise similar accounting options is not in any way impaired by the fact that these are matters of form rather than substance. Similarly, a taxpayer with several blocks of stock of the same company, purchased over a period of time at different prices, can sell either high cost or low cost shares merely by delivering one certificate rather than another or even, when a particular lot of shares cannot be traced into a separate certificate, by designating which shares he proposes to sell. Whichever form is employed to separate the shares sold from those retained, it will have no nontax ramifications. There are also a few statutory provisions that, the courts have held, deliberately elevate form above substance. An example is IRC § 71(b), providing that a payment under a decree of divorce or separate maintenance is not taxable to the wife if the decree fixes it “as a sum which is payable for the support of minor children of the husband,” a condition that requires “specific earmarking” and cannot be satisfied by evidence that in substance, though not in form, the payment was made for the support of the

author went on (at 341-342) to lament (with, needless to say, no success) judicial searches for the substance behind a transaction's form:

But in cases involving merely the interpretation of tax laws, would it not have been better to place the emphasis on form? Form is definite and certain; all possible acts of persons have been classified and defined through the hundreds of years of judicial transaction known to trade and commerce has its precise label or tag. . . . What a nightmare “substance” must have been during all these years to that harassed and overworked individual, the Commissioner of Internal Revenue!


31. Provisions like § 472(c), permitting LIFO accounting for inventories to be used for tax purposes only if the same method is used by the taxpayer in reporting to investors and lenders, are exceptions to this general principle. See Blum, The Importance of Form in the Taxation of Corporate Transactions, 54 TAXES 613 (1976); Kingston, The Deep Structure of Taxation: Dividend Distribution, 85 YALE L.J. 861, 863 et seq. (1976).

32. See, for example, Rev. Rul. 56-653, 1956-2 CB 185.
children. 33

Despite these examples of the occasional pre-eminence of form, in deciding federal tax cases the courts are ordinarily willing if not eager to take account of the substance behind the veil of form. 34 Randolph Paul once said that “lawyers who do not know that form sometimes controls, should not be practicing law.” 35 With equal force, it can be said that those who do not know that form is often disregarded should also be barred from practice. The appeal from form to substance is often deplored as more confusing than helpful, and the words themselves have been catigated by Judge Learned Hand as “vague alternatives . . . anodynes for the pains of reasoning,” 36 but it is hard to imagine how a mature jurisprudence could consistently adhere to formalities in all circumstances. To reach no further back than the Europe of the Middle Ages and Renaissance, for an example, the Catholic Church’s prohibition of usury set into motion a never-ceasing inquiry into the form of transactions designed to evade the restriction, including sales of property with an option in the seller to repurchase for a higher price at a later date—a device that is still sometimes used in the hope of avoiding the tax results of a mortgage. 37

Unfortunately, it is almost impossible to distill useful generalizations from the welter of substance-over-form cases. First, the facts of particular cases are usually complicated, and it is not clear which facts are crucial to the decision and which are irrelevant; this uncertainty about the precedential value of the decision is often compounded by the court’s failure to say whether its conclusion rests on a finding of fact that might have gone the other way if a witness had

33. Commissioner v. Lester, 366 U.S. 299 (1960). Although this case involved a correlative deduction by the husband under the statutory predecessor of § 215, the Court’s insistence on form clearly applies equally to § 71, with the result that both the husband (in claiming a deduction) and the Internal Revenue Service (in seeking to tax the payments to the wife) are bound by the form rather than substance of the agreement or decree. See also IRC § 152(e)(2) (agreement between divorced parents regarding the dependency exemption for their children), and Foxman v. Commissioner, 41 TC 535, 551 (1964) (partnership provisions permitting “the partners themselves to determine their tax burdens inter se to a certain extent”).

34. Tax cases, of course, are not unique in searching for substance; a common analogue is the piercing of the corporate veil in private lawsuits. See BALLANTINE ON CORPORATIONS (rev. ed. 1946), Sec. 122; see also Paul, supra note 11, at 66-73.

35. Paul, supra note 11, at 89, n.304.


been more credible, or was required as a matter of law. In a leading case, for example, the Supreme Court held that a transaction (the purchase of ten 30-year deferred annuity savings bonds, financed by a down payment and funds borrowed from the issuer against their cash surrender value) was "a sham," devoid of appreciable economic results, because "there was nothing of substance to be realized [by the taxpayer] beyond a tax deduction."38

The factual basis for this conclusion was that the taxpayer was paying interest to the issuer of the bonds at the rate of 3-1/2% on its financing loan to him, while the investment was growing in value by only 2-1/2% annually; the net annual cash loss of one percent of the borrowed funds was incurred only to achieve a tax deduction for the interest paid, not for an "economic" profit. Although the taxpayer had the right to refinance the loan if funds became available from other lenders at a lower rate, he either offered no evidence on the prospect of such a reduction in interest rates or failed to convince the trial judge that refinancing was a viable option, and the Supreme Court implicitly assumed that it was not. But a drastic, albeit unlikely, decline in interest rates could have converted the investment into a profitable venture, and another taxpayer, with faith in such a change, might have believed that an economic profit could be made from the very transaction that the Court characterized as a "sham." In doing so, the Court incorporated the trial judge's findings of fact, thereby implying a limited scope for the decision but other parts of the opinion suggest that any taxpayer purchasing a similar contract would be denied a deduction, regardless of his economic expectations, at least if he embarked on the investment when money market conditions were similar to those prevailing during 1953 and 1954, the years before the Court.

