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THE SHAM TRANSACTION DOCTRINE: AN OUTMODED AND UNNECESSARY APPROACH TO COMBATING TAX AVOIDANCE

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I. INTRODUCTION

For decades the courts have invoked the sham transaction doctrine to deny legal effect to transactions which they believe to be fictitious or not reflecting reality. The sham transaction doctrine has been one of a number of approaches that the courts have utilized to combat tax avoidance, along with the business purpose doctrine, the doctrine of substance over form, the corporate entity doctrine, and the step trans-

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action doctrine. However, upon analysis of the cases that discuss or invoke the sham transaction doctrine, it becomes apparent that this doctrine is either duplicative or useless, a doctrine that permits courts to engage in name-calling rather than thoughtful analysis. In other words, either courts are engaging in analysis that is subsumed within other judicial doctrines curtailing tax avoidance, or courts are simply stating conclusions by labeling transactions as shams. Moreover, Congress has enacted remedial measures in many instances where courts have invoked the sham transaction doctrine. Such legislative action should be the primary mechanism to control tax avoidance. Courts, in turn, should eliminate the sham transaction doctrine and address inappropriate tax behavior through the use of other judicial doctrines or through the application of legislative provisions. Simply labeling behavior a sham transaction is not a worthy function and displaces careful analysis.

Parts II and III of this article examine the development of the sham transaction doctrine at the Supreme Court and lower federal court levels. Analysis of the cases reveals three interrelated aspects to the courts' development of the sham transaction doctrine. Fictitious activity, lack of a business purpose or motive, and discrepancy between the substance and form of the transaction have been the cornerstones of sham transaction theory. Commentators have long questioned the business purpose or motive test discussed in part IV. The fictitious activity test is really an illustration in more egregious circumstances of the importance of looking at the substance rather than the form of the transaction. Thus, part IV argues that courts should recognize the sham transaction doctrine for what it is or should be: an analysis of substance over form, or alternatively, a requirement of economic substance. Even with the understanding that the proper test is the substance of the transaction test, however, courts must give content to the test if it is to be useful. Thus, part V applies the substance of the transaction test to a number of different situations in which courts have previously invoked the sham transaction doctrine.

II. Development of the Sham Transaction Doctrine at the United States Supreme Court: *Gregory*, *Knetsch*, and *Frank Lyon*

Modern sham transaction jurisprudence draws heavily from three Supreme Court cases, decided over a forty-three-year period, beginning with *Gregory v. Helvering*[1] in 1935. Although the Court in *Gregory*

1. 293 U.S. 465 (1935).

did not explicitly use the word "sham,"[2] it did develop several concepts that subsequently have become critical elements of the sham transaction doctrine.

Gregory involved a taxpayer seeking to sell certain assets from a corporation that she owned. Mrs. Gregory created a new corporation and transferred the particular assets of the old corporation to the new entity in exchange for all of its stock. She then liquidated the new corporation, resulting in her receiving all of the assets in question. Upon the sale of the assets she reported a net capital gain, producing a lower tax than if she were taxed on receiving a dividend from the old corporation. The Court refused to recognize this as a qualifying reorganization.[3]

In analyzing this transaction, the Court first recognized that taxpayers could legitimately utilize legal means to reduce their taxes,[4] but that the critical inquiry was "whether what was done, apart from the tax motive, was the thing which the statute intended."[5] The congressional intent behind the reorganization provisions involved in *Gregory* was to permit reorganization of corporate business. Therefore, the Court concluded that a reorganization had to have some relation

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2. The Supreme Court did not use the term "sham" anywhere in its opinion. It did, however, use synonyms for sham, such as "device," "disguise," "contrivance," "masquerad[e]," and "artifice." *Id.* at 469-70. It is interesting that the Supreme Court did not use the term "sham," although Judge Learned Hand had in fact used the term in his opinion for the Second Circuit below. The Second Circuit had concluded that

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

Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934) (emphasis added).

3. 293 U.S. at 470. *Gregory* has been described and analyzed frequently. Particularly thoughtful analyses include: Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355 (1963); Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021 (1953). Both Fuller and Rice offer devastating criticisms of the lack of content inherent in the *Gregory* tests described *infra* notes 4-9.

4. This was expressed more eloquently in Judge Hand's opinion for the Second Circuit, which stated 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.

Gregory, 69 F.2d at 810.

5. *Gregory*, 293 U.S. at 469.

to the business of one of the corporations involved to qualify for favorable treatment.[6] This aspect of *Gregory*, requiring that there be some business purpose for the transaction, has been termed the business purpose doctrine[7] and is perhaps the aspect of *Gregory* most frequently remembered. Inherent in this doctrine is a conflict, or at the least a tension, between the principle that taxpayers may legitimately act to reduce their taxes and the requirement of a business purpose.[8]

Secondly, *Gregory* enunciated the principles that became the substance-over-form doctrine. The Court refused to give effect to the purported reorganization because it was

> a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character . . . . The whole undertaking . . . 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 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.[9]

This passage provides a basis for the development of the doctrine that the substance, rather than the form, of a transaction should determine its tax treatment.[10] The Court concluded that the substance of this transaction was in effect the payment of a dividend since the corporation did not operate in reorganized form. Moreover, this passage provides a basis for the sham transaction doctrine. It characterized the transaction as devious and a disguise of reality. The Court emphasized this aspect of *Gregory* in later cases such as *Helvering v. Minnesota Tea Co.*, where the Court referred to *Gregory* as "reveal[ing] a sham — a mere device intended to obscure the character of the transaction. We of course, disregarded the mask and dealt with realities."[11]

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6. *Id.*

7. *See, e.g.*, Fuller, *supra* note 3, at 357; Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 738 (1978). Fuller also describes *Gregory* as including the concepts of the sham transaction doctrine and the doctrine of substance over form, as well as the business purpose doctrine. Fuller, *supra* note 3, at 360.

8. *See* Gunn, *supra* note 7, at 738-40.

9. *Gregory*, 293 U.S. at 469-70.

10. *See, e.g.*, Gideon, *Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters*, 5 VA. TAX REV. 825, 830-31 (1986); Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 n.1 (1981).

11. 296 U.S. 378, 385 (1935). The Court in *Minnesota Tea Co.* distinguished the situation there involved from *Gregory* on the ground that "[t]he present record discloses no such situation;

Thus, when one examines *Gregory*, the interrelated threads of reasoning weave a pattern: The transaction was not given effect for tax purposes because it had no business purpose and because the form of the transaction differed from its substance. Indeed, the form was a disguise of the real substance.[12] These threads became three separate strands: the business purpose doctrine, the doctrine of substance over form, and the sham transaction doctrine, interrelated in some later opinions but separately dealt with in others.[13]

The second critical Supreme Court precedent giving shape to the sham transaction doctrine was *Knetsch v. United States*,[14] decided in 1960. In this case, Mr. Knetsch had obtained a loan to purchase deferred annuity savings bonds and then borrowed back the difference between the indebtedness and the cash or loan value of the bonds. Since "there was nothing of substance to be realized" by the taxpayer and because there was simply a "facade of 'loans,'" the Court concluded that the transaction was a sham and the interest on the loan was nondeductible.[15]

An insurance company had sold Knetsch deferred annuity savings bonds which paid interest at 2 1/2 percent. Knetsch paid the company a check for $4,000 and also signed a $4,000,000 nonrecourse note for the remainder of the purchase price. The interest rate on the notes was 3 1/2 percent, payable in advance; Knetsch prepaid the first year's

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nothing suggests other than a bona fide business move." *Id.* The reorganization in *Minnesota Tea* was respected because the taxpayer/seller acquired a definite and material interest in the purchaser; it was not a mere device to camouflage a sale. *Id.* at 385-86.

12. According to Professor Chirelstein, Judge Hand's interpretation of *Gregory* simply utilized a business purpose requirement to deter certain transitory legal arrangements; "the business purpose doctrine was thus in a sense an affirmation that form controls substance, but with the qualification that the form adopted must be functional in some respect." Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 452 (1968). Chirelstein believed that Judge Hand found "motive an unacceptable test." *Id.* at 458-59. Nonetheless, as discussed *supra* in text accompanying notes 6-8, others have viewed *Gregory* as including a business purpose test as a major component.

13. Similarly, the commentators have emphasized one or another strand. *See* Blum, Knetsch v. United States: *A Pronouncement on Tax Avoidance*, 1961 SUP. CT. REV. 135, 144 & n.40. Professor Blum quotes Randolph Paul's observation that "the case is all things to all men." *Id.* at 144 n.40 (quoting R. PAUL, STUDIES IN FEDERAL TAXATION 125 (3d ser. 1940)). Also, the courts have cited *Gregory* for numerous principles against tax avoidance. A Lexis search in 1988 revealed over 1100 cases citing *Gregory*. Rice, *supra* note 3, at 1026, characterized *Gregory* as a prime example of "[d]ecision by [i]nvective and [u]nmeaningful [w]ords." Fuller, *supra* note 3, at 366, noted the three strands of *Gregory* and worried that the sham transaction aspect was "essentially contentless and subjective."

14. 364 U.S. 361 (1960).

15. *Id.* at 366.

interest of $140,000 on the day he entered the agreement. Pursuant to the contract, Knetsch could borrow at any time the excess of the stated cash or loan value at year end over the amount of his indebtedness. Thus, within a week of entering the contract Knetsch borrowed $99,000 of the $100,000 excess, and also prepaid the 3 1/2 percent interest on this additional debt, or $3,465. Knetsch's total interest payment as a result of the transaction was $143,465, which he sought to deduct as interest paid during the taxable year. Knetsch repeated this transaction format in the second and third contract years.[16]

When Knetsch terminated the contract in the fourth year, his indebtedness totaled $4,307,000, and the cash or loan value of the bonds was $4,308,000. Upon surrender of the bonds, the company cancelled his indebtedness, and Knetsch received $1,000 in cash. Although the contract had provided for a monthly annuity at maturity thirty years later of $90,171, this amount was to be reduced by any borrowing which reduced the cash or loan value. The borrowing pattern which Knetsch engaged in, leaving only $1,000 as the difference between the cash value and the indebtedness, would have reduced the annuity amount to only $43 monthly, receivable beginning when Knetsch was 90 years old.

The district court found that Knetsch's only motive for the transaction was to obtain an interest deduction.[17] Justice Brennan, writing for the Court, refused to consider this finding because, as *Gregory* had established, a taxpayer had a right to decrease his taxes by lawful means. According to *Gregory*, "'the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.'"[18]

With *Gregory* thus analyzed, Justice Brennan focused on "what was done."[19] In the two tax years involved, Knetsch had paid interest to the insurance company of $294,570 and had received as loans $203,000, a net expense to Knetsch of $91,570. Although "in form"[20] Knetsch had obtained an annuity contract with monthly payments of $90,171 (or life insurance proceeds should he die before maturity), this

16. *Id.* at 363-64. More specifically, in the second year, interest of $143,465 was paid in advance on the aggregate debt; Knetsch also borrowed the $104,000 difference between the cash or loan value and his indebtedness and prepaid interest of $3,640 on this loan, producing a total interest deduction of $147,105. The third year, using the same methods, Knetsch claimed an interest deduction of $150,745. *Id.*

17. *Id.* at 365.

18. *Id.* (quoting *Gregory*, 293 U.S. 465, 469 (1935)).

19. *Id.* at 365.

20. *Id.*

was "a fiction"[21] due to Knetsch's borrowing pattern which kept the net cash value at $1,000. Knetsch's transaction "did 'not appreciably affect his beneficial interest except to reduce his tax . . . .'"[22] The Court's analysis was terse:

> [I]t is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called 'interest' payments. The $91,570 difference retained by the company was its fee for providing the facade of 'loans' whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $223,297.68. There may well be single premium annuity arrangements with nontax substance which create an 'indebtedness' for purposes of . . . section 163(a) . . . . But this one is a sham."[23]

Thus, the Court denied the claimed interest deductions.

Analysis of the Court's opinion in *Knetsch* reveals several critical themes of the sham transaction doctrine. First, the Court was concerned with the tension addressed in *Gregory* involving taxpayers' motives; because taxpayers may properly act to decrease the amount they owe in taxes, courts should disregard the tax motive and instead determine whether the taxpayers' activity was what Congress intended. Second, the Court required that the taxpayer must obtain something of substance from the transaction, some effect on a beneficial interest, beyond a tax consequence.[24] Third, the Court utilized such terminology as "form," "fiction," "ostensibly," and "facade" in the course of reaching the conclusion that the particular transaction

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21. *Id.* at 366.

22. *Id.* at 366 (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion of Learned Hand, J.)). For a discussion of Judge Hand's *Gilbert* dissent, see Chirelstein, *supra* note 12, at 459-74.

23. 364 U.S. at 366.

24. Asimow, *The Interest Deduction*, 24 UCLA L. REV. 749, 788 (1977), identified *Knetsch* as a substance over form case and stated that the difference between that test and the test of appreciably affecting beneficial interests was not clear. Professor Blum argued that the Supreme Court should not have run together the two concepts of appreciably affecting beneficial interests and the substance of the transaction. Blum, *supra* note 13, at 152-53. He gave an example where a taxpayer borrows at a high interest rate and invests at a lower interest rate. Here, the transaction would appreciably affect his beneficial interests but would not have economic substance because the transaction would not be economically sound. This example foreshadows the problem of Tillie Goldstein, discussed *infra* in text accompanying notes 181-93.

was a sham.[25] Thus, in *Knetsch*, the sham transaction doctrine involved fictive activity, where the reality differed from the form adopted by the taxpayer.[26]

It is interesting, in light of the majority's conclusion that the transaction was a sham, to consider the majority's use of Judge Learned Hand's dissenting opinion in *Gilbert v. Commissioner*.[27] Judge Hand had rejected formulation of the test as substance over form, sham, or substantial economic reality because he believed these were undefined terms providing no guidance as to what factors would be determinative. Instead, Hand proposed a test that inquired if the taxpayers "suppose[d] that the difference [between the choice of debt over contribution to capital] would appreciably affect their beneficial interests in the venture, other than taxwise?"[28] Hand then emphasized the *belief* of the taxpayer that his beneficial interests would be affected. Justice Brennan, in *Knetsch*, however, recast this as a more objective test. He questioned whether the taxpayer's beneficial interests were affected and dropped the state of mind component of Hand's formulation. Moreover, Brennan's approach explicitly endorsed an analysis of substance over form and used the terms "fiction" and "sham" to label the transaction as one whose form did not warrant respect. Unfortunately, Justice Brennan failed to give content to these tests. He also failed to analyze specifically why the transaction did not appreciably affect beneficial interests or have substance such that its form should be recognized. Finally, he failed to indicate how to measure these factors.[29]

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25. *Knetsch*, 365 U.S. at 365-66. This raises an important point: whether the Supreme Court is involved in review of a finding of fact or a standard of law. *See* Blum, *supra* note 13, at 141-43. In the context of the sham transaction doctrine, the legal question concerns the appropriate standards for determining that a type of transaction is a sham; the question of fact is whether the particular transaction falls within those legal parameters. *See* Estate of Franklin v. Commissioner, 544 F.2d 1045, 1047 n.3 (9th Cir. 1976).

26. Fuller, *supra* note 3, at 370-71, concluded that *Knetsch* involved real activity by the taxpayer and that there was economic significance to the transaction (payment of money by the taxpayer and receipt of income by the payee) but that the key to the Court's conclusion in *Knetsch* was the total absence of economic purpose, making *Knetsch* as well as *Gregory* easy cases.

27. 248 F.2d 399, 410 (2d. Cir. 1957) (Hand, J., dissenting).

28. *Id.* at 412.

29. The decision is frequently criticized for its lack of content. *See, e.g.*, Blum, *supra* note 13, at 149-51. Professor Blum worried that after *Knetsch* the sham transaction doctrine would be used as a label for the result that the taxpayer loses. *Id.* at 157. But note that Professor Blum also commented that "judicial vagueness may also have a place in coping with the avoidance problem" and preferred this to "an ever-growing crop of detailed statutory enactments tailored to stop specific minimization schemes." *Id.* at 158.

The dissent in *Knetsch*, espoused by Justice Douglas, adopted a narrower view of what constituted a sham transaction. According to this position, "as long as the transaction itself is not hocus-pocus, the interest charges incident to completing it would seem to be deductible."[30] Neither the presence of a dominant motive of tax avoidance nor the absence of commercial substance make the transaction a sham. Since the "transactions were real and legitimate in the insurance world,"[31] courts should respect them for tax purposes, unless Congress specifically legislates otherwise. Hence, the dissenting view significantly limited the sham transaction doctrine and would invoke it only in situations where transactions were intended to deceive.

The third Supreme Court case giving shape to the sham transaction doctrine was *Frank Lyon Co. v. United States*.[32] Taxpayer Frank Lyon Co. (Lyon) entered into a sale and leaseback transaction with a state bank (Worthen). Pursuant to the agreement, Worthen sold a building as it was constructed to Lyon. Lyon then leased the completed building back to Worthen under a net lease arrangement. The total rent payable over the term of the lease equaled the principal and interest necessary to amortize a third-party loan which was obtained to finance construction of the building. Lyon sought to deduct interest paid on the mortgage loan and depreciation on the building. The Commissioner denied these deductions on the theory that Lyon was not the owner of the building, that the sale-leaseback arrangement was actually a loan by Lyon to Worthen of $500,000 (the excess of the price which Lyon paid Worthen for the building over the amount of the mortgage loan), and that Lyon was merely acting as a conduit for Worthen's payments of principal and interest on the mortgage loan from the third party.[33] The Supreme Court, in an opinion by Justice Blackmun, concluded that the transaction was not a sham and should be given effect.[34]

The elements of the sham transaction test utilized in *Frank Lyon* again drew from specific doctrinal patterns. Justice Blackmun began his analysis with discussion of the substance over form doctrine, requir-

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30. *Knetsch*, 364 U.S. at 370 (Douglas, J., dissenting). Justices Whittaker and Stewart joined. The dissent did not define what it meant by hocus-pocus, nor did it give meaningful standards. Webster's New Collegiate Dictionary defines hocus pocus as "sleight of hand" or "nonsense or sham used esp[ecially for] deception." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 574 (9th ed. 1983).

