

January 2005

## The Status of the Judicial Sham Doctrine in the United States

Philip F. Postlewaite  
*Northwestern University*

Follow this and additional works at: <http://epublications.bond.edu.au/rlj>

---

### Recommended Citation

Postlewaite, Philip F. (2005) "The Status of the Judicial Sham Doctrine in the United States," *Revenue Law Journal*: Vol. 15 : Iss. 1 , Article 8.

Available at: <http://epublications.bond.edu.au/rlj/vol15/iss1/8>

This Journal Article is brought to you by the Faculty of Law at [ePublications@bond](mailto:ePublications@bond). It has been accepted for inclusion in Revenue Law Journal by an authorized administrator of [ePublications@bond](mailto:ePublications@bond). For more information, please contact [Bond University's Repository Coordinator](#).

---

# The Status of the Judicial Sham Doctrine in the United States

## **Abstract**

Throughout the early history of the United States income tax law, the courts eagerly scrutinized tax transactions to ensure that their substance comported with their form. The courts developed a common law ensuring that tax transactions were also in keeping with the purpose of the legislation. Recently, courts of the United States appear much more reluctant to intervene to impose purpose over form. Given the rise of textualism - giving a statute its ordinary meaning according to its text, as opposed to inquiring into non-textual sources such as the intent of the legislature - as the preferred mode for judicial interpretation of tax legislation, nothing more than compliance with the statutory language is required. Accordingly, another branch of government, the legislature, is increasingly intervening by statutory provisions to guard against tax avoidance.

## **Keywords**

income tax law, tax avoidance, United States, legislation

## THE STATUS OF THE JUDICIAL SHAM DOCTRINE IN THE UNITED STATES

*Philip F Postlewaite*<sup>1</sup>

Throughout the early history of the United States income tax law, the courts eagerly scrutinized tax transactions to ensure that their substance comported with their form. The courts developed a common law ensuring that tax transactions were also in keeping with the purpose of the legislation. Recently, courts of the United States appear much more reluctant to intervene to impose purpose over form. Given the rise of *textualism* - giving a statute its ordinary meaning according to its text, as opposed to inquiring into non-textual sources such as the intent of the legislature - as the preferred mode for judicial interpretation of tax legislation, nothing more than compliance with the statutory language is required. Accordingly, another branch of government, the legislature, is increasingly intervening by statutory provisions to guard against tax avoidance.

In the summer of 2006, I was invited to participate in a colloquium entitled 'Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of *Rechtsmissbrauch* (*Abus de Droit*).'<sup>2</sup> As described by its organiser,<sup>3</sup> 'the object of the meeting [was] to try to describe the way in which different jurisdictions approach the problem of avoidance/artificial transactions'. The approach of a number of jurisdictions (Germany, Croatia, France, New Zealand, Australia, the United Kingdom, the European Court of Justice, and the United States) was to be described by the various presenters. As I was to be the only American on the panel, my assigned topic was 'The Sham Doctrine in the United States.'

---

1 Professor of Law and Director of the Tax Program, Northwestern University School of Law. © 2006. All rights reserved.

2 The colloquium was sponsored by the International Bureau of Fiscal Documentation, Amsterdam, the Law School of Victoria University of Wellington, the Institute for Policy Studies, Wellington, and the New Zealand Association for Comparative Law. It was held on Monday 31 July 2006.

3 Professor John Prebble of the Law School of Victoria University of Wellington.

## JUDICIAL SHAM DOCTRINE

I quickly accepted the invitation and was honored to participate in a colloquium with what likely would prove to be a discussion of the dramatic and divergent approaches of various tax systems to a never ending, potentially insoluble dilemma. The issue faced universally is, when is the structuring of a transaction acceptable to the agency charged with the enforcement of the tax laws and the courts charged with resolving disputes between taxpayers and the government as aggressive tax planning,<sup>4</sup> and when does it constitute unacceptable tax avoidance. The line of demarcation becomes critical to the success or failure of the tax planning efforts.

Ideally, a tax system provides guidance, whether by judicial interpretation, administrative pronouncement, or legislative enactment, through which the line between the two is easily identified and clear. The United States, with its three equal branches of government (the judiciary, the executive, and the legislature, employing a system of checks and balances) has witnessed the participation of each of these branches in the enforcement and interpretation of the tax laws on such issues. Unfortunately, as is common in this area, one person's tax planning may be another's tax avoidance.