Another barrier to generalizing from the decided cases is uncertainty whether the court, in some cases, is interpreting the particular statutory provision on which the taxpayer relies, or is enunciating a principle to be applied throughout the Internal Revenue Code. Thus, in his famous opinion in the Gregory case, Judge Learned Hand said of certain transactions:

Their only defect was that they were not what [the statutory predecessor of § 368(a)(1)] 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... 

Despite this reference to the meaning of a particular statutory provision, Judge Hand's language is regularly quoted as having much broader significance. A related source of difficulty is the common judicial practice of citing the substance-over-form doctrine in combination with other broad concepts (e.g., the business purpose and step transaction doctrines and the requirement of an accurate accounting method), thus obscuring the independent force of each of these grounds of decision.

Finally, for the reasons just canvassed, when a case holding that the form chosen by a particular taxpayer does not accurately reflect the substance of his transaction are compared with decisions in other cases supporting the taxpayer's version of a similar transaction, it is difficult, if not impossible, to ascertain whether a pair of decisions is in conflict. Yet it would defy experience to conclude that if all cases had been decided by the same judge or panel of judges, the results would be the same. A summary of the substance-over-form cases, therefore, runs the risk of portraying the area as more consistent than any body of law can be.

Turning now to the cases, the substance-over-form doctrine is invoked by the government with greatest success when the transaction under examination entails self-dealing, since in these circumstances the form used often has minimal, if any, nontax consequences and is therefore often chosen solely because it is expected to reduce taxes. For example, a purported credit sale of prop-

40. See also Blum's comment (supra note 38 at 305) that the Supreme Court in Knetsch "was either saying a great deal about many and various tax-avoidance schemes not before the Court, or it was omitting to indicate why the interest deduction should be interpreted as [limited to transactions that appreciably affect the taxpayer's beneficial interests]."

41. Occasionally the Supreme Court grants certiorari because of a conflict among the circuit courts involving cases of this type, but if each case rests on the "genuineness" of the particular taxpayer's transaction, the nature of the "conflict" is unclear. In Knetsch, for example, the conflict was with United States v. Bond, 258 F.2d 557 (5th Cir. 1958), where the trial judge did not find the transaction to be a sham and the appellate court concluded that the bond "is not the mere sham supposed," though it did not discuss the economic viability of the transaction as a whole. See Blum, supra note 38, at 300-301.
42. See Rice, supra note 7, at 1024-1032.
Property by parents to their children may, on analysis, be akin to a gift of the property, because the alleged debt is more likely to be forgiven (or paid off with funds received as gifts from the parents) than to be enforced. Recognizing that "sales" within the family may not be what they purport to be and that evidence of their true nature is peculiarly within the control of the taxpayer, Congress has laid down a number of statutory rules that treat intra-family sales differently from sales to third parties. An example is IRC § 267(a)(1), forbidding taxpayers to deduct losses on such sales, even if affected at the property's fair market value.\(^{43}\)

But even if a transaction is not explicitly condemned by the statute, its form may be disregarded by the courts in appropriate circumstances. For example, a sale and leaseback of real estate may be denied sales status\(^{44}\) and the ostensible date of a sale may be ignored in favor of the time when payment could have been made.\(^{45}\) Loans to members of the lender's family also provide grist for the substance-over-form mill, since it is often a reasonable guess that the borrower will not be pressed for repayment as vigorously as an outsider, and the same can be said of loans by shareholders to their own corporation and, conversely, loans by their company to them, especially if the advances are proportionate to stock ownership.\(^{46}\)

Self-dealing transactions between parent and subsidiary corporations and among other members of an affiliated corporate group provide another set of tempting targets for legislative, administrative, and judicial marksmen, armed with the substance-over-form weapon. Section 482 of the Internal Revenue Code permits the Internal Revenue Service to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" among two or more organizations that are "owned or controlled directly or indirectly by the same interests... in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations." Pursuant to this ample charter of authority, the Treasury has promulgated extensive

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\(^{43}\) See also § 704(e)(3) (sale of partnership interest within family to be treated as a gift), and § 166(d) (nonbusiness bad debt deductible only as capital loss, not as ordinary loss).

\(^{44}\) Century Electric Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), cert. denied, 342 U.S. 952 (1952); contra, Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959).

\(^{45}\) Hineman v. Broderick, 99 F. Supp. 582, 583 (D. Kan. 1951) (receipt by farmer of money for sale of grain delayed two years "to effect a possible saving of federal taxes").

\(^{46}\) See BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (3d ed., 1971), § 4.02 and § 7.05.
regulations that test all transactions among affiliated corporations by the standard of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Transactions that would be vulnerable to attack by the Internal Revenue Service with the substance-over-form doctrine are usually at least equally vulnerable under IRC § 482, and the two are often invoked in tandem by government briefs.

Mention should also be made here of a diametrically opposite approach to self-dealing, exemplified by the statutory permission granted to affiliated corporations to file consolidated returns, under which intra-group transactions are disregarded and the income or loss of the group as a consolidated unit is based on its dealings with the outside world. Though commendably realistic, this statutory option is limited to the corporate members of an affiliated group (as defined), and has no analogue for individual members of a family, no matter how closely related. Thus, when a married couple files a joint return, their financial transactions with each other (e.g., gain on a sale of property) are, in general, reflected on the return rather than disregarded.

