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SUBSTANCE OVER FORM: THE CORNERSTONE OF OUR TAX SYSTEM OR A LETHAL WEAPON IN THE IRS'S ARSENAL?

by

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INTRODUCTION

The doctrine holding that the substance of a transaction—rather than its mere form—controls tax liability is widely, but often unpredictably, applied. The doctrine may affect the amount of taxable income from any type of transaction, and often settles questions of who is taxable on certain income. The Supreme Court has incorporated the doctrine in numerous decisions, and the lower courts have discussed and applied the rule extensively. The doctrine is also incorporated in several sections of the Internal Revenue Code.

In the early 1920s, the Supreme Court treated the superiority of substance over form as a well-settled principle in tax matters:

We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases we have under varying conditions followed the rule.¹

(3) Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants. . . (4) [and w]hen applying the [provisions of the] Sixteenth Amendment and income tax laws enacted [thereunder] we must regard matters of substance and not mere form.²

Over thirty-five years later, the Fifth Circuit called the substance over form principle “the cornerstone of sound taxation.”³ A critical review of the doctrine’s development, however, suggests that it also could be described as a “lethal weapon

* Professors of Accounting, Middle Tennessee State University.
³ Weinert’s Estate v. Commissioner 294 F.2d 750, 755 (5th Cir. 1961).
in the IRS’s arsenal.” The IRS, rather than the taxpayer, normally raises the substance versus form issue, and neither the courts nor the IRS have provided a generally applicable answer to the question of whether substance should prevail over form or form should prevail over substance. Moreover, not all cases involving the substance versus form doctrine have been earmarked as such. Both the courts and the IRS have used a number of ancillary tax principles—e.g., business purpose—to create and shape the substance over form doctrine.

This article reviews the IRS and court usage of the substance over form doctrine to determine its role in the federal tax system. The specific issue addressed is whether the doctrine is the cornerstone of the federal tax system or merely another lethal weapon in the IRS’s arsenal. To accomplish this objective, the article focuses on the doctrine’s development in Supreme Court cases, and describes the primary ancillary tax principles applied to create and shape the doctrine: arm’s-length versus self-dealing, business purpose versus tax avoidance, and step versus independent transaction treatment of a series of interrelated transactions. The issue of whether form or substance generally prevails, and the right of the taxpayer to invoke the doctrine are also addressed.

DEVELOPMENT OF SUBSTANCE OVER FORM DOCTRINE IN SUPREME COURT DECISIONS

The Supreme Court case most widely acknowledged as a source of first principle on substance versus form is Gregory v. Helvering. Several subsequent decisions, however, probably have had an equal impact on the current usage of the terms.

Gregory v. Helvering

In Gregory, the taxpayer, Mrs. Gregory, held all of the stock of United Mortgage Corporation, which in turn held the stock of Monitor Corporation. Mrs. Gregory wished to withdraw the Monitor stock from United so that she could sell it without incurring tax liability. Since a straightforward distribution of the Monitor securities to her in anticipation of the sale would have been taxable as a dividend, she devised a scheme whereby the stock was transferred from United to a newly formed subsidiary, Averill Corporation, in exchange for Averill’s stock. United then distributed Averill’s stock to Mrs. Gregory in a transaction that qualified as a tax-free spin-off or corporate reorganization under the Revenue Act of 1928. Mrs. Gregory subsequently sold the Averill stock to a third party, recognizing long-term...
capital gain on the sale. After the series of transactions was complete, it was clear that Mrs. Gregory had used the reorganization rules to secure capital gain treatment for what, in substance was an ordinary dividend distribution.

The Board of Tax Appeals (BTA) ignored the substance of the transaction and upheld the tax-free corporate reorganization treatment on the ground that "a statute [the reorganization statute] so meticulously drafted must be interpreted as a literal expression of tax policy." In the BTA’s view, Averill Corporation was entitled to recognition, despite its transitory life as a vehicle to transfer the securities from United Corporation to Mrs. Gregory, the sole shareholder. The Second Circuit, however, reversed the BTA’s decision, holding that the transaction did not qualify as a "reorganization" when the purpose of the statutory definition of that term was taken into account.

The Supreme Court affirmed the Second Circuit’s decision, describing the transaction as "an elaborate and devious form of conveyance masquerading as a corporate reorganization." In the Court’s view, the purpose of the conveyance was not to reorganize the business, but rather to transfer the original corporation’s assets to the shareholder, Mrs. Gregory. With this decision, the Court created the substance over form doctrine and the ancillary business purpose test discussed later in this article.