31. *Knetsch*, 364 U.S. at 371.

32. 435 U.S. 561 (1978).

33. *Id.* at 568-69.

34. *Id.* at 580.

ing an analysis of "the objective economic realities of a transaction rather than . . . the particular form the parties employed."[35] Thus, the inquiry in a sale-leaseback case should not stop at the transfer of formal title. It should evaluate whether the transferor retained significant control over the property transferred. The Court emphasized that this transaction involved a third party because of banking law restrictions, that Lyon was obligated on the mortgage notes, and that the arrangement significantly affected Lyon's financial situation. The fact that tax laws helped to shape the transaction was not dispositive; Lyon had also engaged in other activities apart from holding the title to the building. Thus, the Court concluded that the transaction was not "a simple sham."[36] Further analysis of the facts led the Court to conclude that Lyon was both the obligor on the loan and the "one whose capital was committed to the building."[37] For these reasons, the Court approved of Lyon's deductions for interest payments made and for depreciation on the building.

In a subsequent portion of the opinion, after concluding that the transaction was not a simple sham, the Court further investigated what it termed the "substance and economic realities of the transaction."[38] After detailing the unique facts of the case, the opinion concluded:

> we hold that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes."[39]

Here, the Court intertwined the concepts of economic substance and business purpose in assessing the validity of the transaction for tax purposes.

This separate consideration reveals the Court's belief that two levels of analysis were necessary. First, the Court analyzed the trans-

35. *Id.* at 573.
36. *Id.* at 580.
37. *Id.* at 581.
38. *Id.* at 582.
39. *Id.* at 583-84.

action to determine if it was a simple sham. After passing the test for a simple sham transaction, the next level of analysis was a combination of the substance over form and business purpose tests. Interestingly, the Court did not once cite or discuss *Gregory* or *Knetsch* in analyzing the sham transaction doctrine. The Court did not make clear why two levels of analysis were necessary. At bottom, the Court should have respected the transaction if it had substance; i.e., if Lyon were the true owner of the building, it should be entitled to depreciation deductions.[40] An emphasis on the substance of the transaction would properly divert attention from the labeling aspect of the sham transaction doctrine and from the vagaries of the business purpose doctrine.[41] It would also be consistent with the thrust of the factors discussed and the language of *Frank Lyon* that emphasized the substance of the transaction.

These three cases reflect the Supreme Court's attempt to use the sham transaction doctrine to combat tax avoidance. Tax avoidance, of course, takes many forms,[42] and courts must tailor weapons precisely to eliminate particular abuses. Moreover, courts should recognize that the sham transaction doctrine is simply one of a series of judicial doctrines developed to fight tax avoidance,[43] any number of which may be relevant in any given situation.

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40. *See generally* Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 (1981) (criticizing a number of aspects of *Frank Lyon* and urging that the key analysis should have been "the characteristics that distinguish the investment of an owner from that of a lender." *Id.* at 1088.).

41. *See infra* text accompanying notes 93-107.

42. *See generally* Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657 (1985) (an innovative effort to develop an understanding of what constitutes tax avoidance, based on efficiency and equity concerns); Gideon, *supra* note 10, at 849-53 (explanation of how tax shelters work); STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST, SESS., OVERVIEW OF TAX SHELTERS (Comm. Print 1975) [hereinafter OVERVIEW] (prepared for the use of the Committee on Ways and Means, Overview discusses the elements of tax shelters and possible approaches to limit their use). The basics of tax shelters involve deferral, transforming ordinary income into capital gains or other income taxed at lower rates, and the use of leverage (someone else's money) to maximize tax advantages. OVERVIEW at 1; Gideon, *supra* note 10, at 849-53. Tax avoidance may also involve attempts to secure favorable rates or to avoid taxation entirely, in situations where Congress has not so intended. Professor Cooper urged the removal of tax incentives for leverage as a comprehensive measure to reduce tax avoidance. Cooper, *supra*, at 715-18. Cooper decried the patchwork effect created by ad hoc measures. He also recommended elimination of rate differentials between corporations and high bracket taxpayers and elimination of differentials leading to intrafamily and trust transfers, as measures to curtail the need for what he called "dozens of existing damage-control rules." *Id.* at 725-26.

43. *See* Gunn, *supra* note 7.

It is unfortunate, however, that following the decision in *Frank Lyon*, the Supreme Court's jurisprudence on the sham transaction doctrine has remained quiescent. The Court has left fashioning of refinements of the doctrine and determination of what situations fit within its framework to the lower courts. Part III below focuses on these recent lower court decisions and demonstrates the variety of approaches these lower courts have followed.

III. Modern Sham Transaction Jurisprudence: Development in the Lower Federal Courts

The imprecision and ambiguity inherent in the Supreme Court's development of the sham transaction doctrine afforded the lower courts ample freedom to develop meaningful tests to guide analysis. Unfortunately, lower courts all too often miss this opportunity, with many simply repeating the key phrases from the Supreme Court opinions and reaching conclusions summarily.

The best-known effort in the lower courts to shape the sham transaction doctrine stems from the decision in *Rice's Toyota World, Inc. v. Commissioner*[44] in 1985. In this case involving a sale-leaseback of a computer, the Fourth Circuit adopted a test that the Tax Court developed to implement *Frank Lyon*: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."[45] Both the Tax Court and the Fourth Circuit in *Rice's Toyota World* interpreted *Frank Lyon* as establishing a two-part test for a sham transaction. The test inquires into the existence of a business purpose for the transaction and evaluates the economic substance of the transaction. The latter evaluation is to be guided by a more precise test of whether there is a reasonable possibility of a profit. Only if neither test were satisfied would the transaction be considered a sham transaction.

In *Rice's Toyota World*, the taxpayer (Rice's), an auto sales company, purchased a used computer from Finalco, a corporation engaged heavily in leasing capital equipment. Rice's gave Finalco a recourse note of $250,000 and two nonrecourse notes totaling $1,205,227 for a total of $1,455,227. Finalco had previously purchased the computer for $1,297,643. Following their acquisition of the computer, Rice's

44. 752 F.2d 89 (4th Cir. 1985), *aff'g* in part, *rev'g* in part, 81 T.C. 184 (1983).
45. 752 F.2d at 91.

leased it back to Finalco for eight years. Finalco was obliged to pay rent to Rice's in an amount that exceeded Rice's obligations on the nonrecourse notes by $10,000 annually. Although this obligation was contingent upon Finalco's subleasing of the computer, at the time of the agreement, Finalco had already obtained a five-year sublease. After five years, Finalco was to receive thirty percent of the proceeds of any further leasing or sale. Rice's sought deductions for accelerated depreciation on the computer and deductions for the interest paid on the notes. The Tax Court denied these deductions on the grounds that the sale-leaseback transaction was a sham.[46]

The Fourth Circuit evaluated the transaction by applying the two-part test separately. First, the court analyzed the subjective question of the taxpayer's motives in entering the transaction. Rice's sole reason for entering the transaction was to obtain tax deductions. Thus, the circuit court affirmed the Tax Court's finding that Rice's lacked a subjective profit motive for engaging in the transaction.[47]

The second part of the test adopted in *Rice's Toyota World* was termed objective: whether a reasonable possibility of profit from the transaction existed apart from the tax benefits. The Fourth Circuit evaluated the evidence introduced at trial and upheld the Tax Court's finding of no reasonable possibility of profit. This court viewed this aspect of the inquiry as an objective test which required determination of whether the transaction had economic substance.[48]

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46. *Id. See also* 81 T.C. 184 (1983) (for the Tax Court opinion).

47. 752 F.2d at 92-94. The Fourth Circuit evaluated the Tax Court's conclusion that the transaction was a sham under the "clearly erroneous" standard of review applicable to determinations of fact. Looking at the record, the Fourth Circuit found sufficient evidence that Rice's did not investigate the transaction enough to support a conclusion that there had been a profit motive. Moreover, the Finalco literature emphasized the tax reduction potential, Rice's paid on inflated price for the used computer, and the use of nonrecourse notes was found to permit abandonment of the transaction when the tax benefits due to accelerated depreciation waned in later years. Thus, the Fourth Circuit affirmed as not clearly erroneous the Tax Court's finding of no profit motive. *Id.* at 94.

48. *Id.* at 94-95. The Fourth Circuit's analysis turned on the residual value of the computer at the end of the eight-year lease, since that would be the primary mechanism for Rice's to recoup its investment in principal and interest on its recourse note. The Fourth Circuit accepted as not clearly erroneous the Tax Court's conclusion that the experts of the Commissioner were more credible than those of the taxpayer, and that therefore the residual value was not adequate to permit a profit, thus causing the transaction to fail the economic substance part of the test for a sham transaction. *Id.* at 95. *See infra* notes 103-05 (regarding the difficulties of relying on the presence of profits as the sole determinant of whether to give a transaction effect for tax purposes).

Because neither a business purpose nor economic substance existed, the Fourth Circuit affirmed the holding that the transaction was a sham.[49] This result permitted the Commissioner to ignore the form adopted by the parties and to follow the substance of the transaction for tax purposes. The decision that Rice's had not really purchased a computer but rather had paid a fee to Finalco to obtain tax benefits resulted in the denial of depreciation deductions and interest deductions based on the nonrecourse loans. With respect to the interest paid on the recourse note, however, the Fourth Circuit concluded that the situation was fundamentally different. The taxpayer had incurred a genuine debt upon which it made legitimate interest payments. Although the taxpayer subjected itself to this interest expense in order to reduce taxes (a tax avoidance motive), under the Fourth Circuit's interpretation of *Frank Lyon*, the court had to respect that part of the transaction because it had economic substance.[50]

A number of courts have adopted the *Rice's Toyota World* framework in the four years since its formulation. In *Bail Bonds By Marvin Nelson, Inc. v. Commissioner*,[51] the Ninth Circuit determined that a transaction involving a reinsurance agreement and connected loans was a sham because it failed to have either a business purpose or any economic substance.[52] On the other hand, the Tax Court in *Estate of Thomas v. Commissioner*[53] concluded that both tests of *Rice's Toyota World* were satisfied in a computer leasing arrangement.[54] The *Rice's Toyota World* framework has formed the basis for lower court analysis of transactions involving a variety of other situations, including purchases of masters for reproduction[55] and cattle feed transactions.[56]

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49. 752 F.2d at 96.

50. *Id.* at 95-96.

51. 820 F.2d 1543 (9th Cir. 1987).

52. *Id.* at 1550.

53. 84 T.C. 412 (1985).

54. *Id.* at 437. Other cases applying the *Rice's Toyota World* framework in the computer sale and leaseback situation include Johnson v. United States, 11 Cl. Ct. 17 (1986); Larsen v. Commissioner, 89 T.C. 1229 (1987); Torres v. Commissioner, 88 T.C. 702 (1987); Mukerji v. Commissioner, 87 T.C. 926 (1986).

55. *See, e.g.*, United States v. Music Masters, 621 F. Supp. 1046 (W.D. N.C. 1985) (purchase and lease of master sound recordings); United States v. Philatelic Leasing Ltd., 794 F.2d 781 (2d Cir. 1986) (purchase and sale of stamp masters).

56. *See, e.g.*, Packard v. Commissioner, 85 T.C. 397 (1985) (utilizing the *Rice's Toyota World* framework in a cattle feed operation case to conclude that the transaction was not a sham, but then applying the step transaction doctrine to recast the transaction as a partnership, ignoring the intermediate corporate steps).

Although a number of decisions as described have utilized the criteria outlined in *Rice's Toyota World*, a number of others have emphasized differing aspects in the analysis and application of the sham transaction theory. The alternative formats take several forms. One approach appears to merge a focus of whether the form of the transaction accurately reflects the reality, with some reference to the absence of business purpose. An example of this approach is the Tax Court's "sham in substance doctrine," developed in *Falsetti v. Commissioner*.[57]

Falsetti defined a "sham in substance" as "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits."[58] This approach focused on the substance over form doctrine, asking whether the reality of the transaction had economic significance. The *Falsetti* court questioned whether there was in fact a sale of property to the taxpayers' partnership. In concluding that the transaction was not a sale, the Tax Court looked at the failure of legal title to pass, the lack of arm's-length dealings, the gross excess of the stated purchase price over the fair market value, the failure of the parties to treat the transaction in a manner consistent with the transfer of ownership, and the complete disregard for the terms of the written contract.[59] However, the Tax Court also stated that in order to conclude that the transaction was a sham, it needed to determine whether the taxpayers had a nontax purpose for entering into the transaction.[60] Because the taxpayers had not ascertained the fair market value of the property, had not protected their interest in the property, had not asserted control over the property, and did not determine that their interests were disposed of at a fair price, the Tax Court determined that they had not established a business purpose for the transaction.[61] Thus, the court concluded,

> considering the totality of the facts and circumstances surrounding the purported sale transactions, we conclude that petitioners engaged in the expedient of drawing up papers to characterize the transactions in question as something contrary to the economic realities thereof, solely to obtain unallowable tax benefits. What pretended to be a sale was really a loan by the individual petitioners . . . on which

57. 85 T.C. 332 (1985).
58. *Id.* at 347.
59. *Id.* at 348-49.
60. *Id.* at 347.
61. *Id.* at 354.

> 10-percent annual interest was ultimately paid. Petitioners had no interest in the property, which at all times remained under the dominion and control of Harris. In short, what we have before us is in substance a sham, the expected tax benefits of which will be disregarded.[62]

This language, while focusing on the substance of the transaction, also included some determination by the court that a business purpose was lacking.

The Tax Court has utilized this approach emphasizing the substance of the transaction and the "sham in substance" theory in other cases as well. For example, in *Brown v. Commissioner*,[63] the Tax Court considered a situation in which the taxpayer sustained losses by cancelling a series of forward contracts for mortgage certificates. The court determined that these losses were "factual shams"[64] rather than the result of bona fide transactions. In reaching its conclusion, the court noted that all of the forward contracts involved the promoter and taxpayer or other similar investors. It also noted that each investor, including taxpayer, gave a power of attorney to the promoter permitting the promoter to control the contracts fully. Additionally, the promoter could manipulate the profits on the transactions. Finally, the court found the investment involved no risk, which is unusual in legitimate straddles.[65] However, in reaching the conclusion that these transactions were factual shams, the Tax Court once again made passing reference to the business purpose component: "the disputed transactions constituted 'factual shams' which were inspired, designed, and executed by [the promoter] . . . for the sole purpose of attempting to achieve tax losses for their investors."[66] Finally, the court stated that the statutory provisions regarding straddles did not apply where the "alleged straddles . . . are in fact fake or fictitious."[67]

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62. *Id.* at 355.

63. 85 T.C. 968 (1985), *aff'd sub nom.* Sochin v. Commissioner, 843 F.2d 351 (9th Cir.), *cert. denied*, 109 S. Ct. 72 (1988).

64. *Id.* at 1000. In a subsequent case, Glass v. Commissioner, 87 T.C. 1087 (1986), *aff'd sub nom.* Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988), the Tax Court tried to explain both the sham in substance and factual sham tests. Sham in substance was defined as "simply a mislabeling of what actually occurred," whereas factual shams were described as "those situations where the taxpayer does not establish the jural relationship he purports to create." 87 T.C. 1087, 1176 (1986). In other words, shams in substance occur when the substance differs from the form, and factual shams are fictitious activities. The latter can be viewed as an example of one type of the former.

65. 85 T.C. at 998-99.

66. *Id.* at 998, 1000.

67. *Id.* at 1000.

Many of the sham transaction cases have involved conclusions by the courts that the undertaking was a fiction. A number of appellate courts have affirmed the Tax Court decision in *Forseth v. Commissioner* holding that a series of transactions involving commodity straddles were "factual shams"[68] because the taxpayers had simply paid a fee to purchase fictitiously generated tax losses. The Tax Court enumerated six factors demonstrating the sham nature of the transactions: the correlation of the taxpayers' tax needs and the amount of losses produced by the promoter; the ability of the promoter to predict the amount of losses; the willingness of the promoter to trade before the taxpayers had made margin deposits (indeed, no margin calls were made at all); the closing out of taxpayers' gains to ensure that their overall losses equalled their margin deposits; the failure to produce any evidence of entry into opposite positions; and the manipulation of trading records. The Tax Court concluded that "the real role of [the promoter] was to contrive and/or manipulate an unregulated and unpublished market in gold and platinum forward contracts so that it could deliver to its investors the losses promised by its fee-splitting American liaison."[69] This constituted

> factual shams, inspired, designed, and executed by [the promoter] . . . for the sole purpose of achieving for its investors capital and ordinary losses to offset their unrelated income in 1980 and 1981. Petitioners have failed to prove that there was any actual gold or platinum, that there was any real market or trading, or that there was any purpose, other than the avoidance of taxes, for any of the transactions in issue.[70]

Hence, the Tax Court chose to focus on the substance of the transactions. However, the court also mentioned in conclusion that the sole purpose for the transactions was to avoid taxes.