### **History of the Judicial Formulation and Application of the Sham Doctrine in the United States**

Had I been assigned this task years ago, the description of the approach of the United States would have been simpler and relatively certain. From the earliest days of its income tax law, American courts felt free to scrutinize a transaction, regardless of its literal compliance with the taxing statute, in order to ensure that it was one of substance; compliant not only with the language of the tax law but also with its spirit. The ease with which this was done by the courts during the infancy of the federal tax law was rather remarkable.

The Sixteenth Amendment authorizing an income tax was ratified by the states in 1916. The statute was miniscule compared to the tome it has become. Treasury

---

4 A frequently-quoted opinion of Judge Learned Hand assures taxpayers and their counsel that no one is obligated to pay more than their lawful share of taxes. Efforts to minimize such obligations are neither illegal nor immoral *per se*. See *Helvering v Gregory* 69 F 2d 809, 810 (2d Cir 1934): '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.'

Regulations and administrative pronouncements were sparse. Yet as early as 1935,<sup>5</sup> with regard to a transaction complying with the literal text of the 1924 *Revenue Act*, the Supreme Court in its landmark decision of *Gregory v Helvering*<sup>6</sup> applied a judicial sham/business purpose doctrine to a transaction for which the taxpayer sought tax-free treatment. Emphasizing the legislative purpose for the statute, the transaction was invalidated for tax purposes, notwithstanding the transaction's compliance with the literal text of the statute.

Thus, early on, without delay, the courts concluded that it was their duty to ensure that the application of the taxing statute required that the transaction's substance, not its form, be followed. In doing this, they attempted to ascertain the legislative purpose in enacting the statute and to ensure that the transaction complied not only with its text but with its purpose as well. Accordingly, the courts invoked various judicially-created doctrines, all emanating from the same concern but employing different verbiage in their description and application, to safeguard against transactions elevating form over substance.

Initially, the judicial safeguards were frequently referenced as the 'sham doctrine'. However, further refinement of the judicial common law combating tax avoidance occurred as more tax cases were confronted by the courts. While the sham doctrine early on meant all things to all people, it now comprises a shorthand phraseology for any number of judicial safeguards - the doctrine of substance over form, the step transaction doctrine, the economic substance doctrine, or the business purpose doctrine.<sup>7</sup>

---

5 Earlier tax decisions had already shown the judiciary's willingness to intervene where necessary.

6 69 F 2d 809 (2d Cir.1934) aff'd, 293 US 465 (1935). As stated by the Court: 'Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business purpose or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner . . . 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.'

7 A District Court recently revealed the difficulty in attempting to define and apply these different safeguards. See *Long Term Capital Holdings v. United States* 330 F Supp 2d 122 (D Conn, 2004), where the court asserted: 'The terminology used, whether sham, profit motivation, or economic substance is not critical, rather the analysis evaluates both the

## JUDICIAL SHAM DOCTRINE

These judicial safeguards were soon recognized by most tax practitioners as something which required their consideration in structuring a transaction. Concern quickly arose regarding the judicial acceptability of transactions which involved a circular flow of funds, which occurred in a short period of time, produced dramatic tax consequences as part of a minimal investment with little economic return, and other indicia of potential non-compliance with the intent of the statute. The common law surrounding the tax law was something that taxpayers and their counsel learned to integrate into their tax planning, lest their efforts be undercut and thwarted by the application of these judicial safeguards.<sup>8</sup>

After fully signaling the availability of these doctrines and their potential application, the courts experienced a period of relative tranquility with regard to the interpretation and application of these judicial doctrines.<sup>9</sup> While controversies arose in which the Service applied, *inter alia*, one of the judicial safeguards in disallowing the taxpayer's treatment of the matter, their appearance was limited in great measure by the nature of the practice of tax law. While not always easy to define, like obscenity, one 'knew it when he saw it,' and practitioners tended to shy away from transactions which might test such boundaries.

### Tax Products and Increasing Invocation of the Safeguard Doctrines by the Service

However, with the advent of the new millennium, the general hesitancy of tax practitioners to 'push the envelope' apparently softened. Some attribute this combativeness to the under funding by Congress of the enforcement agency, the Internal Revenue Service, which led to a shrinkage in the number of audits and emboldened taxpayers and their advisors. Others suggest that the final step in the transformation of the practice of law from a profession to a business, with its emphasis on significant economic return, may have produced the response. Whatever the cause(s), the tax landscape changed dramatically in the United States in the 1990s.

---

subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance. . .'

8 See generally, Harris, 'The Economic Substance Doctrine in the Federal Tax Law: Understanding When and How It Should Apply' (2006) 64 *NYU Tax Institute* 27-1 to 27-60.