Five Years Later

Five years after deciding Gregory, the Supreme Court touched on the substance versus form question in two additional cases: Higgins v. Smith and Helvering v. F. & R. Lazarus Co. The issue in Higgins was whether the taxpayer could deduct a loss on the sale of securities to a corporation wholly owned by the taxpayer. The IRS argued that Gregory supported the "natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." The taxpayers countered that Burnet v. Commonwealth Improvement Co., in which the Court held that a wholly owned corporation was taxable on a gain realized on the sale of its stock to its shareholder, supported the deduction of the loss.

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9 Gregory v. Helvering, 293 U.S. at 467.
10 Id.
12 Id.
13 Helvering, 69 F.2d at 809.
14 Gregory, 293 U.S. at 470.
15 Id.
18 Higgins, 308 U.S. at 476.
20 Burns, 287 U.S. at 419-20.
The Court agreed that Commonwealth Improvement required it to recognize the separate identities of the corporation and its shareholders, but that if a tax advantage resulted, the Government did not have to accept the form adopted by the taxpayer. Instead, the Government "may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." 21 Observing that "the command of income and its benefits... marks the real owner of property," 22 the Court upheld the disallowance of the claimed loss.

In F. & R. Lazarus, the taxpayer transferred title to two properties to a trustee for land-trust certificates and leased the properties back for ninety-nine years, with options to renew the leases and purchase the properties. 23 Subsequently, the taxpayer claimed depreciation deductions on the transferred properties. 24 The IRS contested the deductions, arguing that the right to deduct depreciation follows legal title, and thus, belonged to the trustee. 25

The Court upheld the taxpayer's claim in Lazarus, concurring with the trial court's finding that the transactions involved were in substance mortgages rather than sale-leasebacks. 26 The Court pointed out that "in the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." 27

Shareholders as Conduits for Corporate Liquidations

Two of the more significant Supreme Court cases involving the substance versus form issue, Commissioner v. Court Holding Co. 28 and U.S. v. Cumberland Public Service Co., 29 involved the use of shareholders as mere conduits for the sale of corporate assets. In Court Holding, on the eve before signing a contract for the sale of its only asset, the corporate taxpayer liquidated, and its shareholders consummated the sale. Observing again that the "incidence of taxation depends upon the substance of a transaction," 30 the Court upheld the trial court's conclusion

21 Higgins, 308 U.S. at 477.
22 Id. at 478. Congress codified this result in the Revenue Act of 1934, § 24(a)(6) (currently I.R.C. § 267(1991)).
24 Id.
25 Id.
26 Id. at 255.
27 Id.
30 Commissioner v. Court holding Co., 324 U.S. at 334. See also Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938) (cash received by a corporation and distributed, to its shareholders, with the understanding that they would use it to discharge corporate debts held in substance not distributed, and thus taxable, to the corporation).
that the gain on the sale of the property was taxable to the corporate taxpayer. Explaining its decision, the Court stated:

A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.31

Addressing essentially the same issue in Cumberland Public Service Co., the Court held that the shareholders had made the sale after liquidation of the corporation. In reaching this conclusion, the Court acknowledged that the distinction between Cumberland Public Service and Court Holding might be “particularly shady and artificial,”32 but that the trial court’s findings in Cumberland Public Service warranted this distinction. The corporation was, in fact, liquidated before the shareholders negotiated the sale of the assets in their own capacity. The IRS’s theory that the shareholders acted as mere conduits for the sale by the corporation was inconsistent with these findings.

Deductibility of Losses on Sales Between Family Members

In McWilliams v. Commissioner,33 the Court applies the substance over form doctrine to a statute that prohibited a deduction for a loss on the sale of property, directly or indirectly, between family members.34 The husband and wife taxpayers in McWilliams filed separate tax returns.35 To establish a tax loss, one spouse used the stock exchange to sell shares to an unrelated and unknown purchaser.36 Simultaneously, the other spouse used the stock exchange to purchase an equal number of the same shares from an unrelated and unknown seller.37 The Court agreed that in form the sales were bona fide sales to strangers, but concluded that the substance of the transactions amounted to indirect sales between family members.38 In the Court’s view, accepting the taxpayers’ literal interpretation of the statute “would be reading into it a crippling exception which is not there.”39