Transactions at arm's length between the taxpayer and outsiders are far less vulnerable to substance-over-form attacks by the government than self-dealing transactions. For nontax reasons, the parties usually fully express their understanding in the documents, so that the chosen form ordinarily embodies the substance of their transaction. This fusion of form and substance is fostered if, as often occurs, they have divergent tax interests. Thus, when a business pays an employee for his services, the desire to deduct the payment as a business expense will lead the employer to resist suggestions by the recipient that the payment be disguised as a tax-free gift rather than reported as taxable wages.

This frequent opposition of interests does not mean that the characterization adopted by the parties to an arm's-length bargain is invariably conclusive. The employer, to continue with the example just used, may be a tax-exempt organization or a persistently unsuc-

47. Treas. Regs. § 1.482-1(b).
48. IRC § 1501.
49. See IRC § 274(b) (deduction for business gifts limited to $25 per donee per year, if amount is excludible from donee's income under IRC § 102).
cessful enterprise with more deductions than it can use; if so, it may be willing to cooperate with the employee, either as a costless gesture of benevolence or in return for a concession by him. A more complex bargain may be struck when two parties expect to be taxed at very different rates, in which event they may choose a legal form that will assign the tax advantages to the party who can best "use" them, and then divide the tax savings thus achieved. Thus, the amount to be paid under an alimony agreement is often affected by the fact that the husband's right to deduct the payment will reduce his taxes more than receiving the same amount will increase the wife's taxes; railroads and airlines with a long history of business losses often lease equipment rather than buy it, thereby enabling the lessor to derive a tax advantage from depreciation deductions or investment credits that would be useless to them; and most tax shelters similarly serve to shift tax allowances to investors who can deduct them from top bracket income.

If the transaction as consummated is clothed in a form that fairly reflects its substance, however, it will ordinarily pass muster despite the conscious pursuit of tax benefits; in this respect, it resembles an individual taxpayer's isolated decision to pursue a tax-minimizing route rather than a taxable one. On the other hand, if the form of the transaction does not coincide with its substance, the fact that it was negotiated at arm's-length by unrelated taxpayers will not protect it against attack by the government, since the assumption of opposing tax interests is inapplicable. The government can successfully invoke the substance-over-form doctrine, for example, in order to treat a purported lease of business equipment with an option in the "lessee" to purchase the property at the end of the term as a sale on credit, if the option price is nominal in amount, the term of the lease is coextensive with the anticipated useful life of the property, or other substantive aspects of the arrangement are inconsistent with its form.50

The presence of a third party with whom the taxpayer has bargained at arm's-length will also fail to protect a tax avoidance plan if the formalities employed by the taxpayer have no significant impact on the other contracting party and are tolerated or accepted by him as an accommodation rather than viewed as an integral part of

the basic transaction. This phenomenon is characteristic of cases in which the taxpayer engages in preliminary mumbo-jumbo to prepare assets for an impending sale or effects the transfer through a conduit rather than directly. An acerbic comment by Chief Judge John R. Brown of the Court of Appeals for the Fifth Circuit can stand as a summary of this attitude. Refusing to allow the taxpayers in a complex transaction to hide behind a facade entailing the use of an intermediary named, by an appropriate fortuity, W.R. Deal, he said: "The Deal deal was not the real deal. That ends it."51

Although the substance-over-form doctrine is ordinarily a one-way street, taxpayers are sometimes permitted to repudiate the form of a transaction which was accepted in ignorance, especially if the taxpayer has the victim of another party's sharp practices or deception or other mitigating circumstances make it possible to characterize the form as a trap for the unwary.52 The courts have not gone so far as to require "informed consent" before holding a taxpayer to his own red tape, however, and these cases of lenience, though important, remain exceptional. More pervasive is the judicial willingness to disregard book entries, which may evidence the taxpayer's contemporaneous opinion about a transaction but are not intended as a representation of its tax consequences.

A rogue offshoot of the substance-over-form doctrine suggests that when a taxpayer selects one of several forms that have identical practical consequences in the real world, the government can disregard the chosen form and tax the transaction as though the most costly of the alternatives had been employed. The implications of this theory are mind-boggling for even the most routine of business transactions. Thus, a $10,000 salary paid to the sole shareholder of a corporation could be analogized to (a) a contribution by him of his labor without charge, coupled with (b) a distribution to him of a $10,000 dividend. If the services are worth $10,000, the hypothetical contribution-plus-dividend increases the value of the shareholder's stock by $10,000, while the dividend decreases it by the same amount. Judged by an arm's-length standard, the salary that was in fact paid for the shareholder's services is a reasonable business ex-

51. Blueberry Land Co. v. Commissioner, 361 F.2d 93, 102 (5th Cir. 1966).
pense; yet nothing but its form—which may have been chosen solely to reduce the corporation's federal income tax—distinguishes this transaction from its hypothetical alternative. 53

The same mode of analyzing transactions between related taxpayers could be applied to virtually all contracts, leases, and loans between shareholders and their corporations or among affiliated corporations; in each instance, the same practical and economic results could ordinarily be achieved, though at greater tax cost, by combining a taxable dividend with a gratuitous transfer of the property or services. Indeed, pushed to a drily logical extreme, the recasting of transactions to accord with the most costly practical equivalent would not have to await an actual transaction between the related parties. Thus, a profitable corporation's accumulated earnings could be treated as having been, in effect, (a) distributed to its shareholders (who, after all, have complete control over the corporation's dividend policy) and (b) returned by them to the corporation as a contribution to its capital. For some purposes, it would be entirely appropriate to describe the accumulation of earnings by the corporation as an abbreviated way of achieving the distribution and reinvestment of the funds, just as an economist, when computing opportunity costs, treats an investor's decision to hold an asset as the practical equivalent of selling it and immediately reinvesting the proceeds in the same asset. Whether this brutally realistic mode of analysis should be used to fix the tax consequences of a transaction is another matter.