In affirming the Tax Court's decision in *Forseth*, several appellate courts emphasized the fictitious nature of the transactions. The Seventh Circuit in *Forseth v. Commissioner* characterized the transactions as "artifice, the essence of which was the sale of bogus tax losses to appellants for a fee."[71] The Ninth Circuit affirmed in *Enrici v. Commissioner* on the grounds that the Tax Court decision that "no real transactions were taking place"[72] was not clearly erroneous and

68. 85 T.C. 127 (1985), *aff'd* in a number of cases. *See infra* notes 71-75.
69. *Id.* at 165.
70. *Id.*
71. 845 F.2d 746 (7th Cir. 1988).
72. 813 F.2d 293, 295 (9th Cir. 1987).

that "the parties were merely rigging paper prices, losses, and gains to effectuate a sale of generated tax losses."[73] Thus, the Ninth Circuit concluded that the straddles were "artificial" rather than "real."[74] The Sixth Circuit, in *Mahoney v. Commissioner*, noted that not only were the transactions fictitious, but also that the taxpayer had no motive in entering the investment except tax avoidance.[75]

In a number of cases, the courts have examined the substance of a transaction and concluded that the transaction was contrived or unreal and, therefore, a sham. The decision of the Seventh Circuit in *Saviano v. Commissioner*[76] illustrates this approach. The court concluded that the economic substance of a purported loan arrangement was really a joint investment and disregarded the loan as a sham.[77] Focusing on the economic substance, on the actual transaction rather than the form, the court viewed the taxpayer's action as a "ruse," a "transparent attempt" using "misleading terminology" to obtain a desired tax deduction.[78] Other courts similarly have addressed the substance of a transaction and concluded that it was a sham, concurrently using terms such as "not bona fide,"[79] bogus,[80] artifice,[81] phony,[82] or pretended[83] to describe the arrangement.[84]

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73. *Id.* at 296.

74. *Id.*

75. 808 F.2d 1219, 1220 n.2 (6th Cir. 1987). Other circuits affirmed without published opinion. Bramblett v. Commissioner, 810 F.2d 197 (5th Cir. 1987); Wooldridge v. Commissioner, 800 F.2d 266 (11th Cir. 1986).

76. 765 F.2d 643 (7th Cir. 1985); *see infra* notes 292-94 and accompanying text.

77. *Id.* at 650.

78. *Id.* The court focused on such factors as inadequate capital, allocation of risk, and control by the borrower of repayment as demonstrating that this nonrecourse loan was not a normal loan but rather a joint venture. The court believed that "only a fool would actually believe that the transactions did in fact occur as described. The many elements of commercial surrealism present in these tax shelters . . ." made it clear that it was a sham. *Id.* at 654.

79. Cases using the term "not bona fide" include: Price v. Commissioner, 88 T.C. 860 (1987) (describing transactions involving Treasury bill straddles as "fictitious," "bookkeeping legerdemain," "playing a football game without the football," "not bona fide," and "contrived." Moreover, even if the transactions were not fictitious, the court concluded that they lacked economic substance since there was no possibility of realization of any economic gain); Thompson v. Commissioner, 631 F.2d 642 (9th Cir. 1980) (describing sale of property at vastly inflated price as revealing transaction was not bona fide, lacked economic substance, and was a sham); United States v. Atkins, 661 F. Supp. 491 (S.D.N.Y. 1987) (stating that test for sham transaction is linked with economic substance, there must be a bona fide transaction, and substance rather than form controls); Brown v. Commissioner, 85 T.C. 968 (1985) (concluding that transactions involving forward contracts were not bona fide, but rather were fake or fictitious and thus were factual shams).

80. *See, e.g., Forseth*, 845 F.2d at 746 (straddle was an "artifice," involving sale of "bogus" tax losses, and therefore a sham lacking economic substance).

81. *See, e.g., id.* at 749.

One approach focused on the taxpayer's intent in undertaking the transaction to have the substance of the arrangement correspond to its form. For example, in *Boyter v. Commissioner*,[85] the Fourth Circuit quoted at length from *Gregory* in concluding that the key question was taxpayer intent. "[T]he sham transaction doctrine may apply in this case if, as the record suggests, the parties *intended* merely to procure divorce papers rather than actually to effect a real dissolution of their marriage contract."[86] This inquiry focused on the taxpayer's intent to have the form diverge from the real substance of the situation, resulting in an interesting combination of the purpose or intent test, and the substance over form doctrine. However, the Fourth Circuit decided *Boyter* prior to the emergence of the *Rice's Toyota World* concept, which arguably represents its current theoretical approach.

Another approach taken by some courts links the sham transaction doctrine with an evaluation of other substantive law questions. Several cases in which the taxpayer has made an invalid attempt to assign income through the use of a trust and where the taxpayer failed to satisfy grantor trust provisions in the Internal Revenue Code represent a prime example of this approach.[87] In these instances, the sham transaction doctrine generally duplicates more carefully tailored approaches and must not conflict in any way with the statutory plan selected by Congress. Another case illustrating this linkage approach is *F.P.P. Enterprises, Inc. v. United States*,[88] where the court held

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82. *See, e.g.*, Milbrew v. Commissioner, 710 F.2d 1302 (7th Cir. 1983) (where plant sold at greatly inflated price, where sale not at arm's-length and treated informally, and where strong tax avoidance motive, sale was a "phony" and sham transaction doctrine applied).

83. *See, e.g.*, United States v. Clardy, 612 F.2d 1139 (9th Cir. 1980) (a loan was "pretended" to permit taxpayer to pay interest; this was nothing but an illusion, created by check swapping, for sole purpose of creating an interest deduction, with no intent to complete the transactions; hence sham transaction doctrine applied).

84. Some of these cases discussed in notes 79-83 *supra* also discuss the taxpayer's motive, as well as focusing on the substance of the transaction.

85. 668 F.2d 1382 (4th Cir. 1981). *See infra* notes 279-82 and accompanying text. *Boyter* involved taxpayers who were husband and wife who obtained a Haitian divorce at the end of a tax year, remarried soon in the next tax year, then redivorced in the Dominican Republic at the end of the second tax year and remarried once again after the second tax year closed, all for the sole purpose of reducing the added tax caused by the marriage penalty in the rate structure.

86. 668 F.2d at 1387 (emphasis added). *Boyter* was remanded to the Tax Court for a factual determination of whether the transaction was a sham transaction under the principles outlined by the Fourth Circuit. No opinion on remand was reported.

87. *See, e.g.*, United States v. Buttorff, 761 F.2d 1056 (5th Cir. 1985); Holman v. United States, 728 F.2d 462 (10th Cir. 1984); Hanson v. Commissioner, 696 F.2d 1232 (9th Cir. 1983).

88. 830 F.2d 114 (8th Cir. 1987). *See infra* notes 203-05 and accompanying text.

a transfer of assets to a family trust was a sham transaction lacking economic substance because the taxpayers continued to use the property as their own. The court also held the transfers to the trusts fraudulent under state law.[89] It is questionable whether state law regarding fraudulent conveyances should be binding or even relevant for federal tax determination.

The brief review of the cases decided by the lower courts utilizing the sham transaction doctrine demonstrates that great uncertainty exists concerning the meaning and application of the doctrine. Moreover, many courts are merging a variety of complex concepts without clarifying theoretical interrelationships. The courts tend to use the sham transaction doctrine to label tax avoidance the courts believe improper, without the analysis necessary to justify this label. Finally, the varying relationships in different opinions among the business purpose doctrine, the substance over form doctrine, and the sham transaction doctrine prevent predictability of analysis. A cohesive analytical approach is needed.

IV. The Proper Analysis: Evaluation of the Substance of the Transaction

Continuation of the sham transaction doctrine in its various forms is unnecessary and unwise. The label "sham transaction" permits courts to avoid analysis. The proper analysis involves focusing on what the taxpayer is actually undertaking. In other words, what is the economic substance of the transaction? If there is economic substance, then the courts should respect the form of the transaction for tax purposes. However, if the taxpayers are really attempting a transaction at variance with the form which they have adopted, then the courts should reject the form and recharacterize the transaction for tax purposes according to its actual substance.

This approach involves compressing the concerns variously labeled by the courts as the sham transaction doctrine, the doctrine of substance over form, or the requirement of economic substance into one consideration: what is the substance of the transaction? This substance of the transaction approach will eliminate the use of the sometimes

89. 830 F.2d at 117; *see also* Carr Enterprises, Inc. v. United States, 698 F.2d 952 (8th Cir. 1983) (transfer of property to shell corporations was both a sham transfer and a fraudulent conveyance under state law), *aff'g*, 539 F. Supp. 528 (D.S.D. 1982). The district court in *Carr* had stated that the transfers were shams and therefore were attempts to defraud the United States government in violation of the state's fraudulent conveyance statute. *Carr*, 539 F. Supp. at 531.

conclusory label "sham," which is a value-laden term having no inherent meaning. It will also eliminate concern over the taxpayer's purposes, whether the taxpayer's purpose solely is to reduce taxes or whether he has a business purpose for the transaction. The court may still give separate consideration to the business purpose of the arrangement in limited circumstances.[90] The sham transaction doctrine essentially addressed the same concerns as the substance over form test, yet the labeling aspect obscured or discouraged analysis. Because of this fault, courts should refrain from the continued use of the historical sham transaction doctrine.[91]

The substance of the transaction inquiry requires more complex analysis than a sham transaction test which limits shams to fictitious or fake transactions. Although courts clearly will deny fake transactions tax effect under the proposed test because they lack substance, non-fictitious transactions may also fail the proposed test where analysis of the transaction reveals that the substance differs from the form adopted. This article argues that the key to decision is the substance of the transaction. Scrutinizing fake arrangements under the substance of the transaction test promotes analysis and avoids the labeling aspect so often determinative in the sham transaction doctrine.[92]

The substance of the transaction approach also requires elimination of an inquiry into the taxpayer's purpose or motive in undertaking a transaction.[93] Because of the difficulties inherent in a state of mind

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90. The most obvious use of the business purpose analysis will continue where Congress has incorporated the concept in statute. Even the use of business purpose tests in statutory provisions requires great care. *See* Fuller, *supra* note 3, at 389-93 (describing a number of statutory provisions incorporating a state of mind analysis and urging "a fundamental reconsideration" of those statutes requiring that the taxpayer not have a primary purpose of tax avoidance; favoring the more objective business purpose test). Summers, *A Critique of the Business-Purpose Doctrine*, 41 OR. L. REV. 38, 45-47 (1961), suggested statutes could be redrafted to achieve the same results without including a business purpose component.

91. *Cf.* Asimow, *supra* note 24, at 784-93 (recognizing the interrelationship between the tests of sham, substance over form, and business purpose).

92. *But see* Gideon, *supra* note 10, at 828 (urging the sham transaction be restricted to fake transactions).

93. Professor Blum has provided an admirable foundation for the evaluation of state of mind (purpose, motive and intent) in tax law. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967). Borrowing from the criminal law, Blum suggested that purpose addresses the question what the taxpayer sought to accomplish, intent addresses the question whether the taxpayer desired the acts that occurred, and motive addresses the question of why the taxpayer wanted to accomplish his action. *Id.* at 486-87, 494-95. Generally tax law has focused on purpose, and rarely on motive, in part Blum argued because of the maxim in *Gregory* that a tax avoidance motive does not make unlawful activity complying with

analysis, it is desirable to eliminate the subjective element when such an inquiry is unnecessary to the analysis. Clearly, state of mind analysis involves difficulty in ascertaining and proving the existence of a particular taxpayer's state of mind in a specific transaction.[94] The court can overcome this difficulty to a degree by generalizing to consider what the hypothetical average taxpayer's state of mind would be in similar circumstances. Such analysis, however, would likely be based on observation of external factors, such as the substance of the transaction.[95] Hence, the more straightforward analysis eliminates the state of mind concept and focuses instead on the substance of the transaction.[96]

Other problems with the state of mind analysis include the lack of precision inherent in such a standard. What level of nontax reduction motive or purpose should the court require of a taxpayer to satisfy the business purpose test? Should the business purpose be the dominant purpose? Should it be *the* primary purpose? Or should it merely be *a* primary purpose? What does primary mean? Should the standard differ from one tax avoidance setting to another, or from one aspect of tax law to another, and if so, why? How do we determine a person's primary purpose? These questions have long troubled courts and commentators.[97] They have not been, nor can they be, conclusively resolved.

Another critical problem is how to determine when state of mind analysis is relevant. Can the courts resolve the tension in *Gregory*

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the Internal Revenue Code. *Id.* at 495. *But see* Gunn, *supra* note 7, at 744 n.40 (suggesting distinctions between motive and purpose are irrelevant for tax avoidance analysis and that they overlap with intent considerably).

94. *See generally* Blum, *supra* note 93, at 498-99 (judgments about an actor's state of mind typically rest on inferences drawn from introspection); Summers, *supra* note 90, at 41 (findings of fact with respect to taxpayer motivation are based on evidence which is easily manufactured). The possibilities of self-serving statements by taxpayers as to their purpose, motive, or intent are boundless. The difficulties of proof of contrary state of mind by the IRS are enormous. *But see* Gunn, *supra* note 7, at 743 45 (suggesting difficulty of proof should not be determinative, analogizing to laws to deter mugging despite difficulty of catching muggers).

95. *See* Blum, *supra* note 93, at 501-05. Summers, *supra* note 90, at 43-47, argued the business purpose test is unnecessary, and a wholly objective test is sufficient.

96. Summers, *supra* note 90, at 47-48, even worried that the appreciably affecting beneficial interests test adopted in *Knetsch* would be a substitute for analysis. The substance of the transaction test must avoid that problem.

97. *See* Cooper, *supra* note 42, at 684-85. Blum, *supra* note 93, at 512, concluded that the primary purpose test "cannot be made very precise, and it is workable only so long as a great deal of vagueness is accepted." *Id. See also* Rice, *supra* note 3, at 1041-46 (concluding that the business purpose rule is neither theoretically coherent nor uniformly applied).

between allowing taxpayers to act legitimately to reduce their taxes while still requiring a genuine business purpose for the transaction?[98] If the business purpose test means simply that any business purpose no matter how small is enough, then the doctrine loses force as a weapon to combat tax avoidance because in most instances the taxpayer may argue some business purpose. If the court requires a more convincing business purpose to counteract the taxpayer's motive of tax reduction, the test conflicts with the principle that taxpayers may act to reduce their taxes. A final example demonstrates the vagaries of use of the business purpose doctrine: a taxpayer may choose to invest in tax exempt rather than taxable bonds simply because of the favorable tax rates, yet courts have not held this action impermissible under a state of mind analysis.

Also significant is the interrelation of a state of mind or business purpose test with congressional action. When Congress has enacted tax benefits, courts should not punish taxpayers taking advantage of those benefits. In many instances, specific tax provisions (such as incentives for investment in low income housing) exist to encourage taxpayer activity in particular areas. Taxpayers who engage in that activity because of tax benefits have accomplished exactly what Congress desired. As we know from *Gregory*, taxpayers are entitled to use statutory provisions to minimize their taxes.[99] Thus, state of mind analysis would seem inapplicable in these situations. Alternatively, Congress may have chosen specifically to limit tax benefits where taxpayers do not have a business purpose or profit motive. For example, in the section 183 hobby loss situation, Congress has limited deductions when an activity is not engaged in for profit.[100] In those circumstances, courts must operate within the statutory confines and attempt to interpret the statute according to congressional intent. An intermediate situation exists when Congress has neither intended tax benefits to flow nor specifically enacted a state of mind or business purpose component. The courts should resolve these cases through a substance of the transaction analysis. The weaknesses and ambiguities inherent in the state of mind test make the latter analysis counterproductive.

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98. Gunn, *supra* note 7, at 748, urged that the use of tax avoidance motive cannot be justified because we cannot distinguish those cases where a tax motive should apply from those where it shouldn't, and stated that "distinctions between tax-motivated and other behavior [are indefensible]." *Id.* at 765. *See also* Rice, *supra* note 3, at 1036-38, 1041-46 (generally criticizing cases discussing taxpayer intent, and calling business purpose test akin to "decision by invective," "a doctrine of last resort," "thoroughly unpredictable," and "too evanescent to be helpful").

99. *See supra* text accompanying note 4.

100. I.R.C. § 183 (1989).

Acknowledging many of the weaknesses inherent in state of mind analysis, Professor Blum has urged that state of mind analysis generally becomes focused "on whether any non-tax goals or functions were or plausibly could have been served by the action."[101] This article goes one step farther, however, and urges that it is not the non-tax objective but rather the substance of the transaction that courts should analyze. Courts should look at what is really occurring in the transaction, rather than focusing on the taxpayer's goals or objectives. In many cases, a particular factor will indicate that the form of the transaction has substance, and that a hypothetical taxpayer has reasonable non-tax (i.e., economic) objectives. However, the courts should focus on the former question of substance absent specific directives from Congress to inquire into the taxpayer's objectives, purpose, or motive.[102]

Substance of the transaction analysis would also minimize the problem identified by Professor Warren as inherent in requiring some economic profit in tax-motivated transactions.[103] Professor Warren's dilemma was that if courts required simply some pre-tax economic profit, the presence of trivial profits would validate transactions which substantively were quite similar to those with zero profit or slight loss. On the other hand, to require a reasonable profit or full market return would be arbitrary and would ignore the role of capital markets in setting relative prices in light of tax advantages.[104] Others have characterized this problem as inherently insoluble.[105] But by focusing on the variety of factors that a particular context makes important for determining the substance of the transaction, the courts need not rely entirely on some measure of pre-tax economic profit as the key determinant in validating the form of a transaction.[106] Economic profit will simply be one of a series of factors that courts may evaluate in a given context in determining what is the substance of the transaction.