Deductibility of Interest

At issue in the 1946 companion cases of John Kelley Co. v. Commissioner:40

31 Id. (footnote omitted). Revenue Act of 1954, § 337 provided that most gains realized by a corporation on the sale of property in connection with its liquidation are not taxable. However, I.R.C. § 631(a) (1986) repealed this section of the 1954 Act.
32 Cumberland Public Service Co., 338 U.S. at 454.
33 McWilliams v. Commissioner 331 U.S. 694 (1947).
34 Revenue Act of 1938, § 24(b) (a) (currently I.R.C. § 267 (1991)).
35 McWilliams, 331 U.S. at 695.
36 Id.
37 Id.
38 Id. at 703
39 Id.
and *Talbot Mills v. Commissioner* and the more recent cases of *Knetsch v. U.S.* and *Frank Lyon v. U.S.*, was the deductibility of amounts paid in the form of interest, but argued by the IRS to be in substance nondeductible dividends, or worse, merely a sham. *Frank Lyon* also involved a depreciation deduction contested by the IRS.

1. *John Kelley and Talbot Mills*

In *John Kelley and Talbot Mills*, the Court stated that "the wholly useless temporary compliance with statutory literalness" found in *Gregory* was not present in either of the cases. The purported debt in *Kelley* consisted of 8 percent noncumulative income debentures subordinated to the claims of all other creditors. In *Talbot Mills*, the debt at issue consisted of notes bearing interest at a rate between 2 percent and 10 percent, depending upon corporate earnings. Finding the issue to be more factual than legal, the Court upheld the Tax Court's conclusions that the amounts paid on the *Kelley* debentures were deductible as interest, but that the "interest" paid on the Talbot Mills notes was in substance a dividend. 45

2. *Knetsch*

In the 1960 *Knetsch* case, the taxpayer purchased ten, thirty-year, 2.5 percent deferred annuity savings bonds in an aggregate amount of $4 million. 46 The taxpayer paid for these bonds with a $4,000 check and a 3.5 percent nonrecourse note in the amount of $4 million. 47 At the date of purchase, the taxpayer prepaid the first year's interest on the note, $140,000; issued 3.5 percent notes equal to the loan value of the bonds, approximately $99,000; and prepaid interest of $3,465. 48 The taxpayer repeated this performance the next two years before terminating this arrangement in the fourth year. 49 At the termination date, the taxpayer received $1,000, which represented the difference between the cash value of the bonds ($4,308,000) and the amount owed ($4,307,000). 50

The point in contention in *Knetsch* was the deductibility of the interest payments by the taxpayers in the first two years of the life of the bonds. The Court agreed with the trial judge's findings that (1) "[t]here was no commercial economic substance to the... transaction," (2) "[n]o indebtedness of [the taxpayer] was created.

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41 Id.
44 John Kelly, 326 U.S. at 525.
45 Id. at 530.
46 Knetsch, 364 U.S. at 362.
47 Id.
48 Id. at 363.
49 Id.
50 Id.
by any of the ...transactions,' [and] (3) '[n]o economic gain could be achieved from the purchase of these bonds without regard to the tax consequences...'. In the Court’s view, what the taxpayer borrowed was in reality only a rebate of a substantial part of what was labeled interest. Although acknowledging that some single premium annuity arrangements with nontax substance might create indebtedness, the Court concluded that ‘this one is a sham,’ and thus, disallowed the claimed interest deductions.

3. Frank Lyon

The 1978 *Frank Lyon* case contains the Supreme Court’s last word on the substance versus form issue. The taxpayer financed the purchase of a bank building with funds largely borrowed from an independent lender, and then leased the building back to the bank at a rental just sufficient to service the loan. Upon repayment of the loan and termination of the initial term of the lease, the bank had an option to purchase the building for a fixed price—the building’s fair market value as estimated at the inception of the lease—or renew the lease at a reduced rental.

At issue in the case was the taxpayer’s right to deduct interest and depreciation. The Government contended that the sale and leaseback was simply a financing, and that the taxpayer was acting merely as a conduit in passing on the “rental” payments to the lender. The Court, however, disagreed with the Government primarily because (1) legalities precluded the bank from borrowing directly from the lender and (2) the taxpayer was clearly liable on the borrowing. Conceding that ‘there is no simple device available to peel away the form of this transaction and to reveal its substance,’ the Court found that the taxpayer was the party with its capital invested in the building, and thus, was entitled to the interest deduction.

Ancillary Tax Principles Affecting Substance Versus Form Doctrine

Self-Dealing Versus Arm’s-Length Transactions

The IRS seems to invoke the substance over form doctrine with greatest ease.