On close inspection, the most-costly-alternative theory turns out to be a drastic extension, rather than a mere restatement, of the substance-over-form doctrine. Thus, although a salary paid by a one-man corporation to its shareholder-employee is virtually identical in practical results to a dividend coupled with unpaid services, it does not follow that the salary is mere "form" and that the hypothetical combination of unpaid services and a dividend is the "substance" of the relationship. In actuality, both are formal ways by which the corporation receives services and shareholder receives money. The legal

53. The hypothetical dividend might have to be repaid at the suit of a creditor if the payment violated the applicable state dividend law, while the salary might not be vulnerable to this attack; but this nontax distinction might be too trivial to be taken into account and would, in any event, arise only if state law distinguished between the two transactions, despite their practical equivalence.
issue is whether the shareholder-employee received the money as employee or as shareholder, and the substance-over-form doctrine sheds no light on this problem of characterization. Since the practice of paying salaries to shareholder-employees antedates the federal income tax and is customary quite without regard to its tax consequences, shareholder-employee salaries are routinely accepted at face value, so far as the substance-over-form doctrine is concerned, provided only that the salary does not exceed the fair value of the services. While the most-costly-alternative theory would permit virtually all such cases to be recast as a combination of unpaid services and a dividend, the government has rarely even attempted to exploit this mode of increasing the tax bite. Perhaps this is because the Code accepts at face value so many fictions (e.g., the separate identity of corporations, the independence of all members of the same family, etc.), regularly imposing tax liabilities on this basis, that it impliedly authorizes taxpayers to act on the same fictions. As Holmes said in rejecting a taxpayer's request that the courts pierce a corporation's veil in a state tax case: 

> "[I]t leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true."

Finally, it should be noted that terms like "sham," "camouflage," and "disguise" are not ordinarily used in substance-over-form cases to impute fraudulent misconduct to the taxpayer, who usually makes full disclosure of the formalities and is not a party to any inconsistent secret understanding or commitments. On the other hand, in appropriate situations, the full force of these pejorative terms may be warranted, since formalities may be deliberately fashioned and employed to cover up fraud.

54. See especially Judge L. Hand, dissenting, in Gilbert v. Commissioner, 248 F.2d 399, 410-412 (2d Cir. 1957) (shareholders' right to deduct, as bad debts, their pro rata advances to their corporation when it became insolvent), discussed by Chirelstein, supra note 16, at 460-472.

55. Chirelstein (supra note 16, at 471) attributes to Judge L. Hand "a perception that the Internal Revenue Code is in part a clumsy system of implied elections, of which some, such as the choice to do business in corporate form, are freely exercisable by the taxpayer and binding on the Commissioner, while others, notably those involving self-dealing transactions, are within the Commissioner's discretion to approve or reject." Viewed in the large, the Code's "clumsy system of implied elections" is even more favorable to the taxpayer, because it is less restricted by the most-costly-alternative theory than Judge Hand evidently wished.

D. Business Purpose

As applied to tax matters, the business purpose doctrine originated with the Gregory case, involving the sole shareholder of a corporation which owned certain marketable securities that she wanted to obtain in her personal capacity for sale to a third party. A straightforward distribution of the securities to her in anticipation of the sale would have been taxable as a dividend. To avoid this result, the securities were transferred by the corporate owner to a newly created second corporation, whose stock was issued to the taxpayer; and she then dissolved the new corporation, receiving the securities as a liquidating distribution. Under the statutory predecessor of IRC § 368(a)(1), taken literally, this transaction was a tax-free corporate reorganization, and the trial court held that "[a] statute so meticulously drafted must be interpreted as a literal expression of the taxing policy" and that the second corporation was entitled to recognition, despite its transitory life as a vehicle for achieving a transfer of the securities from the first corporation to its sole shareholder.57 The Court of Appeals for the Second Circuit reversed, holding that the transaction did not qualify as a "reorganization" when the purpose of the statutory definition of that term was taken into account:

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 "reorganization."58

The Supreme Court explicitly endorsed this reasoning, observing:

Putting aside . . . 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.59

Though its career was launched by a decision concerned only with whether the steps employed by the taxpayer to achieve her objective were "what the statute means by a 'reorganization,'"60 the business purpose standard rapidly proliferated as an implied requirement of other statutory provisions. In 1949, Judge Learned Hand summarized its jurisdiction as follows:

The doctrine of Gregory v. Helvering . . . means that in construing words of a tax statute which describes commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.61

Judge Hand's reference to statutory provisions that describe "commercial or industrial transactions" seemingly excludes application of the business purpose doctrine to the so-called personal (or "itemized") deductions, and indeed the concept of a "business" purpose is ill-suited to tax allowances for payments that are not profit-oriented, like alimony, medical expenses, and charitable contributions. Taxpayers routinely deduct these payments, even though they serve personal rather than business purposes, and the Code obviously contemplates this practice.