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101. Blum, *supra* note 93, at 523. He also distinguished two views of business purpose: an objective test of what a reasonable businessman would do and a subjective state of mind inquiry regarding the particular taxpayer. *Id.* at 524 n.106. He endorsed an objective evaluation of a taxpayer's nontax goals and objectives, looking at external factors. *Id.* at 536-44.

102. This may be what Justice Brennan intended in *Knetsch* in his shift from Judge Hand's inquiry in *Gilbert*, regarding the taxpayer's *belief* in an effect on beneficial interests, to the *Knetsch* form looking directly at the effects on beneficial interests. *See supra* text accompanying notes 27-29.

103. *See generally* Warren, *supra* note 10.

104. *See id.* at 987.

105. *See* Gideon, *supra* note 10, at 834-39. He urged inquiry into "magnitude and likelihood of the profits which may be achieved in comparison to the size of the investment," although he recognized that this formulation also triggered Professor Warren's objections. *Id.* at 837-38.

106. *Cf. id.* at 841 (inquiring whether ownership as opposed to a "not-for-profit" analysis would better resolve these transactions).

The substance of the transaction approach avoids the problems inherent in state of mind analysis. However, if this approach is to succeed, courts must make a careful analysis based on the nature of the particular transaction involved to determine whether the realities of the arrangement conform sufficiently to the form to give that form effect for tax purposes. In other words, the courts must give content to the substance of the transaction test in order to prevent that test from deteriorating into the labeling exercise of the sham transaction doctrine at its worst.[107] An analysis of the typical situations in which courts historically have invoked the sham transaction doctrine is helpful in providing content to the substance of the transaction test. Such an investigation takes place in part V below.

V. Analysis of Common Tax Shelter Problems, Comparing Recent Case Law with the Proposed Substance of the Transaction Test

The substance of the transaction test will permit courts properly to analyze the wide variety of situations in which courts previously have applied the sham transaction doctrine. In recent years sham transaction cases have fallen into certain common factual scenarios that generally involve:

(1) sale-leaseback situations;
(2) sale and ownership questions;
(3) interest deductions;
(4) family trust situations and gift-leasebacks;
(5) straddles; and
(6) other situations.

Courts could more appropriately resolve cases in each of these areas under the substance of the transaction test. Use of sham transaction terminology is unnecessary and potentially misleading.

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107. *See* Rice, *supra* note 3, at 1028-32 (urging that the doctrine of substance over form is unrealistic and unenlightening). Rice concluded that given the weaknesses of all the various tax avoidance doctrines, the best solution was to ascertain and describe "what the courts have done in fact" to try to develop some predictable patterns. *Id.* at 1051.

Moreover, form may sometimes be respected regardless of substance, as where the Internal Revenue Code provides an election for taxpayers. *See* Gunn, *supra* note 7, at 746-47 n.44. Blum, *supra* note 13, at 146-47, criticized the substance over form test for not providing clear guidelines when form alone may be respected. However, his example, drawn from comparison between wash sales losses and wash sales gains, could be handled by the observation that since Congress explicitly limited wash sales losses but not wash sale gains, Congress has indicated its approval of formal transactions in that particular context.

A. *Sale-Leaseback Situations*

As discussed above in part II and part III, two of the most renowned sale-leaseback cases, *Frank Lyon Co.* and *Rice's Toyota World*, were key cases shaping the existing sham transaction doctrine. The Fourth Circuit, in an effort to interpret *Frank Lyon Co.*, enunciated in *Rice's Toyota World* a two-part test for a sham transaction. The court defined a sham transaction as one in which there is both no business purpose and no economic substance to the transaction.[108] As part III established more fully, in *Rice's Toyota World* the Fourth Circuit and the Tax Court both found that the taxpayer lacked a subjective profit motive and that there was no reasonable possibility of profit.[109]

Numerous other cases have analyzed the application of the sham transaction doctrine in connection with the sale-leaseback phenomenon. In surveying these cases, several distinctive elements become apparent. First, some cases have focused on the substance of the transaction by ascertaining whether there was a realistic opportunity for economic profit or other factors indicative of substance.[110] Indeed, the Claims Court has equated the sham transaction doctrine with the test of economic substance.[111] Second, some cases have focused on the burdens and benefits of ownership, permitting tax benefits to flow only to those who are also subject to the burdens of ownership.[112] Third, some cases have included an investigation of the taxpayer's purpose or motive: was there a business purpose or a profit-making intent? The courts have viewed this factor as either a component of the sham

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

109. *Id.* at 95; 81 T.C. at 206.

110. *See, e.g.*, Larsen v. Commissioner, 89 T.C. 1229 (1987); Torres v. Commissioner, 88 T.C. 702 (1987); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985); Hilton v. Commissioner, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982) (finding sale-leaseback was a sham, applying *Frank Lyon*, and emphasizing analysis of substance of transaction, especially noting rent not based on fair market value, absence of taxpayer's own funds, inability of taxpayer to dispose of property at profit, packaging as a tax shelter, and carelessness in arranging relevant partnerships). *Cf.* Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976) (where purchase price not shown to approximate fair market value but appeared to exceed it, substance of transaction was not sale; court chose not to use "sham" but disallowed deduction on ground of economic substance).

111. Johnson v. United States, 11 Cl. Ct. 17, 25 (1986). The Claims Court then proceeded to quote *Rice's Toyota World*'s two-part test favorably. *Id.*

112. *See, e.g.*, Torres v. Commissioner, 88 T.C. 702 (1987); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985). Note that the Ninth Circuit in Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976), speaks of an investment in property as a requirement for depreciation, not just ownership.

transaction doctrine,[113] or in some cases, an entirely separate test under section 183.[114] A subissue is the quantum of profit motive required; some courts indicate that this inquiry varies, depending on whether the courts view the issue as a component of the sham transaction doctrine or the for-profit requirement under section 183.[115] Of course, many courts have considered all factors in reaching a conclusion.[116]

Illustrative of the multifaceted approach is *Torres v. Commissioner*[117] in which the Tax Court upheld a computer sale and leaseback, analyzing the transaction in terms of three different tests. First, the court applied the *Rice's Toyota World* test and concluded that because the taxpayer had a reasonable chance of realizing an economic profit, the transaction had economic substance and was not a sham.[118] Indeed, the Tax Court concluded that a profit was virtually assured. Second, the court concluded that the form of the transaction deserved respect because the benefits and burdens of ownership had passed under the arrangement.[119] Finally, the court determined the transaction satisfied section 183(a) since the taxpayer had an intent to make a profit as determined under the regulations.[120] Each of these components in *Torres* deserves careful scrutiny.

With respect to economic substance, the Tax Court continued to rely on the *Rice's Toyota World* definition of sham transaction as the key to analysis. Focusing on the reasonable possibility of economic profit, the Tax Court concluded that the taxpayer was very likely to profit economically from the transaction and hence the investment did

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113. *Rice's Toyota World*, 752 F.2d 89; Levy v. Commissioner, 91 T.C. No. 54 (Nov. 2, 1988); Larsen v. Commissioner, 89 T.C. 1229 (1987); Mukerji v. Commissioner, 87 T.C. 926 (1986); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985).

114. *See* Torres v. Commissioner, 88 T.C. 702 (1987) (noting reference to *Rice's Toyota World* business purpose component but focusing on economic substance).

115. *See* Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985) (simply requiring more than de minimis potential for profit to meet purpose requirement of sham transaction doctrine; referring to § 183 as "a closely related context"). *But see* Johnson v. United States, 11 Cl. Ct. 17, 25-28 (1986) (discussing profit standard under § 183 in sale-leaseback situations; concluding that the profit requirement of § 183 does not apply with the same vigor in sale-leasebacks as in hobby losses, and not requiring primary or dominant profit motive but requiring more profit motive than necessary to withstand sham transaction, i.e., "reasonable in the circumstances").

116. *See, e.g.*, Levy v. Commissioner, 91 T.C. No. 54 (Nov. 2, 1988); Torres v. Commissioner, 88 T.C. 702 (1987); Mukerji v. Commissioner, 87 T.C. 926 (1986); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985).

117. 88 T.C. 702 (1987).

118. *Id.* at 719.

119. *Id.* at 727.

120. *Id.* at 734.

have economic substance.[121] The court drew this conclusion from the significant residual value of the computers at the end of the lease, the excess of the expected contingent rent over the taxpayer's cash payments within the initial three-year period, and the strong likelihood of positive cash flow from the equipment in early years. This finding meant that the court would respect the transaction for tax purposes; it was not a sham under the *Rice's Toyota World* framework.[122]

The second stage of analysis for the Tax Court in *Torres* concerned whether the taxpayer had sufficient benefits and burdens of ownership to qualify for deductions which were available only to true owners. The key issue centered on relevant factors in determining ownership. After outlining fourteen factors, the Tax Court focused on the evidence in the record: the taxpayer paid the fair market value for the equipment; the expected useful life of the equipment exceeded the leaseback term; and a significant residual value for the equipment would remain at the end of the leaseback. Moreover, both parties had treated the transaction as a sale, the lessee had a present obligation to make rental payments, the cash flow arrangements (larger cash flow in early years) were consistent with ownership, and the taxpayer had a reasonable possibility of both recouping the initial investment and earning a substantial profit from the income and residual value of the equipment. Hence, the taxpayer possessed sufficient ownership attributes to qualify as owner for tax purposes.[123]

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121. *Id.* at 727-34.

122. *Id.* at 719. Another example is Mukerji v. Commissioner, 87 T.C. 926 (1986), where the court noted that the purchase price was at or less than fair market value, the residual value was reasonable, and there was a virtually guaranteed cash flow. *Mukerji*, 87 T.C. at 957. Hence, the court concluded that there was the opportunity for profit. *Id.* Similarly the court in Estate of Thomas v. Commissioner, 84 T.C. 412, 437, 439 (1985), found that a reasonable potential for profit met the economic substance requirement. *See also* Levy v. Commissioner, 91 T.C. No. 54 (Nov. 2, 1988) (sale-leaseback transaction had a business purpose and economic substance because petitioners owned the equipment, were at risk for the debt obligations, and entered the transaction for profit). *Cf.* Larsen v. Commissioner, 89 T.C. 1229 (1987) (two transactions met and two did not meet the economic substance standard based on evidence regarding the purchase price, fair market value, residual value, and rental values).

123. *See also* Mukerji v. Commissioner, 87 T.C. 926 (1986) (concluding that the taxpayer retained significant benefits and burdens of ownership). These factors are really basically the same as those involved in the sham transaction analysis. In *Mukerji*, the court also concluded that there was genuine indebtedness supported by actual investment. *Id.* at 968 n.34; *see also* Levy v. Commissioner, 91 T.C. No. 54 (Nov. 2, 1988); Larsen v. Commissioner, 89 T.C. 1229, 1266-68 (1987) (holding two transactions where taxpayer acquired benefits and burdens of ownership are recognized for tax purposes); Estate of Thomas v. Commissioner, 84 T.C. 412, 433-36 (1985) (concluding that taxpayer retained significant benefits and burdens, looking at reasonable rental payments, parties' treatment of lease, risks and benefits of ownership, e.g., residual value).

Finally, the Tax Court in *Torres* turned to whether the taxpayer had a bona fide intent to make a profit independent of tax benefits.[124] Here the Tax Court simply analyzed the requirements of section 183(a), which limits the allowable deductions if an activity is not undertaken for profit. After citing the nine factors specified in the Regulations under section 183, the Tax Court focused on the substantial profit expected and actually obtained by the taxpayer from the transaction. Moreover, the expected economic benefits were substantial compared to the expected tax benefits. Indeed, the taxpayer expected no net tax benefits at all. Thus, the taxpayer had a bona fide intent to profit from the transaction, sufficient to meet the standard of section 183(a).[125]

This treatment contrasts interestingly with the analysis of the Claims Court in *Johnson v. United States*.[126] According to that court, the profit test under section 183 should not weigh potential tax benefits.[127] Pursuant to section 183, a court must require more profits than the "modicum" necessary to survive characterization as a sham: "a profit reasonable in the circumstances should be anticipated to pass muster under section 183."[128] The court articulated a test that would require the "objective of, and a reasonable chance of making, a reasonable profit apart from tax considerations."[129] Of course, this level of profit also would satisfy the sham transaction standard. Applying this standard, the Claims Court examined the facts of the case and found that an annual return of 6.27 percent was reasonably likely. Thus, the court held the transaction met the profit test of section 183 and also found the transaction was not a sham.[130]

As noted above, in *Rice's Toyota World* and many other sale-leaseback cases, the Tax Court has analyzed business purpose in de-

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124. 88 T.C. at 727.

125. *Id.* at 734. Compare this aspect of *Torres* with Mukerji v. Commissioner, 87 T.C. 926, 968 n.34 (1986) (court simply stated that there was a business purpose and that the taxpayers were acting as "prudent businessmen" who scrutinized their investments carefully); with Estate of Thomas v. Commissioner, 84 T.C. 412, 433, 438, 440 n.52 (1985) (court stated that the record showed there was reasonable potential for profit and hence the taxpayer had the objective of making a profit, and court only required more than de minimis potential profits to find that tax avoidance was not the sole motive). *See also* Levy v. Commissioner, 91 T.C. No. 54 (Nov. 2, 1988) (requiring that there be "an actual and honest profit objective for entering the activity" in order to satisfy § 183).

126. 11 Cl. Ct. 17 (1986).

127. *Id.* at 26.

128. *Id.* at 28.

129. *Id.*

130. *Id.* at 37.

termining whether the transaction was a sham.[131] The analysis, however, should focus on the substance of the transaction and bypass the search for a business purpose. In evaluating the substance of the transaction, the courts necessarily will determine whether a sale has in fact occurred, i.e., whether the seller has transferred the benefits and burdens of ownership in light of the whole transaction including the leaseback. If the substance of the transaction test is satisfied, i.e., if the arrangement possesses the required level of economic substance,[132] then courts properly can consider, as a separate matter, whether the taxpayer has fulfilled the requirements of section 183. At that point, the courts should evaluate the statutory standard intended by Congress in section 183. That standard permits only limited deductions when an activity lacks profit motive. It is only at that point that Congress has clearly spoken, having explicitly chosen to require that the taxpayer have a motive to earn profit in order to claim full deductions. The business purpose inquiry is therefore appropriate in analyzing section 183, but unnecessary and inappropriate in sham transaction analysis.[133] This approach is consistent with that advocated by Professor Warren, who rejected a judicial requirement of a pre-tax profit where Congress has enacted tax preferences.[134] Courts obviously must undertake an analysis of profits or profit motives where Congress has required.

B. *Sales and Ownership Situations*

In a number of cases, courts have had to decide whether a transaction framed as a sale should be respected for tax purposes. In many of these cases, courts have used some form of the sham transaction doctrine. In others, the courts have focused primarily on the substance of the transaction and determined whether the incidents of ownership had passed. In this area, the sham transaction doctrine is a useless appendage to the determinative analysis of whether the attributes of ownership have transferred to the buyer. Thus, analysis should focus on the substance of the transaction, particularly on the question of whether the seller has transferred the incidents or attributes of ownership to the buyer.

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131. *See supra* notes 113-16 and accompanying text.

132. *Cf.* Steele, *Sham in Substance: The Tax Court's Emerging Standard for Testing Sale-Leasebacks*, 14 J. REAL EST. TAX'N 3 (1986) (describing factors important in determining substance of a sale-leaseback transaction).

133. Section 183(c) defines "activity not engaged in for profit" as activities other than those with respect to which deductions are allowed under §§ 162 or 212. However, the Regulations under § 183 establish with some precision a definition, identifying nine relevant factors. Treas. Reg. § 1.183-2. The Regulations purport to be utilizing an objective standard.

Recent Tax Court decisions adopt a two-step approach for analyzing sales transactions, first determining whether a sale of property has occurred and then determining whether the court should disregard the transaction for tax purposes because it lacks substance. Illustrative of this approach is *Grodt & McKay Realty, Inc. v. Commissioner*,[135] involving taxpayers who purported to purchase units of cattle, at $30,000 per unit, each consisting of five breeding cows. The taxpayers paid a small down payment (no more than $1,500) per unit, with the remainder of the purchase price payable through a nonrecourse promissory note. The seller retained and managed the herd and received a management fee. Moreover, the seller was to retain the bulk of the proceeds of the business as either payment of outstanding interest and principal on the notes or as management fees. After evaluating these and other aspects of the transaction, the Tax Court concluded that it was not a sale and lacked economic substance apart from desired tax benefits.[136] Hence, the court disregarded the taxpayers' characterization of the arrangement as a sale and held the transaction taxable in accordance with its substance, not its form.

In *Grodt & McKay*, the Tax Court framed the critical inquiry in determining a sale as depending on whether the benefits and burdens of ownership had passed from the seller to the purchaser.[137] The court derived from other precedents eight key factors to determine whether a sale had occurred:

> (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.[138]

Using these standards to evaluate the evidence in the case, the Tax Court concluded that the transaction was not a sale.[139] Critical factors

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134. *See* Warren, *supra* note 10, at 989-90.
135. 77 T.C. 1221 (1981).
136. *Id.* at 1245-46.
137. *Id.* at 1237.
138. *Id.* at 1237-38 (citations omitted).
139. *Id.* at 1245.

were the gross excess of the purchase price over the fair market value of the cattle (purchase price was ten times market value), the absence of any right to possess or control the cattle, the absence of any risks of ownership on the part of the purchasers, and the allocation of the overwhelming majority of the profits to the sellers.[140] Thus, the Tax Court refused to consider the transaction a sale for tax purposes.