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52 Id. at 368-69.
53 Id. at 366 (footnote omitted).
56 *Frank Lyon*, 435 U.S. at 563.
57 Id. at 566.
58 Id. at 568-69.
59 Id. at 582-84.
60 Id. at 576.
61 Id.
when the transaction involves self-dealing. The form used in self-dealing transactions often has minimal, if any, nontax consequences, and is chosen solely because it is expected to reduce taxes. For example, a purported credit sale of property by parents to their children may, on inspection, be a gift of the property, because neither the parents nor the children have taken seriously the purported obligation to pay the agreed price. Self-dealing transactions between parent and subsidiary corporations provide another set of tempting targets for legislative, administrative, and judicial marksmen armed with the substance over form weapon.

Arm's-length transactions between the taxpayer and independent parties are far less vulnerable to substance over form attacks by the IRS than self-dealing transactions. For nontax reasons, the parties usually fully express their understanding in the documents so that the chosen form reflects the substance of the transactions. The Seventh Circuit established this point in *Campana Corp. v. Harrison*, where it defined an arm's-length transaction as a sale between parties with adverse economic interests.

**Differing Tax Interests**

Differing tax interests on behalf of the parties to the transaction also normally make the substance and form of the transactions more congruent. For example, when a business pays an employee for services, the desire to deduct the payment as a business expense usually leads the employer to resist the employees suggestions to disguise the payment as a tax-free gift. This principle does not hold in all cases, however. For instance, if the employer in the above example is a tax-exempt organization or a persistently unsuccessful enterprise with more deductions than it can use, it may be willing to cooperate with the employee as a costless gesture of charity or in return for a concession by the employee. A similar bargain may be struck when two parties expect to be taxed at significantly different tax rates, and they can devise a legal form that will assign the tax advantages to the party who can best use them. For example, a husband may be willing to pay more in alimony because his right to deduct the payment will reduce his taxes more than the extra alimony will increase the wife's taxes. Similarly, a railroad or airline company with

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62 See, e.g., *Campana Corp. v. Harrison*, 114 F.2d 400 (7th Cir. 1940); *Limericks, Inc. v. Commissioner*, 7 T.C. 1129 (1946), aff'd, 165 F.2d 483 (5th Cir. 1948); *58th Street Plaza Theatre v. Commissioner*, 16 T.C. 469 (1951), aff'd, 195 F.2d 724 (2d Cir. 1952); *Central Cuba Sugar Co. v. Commissioner*, 16 T.C. 882 (1951), aff'd on this point, 198 F.2d 214 (2d Cir. 1952); *Gladys Chessman Evans v. Commissioner*, 30 T.C. 798 (1958); *Winters v. Dallman*, 238 F.2d 912 (7th Cir. 1956); *United States v. 58th Street Plaza Theatre*, 287 F. Supp. 475 (S.D. N.Y. 1968).

63 See, e.g., *Crown Cork Int'l Corp. v. Commissioner*, 4 T.C. 19, aff'd, 149 F.2d 968 (3d Cir. 1945); *Bank of America Nat'l Trust and Savings Ass'n v. Commissioner*, 15 T.C. 544, aff'd, 193 F.2d 178 (9th Cir. 1951); *A. Arena & Co., Ltd. v. United States*, 103 F. Supp. 505 (S.D. Cal. 1952); *Nat'l Lead Co. v. Commissioner*, 336 F.2d 134 (2d Cir. 1964), cert denied, 380 U.S. 908 (1964).

64 See *Campana Corp.*, 114 F.2d 400.

65 Id.

66 Id.
a long history of losses may be willing to lease rather than buy equipment, so that the lessor can derive the tax benefits that otherwise would be useless to the lessee. Finally, tax shelters tend to be successful because they are able to shift tax allowances to investors who can deduct them from their top bracket taxable income.

Substance of Arm’s-Length Transaction not Always Upheld

In Campana, the court made it clear that the form of a transaction will not automatically be disregarded in a non-arm’s-length transaction. Generally, if a transaction is housed in a form that fairly reflects its substance, it will withstand scrutiny despite the conscious pursuit of tax benefits. In this respect, the transaction resembles an individual taxpayer’s isolated decision to pursue a tax-minimizing route rather than a taxable one. On the other hand, if the form of a transaction does not coincide with its substance, the fact that it was negotiated at arm’s-length by unrelated parties will not protect it against attack by the IRS. For example, the IRS may apply the substance over form doctrine to treat a purported lease of business equipment as a sale if the lessee has the option to purchase the property at a nominal amount at the end of the lease term, or if the lease term is equal to the anticipated useful life of the property.

Business Purpose Versus Tax Avoidance

As previously noted, the business purpose test originated with the Supreme Court’s decision in Gregory v. Helvering. In Gregory, the Court held that there was not a statutory reorganization, even though the taxpayer complied with the literal terms of Section 112(g) of the 1928 Act, because the transaction lacked a bona fide business purpose. The regulations restate this business purpose requirement in two sections—regulations section 1.368-1(b) and (c).