More troublesome, however, is the status of interest paid on loans incurred in tax avoidance transactions that promise no economic gain, but will be worthwhile if the interest can be deducted. Section 163 allows interest to be deducted even though the funds are borrowed in a wholly personal context (e.g., a loan to finance a summer vacation), but does it also sanction a deduction for interest paid to finance an uneconomic transaction serving only a tax avoidance purpose? The leading case on this subject, Knetsch v. United States

60. For its ramifications in its original area of application, see Bittker & Eustice, supra note 46, at § 14.51.
(discussed earlier),\textsuperscript{62} denied an interest deduction for loans of this type on the ground that the transaction itself was a sham, without explicitly employing the business purpose doctrine, but some decisions on identical transactions relied primarily on \textit{Gregory} in reaching the same result, and these opinions were cited with apparent approval by the Supreme Court in \textit{Knetsch}.\textsuperscript{63} Another formulation is that such a transaction lacks economic reality; in effect, it is all form and no substance.

In another case of this type the court was unwilling to characterize the transaction as a sham, but it denied the deduction because the loan did not have "purpose, substance, or utility apart from [its] anticipated tax consequences."\textsuperscript{64} Recognizing that IRC § 163 is not limited to interest paid on profit-oriented borrowings, the court nevertheless held that \textit{some} purpose other than tax avoidance was required by the statute. Conscious of the fact that taxpayers who can afford to pay cash often buy automobiles and residences on credit, partly because the interest will be deductible, however, the court limited its decision to "pure" tax avoidance transactions:

Section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what within reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. . . . On the other hand, and notwithstanding Section 163(a)'s broad scope this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to

\textsuperscript{62} Knetsch v. United States, 364 U.S. 361. \textit{See also} Blum, \textit{supra} note 38.


\textsuperscript{64} Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), \textit{cert. denied}, 385 U.S. 1005 (1967).
obtain the tax benefit of an interest deduction; and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential. 65

By rephrasing the business purpose doctrine so that any "purposive activity" (other than the mere reduction of taxes) will qualify under statutory provisions that embrace nonbusiness transactions, the court obviously sanctioned a tax deduction for the paradigmatic taxpayer who borrows in compliance with the American way of life—"spend now, pay later."

E. Step Transactions

The step transaction doctrine—requiring the interrelated steps of an integrated transaction to be taken as a whole, rather than treated separately—began as an interpretation of a detailed statutory provision, 66 as did the business purpose doctrine; but it has been an equally successful cultural imperialist, gaining a foothold in almost every area of the income tax law. It has been most extensively applied to corporate shareholder relations, however, and can be best illustrated with examples from that area of the tax law. 67

A business transaction, like the rest of life, often has no sharp beginning or clearly defined end; but since income must be computed annually, it is often necessary to cut a transaction into its constituent elements for tax purposes. If a segment is sliced too thin and taken in isolation, however, it may be too artificial a base for tax

65. Id. at 741-742.

66. It is dangerous to be dogmatic in pinpointing the source of a protean doctrine, particularly since in its earlier days it was sometimes regarded as an aspect of the pervasive injunction to look at substance rather than form, but the earliest explicit statement of the step transaction doctrine seems to be Warner Co. v. Commissioner, 26 B.T.A. 125, 126 (1932)(A) ("the phrase ‘in connection with a reorganization’ [in § 204(a)(7) of the Revenue Act of 1926] permits, if it does not require, an examination of the several steps taken which culminated in the taxpayer’s acquisition of the . . . assets"). See also Carter Publications, Inc. v. Commissioner, 28 B.T.A. 160, 164 (1933) ("the whole series of acts, corporate and otherwise, constituted only a single transaction . . . .") and Tulsa Tribune Co. v. Commissioner, 58 F.2d 937, 940 (10th Cir. 1932) (rejecting, a few months before Warner Co. was decided, an “attempt [by the government] to break this transaction up into two elements by saying that Jones bought the property and then transferred it to the corporation in exchange for its capital stock”).

computations. As a consequence, a series of formally separate steps may be amalgamated and treated as a single transaction if they are in substance integrated, interdependent, and focused on a particular end result. Thus, the tax treatment of certain transfers of property to a corporation in exchange for its stock depends on whether the transferors had control of the corporation “immediately after the exchange,”68 a phrase that seems to focus on an instantaneous point of time, and thus to exclude where the requisite control is acquired in a series of steps. But the Treasury Regulations, in conformity with the case law, state that the statutory condition “does not necessarily require simultaneous exchanges . . . but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.”69 Another consequence of taking all integrated steps together in determining whether control exists “immediately after the exchange” is that momentary compliance with this statutory condition is insufficient if control is then lost by reason of a transfer of stock that, though somewhat delayed, was contemplated from the outset as an essential part of the transaction.70

A similar example of the scope of the step transaction doctrine is the “creeping control” concept applied in determining whether an acquisition of stock of a target corporation by an acquiring corporation is “in exchange solely for . . . voting stock” within the meaning of IRC § 368(a)(1)(B). If, for example, the acquiring corporation bought part of the target corporation’s stock for cash in 1976, and then acquired an additional block in 1977 solely in exchange for its voting stock, does the 1977 transaction meet the requirement of IRC § 368(b)(1)(B) that “the acquisition” be solely for stock? Taken by itself, it appears to do so, but if the 1976 and 1977 acquisitions are viewed as interrelated steps in a single transaction, the statutory standard is violated because both cash and stock were used. Whether there was only a single non-qualified acquisition for cash plus stock, or one acquisition for cash and a later separable qualified acquisition for voting stock depends on all of the facts and circumstances. If the 1976 purchase was consummated for its own sake, not as part of

68. IRC § 351(a).
70. See Bittker & Eustice, supra note 46, at ¶ 3.10.
an integrated plan that included the 1977 exchange, it can be disregarded as "old and cold," with the result that the 1977 acquisition meets the test of IRC § 368(a)(1)(B).71