The Tax Court in *Grodt & McKay* did not accept the Commissioner's argument that any purported sale transaction which was found not to be a sale was necessarily a sham. Rather, the court decided completely to disregard this transaction for tax purposes because it failed to have "any economic, commercial, or legal purpose" beyond tax consequences.[141] Because there was no realistic possibility of economic profit except for tax benefits, the court found no business substance to the transaction and disregarded it for purposes of taxation.[142] Although the court used the word "sham" occasionally,[143] the essence of the decision was to focus on the substance of the transaction.

The approach of the Tax Court in *Grodt & McKay* thus involved a determination of whether the transaction was a sale, and then whether any substance to the transaction existed apart from tax benefits. One troubling aspect of the decision is that it is not entirely clear where the court would draw the line between those transactions which should be disregarded completely for tax purposes and those which should be respected. Indeed, the court itself refused to attempt to draw such a line.[144] Another troubling aspect was the court's merging of analysis of the substance of the transaction with constant reference to the taxpayer's purpose, as if the two ideas were synonymous. Apparently, the lack of economic substance combined with the presence of desired tax consequences led the court to the conclusion to disregard the transaction for tax purposes.

The Tax Court followed the same basic approach in *Falsetti v. Commissioner*, where it concluded that sales of real estate were "shams in substance."[145] The court defined shams in substance by reference to *Knetsch* and *Frank Lyon* as "the expedient of drawing up papers to characterize transactions contrary to objective economic

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140. *Id.* at 1238-43.

141. *Id.* at 1243, relying on *Knetsch, Gregory* and *Estate of Franklin.*

142. *Id.* at 1244-46.

143. The court used the word "sham" or synonyms such as "facade" several times. *See, e.g., id.* at 1221 (describing the issue); *id.* at 1243 (stating that the finding of no true sales did not necessarily mean that the transaction was a sham); *id.* at 1241 (transaction a mere facade).

144. *Id.* at 1244.

145. 85 T.C. 332, 347 (1985), discussed *supra* in text at notes 57-62.

realities and which have no economic significance beyond expected tax benefits."[146] After defining sham in substance, the Tax Court applied *Grodt & McKay* and concluded that the seller had not transferred the burdens and benefits of ownership to the buyer. Therefore, the transaction did not rise to the level of a sale.[147] Again, following the pattern of *Grodt & McKay*, the Tax Court analyzed the transaction to determine whether any economic, commercial, or legal purpose existed apart from tax consequences.[148] In substance, the transaction was a loan rather than a purchase of an ownership interest in the property. Thus, the court concluded that the transaction was a sham in substance. The court determined that the taxpayers had "engaged in the expedient of drawing up papers to characterize the transactions in question as something contrary to the economic realities thereof, solely to obtain unallowable tax benefits."[149]

The bifurcated analysis in *Grodt & McKay* and *Falsetti* is confusing and unnecessary. The concept of sham or sham in substance adds nothing of significance to the court's analysis. Moreover, a phrase such as sham in substance is counterproductive to the extent that it encourages simply labeling. The proper analysis requires a determination of the substance of the transaction.[150] Using factors such as those mentioned in *Grodt & McKay* for ascertaining whether a sale occurred, the court should evaluate the transaction to determine whether in fact the burdens and benefits of ownership were transferred.

In *Milbrew v. Commissioner*, the Seventh Circuit analyzed a sale transaction and found that the sale of a manufacturing plant was a sham and hence should be disregarded.[151] Looking at a series of factors,

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146. *Id.*

147. *Id.* at 355. Critical factors in *Falsetti* were the failure of legal title to vest with the purchaser, the absence of an arm's-length transaction, the disproportionately high purchase price compared to the fair market value, and the behavior of the parties inconsistent with the purchaser's ownership. *Id.* at 349-51. Other factors included that the sellers continued to use the property as security; that subsequent sales ignored the taxpayer purchaser's interest; and that the parties disregarded the terms of the contract. *Id.* at 351-54.

148. *Id.* at 354 (citing *Grodt & McKay*, 77 T.C. at 1243). Since the taxpayers had not investigated their investment, had not protected their investment once made, had not controlled the property, and had not protected their interest upon its disposition, there was a failure of the "requisite minimum business purpose." *Id.* at 354.

149. *Id.* at 355. *Falsetti* has been followed by the Tax Court in other sales situations. *See, e.g.*, Helba v. Commissioner, 87 T.C. 983 (1986) (applying the sham in substance test, looking at both the substance of the transaction and the business purpose in a case involving a purchase of videotape productions).

150. *See* Gideon, *supra* note 10, at 842-43 (urging that the key is the determination of ownership).

151. 710 F.2d 1302, 1307 (7th Cir. 1983).

the court concluded that "[t]he unrealistic price in the contract, together with the payment terms and history, the family relationship, the presence of a strong tax-avoidance motive, and the informality of the arrangement"[152] warranted the conclusion that the sale was a sham transaction. While Judge Posner mentioned the taxpayer's tax avoidance motive, his opinion otherwise supports a substance of the transaction test as proposed in this article. Under the proposed test, the court should respect a sale type of transaction for tax purposes if and only if the substance of the transaction reflects the transfer of the incidents of ownership to the purchaser. It does not enhance the analysis to call the transaction a "sham" or a "phony."[153]

Another example of the emphasis on the substance of a transaction while reaching a conclusion that the transaction was a sham is *Thompson v. Commissioner*.[154] In that case, the Ninth Circuit upheld the Tax Court determination that the real property sold was disproportionately overpriced and that the sale was a sham.[155] An additional factor the court relied on was the option of the seller to repurchase the land for a substantially lower price than that at which it was sold to the purchaser. The Ninth Circuit noted the transaction was probably artificially arranged to create tax benefits. However, that determination was not necessary to sustain the Tax Court's decision. The key to the decision appears to be the artificially high price at which the seller sold the property. At bottom, this constituted the basis for disregarding the transaction. Under the approach proposed in this article, the court should analyze the substance of the transaction. Certainly a key factor in the analysis is the level of the purchase price and the method of financing the transaction.

Thus, in evaluating typical cases involving purported sales transactions, courts need not utilize the sham transaction doctrine. The critical inquiry involves determining the substance of the transaction. Courts can answer this inquiry by evaluating a series of factors such as those enumerated in *Grodt & McKay* for determining whether a sale has occurred, i.e., whether the benefits and burdens of ownership shifted to the buyer. In essence, that is a substance of the transaction analysis. The sham transaction doctrine, interpreted as a substance of the transaction test, is already included in the determination of whether the

152. *Id.*
153. *See id.* at 1304, 1307.
154. 631 F.2d 642 (9th Cir. 1980), *cert. denied*, 452 U.S. 961 (1981).
155. *Id.* at 646-49.

transaction is a sale. To the extent that the sham transaction doctrine involves inquiry into taxpayers' motives, it suffers from the problems discussed above.[156]

C. *Interest Deductions*

Over the years, numerous courts have discussed the sham transaction doctrine in cases involving claimed interest deductions. These cases are most appropriately analyzed under the proposed substance of the transaction test: Has the taxpayer made a genuine payment of interest on a real debt; is the payment made for the use of money?[157] The application of this test is best understood by exploring several types of situations involving interest deductions in which courts have previously invoked the sham transaction doctrine.

One frequent scenario challenged recently under the sham transaction doctrine concerns circular financing schemes, involving circulation of funds creating formal but artificial interest payments. In a series of cases, the Ninth Circuit denied interest deductions under the sham transaction doctrine, using many of the variations of the doctrine described above.

In an early example, *United States v. Clardy*,[158] the Ninth Circuit focused on the facade aspects of the transaction, using words such as pretended, sham, and illusion. The defendant had engineered for other taxpayers the purported prepayment of substantial amounts of interest by utilizing a check swapping technique. In reality, the self-cancelling transactions of loans and payments resulted in the involved parties ending up in the same position they started from, but for the purported payment of interest. The court concluded that the taxpayers had no serious intent to complete any of the transactions. There was no real money in existence. The court wrote that a "'a loan' was made from the prepaid interest which it was supposed to enable to be 'paid.'"[159] Hence, no prepaid interest was paid. In *Clardy*, the court's analysis focused on the illusory nature of the transaction, and questioned whether any substance existed behind the forms given to the arrangement.[160] Finally, the court drew an analogy to *Knetsch*, concluding that these

156. *See supra* text accompanying notes 93-102.

157. The definition of interest as "compensation for the use or forbearance of money" stems from Deputy v. du Pont, 308 U.S. 488, 498 (1940), and is frequently cited. *See, e.g., Knetsch*, 452 U.S. at 365; Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976).

158. 612 F.2d 1139 (9th Cir. 1980).

159. *Id.* at 1151.

160. *Id.* at 1152.

were paper transactions solely used to create interest deductions without any intent to complete the transactions.[161]

Seven years later, another circular financing scheme was utilized to create purported interest deductions in *United States v. Schulman*.[162] As in *Clardy*, the taxpayer undertook check swapping to create "loans" and corresponding interest payments. In concluding that the transactions were shams, the Ninth Circuit relied on *Commissioner v. Court Holding Co.*[163] for the principle that "the true nature of a transaction may not 'be disguised by mere formalisms, which exist solely to alter tax liabilities.'"[164] The Ninth Circuit also relied on *Knetsch* as establishing the requirement that there be genuine indebtedness. The test, according to the court, was "whether there were real interest payments on genuine indebtedness."[165] The transactions were void of substance because of the lack of economic risk associated with the loans.[166] The debts did not involve a genuine conveyance of real money. Hence, the court determined that the transactions were shams and permitted the case against the taxpayer to go forward.

In a final example from the Ninth Circuit, *Bail Bonds By Marvin Nelson, Inc. v. Commissioner*,[167] the court defined a sham as a transaction that "has no purpose or economic effect other than the creation of tax deductions" and stated that the focus should be on the substance of the transaction.[168] The business purpose portion of the test involved the subjective issue of the taxpayer's motivation. Economic substance, on the other hand, involved determination of whether the substance coincided with the form and whether economic benefits were likely to result from the transaction. In this case, through fictitious transfers of money, the taxpayer supposedly borrowed $25,000 from one entity and purported to pay the principal and interest back with loans from a related entity. The court concluded that the transaction was a sham because the taxpayer had no business purpose for the loans, the loan and repayment were simply circulation of funds through a tax avoidance system, no evidence existed of a legal obligation to repay the

161. *Id.* at 1153.

162. 817 F.2d 1355 (9th Cir.), *cert. dismissed*, 108 S. Ct. 362 (1987).

163. 324 U.S. 331 (1945).

164. *Schulman*, 817 F.2d at 1359 (quoting *Court Holding Co.*, 324 U.S. 331, 334 (1945)).

165. *Id.*

166. *Id.* at 1359-60. A similar approach focusing on the substance of the transaction is found in Goldberg v. United States, 789 F.2d 1341 (9th Cir. 1986), where the court upheld a determination of sham because of the absence of arm's-length transactions and the failure of the taxpayer to show "any actual economic liabilities of any substance." *Id.* at 1343.

167. 820 F.2d 1543 (9th Cir. 1987).

168. *Id.* at 1548.

loan except at best a purely formal obligation, and no evidence was demonstrated that the loans could have benefited the taxpayer economically.[169]

The courts should analyze all of these cases in a straightforward manner under the substance of the transaction test. The taxpayers had no real obligation to repay an actual indebtedness, hence there was no payment of interest for the use or forbearance of money. The key, then, is to identify whether the transaction complies with the statutory language requiring (1) interest, (2) paid or accrued on, (3) indebtedness.[170] The courts should determine these component factors by analyzing the economic substance of the transaction, without considering the investment's business purpose.[171] The courts would not need to conduct a business purpose analysis. In some ways, *Knetsch* is an example of this scenario, for it involved a circular scheme of borrowing, payment of interest on the loan, and rebates of interest through the loan back of money (the excess of cash value over the amount of debt).[172] Looking at the substance of the transaction from that perspective, the rebates of interest offset the obligation to pay corresponding amounts of interest. Characterization of the remaining interest as a fee for the tax deduction is not unreasonable.[173] Another example is *Salley v. Commissioner*,[174] in which the taxpayer borrowed substantial amounts from an insurance company, paying interest on the loans. Concomitantly, the taxpayer received substantial amounts as nontaxable insurance dividends resulting in a net, out-of-pocket expenditure of $7,000 and interest deductions of $50,000. Relying on *Knetsch*, the Fifth Circuit found no economic substance to the transaction, no payment for the use or forbearance of money, and no business purpose.[175] The business purpose aspect is irrelevant under the proposed analysis. The court would reach the same result by simply analyzing the substance of the transaction.[176]

Application of the substance of the transaction test in place of the sham transaction doctrine would not produce startling results in this

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169. *Id.* at 1550.

170. I.R.C. § 163(a) (1986).

171. *See generally* Asimow, *supra* note 24 (providing economic analysis of what is interest and what is indebtedness and describing and criticizing cases).

172. *Knetsch*, 364 U.S. at 366.

173. *Id.*

174. 464 F.2d 479 (5th Cir. 1972).

175. *Id.* at 482-85.

176. The court in *Salley* also relied on the Second Circuit opinion in *Goldstein*, discussed *infra* at notes 181-89, stating that where there is no business purpose and no economic substance the transaction need not be given effect for tax purposes.

context. Indeed, it is an approach several courts have long favored, most notably the Second Circuit in *Lynch v. Commissioner*.[177] In that case, Judge Friendly eschewed looking at the taxpayer's purpose but instead evaluated the substance of the entire transactions, the "objective realities."[178] These "realities" indicated that the elaborate forms which the taxpayer utilized did not result in legal transactions involving the use or forbearance of money, and hence the claimed interest deduction was disallowed.[179]

A second scenario involving challenges to interest deductions derives from taxpayers borrowing at interest rates higher than the income generated by their investment of borrowed funds. Of course, the factors in *Knetsch* itself involved this type of situation: Knetsch borrowed at 3 1/2 percent in order to purchase annuity bonds yielding 2 1/2 percent interest.[180] Another illustration of the problems posed in analyzing this type of transaction is found in the 1966 Second Circuit decision in *Goldstein v. Commissioner*.[181] In this case, made famous by its inclusion in basic federal tax casebooks,[182] Tillie Goldstein won the Irish Sweepstakes resulting in a substantial increase in her income. She borrowed significant amounts from a bank and used the funds to purchase U.S. Treasury notes, which she pledged as collateral to secure the loan. Goldstein prepaid interest on the loan and claimed the expense as an interest deduction in the year the Sweepstakes proceeds were declared as income. The interest which the taxpayer paid on the loans (4 percent) was substantially higher than what she earned on the government obligations (1 1/2 percent).[183]

The Second Circuit held that the transactions were not shams, relying on four factors. First, the banks involved were independent financial institutions. Second, the loans did not return the parties to their starting points within a few days. Third, the independent financial institutions had significant control over the future of the loan arrangements. Fourth, the notes were recourse notes. Hence, the

177. 273 F.2d 867 (2d Cir. 1959).

178. *Id.* at 872.

179. *Id.* at 871-72; *see also* Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959) (concluding that the substance of the transaction was neither borrowing of funds nor the payment of interest); Karme v. Commissioner, 73 T.C. 1163 (1980) (applying substance of the transaction test and concluding loan transaction was a sham), *aff'd*, 673 F.2d 1062 (9th Cir. 1982).

180. 365 U.S. at 362-63.

181. 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

182. *See, e.g.*, W. ANDREWS, BASIC FEDERAL INCOME TAXATION 461 (3d ed. 1985).

183. 364 F.2d at 739.

Second Circuit concluded that the transactions were not shams and did not fail to create genuine indebtedness.[184]

Despite finding that the transactions were not shams, the Second Circuit nonetheless refused to allow an interest deduction on the loan[185] The evidence demonstrated that the taxpayer would suffer an economic loss on the transaction given the excess of the interest rates paid on the loan over those earned on the purchased Treasury obligations. The court discounted the taxpayer's explanation that the transaction might produce a profit if the market for Treasury obligations rose. Thus, the court concluded that the taxpayer entered the transactions "without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction in 1958 which could be deducted from her sweepstakes winnings in that year."[186] Hence, the court concluded that section 163(a) did not permit an interest deduction where the transactions "can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences."[187]

The Second Circuit attempted to coordinate the broad scope of section 163 and the question of motive addressed in *Gregory v. Helvering*. The court admitted that the congressional purpose behind section 163 was broad, but the court believed that limits were inherent in Congress' decision to encourage purposive activity financed through borrowing. The court wrote that

> 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 with 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.[188]

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184. *Id.* at 737-38. The court distinguished here *Lynch*, discussed in text accompanying *supra* notes 177-79, and *Goodstein*, discussed *supra* note 179, as cases were the "'sham' and 'absence of indebtedness' rationales" are best reserved, because of the absence of most of these four factors. 364 F.2d at 738.

185. 364 F.2d at 742.

186. *Id.* at 740.

187. *Id.*

188. *Id.* at 741.

While struggling with the language in *Gregory* that a taxpayer has the right to try to decrease his taxes lawfully, the court was reluctant to permit the deduction when the transaction had no substance or purpose aside from a tax benefit. Otherwise, investors would undertake transactions with no economic utility. Thus, the court concluded that when the arrangement possessed no substance, utility, or purpose beyond the tax deduction, there should be no deduction. The court carefully distinguished this ground from a finding of a sham transaction.