9 The most recent pronouncement on these doctrines by the Supreme Court occurred in *Frank Lyon Co v United States* 435 US 561 (1978), involving a sale-leaseback transaction. The Court upheld the transaction, employing a multi-factor test, because it 'was not shaped solely by tax avoidance features that have meaningless labels attached. . .'

As a consequence, the definition and application of these doctrines entered a new round of scrutiny and interpretation. Increasingly, practitioners attempted to generate beneficial tax consequences through transactions complying literally with the Code and Regulations in settings which most likely, given the substantial tax benefits produced with minimal economic risk, were never contemplated by Congress. The rise of tax products, prepared generically for any wealthy taxpayer with a need for tax benefits, designed and peddled by accounting firms, investment bankers, and some law firms, has led to a more frequent consideration of these doctrines by the courts, because the Service in its disallowance of the claimed tax consequences almost without exception relies on the judicial common law of safeguards.

Many of these tax product transactions appeared reminiscent of the excessive efforts of the early days of the tax law which led to the creation and application of the judicial safeguard doctrines. Nevertheless, surprisingly, given their prior judicial activism, the courts have struggled more than one would have expected, with far more decisions favoring the taxpayer than most would have imagined.

### **The Rise of the Judicial Safeguard of Economic Substance**

The wave of tax products has led to substantial litigation and the rise of the latest judicial formulation through which to safeguard against abuse - 'economic substance.'<sup>10</sup> Without such, a tax-driven transaction will not withstand a challenge by the Service.

Economic substance is typically described as a two-prong test.<sup>11</sup> First, the court must find that the taxpayer subjectively had a non-tax purpose for the transaction. Second, there must be an objective showing of a realistic possibility of pre-tax profit.

The application and interpretation of this standard is fraught with uncertainty. While increasingly embraced by the lower courts as the appropriate measuring rod, this recent formulation of economic substance has not been considered by the Supreme Court. As a consequence, it has not been defined on a uniform basis. For example, is the determination exclusive or is it combined with other factors? Is the test disjunctive or conjunctive? The courts have varied with their answers.<sup>12</sup> The confusion continues

---

10 See Harris, above n 8, 27-5, that traces the origins of the doctrine to *Gregory*.

11 See Harris, above n 8, 27-4.

12 See *Transcapital Leasing Assocs 1990-II LP v United States* 97 AFTR 2d 2006-1916 (WD Tex 2006), in which the court noted the different approaches of three Circuit Courts of Appeal in applying the economic substance doctrine.

## JUDICIAL SHAM DOCTRINE

to date with differences appearing among the Circuit Courts of Appeal in the test's formulation and application.

This modern era of determining whether the anti-avoidance judicial safeguards apply to tax products began with *ACM Partnership v Commissioner*.<sup>13</sup> Therein, the government prevailed. While acknowledging its tax-motivated structuring, the taxpayer attempted to justify the tax consequences due to other considerations. The efforts were unsuccessful in large measure because the court concluded that the structures were shams, lacked business purpose, and/or lacked sufficient economic substance.

Notwithstanding its success in the ACM-type cases, among the never-ending parade of subsequent cases posing tax product issues, taxpayer success has been dramatic, both in number and in the extreme nature of the products' design. Taxpayer victories include *IES Industries, Inc v United States*,<sup>14</sup> *United Parcel Service of America Inc. v Commissioner*,<sup>15</sup> *Black & Decker Corporation v United States*,<sup>16</sup> *Compaq Computer Corp v Commissioner*,<sup>17</sup> *TIFD III-E v United States*,<sup>18</sup> and *Coltec Industries, Inc. v United States*.<sup>19</sup> This string of victories by taxpayers is unprecedented and suggests a change in the judicial climate when such issues present themselves.

---

13 TC Memo 1997-115, aff'd in part and rev'd in part, 157 F 3d 231 (3rd Cir 1998). The ACM progeny were similarly invalidated such efforts as unacceptable tax-driven structures. See *ASA Investerings Partnership v Commissioner*, 201 F 3d 505 (DC Cir 2000), *Saba Partnership v Commissioner* 273 F 3d 1135 (DC Cir 2001), and *Boca Investerings Partnership v United States* 314 F 3d 625 (DC Cir 2003). See also Harris, above n 8, 27-18. While this might appear to be a significant streak of victories by the government, they all involved the same issue, the same tax product, and the same Court of Appeals. Accordingly, the impact of this precedent upon other controversial transactions was not as great as one might otherwise have expected.

14 253 F 3d 350 (8th Cir 2001).