The same principle is illustrated by the "source of supply" cases, in which a business enterprise acquires all of the stock of a supplier and promptly liquidates it because the real target is the supplier's inventory or equipment. If the two steps are clearly intended as an integrated transaction, it will be treated as a purchase of the assets, rather than as broken down into two separable steps (a purchase of stock, followed by a liquidation of the acquired corporation). If the stock was purchased as an investment, however, a later decision to obtain the assets by liquidating the corporation would be treated as a separable transaction.72

Although the foregoing illustrations all involve corporate-shareholder relations, the step transaction doctrine is also encountered with increasing frequency in other areas of tax law.73

While it is comparatively simple to foresee the results that flow from the step transaction doctrine if it applies, it is more difficult to predict whether it will be adopted as the proper method of analyzing a set of facts. At one extreme, if the parties have agreed to take a series of steps, no one of which will be legally effective unless all are consummated, application of the step transaction is ordinarily assured. In the absence of such an all-or-nothing plan, however, predictions are more perilous. Sometimes a series of steps, though independent, may occur simultaneously or in rapid succession; the taxpayer may simply seize upon the fact that he is engaged in negotiations, or has a lawyer at hand, to achieve several independent objectives, each of which would be pursued on its own even if the others had to be abandoned. Recognizing this possibility, the Tax Court has said: "The test [for applying the step transaction doctrine] is, were the steps taken so interdependent that the legal relations cre-

71. Id. at ¶ 14.13.
73. See, for example, Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951) (re IRC § 1031, relating to like kind exchanges); Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968) (sale of old equipment and purchase of new, though purportedly separate events, treated as a single transaction, subject to IRC § 1031); Coupe v. Commissioner, 52 T.C. 394 (Acq. in result only, 1970-1 CB xv) (3-party exchange); Magnolia Development Corp. v. Commissioner, ¶ 60,177 P-H Memo T.C. (1960) (transaction with charity).
ated by one transaction would have been fruitless without a completion of the series."74 Despite intimations to the contrary in the early cases, the step transaction doctrine does not require a prior agreement committing the parties to the entire series of steps once the first is taken; there is ample authority for linking several prearranged or contemplated steps, even in the absence of a contractual obligation to follow through.75 Moreover, while simultaneity is often the best evidence of interdependence, the step transaction doctrine has been applied to events separated by as much as 5 years and, on other facts, held inapplicable to events occurring within a period of 30 minutes.76

The step transaction doctrine is usually enunciated as a general principle of tax law, but the courts may be more ready to fuse several steps into an integrated whole when applying one statutory provision over another, implicitly assuming that Congress would have intended this difference in approach. In applying a provision that involves only a single taxpayer, for example, it would be fruitless to ask whether several steps are linked together by contract; the statutory focus may be wholly on the taxpayer's intent. Much can be said for declining to link commercial transactions (e.g., the incorporation of a proprietorship) with noncommercial events (e.g., gifts by the taxpayer to members of his family), even if they occur simultaneously.77 But if the courts have been significantly influenced by considerations of this type, they have not explicitly said so.78

Although step transaction cases often, perhaps even usually, are concerned with whether a particular step with significant legal or business consequences should be treated as part of a larger single

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74. Manhattan Bldg. Co. v. Commissioner, 27 T.C. 1032, 1042 (1957), citing American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). The "interdependency test" was proposed and extensively discussed by Paul, supra note 19. See also Mintz and Plumb, supra note 67, at 285, concluding that in reorganization cases, the test "seems to be whether the step was intended, or even contemplated as an alternative" rather than the interdependency test proposed by Paul.

75. See King Enterprises, Inc. v. United States, 418 F.2d 516, (Ct. Cl. 1969).

76. Douglas v. Commissioner, 37 B.T.A. 1122 (1938) (5 year delay in consummating a corporate reorganization resulting from non-assignability of contracts and disputed claims); Henricksen v. Braicks, 137 F.2d 632 (9th Cir. 1943) (liquidation treated as independent of transfer of assets to new corporation 30 minutes later).

77. See Bittker & Eustice, supra note 46, at ¶ 3.10.

78. For a classification of "step transaction" cases by type of business transaction, see Murray, supra note 67, and Mintz and Plumb, supra note 67.
transaction, there are also many cases in which particular steps in an integrated transaction are disregarded as transitory events or empty formalities. These rather different results of the step transaction doctrine can be illustrated by two contrasting cases. First, assume that the taxpayer transfers property to a corporation in exchange for its stock, intending to sell half of the stock to a third party as soon as the first step is completed. If the two steps are found to be interrelated and mutually dependent, the taxpayer will not have control of the transferee corporation "immediately after the exchange" within the meaning of § 351(a), with the result that any gain or loss realized on transferring the property for the stock will be recognized for tax purposes. The sale of the stock in this case is a serious, indeed a fateful, step in the integrated transaction.