The best way to accommodate these concerns in the case of interest deductions is to evaluate the substance of the transaction and determine what kind of arrangement really is involved. This analysis becomes particularly difficult in cases such as *Goldstein* because of two different views of substance. With respect to the simple borrowing of money, where there is a real obligation to pay interest, the substance over form test would suggest that the interest deduction is proper. The form of the transaction corresponds to a genuine obligation to pay the principal and to compensate the lender for the use of that principal, i.e., interest. Even here, however, the Internal Revenue Service could argue that the payments are not, in fact, interest as that term is understood.[189] On the other hand, when one analyzes the economic substance of the whole transaction, the taxpayer is borrowing at 4 percent and earning interest at 1 1/2 percent, a transaction which lacks any likelihood of economic benefit. This analysis suggests that when, as here, no economic benefit accompanies the transaction when viewed as a whole, the taxpayer should receive no tax relief. Thus, despite the fact that the taxpayer genuinely incurs an obligation to pay interest, the whole transaction lacks economic substance.

This conclusion requires a choice of whether to evaluate the transaction step by step, or to compress the transaction and consider it in its entirety. This decision opens the debate inherent in the application of the step transaction doctrine, another doctrine used to combat tax avoidance. The traditional situations in which courts have invoked the step transaction doctrine are: 1) where the taxpayer intends to reach a particular result at the end of a series of steps, 2) where the taxpayer engages in steps which are so interdependent that the separate steps would be fruitless if not accompanied by the others, and 3) where the taxpayer has made a binding commitment to take subsequent steps

189. *See* Gunn, *supra* note 7, at 753 (arguing Goldstein's payment was not interest because the payment was not for the use of money, analogizing to Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), and Lynch v. Commissioner, 273 F.2d 867 (2d Cir. 1959)).

after taking the first step.[190] The step transaction doctrine retains the possibility of using state of mind considerations in determining when to view separate steps as an integrated whole.[191] Again, it appears that the central analysis should inquire into the substance of the transaction looking at its entirety.[192] Thus, in the *Goldstein* situation, combining an inquiry into the substance of the entire transaction with the step transaction doctrine would lead the court to deny the deduction.[193]

Estate of Franklin v. Commissioner[194] typifies another situation involving interest where courts successfully have applied the substance of the transaction test. In that case, the Ninth Circuit denied an interest deduction on the ground that where the transaction involved nonrecourse debt, and where the taxpayer did not show that the purchase price of the property approximated fair market value, the purchaser-borrower had not secured the use or forbearance of money.[195] In the court's view, the nonrecourse debt would have economic significance only if the property substantially appreciated in value. This result was necessary to make the debt bona fide and capable of justifying an interest deduction. In other words, the court believed that a real debt with legitimate interest expense would exist only when it was economically reasonable for the taxpayer to invest in the amount of the unpaid purchase price. Although the Commissioner argued that the transaction was a sham, and the Tax Court held that the transaction was the purchase of an option to acquire property, the Ninth Circuit emphasized that the substance did not mesh with the form of the transaction when the purchase price exceeded fair market value. With respect to the interest deduction, the nonrecourse nature of the loan coupled with the purchase price in excess of fair market value meant that "the transaction in economic terms [was] a mere chance that a genuine debt obligation may arise."[196]

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190. *See* Chirelstein & Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 TAXES 970 (1982) (describing the three major variations of the step-transaction doctrine, known as the end result test, the mutual interdependence test, and the binding commitment test).

191. Blum, *supra* note 93, at 529-36.

192. *See supra* notes 93-102. According to Rice, *supra* note 3, at 1046-47, with respect to the step-transaction doctrine, "prediction is difficult to the point of impossibility, . . ." and he urged evaluation of objective evidence.

193. This approach advocated here differs substantially from that recommended by Asimow, *supra* note 24, at 791-93, who embraced the implication of a requirement of motive in § 163. Recognizing that motive is difficult to prove and that it must be determined on the basis of what actually happened, he wondered whether there were any real differences.

194. 544 F.2d 1045 (9th Cir. 1976).

195. *Id.* at 1049.

196. *Id.*

Thus, although ultimately not a sham transaction case, *Estate of Franklin* illustrates how courts can answer a common question of the propriety of interest deductions satisfactorily by using the substance of the transaction analysis.[197]

Significant congressional action makes the analysis of interest deductions substantially easier today. Congress has reacted to efforts of taxpayers as described above by limiting deductibility of investment interest[198] and interest on debt incurred to purchase or carry tax exempt obligations.[199] These statutory provisions will reduce the need to use judicial doctrines to combat tax avoidance involving interest. Moreover, tax avoidance potential is diminished after the 1986 Tax Reform Act through the denial of personal interest deductions.[200]

D. *Application to Trusts and Gift-Leasebacks*

A number of recent cases have disregarded family trust or other similar arrangements on the grounds that they were shams. These cases have applied a variety of theories to conclude almost uniformly to disregard the transactions for tax purposes. In the context of trusts and gift-leasebacks, it is again appropriate to conclude that the courts' use of the sham transaction doctrine is unnecessary and possibly misleading. Particularly in the trust area, courts successfully can analyze the underlying situation through the use of the substance of the transaction doctrine and other judicial doctrines and statutory limitations already in place.

In evaluating trust arrangements, numerous courts have used multiple theories, including the sham transaction doctrine, in disregarding particular transactions for tax purposes. An illustrative case is *Neely v. United States*.[201] The Ninth Circuit found a sham transaction when the taxpayers transferred title to certain family assets to a family

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197. *Compare id.* at 1045 *with* Karme v. Commissioner, 73 T.C. 1163 (1980), *aff'd*, 673 F.2d 1062 (9th Cir. 1982) (utilizing substance of the transaction test and *Estate of Franklin* criteria to conclude loan transaction was a sham where there was great discrepancy between purported indebtedness and fair market value of asset, where taxpayer failed to investigate purchase, where circular transactions were involved, and where inconsistencies were found in documents). *See* Asimow, *supra* note 24, at 790-91 (arguing that *Estate of Franklin* will be "difficult to administer" but is theoretically sound).

198. I.R.C. § 163(d) (limiting deduction for investment interest to net investment income).

199. I.R.C. § 265(a)(2) (1986) (denying deduction for interest on indebtedness incurred or continued to purchase or carry tax exempt obligations).

200. I.R.C. § 163(h) (disallowing personal interest deduction except for qualified residence interest).

201. 775 F.2d 1092 (9th Cir. 1985).

trust. The taxpayers nonetheless retained the use and enjoyment of the assets, and sought deductions for expenses connected to the creation and management of the trust. The court defined a sham transaction as one without economic effect apart from the creation of income tax consequences.[202] Although the court adopted a substance over form analysis, it also stated that it would disregard a transaction if the taxpayer's sole purpose was tax avoidance. This analysis embraces a business purpose doctrine as well as an economic substance approach. In addition to concluding that the transaction was a sham, the court determined that the grantor trust provisions of the Internal Revenue Code were not satisfied because of the substantial control that the grantor (taxpayer) retained. This finding would also require taxing the grantor. Hence, the court set forth a series of factors as the rationale for affirming the district court's decision to disallow the deductions.

Another illustration of the use of multiple theories culminating in the finding of a sham transaction is the Eighth Circuit's decision in the family trust case *F.P.P. Enterprises v. United States*.[203] Here, the court focused primarily on the question of economic substance. The court concluded that the trusts were shams without economic substance because the taxpayers continued to exercise control over assets which they had purported to transfer in trust.[204] In addition, the court stated that the continued control demonstrated that the transfers to the trusts violated state law defining fraudulent conveyances. The state's law did require an intent to defraud, which the court found from evidence that the taxpayer transferred assets to the trusts to shelter his assets from potential creditors and claimants.[205] Finally, the court concluded that the trusts were simply the alter egos of the taxpayers and were not entitled to separate tax treatment. Again, the court utilized a variety of theories in reaching the conclusion that the transaction was a sham.

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202. *Id.* at 1094.

203. 830 F.2d 114 (8th Cir. 1987).

204. *Id.* at 118. The taxpayer transferred to a trust created by another person all of his properties in exchange for shares of the trust. The taxpayer continued to live in and use the properties and to pay the expenses. The government sought to levy on certain of the property conveyed to the trust to satisfy the taxpayer's tax liability.

205. *Id.*; *see also* Carr Enterprises, Inc. v. United States, 698 F.2d 952 (8th Cir. 1983) (finding transfer to trust both a sham transaction and a fraudulent conveyance under state law). These cases raise the problem of linkage between state law and federal tax law. Courts should be wary of connecting the two areas unless Congress has clearly spoken or has clearly left an area to be governed by state law. *Cf.* Boyter v. Commissioner, 668 F.2d 1382 (4th Cir. 1981) (considering sham transaction doctrine in the context of divorce, a matter normally governed under state law).

Several of the recent family trust cases have also utilized the assignment of income doctrine from *Lucas v. Earl*,[206] as well as the sham transaction doctrine, to disregard the form of a trust. For example, the Tenth Circuit in *Holman v. United States*[207] applied the assignment of income doctrine, the grantor trust provisions, and the sham transaction doctrine in reaching the conclusion that the trust was a sham which should be disregarded. Applying *Lucas v. Earl*, the Tenth Circuit found that the taxpayer's trust was a "transparent attempt" to assign the income of the doctor-settlor, because the trust did not supervise the doctor's employment, the trust did not determine his compensation, and the doctor had no obligations to perform for the trust.[208] With respect to the grantor trust provisions of the Internal Revenue Code, the court found that the taxpayer violated aspects of sections 671-79 in that he could exercise power over the trust without consent of an adverse party.[209] This failure to satisfy the judicial assignment of income doctrine and the statutory grantor trust provisions led the *Holman* court to conclude that the transaction was a sham. The court observed both that the transaction was simply designed for tax avoidance purposes and that the transaction lacked any economic substance, the two aspects of *Rice's Toyota World* test for a sham transaction. Thus, *Holman* illustrates the approach of numerous courts using a substantial number of the vast array of weapons to disqualify a transaction.[210]

The Fifth Circuit in *United States v. Buttorff*[211] followed a similar approach, holding a trust invalid because it was fraudulent, violated the assignment of income doctrine, violated the statutory grantor trust requirements, and was a sham. Sham was defined as "wholly lacking in any real substance."[212] However, the court engaged in no significant independent analysis of the sham nature of the transaction. Although the court used the test for a sham transaction advocated in this article,

206. 281 U.S. 111 (1930). The Supreme Court established that income should be taxed to the person earning it, and that anticipatory assignments of income were ineffective to transfer tax liability. *Id.* at 112. The role of the assignment of income doctrine as a means of reducing improper tax avoidance is discussed in Gunn, *supra* note 7, at 758-65.

207. 728 F.2d 462 (10th Cir. 1984).

208. *Id.* at 464.

209. *Id.* at 464-65.

210. *See also* Hanson v. Commissioner, 696 F.2d 1232 (9th Cir. 1983) (refusing to give tax effect to a family trust which was an anticipatory assignment of income, which had no economic substance, and which did not conform to the grantor trust provisions). *Knetsch* was cited as support for the conclusion to disregard the transaction. *Id.* at 1234.

211. 761 F.2d 1056 (5th Cir. 1985).

212. *Id.* at 1062.

i.e., the test of economic substance, there seems to be little need for the sham transaction doctrine in this context when other doctrines or approaches are more precisely tailored to analyze the problem.[213]

Zmuda v. Commissioner illustrates the convergence of the various theories in the trust area.[214] The Ninth Circuit concluded in *Zmuda* that "[t]here is no real difference between the business purpose and the economic substance rules; both simply state that the Commissioner may look beyond the form of a transaction to discover its substance."[215] The court observed that the judiciary generally invokes the business purpose rule to determine the validity of the formation of an entity. In contrast, courts apply the economic substance rule more often in the context of particular transactions. However, courts have applied the economic substance rule in the context of business purpose determinations and vice versa. Thus, because the business purpose and economic substance rules have the same rationale, both emphasizing substance over form, the court concluded that the trusts were shams under either test.[216] The critical factors noted were the complete control retained by the settlors and the trusts' complete absence of business activity.[217]

The gift-leaseback situation is closely related to the trust area, and the sham transaction analysis is equally unnecessary in this context. In the typical gift-leaseback situation, a donor gives property to a trust established for his children and then leases the property back for use in his business. The donor seeks to take rental deductions under section 162(a)(3)[218] and to have the children report the rental income

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213. Examples of this approach abound. *See also* United States v. Krall, 835 F.2d 711 (8th Cir. 1987) (finding a sham on grounds of the taxpayer's exercise of control and by examination of the true nature of the transaction); United States v. Smith, 657 F. Supp. 646 (W.D. La. 1986) (finding a sham after looking at the substance of the transaction, finding that the only economic effect was to create deductions, but also stating that there must be a legitimate business purpose for the conveyance and leaseback of property).

214. 731 F.2d 1417 (9th Cir. 1984).

215. *Id.* at 1420.

216. *Id.* at 1423.

217. *Id.* at 1421. The essential facts in *Zmuda* involved the transfer by the Zmudas of income producing property to a foreign trust, which distributed income to another foreign trust, which loaned money to the Zmudas in exchange for promissory notes, which were then delivered as gifts to the Zmudas. *Id.* at 1419.

218. I.R.C. § 162(a)(3) (1986) allows a deduction for "rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

at their lower bracket rate.[219] The Commissioner has attacked this gift-leaseback approach as a sham transaction because the arrangement merely involves a taxpayer creating a rental obligation in order to reduce his taxes.[220] The Commissioner has urged that a business purpose must exist for the entire gift-leaseback transaction, not just for the leaseback itself.[221]

Courts evaluating gift-leaseback transactions have also taken a variety of approaches. One view, endorsed by the Fourth Circuit in *Perry v. United States*[222] and the Fifth Circuit in *Van Zandt v. Commissioner*,[223] required a business purpose for the entire transaction, i.e., for the gift *and* the leaseback. These opinions embraced the view that "a multistep transaction [should be judged] by its overall effect and not simply by scrutiny of mutually dependent steps,"[224] and that deductibility under section 162 requires that the whole transaction have a business purpose.[225] This analysis would, of course, invalidate most gift-leasebacks because a business purpose rarely accompanies the original gift; it usually is undertaken to minimize taxes by division of income among family members. Moreover, to consider providing for one's children's well-being as a business purpose would render the business purpose requirement meaningless.[226] Interestingly, the Fifth Circuit subsequently embraced a substance over form analysis in *Mathews v. United States*[227] and disregarded a gift-leaseback arrange-

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219. The "kiddie tax," enacted in the Tax Reform Act of 1986, eliminates the benefits of this approach for children under age 14, since they are taxed at their parents' marginal rate. I.R.C. § 1(i) (1986).

220. *See, e.g.*, Rosenfeld v. Commissioner, 706 F.2d 1277, 1280 (2d Cir. 1983) (upholding gift-leaseback since trustees were independent and taxpayer's control was not substantially the same under trust).

221. *See, e.g., id.* at 1281; Quinlivan v. Commissioner, 599 F.2d 269, 272 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979) (and cases cited therein).

222. 520 F.2d 235 (4th Cir. 1975), *cert. denied*, 423 U.S. 1052 (1976).

223. 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

224. *Perry*, 520 F.2d at 238.

225. *Id.* at 238-39; *Van Zandt*, 341 F.2d at 443-44. *Van Zandt* noted that "factors such as the short term of the trust, reversion to the settlors, predetermination of the right to possession of the property, and the like, while perfectly permissible so far as taxability of the trust and the settlors goes, bear heavily on the element of business purpose." *Id.* at 444. Hence the court denied a rental deduction.

226. *See also* Peroni, *Untangling the Web of Gift-Leaseback Jurisprudence*, 68 MINN. L. REV. 735, 762-63 (1984) (arguing donor's purpose in gift-leaseback is consistent with Congress' intent in enacting grantor trust provisions and that meaning of gift is incompatible with business purpose concept).

227. 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

ment because the taxpayer was in the same position both before and after the creation of the trust. The taxpayer retained complete control over the property at all times so the transaction was devoid of economic reality.[228]

On the other hand, a number of appellate courts have endorsed the Tax Court's approach of evaluating four factors. Pursuant to this approach, the courts permit a rental deduction if: 1) the grantor did not retain substantially the same control over the property, 2) the leaseback was in writing and required reasonable rent to be paid, 3) the *leaseback* had a bona fide business purpose, and 4) the grantor did not have a disqualifying equity in the property.[229] Illustrative of this approach is *Rosenfeld v. Commissioner*[230] in which the Second Circuit concluded that a gift-leaseback was not a sham. After describing the Tax Court's four-factor test, the Second Circuit focused on the business purpose issue. The court noted that Congress had explicitly addressed the question of short term trusts in the Clifford trust provisions of sections 671-78. Thus, the court determined that the Commissioner's argument requiring a business purpose for the gift as well as the leaseback ignored the policy determination that Congress had made concerning the shifting of income.[231] Trusts complying with the statutory grantor trust provisions were valid trusts, and thus the Second Circuit refused to adopt the Commissioner's business purpose standard as an additional gloss on gift-leasebacks.[232]

Instead of a business purpose test for the entire transaction, the Second Circuit embraced in effect a substance of the transaction test. Specifically, the court wrote that "our inquiry should focus on whether there has been a change in the economic interests of the relevant parties. If their legal rights and beneficial interests have changed, there is no basis for labeling a transaction a 'sham' and ignoring it for tax purposes."[233] Because a real change in the legal rights and economic

228. *Id.* at 325. Although *Mathews* utilizes the economic reality test and *Van Zandt* uses the business purpose test, in some ways it is difficult to say that *Mathews* is a departure from *Van Zandt* because the former refers frequently to the latter as precedent.