15 254 F 3d 1014 (11th Cir 2001).

16 436 F 3d 431 (4th Cir 2006), involving a grant of a motion for summary judgment with a remand for a further determination of whether the sham transaction doctrine is applicable.

17 277 F 3d 778 (5th Cir 2001).

18 342 F Supp 2d 94 (D Conn 2004).

19 62 Fed Cl 716 (2004). As this essay went to press, the Federal Circuit reversed the *Coltec* decision 2006 US App. LEXIS 17351 (Fed Cir 2006), on the basis of economic substance. However, that victory was quickly undercut by a District Court decision involving a 'Son of Boss' transaction, which had been aggressively audited by the Service, contested by Regulations promulgated by the Treasury, and, for those who did not settle, hotly contested before the courts.



### The *Compaq* Decision—Too Good to Be True?

Most indicative of the increasing hesitancy of the courts to invoke these judicial safeguards is the Fifth Circuit's decision in *Compaq*.<sup>20</sup> The significance of *Compaq* is that, on its facts, it is one of the most extreme settings of the cases producing taxpayer victories. If there were ever a case which would have been classified a decade ago as virtually certain to fall prey to the application of judicial safeguard doctrines, it was *Compaq*. The duration of the transaction was less than 24 hours; it had little or no relevance or connection to the taxpayer's business, the transaction costs were significant; the economic profit was virtually nonexistent; the seller of the stock was a tax-exempt entity to which the foreign tax credit was of no value, and the tax savings were dramatic.

If confronted with the facts of the case as a proposed transaction to be entered by their client, most tax practitioners in the 1990s would have had grave difficulties in blessing the transaction. Nevertheless, reflective of a new era of broad judicial latitude and deference to tax transactions, excessive interpretive literalism, and increasing judicial restraint, the transaction and its dramatic tax savings were upheld.

The facts of *Compaq* involved the taxpayer's purchase of stock of a Dutch corporation on which a dividend had been declared which was sold almost immediately (one hour), to the original seller no less, after *Compaq* became the owner of record. As characterized by a leading commentator: 'The strategy was designed to essentially provide for the risk-free purchase of foreign tax credits...'<sup>21</sup> As noted by the Court, the purchase price was approximately \$888,000,000, reflecting a net dividend of approximately \$19,000,000 (the actual dividend of approximately \$22,000,000 less the 15% withholding tax payable to the Netherlands). The sale price an hour later was approximately \$868,000,000, the purchase price less the amount of the net dividend payable to *Compaq*. Transaction costs, the net out of pocket costs of participating in the tax-saving device, totaled \$1,500,000.

While the transaction produced an overall economic loss, of which most rational taxpayers would stay clear, the motivation for *Compaq*'s participation was the foreign tax credit generated by the 15% withholding tax. The near \$22,000,000 dividend was taxable by the United States, the approximately \$19,000,000 loss on the sale sheltered related gains from other transactions entered by *Compaq*, and the transaction costs were deducted, resulting in additional tax to the United States of about \$500,000 given

---

20 277 F 3d 778 (5th Cir 2001). The same issue was presented in *IES Industries, Inc v United States* 253 F 3d 350 (8th Cir 2001), which also held in favor of the taxpayer.

21 See Harris, above n 8, 27-32.

## JUDICIAL SHAM DOCTRINE

Compaq's tax rate of 33%.<sup>22</sup> The overall cost before taking the foreign tax credit into account was more than \$2,000,000 (transaction costs plus increased tax liability). Nevertheless, as the transaction generated an additional foreign tax credit of over \$3,000,000, it produced an overall benefit of approximately \$1,000,000. The investment of pre-tax \$1,500,000 resulted in a post-tax gain of \$1,000,000 which 'was accomplished in an hour and possessed minimal market risk'.<sup>23</sup>

The Tax Court concluded that the transaction lacked both a business purpose and pre-tax profit potential.<sup>24</sup> Nevertheless, the Fifth Circuit faulted its analysis for focusing on the net, rather than the gross, dividend. Instead, it concluded that there was a pre-tax profit of approximately \$1,500,000. The court further emphasized the taxpayer's lack of control over the market, the possibility (although not a probability) of price fluctuations, and the risk that the dividend might not actually be paid.<sup>25</sup> Accordingly, the Fifth Circuit upheld the transaction.

### Textualism in the Application of the Tax Law

Great uncertainty remains about the application of the judicial safeguard doctrines to income tax cases in the United States. None of the recent cases challenged on the basis of such doctrines has yet been considered by the Supreme Court.