Suppose, by way of contrast, that an individual proprietor has an opportunity to sell the entire merchandise inventory of his business, but would like to report the impending profit as capital gain rather than as ordinary income. Knowing that merchandise does not qualify for capital gain treatment but that corporate stock usually does, he transfers the merchandise to a newly created corporation in exchange for its stock, which he promptly sells to the prospective buyer, who in turn liquidates the corporation in order to get the assets. On these facts, the sale of the stock would almost certainly be regarded as a step in an integrated transaction by which the merchandise was sold; but rather than being treated as a significant step (as was the sale of stock in the prior example), it would be disregarded, and the transaction would be taxed as though this unnecessary step had not occurred. The classic formulation of this variation of the step transaction doctrine is: "A given result at the end of a straight path is not made a different result because reached by following a devious path." The unnecessary step in this case was a distribution of cash by a bankrupt corporation to its shareholders, who were required to pay the funds over to the company's creditors. In holding that this was only a "devious path" by which corporate funds were routed to its

79. See supra note 73.
80. IRC § 1221(1).
creditors (rather than a true distribution to the shareholders), the Court said:

The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors . . . so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit.82

When the step transaction doctrine is thus employed to eliminate transitory or unnecessary steps, it overlaps and becomes almost indistinguishable from the business purpose doctrine (under which the unnecessary step is disregarded because lacking in business purpose) and the substance-over-form principle (nullifying the unnecessary step as a formality that merely obscures the substance of the transaction).83 In a typical amalgamation of all three ideas, for example, Rev. Rul. 70-140 provides:

The two steps of the transaction described above were part of a prearranged integrated plan and may not be considered independently of each other for Federal income tax purposes. The receipt by A of the additional stock of X in exchange for the sole proprietorship assets is transitory and without substance for tax purpose since it is apparent that the assets of the sole proprietorship were transferred to X for the purpose of enabling Y to acquire such assets without the recognition of gain to A.84

The principal practical difference between the "critical step" and "unnecessary step" variations of the step transaction doctrine seems to lie in the taxpayer's greater ability to invoke the former than the latter. The reason for linking together all interdependent steps with legal or business significance, rather than taking them in isolation, is to base tax liabilities on a realistic view of the entire transaction. For this reason, and because the steps themselves are not

82. Id.
83. The Gregory case, 293 U.S., is the classic precedent for disregarding unnecessary steps; it is usually cited as a source of the business purpose and substance-over-form principles, but could equally well be viewed as a step transaction case, and it is cited in the Minnesota Tea case, 302 U.S. in support of the "devious path" formula.
84. Rev. Rul. 70-140, 1970-1 C.B. 73. See also J.M. Turner & Co. v. Commissioner, 247 F.2d 370, 376 (4th Cir. 1957) ("it is the substance, not the form, of the transaction, which must control our conclusion, and a transaction accomplished in two mutually dependent steps should be viewed as a whole"); Perry v. United States, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976) (business purpose for an isolated step in a multistep integrated transaction insufficient; business purpose must be shown for a transaction as a whole).
ordinarily intended to obscure the transaction's substance, the taxpayer is ordinarily as free as the Commissioner to insist that it be viewed as a whole.\(^85\) When unnecessary or transitory steps are deliberately employed by the taxpayer, however, the courts are less disposed to permit the taxpayer to retrace his steps in order to leave his devious path and get back on the straight and narrow; in these circumstances, the privilege of disregarding the unnecessary steps is usually reserved for the Internal Revenue Service.\(^86\)

**F. Disavowal of Form by Taxpayers**

When taxpayers invoke the substance-over-form, business purpose, or step transaction doctrines in order to escape the normal tax consequences of a transaction to which they are parties, the judicial reaction gravitates between two extremes.\(^87\)

At one end of the spectrum, taxpayers have been told that the government can cut through their red tape if it wishes, but that it is equally free to leave them entangled in the form they selected. The classic statement of this principle occurs in *Higgins v. Smith*, a 1940 opinion of the Supreme Court, holding that a taxpayer did not incur a deductible loss on selling depreciated securities to a wholly-owned corporation.\(^88\) Referring to *Burnet v. Commonwealth Improvement Co.*,\(^89\) an earlier case taxing the gain on a similar sale despite the taxpayer's argument that the transaction resulted in a paper profit but not an economic gain, the court said:

In the *Commonwealth Improvement Company* case, the taxpayer, for reasons satisfactory to itself voluntarily had chosen to

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85. See Commissioner v. Ashland Oil & Refining Co., 99 F.2d 568, 591 (6th Cir. 1938) (taxpayer wanted to acquire assets of another corporation, but was compelled to acquire its stock, which was promptly surrendered in complete liquidation; held, the transaction was in effect an acquisition of the assets; "closely related steps will not be separated either at the insistence of the taxpayer or the taxing authority"); Helvering v. New Haven & S.L.R., 121 F.2d 985, 988 (2d Cir. 1941) (rejecting "the effort of the Commissioner to atomize the plan, as it were; i.e., to separate into its separate steps and treat the last as though it stood alone").

86. *Infra* note 90.

87. See generally *supra* note 52.

88. *Higgins v. Smith*, 308 U.S. 473 (1940). Subsequent to the taxable year before the Court, Congress enacted the predecessor of IRC § 267(a)(1), which explicitly denies a deduction for such losses; but the Court held that this statutory provision did not imply that the law was otherwise in prior years.

89. *Burnet v. Commissioner Improvement Co.*, 287 U.S. 415 (1932). In this case, the securities were sold by the corporation to its sole shareholder, but this factual difference was not regarded as relevant in *Higgins v. Smith*, 308 U.S.
employ the corporation in its operations. A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.