229. *See, e.g.*, the Tax Court opinions in May v. Commissioner, 76 T.C. 7, 13 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984); Mathews v. Commissioner, 61 T.C. 12, 18-19 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

230. 706 F.2d 1277 (2d Cir. 1983).

231. *Id.* at 1281-82.

232. *Id.* at 1282-83. The court cited in support numerous commentators. *See id.* at 1282 n.5. Other courts take the same view. *See, e.g.*, Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979) (if requirements of §§ 162(a)(3) and 671-78 are met, taxpayers are entitled to deductions).

233. *Rosenfeld*, 706 F.2d at 1282.

positions of the parties had occurred (e.g., broad powers were given to independent trustees, a fair rental was required of the donor, and the donor retained no right in the property), the court concluded that the transaction was not a sham. Almost in passing, the court also noted legitimate nontax motives for the gift-leaseback did exist, i.e., the financial protection of the children and the need to have a business office.[234] Why the court felt it necessary to mention motive when the court had earlier noted that Congress legitimated income shifting devices in the Clifford trust context is unclear.[235] In light of the court's holding that the transaction was valid because it substantially changed the taxpayer's economic and beneficial rights, and because the court rejected the business purpose requirement for the entire transaction, this brief reference to motive properly should be ignored.

The *Rosenfeld* approach is similar to that of a number of other circuit courts. The courts elaborate additional factors in many of these opinions to provide guidance for evaluation of whether the taxpayers have accomplished a change in beneficial interests. For example, in *May v. Commissioner*,[236] the Ninth Circuit evaluated the sufficiency of a property transfer in terms of the duration of transfer, the donor's retained control, the donor's subsequent use of the property for his own benefit, and the trustee's independence.[237] When these factors were satisfied, the transfer was "grounded in professional or economic reality,"[238] and was not a sham. The taxpayer could deduct rental payments under section 162(a)(3) because the leaseback portion of the transaction had a business purpose. A focus on the requirements of section 162(a)(3) is another approach which some courts have endorsed. This approach goes to the substance of the transaction concept as measured by particular statutory requirements.[239]

In conclusion, the sham transaction doctrine is unnecessary in the trust and gift-leaseback areas. With respect to trusts, numerous statutory provisions narrow the range of maneuverability for taxpayers. Courts should coordinate judicial doctrines with these statutory formu-

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234. *Id.*

235. *Id.* at 1281-82.

236. 723 F.2d 1434 (9th Cir. 1984).

237. *Id.* at 1436. These factors had previously been elaborated in Brooke v. United States, 468 F.2d 1155, 1157 (9th Cir. 1972).

238. *May*, 723 F.2d at 1437.

239. *See, e.g.* Quinlivan v. Commissioner, 599 F.2d 269, 272-74 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979) (also rejecting the test of a business purpose for the whole transaction and noting specific congressional action regarding Clifford trusts). *See generally* Peroni, *supra* note 226 (analyzing grantor retention of reversionary interest under § 162(a)(3)).

lations.[240] The judiciary can best accomplish this goal by analyzing the substance of the transaction. With respect to gift-leasebacks, no specific statutory framework exists.[241] However, in light of the parallels between gift-leasebacks and trusts as devices to transfer wealth or income, it is also desirable for courts to focus on the substance of the transaction test in determining whether the transaction will be respected as structured.[242]

E. *Straddles*

Courts have utilized the sham transaction doctrine in a series of recent cases to deny tax effect to various permutations of straddles. These cases can be grouped into two categories according to the specific nature of the sham transaction doctrine applied by the courts.

One approach has focused on the fictitious or fake nature of the transaction. *Forseth v. Commissioner*,[243] a case concerning multiple taxpayers engaged in precious metal commodity straddles, typifies this line of decision. Several courts of appeals affirmed the Tax Court's determination that the transactions were factual shams involving fictitious activity.[244] In *Forseth*, the Tax Court focused on the substance of the transaction and concluded the taxpayers had failed to prove that real precious metals were involved or that a real market or actual trading existed. Instead, the Tax Court found that the promoter's role "was to contrive and/or manipulate an unregulated and unpublished market in gold and platinum forward contracts so that it would de-

240. Of course, the statutory grantor trust provisions themselves derived from early judicial decisions. As Fuller has noted, "[t]he development of the Code provisions governing grantor trusts is the classic example of the evolution of independent, objective criteria of tax law from broad statements of judicial decisions, to administrative regulation, to codification." Fuller, *supra* note 3, at 396. Once Congress has acted, then judicial doctrine should carefully complement the statutory framework.

241. The legislative context for gift-leasebacks is described in Peroni, *supra* note 226, at 752-56. He concluded that Congress left to the courts the limitation of abusive gift-leasebacks, and that courts should be guided by the grantor trust rules.

242. Peroni, *supra* note 226, at 744. Peroni also argued that the courts have improperly applied a business purpose analysis and urged that the key test be "what the transaction accomplished." *Id.* at 745. *Cf.* Gunn, *supra* note 7, at 742-43 n.34 ("Since there is no economic difference between the assignments of income permitted under the grantor trust provisions and those involved in a transfer and leaseback, the rules the courts devise for the leaseback cases should parallel those of the grantor trust sections.").

243. 85 T.C. 127 (1985).

244. Forseth v. Commissioner, 845 F.2d 746 (7th Cir. 1988); Enrici v. Commissioner, 813 F.2d 293, 296 (9th Cir. 1987); Mahoney v. Commissioner, 808 F.2d 1219, 1220 (6th Cir. 1987) (unpublished opinion); Bramblett v. Commissioner, 810 F.2d 197 (5th Cir. 1987) (unpublished opinion); Wooldridge v. Commissioner, 800 F.2d 266 (11th Cir. 1986) (without opinion).

liver"[245] promised tax losses to the taxpayers, and that the sole purpose involved was tax avoidance. Indeed, at various times, the Tax Court expressed the view that the transactions were artificial and unreal.[246] The courts of appeals in several circuits have affirmed the Tax Court's reasoning in striking down these transactions as fictitious, unreal, and artificial.[247] In subsequent cases, the Tax Court referred to *Forseth*'s factual sham test as involving "those situations where the taxpayer does not establish the jural relationship he purports to create."[248] Courts have used the sham transaction doctrine in a number of other cases to disregard arrangements involving straddles because the courts found that the transactions were fake or fictitious.[249]

Glass v. Commissioner[250] exemplifies the second approach to the sham transaction doctrine in relation to straddles, focusing on both motive and substance. Here, the Tax Court determined that the taxpayers did not enter the transactions primarily for economic profit, and that the expected economic benefits were slight compared to tax benefits.[251] The essence of the taxpayers' arrangements was to engage

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245. *Forseth*, 85 T.C. at 165. Factors which led the Tax Court to reach this conclusion included close correlation between tax benefits and taxpayers' tax needs; accurate predictions by the promoter of the tax benefits; failure of the promoter to enforce margin requirements to insure against risks; absence of credible third-party evidence of published prices in the London market for forward contracts in the metals and closing of taxpayers' accounts at convenient prices; prescience in an inherently volatile market; unexplained bookkeeping entries without documentation; lack of documentation of initial market-maker positions; manipulation of trading records.

246. *See, e.g., id.* at 156-63.

247. *See Forseth*, 845 F.2d at 749 ("entire tax straddle arrangement was an artifice, the essence of which was the sale of bogus tax losses to [taxpayers] for a fee."); *Enrici*, 813 F.2d at 296 (upholding Tax Court conclusion that taxpayers were "rigging paper prices, losses, and gains to effectuate a sale of generated tax losses," and stating that the transactions were "artificial transactions," not "real transactions"); *Mahoney*, 808 F.2d at 1220 (taxpayers "really just paid a fee to buy fictitiously generated tax losses" tailored to their precise needs).

248. *See, e.g.* Glass v. Commissioner, 87 T.C. 1087, 1176 (1986), *aff'd sub nom.* Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988).

249. *See, e.g.*, Brown v. Commissioner, 85 T.C. 968, 1000 (1985) (transactions were not bona fide but were fake or fictitious), *aff'd sub nom.* Sochin v. Commissioner, 843 F.2d 351 (9th Cir.), *cert. denied*, ___ U.S. ___, 109 S. Ct. 72 (1988); Julien v. Commissioner, 82 T.C. 492, 508 (1984) (no evidence that straddle transactions actually occurred; "a grotesque distortion of the orthodox commodity straddle"); United States v. Atkins, 661 F. Supp. 491, 496 (S.D.N.Y. 1987) (prearranged or bogus transactions in commodities); Price v. Commissioner, 88 T.C. 860, 883-84 (1987) (fictitious transactions in securities where no securities existed).

250. 87 T.C. 1087 (1986), *aff'd sub nom.* Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988). According to the *Yosha* court, nine other circuits are considering appeals from various taxpayers in *Glass*, and 25,000 other straddle cases are in dispute at the administrative and judicial levels.

251. *Glass*, 87 T.C. at 1162-63.

in multiple offsetting positions combining option and futures contracts in metals. Taxpayers would claim an ordinary loss in the first year and then report a capital gain on a switch transaction in the second year. Although the Treasury's interpretation of the applicable Internal Revenue Code sections technically permitted this activity,[252] the Tax Court found that looking at the whole commodity straddle scheme, the transactions were designed simply to achieve tax avoidance.[253] Later, the court emphasized that the straddle arrangement was a mere device used to conceal its real character. The transactions lacked economic substance, because only a de minimis chance of economic profit existed, and were, therefore, shams.[254] Throughout the opinion, the Tax Court emphasized that the only reason for the arrangement was to obtain tax benefits, and that there was neither an objective nor a realization of actual economic gains.

The court in *Glass* also discussed some of the relevant legislative developments concerning straddles. In 1976, Congress had amended section 1234(b) to provide prospectively that gain or loss from a closing transaction involving an option should be treated as short-term capital gain or loss, unless the option was granted in the ordinary course of the taxpayer's trade or business.[255] The Tax Court interpreted this provision as demonstrating Congress' distaste for tax shelter activity in which the primary objective is not that of making an economic profit.[256] Subsequent legislation in 1984[257] and 1986[258] concerning the treatment of losses on straddles entered into before 1981, when Congress enacted major legislation in the Economic Recovery Tax Act of 1981[259] restricting straddles, limited the deductibility of such losses.

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252. The essence of this development is described facilely in Judge Posner's opinion in *Yosha*:

> The Treasury Department had decided that while a loss or gain incurred on the purchase of an option was capital in nature — the right being a capital asset owned by the holder — a loss or gain incurred on the sale of an option was not. *Why* the seller's gain or loss should be thought different in character from the buyer's beats us, but there it is, and taxpayers were entitled to take advantage of this curiously asymmetrical treatment of the different legs of a straddle before Congress eliminated the asymmetry.

861 F.2d at 497 (emphasis original).

253. *Glass*, 87 T.C. at 1163.

254. *Id.* at 1176.

255. Pub. L. No. 94-455, § 2136(a), 90 Stat. 1929 (1976) (codified at I.R.C. § 1234(b) (1988)).

256. *Glass*, 87 T.C. at 1154-55, 1162-64.

257. Tax Reform Act of 1984, Pub. L. No. 98-369, § 108, 98 Stat. 494, 630.

258. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817 (1986) (codified at I.R.C. § 1092, note (1988)).

259. Pub. L. No. 97-34, 95 Stat. 172, 323-34 (1981) (codified at I.R.C. §§ 1092, 1256 (1988)) [hereinafter ERTA].

However, investors could deduct the losses if they could establish that they incurred the losses in a trade or business or in a transaction entered into for profit. This language is commensurate with the limitation on loss deductions in section 165(c).[260] This legislative action led the

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260. *Glass*, 87 T.C. at 1164-69. The legislative history of § 108 of the Tax Reform Act of 1984 and § 1808(d) of the Tax Reform Act of 1986 demonstrates the complex interaction between courts and Congress in determining exactly what Congress intended. Section 108 allowed the deduction of losses in certain straddles if part of a "transaction entered into for profit" and established a presumption that transactions by commodity dealers or those regularly engaged in investing in regulated futures contracts would be rebuttably presumed to be in transactions for profit. Based on legislative history, § 108 was interpreted by some courts as requiring a lesser test of "entered into for profit" than was required in other contexts, such as § 165(c)(2), where the courts have demanded that a taxpayer have a primary profit motive for a transaction. *See, e.g.*, Helvering v. National Grocery Co., 304 U.S. 282, 289 n.5 (1938). Thus in Miller v. Commissioner, 84 T.C. 827 (1985), the Tax Court relied on a passage in H. CONF. REP. NO. 861, 98th Cong., 2d Sess. 917 (1984), which allowed a loss "if there is a reasonable prospect of any profit from the transaction" as establishing only a requirement that a taxpayer satisfy an objective test of a reasonable prospect of profit, rather than the more difficult subjective test of a showing that the transaction was entered primarily for profit. *Miller*, 84 T.C. at 839. This judicial endorsement of a lesser standard led Congress to enact § 1808(d) in the Tax Reform Act of 1986, permitting the loss to be deductible only if the loss was incurred in a trade or business or a transaction entered into for profit, and to establish a presumption that only commodities dealers were engaged in a trade or business. The House Report included the following passages:

> A taxpayer who does not satisfy the indicia of trade or business status, such as the taxpayer in *Miller* . . . , would not be considered in the trade or business of trading commodities. Further, the presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member . . . .
>
> Section 108 also restated the general rule that losses from the disposition of a position in a straddle are only allowable if such position was part of a transaction entered into for profit. A majority of the United States Tax Court in *Miller* interpreted section 108 as providing a new, less stringent profit standard for losses incurred with respect to pre-1981 commodity straddles. It was not the intent of Congress in enacting section 108 to change the profit-motive standard of section 165(c)(2) or to enact a new profit motive standard for commodity straddle activities. This technical correction is necessary to end any additional uncertainty created by the *Miller* case.

H.R. REP. NO. 426, 99th Cong., 1st Sess. 911 (1985). The Conference Report followed the House Bill and ended with the intent that pre-ERTA straddle litigation be speedily resolved. H.R. CONF. REP. NO. 841, 99th Cong., 2nd Sess. II-845 (1986) ("the conferees clarify their intent that the Internal Revenue Service bring all outstanding pre-ERTA straddle litigation to a speedy resolution, so that the large docket of cases on this issue may be cleared, in a manner consistent with this legislation.").

Miller has since been reversed on appeal by the Tenth Circuit, Miller v. Commissioner, 836 F.2d 1274 (10th Cir. 1988), and abandoned by the Tax Court, Boswell v. Commissioner, 91 T.C. No. 15 (July 26, 1988). *See also* Landreth v. Commissioner, 859 F.2d 643 (9th Cir. 1988) (reversing several other Ninth Circuit opinions and ultimately holding that "entered into for

Tax Court to investigate whether a profit objective was involved in the commodity straddles. The Tax Court concluded, in looking at the whole commodity straddle scheme, that there was "*no* perceptible profit objective."[261] The Tax Court rejected the thought that formal compliance with the literal provisions of the Code automatically conferred deductibility. Because the taxpayers had no prospect of profiting economically from the intentionally realized losses in the first year, their losses were not within the scope of deductible losses intended by Congress under sections 165, 1234, and the 1984 and 1986 Tax Reform Acts.[262] The commodity straddle scheme "lacked economic substance and was a sham."[263]

In affirming the Tax Court's decision in *Glass*, the Seventh Circuit in *Yosha v. Commissioner*[264] analyzed the economic substance of transactions while paying particular attention to the taxpayer's motives. Writing for the court, Judge Posner viewed section 165(c)(2) as codifying the economic substance doctrine with respect to loss deductions. In his view, "[a] transaction not 'entered into for profit' is, at the

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profit" language of § 108 should be interpreted identically to same language in § 165(c)(2), thus permitting deduction of losses from pre-ERTA straddle transactions only if primary motive for entering transactions was economic profit, in cases governed by § 108).

261. *Glass*, 87 T.C. at 1175 (emphasis original).

262. *Id.* at 1173-77.

263. *Id.* at 1176. In other cases also involving tax years before ERTA applied, the determination of whether a transaction was a sham has been considered separately from the entered into for profit analysis under the statute. *See* Brown v. Commissioner, 85 T.C. 968, 1000 (1985) (since straddles were fake and fictitious, there was no need to evaluate § 108 of the Tax Reform Act of 1984), *aff'd sub nom.* Sochin v. Commissioner, 843 F.2d 351, 353-54 n.6 (9th Cir.), *cert. denied*, ___ U.S. ___, 109 S. Ct. 72 (1988). Since the Tax Court found that the transaction was not bona fide, but fictitious, the Ninth Circuit believed that the Tax Court had not needed to reach the reasonable expectation of profit issue. Nonetheless, the Ninth Circuit concluded that the proper standard for the sham transaction doctrine was to evaluate economic substance and business purpose, *Sochin*, 843 F.2d at 355-56. Concurring, Judge Beezer stated that a finding of fictitious transactions meant that no inquiry into profit motive was necessary. *Sochin*, 843 F.2d at 355-56. *See also* Perlin v. Commissioner, 86 T.C. 388, 419 (1986) (first finding the transactions were bona fide and not fictitious, then determining that the transactions satisfied the entered into for profit standard of § 108 of the Tax Reform Act of 1984 and therefore the losses were allowable); Fox v. Commissioner, 82 T.C. 1001, 1023 27 (1984) (holding straddle transaction was not entered primarily for profit and hence no deduction was allowed under § 165(c)(2); court did not address sham transaction argument); Smith v. Commissioner, 78 T.C. 350, 390-94 (1982) (taxpayer in straddle transaction lacked economic profit objective necessary for deduction under § 165(c)(2)), *aff'd*, 820 F.2d 1220 (4th Cir. 1987) (unpublished opinion); United States v. Atkins, 661 F. Supp. 491, 495-96 (S.D.N.Y. 1987) (no loss deductions allowed for fictitious or bogus transactions despite provisions in the 1984 and 1986 Tax Reform Acts because the statutes do not permit tax deductions for fictitious or bogus transactions).