Such taxpayer efforts have drawn the attention of Congress, which increasingly proposes to legislate the standard for the judicial determination of economic substance as well as legislating to prevent efforts by taxpayers of judicially approved transactions. Some attribute this possible shift from one branch of the government to another to the rise of textualism as the interpretive standard employed by the courts when addressing tax legislation. The fear of usurping the role of the legislative branch has increasingly led the courts to apply the 'plain language of the statute' in their judicial scrutiny of the transaction and to look no further, such as searching for the purpose of the legislation or attempting to predict how Congress would have reacted if it had actually considered the precise situation presented to the court.<sup>26</sup>

---

<sup>22</sup> See Harris, above n 8, 27-34.

<sup>23</sup> See Harris, above n 8, 27-34.

<sup>24</sup> 113 TC 214 (1999).

<sup>25</sup> Significantly, while the court referenced these possibilities, there were no factual showings of when, if ever, dividends had not been paid or when actual price fluctuations of any materiality had occurred.

<sup>26</sup> See Harris, above n 8, 27-47. In *TIFD III-E v United States* 342 F Supp. 2d 94 (D Conn, 2004), the court expressly indicated its view that such safeguard efforts are exclusively within the province of the legislature by stating: 'The government is understandably concerned that

This recent tendency appears attributable to the Supreme Court's pronouncements in its first tax case of the new millennium. The Supreme Court in *Gitlitz v Commissioner*<sup>27</sup> blessed a transaction producing a tax loss without the taxpayer incurring an accompanying economic loss. In responding to the concern of the Service that without judicial intervention the transaction would produce a 'double windfall', the Court dismissed the concern summarily by stating: 'Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern'.

A similar attitude appears to have enveloped the judiciary of the United States regarding the application of the historic safeguard regimes, moving the issue of which branch of government should address these types of issues sideways.

### **A Shift to the Legislative Branch of the Responsibility to Provide Appropriate Safeguards by Statute**

In many ways, the *Compaq* case evidences the shift for the responsibility of preventing excessive taxpayer behavior from the judiciary to the legislative branch. The courts are becoming increasingly tolerant of taxpayer efforts and concluding that, if safeguards are needed, it is job of Congress to provide them. Ironically, legislation correcting the results obtained in *Compaq* followed through the enactment by Congress of § 901(k), which provides that: 'In no event shall a credit be allowed . . . for any withholding tax on a dividend . . . if—(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 day before the date on which such share becomes ex-dividend with respect to such dividend, or...' Thus,

---

the Castle Harbour transaction deprived the public fisc of some \$62 million in tax revenue. . . . Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws'.

The Federal Circuit in *Coltec*, above n 19, went to some length to arrive at the opposite conclusion. It stated: 'The Supreme Court has explicitly held that when the judiciary goes beyond the literal language of a statute in order to give effect to its purpose, the separation of powers is not violated. . . . Here, the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance. We conclude that there is no basis for holding the economic substance doctrine as unconstitutional.'

27 531 US 206 (2001). It will be fascinating to observe whether the *Coltec* decision, *supra* at notes 19 and 26, will be appealed to the Supreme Court and, if so, how the Court will react. Both *Coltec* and *Gitlitz* involved transactions literally complying with the statute.

## JUDICIAL SHAM DOCTRINE

Congress, rather than the courts, closed the opportunity to produce these tax-driven results.

Interestingly, even with regard to the heart of the judicially created and contoured safeguard doctrines, there have been repeated proposals to legislate the judicial application of the 'economic substance' doctrine. While unaddressed by the House of Representatives, the Senate amended a recent tax bill in May of 2006 in order to provide for the 'clarification of the economic substance doctrine' given the lack of uniformity in its application.<sup>28</sup> The amendment was dropped in the Conference Agreement. This effort reflects a growing Congressional concern with these problems and a willingness to intervene in such matters.

Judicial safeguards are moving sideways to the legislature and receiving greater attention, not only in the definition of such safeguards but increasingly in legislation preventing future taxpayer victories on transactions previously blessed by the courts.<sup>29</sup> Simultaneously, the judiciary has become more restrained in its application of such safeguards, viewing such matters as no longer within its province.

---

28 Section 411 of the Senate Amendment to *the Tax Increase Prevention and Reconciliation Act of 2006* (PL 109-222). The Senate amendment would have strengthened the judicial safeguard by mandating the application of a conjunctive test in which a transaction would be respected only if the taxpayer could meet both prongs of the economic substance test.

29 To reference but a few statutory overrides of judicial decisions, see §§ 901(k), 358(h), 734(d), and 743(d).