On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination if the time and manner of taxation. 90

This judicial refusal to permit taxpayers to repudiate their own handiwork is occasionally supported by the traditional elements of estoppel. The form as characterized by the taxpayer when the transaction is first reflected on the tax return may be accepted at face value by the Internal Revenue Service; and if the taxpayer later attempts to discard the form and portray events in a more realistic light, it may be administratively difficult or even impossible to correct all related prior returns of the taxpayer and other parties to the same transaction, because memories have faded or the statute of limitations has run. 91 But even when no irretrievable waves have been set in motion, taxpayers have been sometimes denied the right to invoke the substance-over-form doctrine:

It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less. 92


It is true that the Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat his corporation as a different person from himself; but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue. See also Matthews v. United States, 36 AFTR 2d 5974 (D.S.C. 1975), and cases there cited.

91. For mitigation of the statute of limitations in the case of inconsistency by either the taxpayer or the IRS, see IRC §§ 1311-1314.

92. Television Industries, Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960). The taxpayer was not necessarily asking for the benefit of the cheapest alternative to the form used; the "substance" of a particular transaction may generate a lesser tax than would be owing if the form is taken at face value, but the former amount may be greater than would have re-
This attitude may be buttressed by a belief that a taxpayer's repudiation of a form deliberately chosen by him is unappealing conduct even when prejudice to the government's interests cannot be proved.

At the opposite extreme from the foregoing line of authority, many cases hold that the substance-over-form doctrine is a two-way street, open to the taxpayer as well as to the government. As early as 1929, for example, the Court of Appeals for the Fourth Circuit cited the "settled principle" that "courts will not permit themselves to be blinded or deceived by mere forms of law," and then observed:

The rule just stated is of peculiar importance in tax cases; for, unless the courts are very careful to regard substance and form in matters of taxation, there is grave danger on the one hand that the provisions of the tax laws will be evaded through technicalities and on the other that they will work unreasonable and unnecessary hardship on the taxpayer. It is instructive to note the many tax cases decided in recent years in which the courts have not hesitated to ignore corporate forms, and to decide the questions involved in the light of what the parties have actually done, rather than on the basis of the forms in which they have clothed their transactions. 93

In a more graphic expression of the same sentiment, the Court of Appeals for the Ninth Circuit said: "One should not be garotted by the tax collector for calling one's agreement by the wrong name." 94

In a similar vein, the Supreme Court has permitted taxpayers to disavow a tax-oriented contract on showing that it conflicted with economic reality, despite the government's willingness to accept the contract as written. 95 In reaching this result, the Court hinted, with-

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93. Western Maryland Ry. Co. v. Commissioner, 33 F.2d 695, 698 (4th Cir. 1929). Other early cases to the same effect are Weiss v. Stearn, 265 U.S. 242 (1924) (looking to substance of transaction at taxpayer's behest); Prairie Oil & Gas Co. v. Motter, 66 F.2d 309 (10th Cir. 1933) (same).

94. Pacific Rock & Gravel Co. v. United States, 297 F.2d 122 (9th Cir. 1961). Despite this auspicious comment, the taxpayer lost; since the court attributed its action to a murky agreement, perhaps it was a case of suicide rather than garotting. See also Clark v. United States, 341 F.2d 691 (9th Cir. 1965), quoting the "garotte" metaphor but finding that the transaction was correctly labelled.

95. Bartels v. Birmingham, 332 U.S. 126 (1947). The case involved an effort to shift liability for social security taxes on the wages of musicians from band leaders to ballroom operators, by vesting the latter with rights under a standard union contract that were not intended to
out explicitly holding, that *Higgins v. Smith* and its other one-way street cases should be confined to "the problem of corporate or association entity."96 There are many lower court decisions that similarly allow the taxpayer to invoke the substance-over-form doctrine, and some important IRS rulings appear to follow suit.97

Between these two extremes can be found cases allowing taxpayers to escape from the forms selected by them, but imposing a more stringent burden of proof than is ordinarily applicable in ordinary tax cases. When the sales price of a going business is allocated by the parties among its components (e.g., inventory, depreciable assets, and a covenant not to compete), for example, some courts permit an unilateral repudiation of the agreed allocation by the buyer or seller only on "strong proof"; and in the Court of Appeals for the Third Circuit, the taxpayer can disavow the allocation only on showing that it was induced by mistake, fraud, or the like.98 This intermediate approach has been applied primarily to the efforts of taxpayers to disavow allocations in contracts for the sale of a going business (including the stock of incorporated enterprises) with a concomitant covenant not to compete.99

be enforced. Despite this bare-faced denial of the employment realities, the IRS was willing to accept the agreement, perhaps because the ballroom operators were more responsible taxpayers than the band leaders. The scope of the decision, which allowed the operators to disavow the contract, is not clear. Three dissenting justices adhered to the one-way street approach:

> If the Government chooses to accept the contract on its face, the parties should be barred from showing that it conceals the real arrangement. Tax administration should not be so easily embarrassed.

96. *Id.*

97. *See*, for example, *Shaw v. Commissioner*, 59 T.C. 375 (1972) ("preference for substance over form in tax matters extends to claims of petitioner and respondent alike"); *Winert's Estate v. Commissioner*, 294 F.2d 750 (5th Cir. 1961) (taxpayer "has a right to assert the priority of substance").

The basic IRS ruling requiring certain purported leases of equipment to be treated as sales does not suggest that its principles are applicable only at the government's initiative, and its neutral language implies that taxpayers can invoke its standards as freely as revenue agents. *See Rev. Rul. 55-540 and Rev. Proc. 75-21, supra* note 50.

98. *See*, for example, *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959) ("strong proof"); *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967) (evidence sufficient to vary the terms of a written contract under common law, such as mistake, fraud, etc.).

99. This line of cases is discussed in detail in a forthcoming treatise on federal taxation by the author, of which this article will form a part.