264. 861 F.2d 494 (7th Cir. 1988).

least (a relevant qualification, as we shall see), a transaction that lacks economic substance. Its only rationale is tax avoidance."[265] According to Judge Posner, if some people would enter a transaction without a tax motive, then the same transaction entered strictly for tax reasons would still have economic substance. However, section 165(c)(2) would allow a loss deduction only if the taxpayer entered into the transaction for profit, interpreted as requiring a primary nontax motive.[266] Here "there was no nontax profit motive and the transactions did not impinge on the world."[267] While the transactions were not fake in the *Forseth* sense, they were artifices or shams because the taxpayers assumed no market risks. Because the taxpayers had no possibility of gain or loss, Judge Posner concluded that the transactions lacked substance. The taxpayers were simply purchasing tax losses.

Viewed in its entirety, Judge Posner's opinion reflects a tendency, found also in other opinions, to intertwine an analysis of the transaction's economic substance with an investigation of the taxpayer's motive. This motive analysis is unnecessary and can produce confusion. Under the substance of the transaction test recommended in this article, courts should separate, instead of merge, the objective and subjective inquiries. The judiciary should limit the sham transaction doctrine to an inquiry regarding the substance of the transaction. Here, Judge Posner's concern with the possibility of gain or loss on the transaction, or the existence of economic risk, is important. Any inquiry into profit motive, however, is relevant only to a second question, separate from the sham transaction doctrine. In the case of straddles, the question of profit motive becomes relevant through the question of statutory interpretation in determining what losses are deductible under section 165(c)(2). Tied in with the question of the interpretation of that general statutory provision is the impact of more specialized straddle provisions, such as those enacted in the Economic Recovery Tax Act of 1981 (ERTA).

In the case of straddles, the specific legislative developments are extremely relevant to the appropriate scope of the sham transaction doctrine. Congress perceived a massive continuing tax shelter problem involving straddles. Because the courts were not dealing adequately

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265. *Id.* at 499.

266. *Id.* at 499-501. Judge Posner's opinion for the Seventh Circuit seems both to endorse the "primarily for profit" test and to question whether a more objective test might be preferable: "[d]espite this growing phalanx of authority, the objective test, strongly urged by the taxpayers in this case, has much to recommend it [since judges can't weigh motives]." *Id.* at 501. The transactions in *Yosha* met neither the objective nor the subjective tests. *Id.* at 502.

267. *Id.* at 499.

with the problem, Congress initiated legislation to restrain taxpayers. In ERTA, Congress enacted a multi-faceted approach to restrict perceived tax shelter abuses inherent in straddle transactions. The Joint Committee on Taxation announced that "[f]undamentally, the new rules require that commodity futures transactions be taxed on their economic substance."[268] Congress selected the particular provisions with that aim.[269] The substance of the transaction test is especially sensible in the area of commodity straddles, in light of the specific statutory provisions and the legislative history outlined above.[270] Congress has indicated when it intends courts to make a profit motive inquiry, as in section 165(c)(2), and in section 108 of the Tax Reform Act of 1984, and section 1808 of the Tax Reform Act of 1986. An investigation of profit motive in the context of the sham transaction doctrine is unnecessary and diverts attention from the crucial question, namely, what is the substance of the transaction? This approach provides an objective inquiry that the courts can analyze independent of a profit motive inquiry. Moreover, the deluge of litigation involving straddles in the 1980s[271] illustrates the fundamental necessity of targeted, precise statutory provisions restricting straddles, such as those enacted in ERTA. This flood of litigation also demonstrates the basic inefficiency of leaving resolution of the massive tax shelter problem to the courts, armed only with judicial doctrines such as the sham transaction doctrine. The weakness of relying on a judicial approach would be exacerbated by utilizing an evaluation of taxpayers' motives instead of focusing on a substance of the transaction analysis. Despite the recent flurry of legislative activity, courts will still need to consider the substance of the transaction doctrine in the straddle context, in at least three different situations: 1) where particular statutory provi-

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268. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 283 (Jt. Comm. Print 1981). For description of the numerous provisions enacted in 1981 to restrict tax shelters involving straddles, see *id.* at 279-315. In its introduction, the Joint Committee on Taxation wrote that "[i]n adding specific statutory rules in the Act to govern the taxation of straddle transactions, the Congress has supplemented the prior law, generally without changing or reinterpreting those rules which remain in effect." *Id.* at 279. Moreover, according to the Joint Committee, "[t]he seriousness of these dangers [revenue losses and undermining of integrity of self-assessment system] made it unwise to wait for a final judicial resolution of taxpayer-government disputes about the proper tax treatment of those transactions and imperative to eliminate any uncertainty about the tax rules for the future." *Id.* at 294.

269. For example, § 1092 denies loss deductions with respect to commodities straddles except to the extent that losses exceed unrealized gains on offsetting straddle positions.

270. *See supra* notes 260 & 268 and accompanying text.

271. *See supra* note 250 (estimating 25,000 straddle cases pending in 1988).

sions are inapplicable, as where they are prospective only; 2) where holes or loopholes are left in statutory coverage; and 3) even if the statute is applicable, where the question is whether the substance of the transaction conforms to the form selected by the taxpayer. In this last category, where the sham transaction doctrine has long coexisted with other specific statutory provisions, it is especially important to follow the approach advocated in this article, and focus on the substance of the transaction.

F. *Other Situations Involving Use of the Sham Transaction Doctrine*

A review of several additional situations in which courts have recently invoked the sham transaction doctrine lends support for this article's recommendation of limiting the scope of the doctrine to an analysis of the substance of the transaction. In many of these additional examples, courts used the sham transaction doctrine to thwart taxpayer efforts to take advantage of favorable statutory provisions through formal compliance, when the substance of the underlying transaction was not commensurate with its form. In these situations, courts should require that the tax effects be tailored to the substance of the transaction rather than the form. Analysis of the taxpayer's motive or purpose should only become a part of this determination when Congress has specified.

In one recent case, *McNamara v. Commissioner*,[272] the Seventh Circuit used the sham transaction doctrine to determine whether a noncorporate lessor could claim an investment tax credit. Section 46(e)(3) limited the credit to situations when the lease term and options were less than 50 percent of the useful life of the property. The court concluded that it should respect the form arranged by the taxpayer, a lease of less than 50 percent of the useful life, where the transaction was not primarily tax motivated, unless the lease was a sham.[273] The court defined a sham as a situation where, notwithstanding the use of the lease form, there was a real shifting of all economic risk to the lessee from the lessor.[274] In other words, the court applied the sham transaction doctrine to require that the lease form must in substance be a lease and not a sale, if it is to be respected for tax purposes. Under the framework proposed in this article, the substance of the transaction should be the test; if the arrangement is in fact a lease of

272. 827 F.2d 168 (7th Cir. 1987).
273. *Id.* at 172.
274. *Id.*

less than 50 percent of the useful life, then the court should respect the form regardless of the taxpayer's intent in undertaking the transaction.

A similar example in a different context involved an attempt to take advantage of the then applicable provisions of section 1253(d)(2)(B)(ii), regarding deduction of installment payments made in purchasing a franchise distributorship. In *Moore v. Commissioner*,[275] the Tax Court concluded that a territorial franchise arrangement was a sham, spurious, and "rested on quicksand."[276] The Tax Court noted the transactions had no business purpose, that they were not within the scope of activities which Congress intended to protect under section 1253, and that the actions of the parties indicated the transactions involving the franchise had no substance.[277] Important to the court's conclusion were the facts that the parties did not take their agreement seriously, that the court did not believe the taxpayer's explanations, that the taxpayer had never investigated the business aspects of the franchise, that the court did not believe that the taxpayer intended to pay the notes involved, and that the court found the transactions were a disguise.[278] This example firmly demonstrates that room exists for a judicial evaluation of the substance of the transaction when a taxpayer attempts to take advantage of particular statutory provisions. Under the framework proposed in this article, judicial evaluation should focus on what the taxpayer was really doing, i.e., did the form of the transaction (here, a franchise arrangement) in fact reflect the substance of the transaction? If in substance the taxpayer did engage in a purchase of a franchise, then the tax effects flowing from the statutory provisions should apply without any inquiry into the taxpayer's motive. In both *Moore* and *McNamara*, an analysis of motive would be appropriate only if called for by the particular statutory provisions.

Another example of the use of the sham transaction doctrine in a rather different context is *Boyter v. Commissioner*.[279] There the court invoked the sham transaction doctrine to determine whether taxpayers could take advantage of favorable rates available to single taxpayers where they had divorced at the end of the tax year and remarried

275. 85 T.C. 72 (1985).
276. *Id.* at 101.
277. *Id.* at 102-04.
278. *Id.* at 106-07.
279. 668 F.2d 1382 (4th Cir. 1981).

shortly thereafter in the next tax year.[280] The Fourth Circuit indicated that "the sham transaction doctrine may apply in this case if, as the record suggests, the parties intended merely to procure divorce papers rather than actually to effect a real dissolution of their marriage contract."[281] The court's language suggests both a substance over form analysis and an inquiry into the intent of the taxpayers. Under the proposed substance of the transaction test, the appropriate question to ask is whether the taxpayers' divorces were real or simply formal, regardless of the taxpayers' intent. This question presents some difficulty in terms of identifying the appropriate scope for consideration. On the one hand, looking simply at the divorces, it is possible to conclude that there *could be* real, significant, and permanent effects from the dissolution of the marriages.[282] On the other hand, considering the transactions in their entirety, there *were* no significant long-term effects on their situations apart from the disputed tax consequences. The subsequent actions of remarriages deprived the (arguably valid) divorces of any substance, because the taxpayers in effect were continuously married, notwithstanding the apparent hiatus of a few months, (at least under a broad-based view of the substance of the transactions). In substance, the court could view the later events of remarriages as confirming that the transactions' form did not conform to their substance. Determining the appropriate scope for consideration is a problem also frequently involved in the step transaction doctrine, when courts must decide whether to view steps of a transaction separately or to view the transaction as an integrated whole. The thrust of the proposed framework, to analyze the substance of the transaction, is not at all inconsistent with the basis for the step transaction doctrine.

Courts have considered other doctrines in conjunction with the sham transaction doctrine in numerous other recent cases. *Packard v. Commissioner*[283] involved a taxpayer that accrued substantial tax

280. *Id.* at 1382-85. The taxpayers' pattern was to divorce at year end in a Caribbean country where divorces could be easily procured, and remarry at the beginning of the next tax year; this was repeated in the following tax year. Since the filing status is determined according to the marital status on the last day of the tax year, this arrangement if respected would permit application of single taxpayer rates, which were lower than married taxpayer rates.

281. *Id.* at 1387.

282. Another issue concerned validity of the divorces under the relevant state law. The majority felt that this question was not necessary to answer, since if the divorces were shams under federal law they would not be respected for federal tax purposes. *Id.* at 1385-86. The dissent, however, felt that the first question for determination was whether the divorces were valid under state law, a question which had not yet been definitively answered by the state courts. *Id.* at 1388-89 (Widener, J., dissenting).

283. 85 T.C. 397 (1985).

losses due to prepaid feed expenditures. These losses offset gain derived from liquidation of a separate company. The Tax Court concluded that the arrangement withstood the sham transaction doctrine as formulated in *Rice's Toyota World* because the cattle feed operation had a business purpose and the transaction had economic substance in the form of genuine indebtedness and possible economic benefits.[284] After finding that the transaction was not a sham, the court then applied the step transaction doctrine to consider the various steps as an integrated whole. The taxpayer had initially used a Subchapter *S* Corporation as the vehicle for entering the cattle feed investment, but soon liquidated that investment and transferred the corporation's assets to a partnership. The Tax Court concluded that the taxpayer had no valid business reason for using the Subchapter *S* Corporation instead of the ultimate partnership. The court then recast the transaction as if originally undertaken by the partnership to reflect the substance of the transaction.[285] This combination of approaches resulted in the taxpayer paying taxes in accordance with the substance of the transaction.[286]

The court in *Bystry v. United States*[287] also used a combination of approaches in deciding whether to disregard the corporate form chosen by the taxpayer. This case illustrates convergence with the doctrine established in *Moline Properties, Inc. v. Commissioner*,[288] where the Supreme Court determined that as long as the purpose for the corporation "is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."[289] However, under the corporate entity doctrine of *Moline*, courts would still disregard the corporate form where it is a sham or unreal. In *Bystry*, the corporation had no assets, no action was taken on behalf of the corporation except completing pre-

284. *Id.* at 417-19.

285. *Id.* at 421-22.

286. In particular, the court decided that (1) the transaction was not a sham, (2) applying the step-transaction doctrine, the court would ignore the intermediate step of utilizing a Subchapter *S* Corporation and thus ignore the attempted step-up in basis, and (3) the taxpayer would be allowed a deduction for prepaid feed expenses because the taxpayer had satisfied the three-part test established earlier by the Tax Court in Van Raden v. Commissioner, 71 T.C. 1083, 1096 (1979) (permitting a deduction for prepaid feed only if the expenditure was a payment, the prepayment was for a business purpose and not only to reduce taxes, and a material distortion of income was not caused by the deduction), *aff'd*, 650 F.2d 1046 (9th Cir. 1981).

287. 596 F. Supp. 574 (W.D. Wisc. 1984).

288. 319 U.S. 436 (1943).

289. *Id.* at 438-39.

requisites for incorporation and the filing of tax returns, and the corporation did not hold itself out as operating the farm in question.[290] Hence, the court concluded that the corporate form was a sham to be disregarded and that the involved individuals should report the income along with other tax attributes in their individual capacity. Again, the court should view this inquiry under a substance of the transaction analysis. In reality, were the corporation or the individuals conducting the business? Whether termed a sham transaction analysis or a disregard of the corporate entity, the underlying analysis is identical: Did the form chosen by the taxpayers correspond to the substance of the transaction?[291]

A final example is suggested by the transaction and analysis undertaken in *Saviano v. Commissioner*.[292] In this case, a taxpayer sought to deduct mining expenses amounting to $30,000 which were incurred in connection with a mineral lease. The taxpayer had obtained that money to pay the expenses through a nonrecourse "loan" from the entity which secured the mineral lease for him. The sole security for the loan was a general lien on the mineral lease. The Seventh Circuit analyzed the economic substance of the transaction, focusing on the allocation of risk and the nature of the possibilities of repayment of the loan, and concluded that the loan was really a joint investment and that the form was misleading and a ruse.[293] In effect, the court equated the sham transaction doctrine with the doctrine of substance over form and concluded that the form did not warrant respect where the underlying transaction was really a joint investment.[294]

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290. *Bystry*, 596 F. Supp. at 578-80.

291. *Cf.* Commissioner v. Bollinger, 108 S. Ct. 1173 (1988) (applying in effect a substance of the transaction test in determining whether a corporation should be treated as a separate taxable entity or as a nontaxable agent of its partnership principal).

292. 765 F.2d 643 (7th Cir. 1985).

293. *Id.* at 654.

294. *Id.* at 650. Similarly, the court analyzed a transaction in a subsequent tax year involving a gold option plan (chosen by the taxpayer because Congress had eliminated the desirability of the mineral lease arrangement selected for the prior year). The substance of the transaction was not a true option. Thus, the court required the taxpayer to report currently the income involved. *Id.* at 654. In concluding its opinion, the Seventh Circuit wrote that

> [o]nly a fool would actually believe that the transactions did in fact occur as described. The many elements of commercial surrealism present in these tax shelters should have put a reasonable person on notice that he was not being shown all the cards in the deck . . . .
>
> The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are

These various examples of transactions and differing combined approaches which the courts take suggest several conclusions. First, courts should refashion the sham transaction doctrine as suggested throughout this article as a doctrine requiring that the substance of the transaction govern. Second, many situations exist where the courts have utilized other doctrines to analyze transactions involving similar circumstances to the sham transaction doctrine. In many of these cases, the court does in fact utilize the substance of the transaction analysis, regardless of the particular phraseology chosen. Third, the key to the substance of the transaction analysis is its content. Courts can best give proper content to their analysis by evaluating the particular aspects of the subject area, as this article has done above in surveying the different subject areas in which courts historically have invoked the sham transaction doctrine.

VI. Conclusion

The critical judicial analysis should be the determination of the substance of the transaction. In effect, many courts have undertaken such an analysis when invoking the sham transaction doctrine. But, some courts have intertwined the substance of the transaction analysis with an investigation of motive or business purpose. Others have used the doctrine to avoid hard analysis and to engage in labeling.

The Supreme Court has failed to provide sufficient content for the sham transaction doctrine in its three basic precedents of *Gregory*, *Knetsch*, and *Frank Lyon*. The lower courts, instead of developing a coherent theory, have mingled the strands of the sham transaction doctrine in unpredictable fashion. When the current problem areas are examined, the proper strand of analysis is clearly evident: Courts should focus on developing criteria for evaluating the substance of the transaction. The content of this test will be shaped by the particular nature of the specific problem involved, as illustrated in part V of this article. Courts should consider taxpayer motives only where Congress has indicated a motive-based analysis is appropriate.

> empowered, and in fact duty bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.

Id. at 654.