The IRS and the courts frequently apply the business purpose test to strike down purported reorganizations where the motive is tax avoidance. Generally, the taxpayer must respond by establishing or proving a business purpose. However, in several cases involving liquidation-reincorporation transactions, the courts have required D reorganization treatment, even though the taxpayer argued that there was no business purpose for a reorganization, as opposed to a liquidation. In these cases, the courts have held that the existence of a business purpose for a liquidation, and the absence of a tax avoidance motive, do not preclude a transaction from qualifying

67 See generally id.
68 See, e.g., Truman Bowen v. Commissioner, 12 T.C. 446 (1949); Rev. Rul. 55-540, 1955-2, C.B. 39; East Coast Equipment Co. v. Commissioner, 21 T.C. 112, aff’d, 222 F.2d 676 (3d Cir. 1955); Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955); Wilshire Holding Corp. v. Commissioner, 262 F.2d 51 (9th Cir. 1958); Lemon v. United States, 115 F. Supp 573 (W.D. Va. 1953).
69 Gregory, 293 United States 465.
as a reorganization when all the technical requirements for such a reorganization are met.\textsuperscript{71}

\textbf{Corporate or Shareholder Business Purpose?}

Current regulations seem to focus on the existence of a corporate business purpose for a reorganization.\textsuperscript{72} The early cases following Gregory also seemed to require a corporate business purpose. Subsequent cases, however, have rejected this approach in favor of an evaluation of all the nontax motives of both the corporations and shareholders involved.\textsuperscript{73} In Lauri v. Commissioner,\textsuperscript{74} for example, the Sixth Circuit held that the preservation of the goodwill and business reputation of the acquiring company and the shareholders constituted a valid business purpose for the merger. Additionally, the assured continuance of air charter and repair services, upon which the acquiring company depended heavily, constituted a valid business purpose for the acquisition of its sister corporation, an air service company.

\textit{Test not Restricted to Corporate Reorganizations}

Despite the fact that it originated in a reorganization case, application of the business purpose test has not been restricted to reorganizations. The Supreme Court applied a similar test to determine whether the separate entity of a corporation should be disregarded.\textsuperscript{75} Other courts have applied the test to leaseback transactions,\textsuperscript{76} and the IRS has announced that it will apply a stringent business purpose test to reinsurance arrangements between domestic and foreign reinsurers where a close relationship exists.\textsuperscript{77}

\textbf{Step-Transactions}

Where a series of steps resulting in a change of interest occurs, the issue arises as to whether to consider each step separately, or to consider in their entirety the steps resulting in a complete transaction, thereby giving effect to the whole transaction rather than any of its separate parts. The step-transaction doctrine requires the latter--i.e., it treats formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused towards a particular result.\textsuperscript{78} Thus, the step-transaction doctrine represents a corollary to the substance over form

\textsuperscript{72} Treas. Reg. § 1.368-1(b) and (c) (1990).
\textsuperscript{73} Compare Lewis v. Commissioner, 10 T.C. 1080 (1948), aff'd 176 F.2d 646 (1st Cir. 1949); and Parshelsky Est. v. Commissioner, 34 T.C. 946 (1960), rev'd, 303 F.2d 14 (2d Cir. 1962); Rafferty v. Commissioner, 55 T.C. 490 (1970), aff'd, 452 F.2d 767 (1st Cir. 1971), cert. denied, 408 U.S. 922 (1972).
\textsuperscript{74} Lauri v. Commissioner, 653 F.2d 253 (6th Cir. 1981).
\textsuperscript{75} Moline Properties v. Commissioner, 319 U.S. 436 (1943).
\textsuperscript{76} Ernest v. Berry, 33 T.C.M. (P.H. 64, 181) (1964); 55 T.C.M. (P.H. § 86, 249) (1986).
\textsuperscript{77} Announc. 61-26 (TIR 300).
\textsuperscript{78} See Penrod v. Commissioner, 88 T.C. 1415, 1427-29 (1987).
The doctrine originated and has been applied, for the most part, in corporate reorganization cases, but it is not limited to these situations.  

While it is usually comparatively simple to foresee the results that flow from applying the step-transaction doctrine, it is more difficult to predict whether the courts or the IRS will adopt it as the proper method of analyzing a set of facts. At one extreme, if the parties to a transaction agree to take a series of steps, no one of which will be legally effective unless all are consummated, application of the step-transaction doctrine ordinarily is assured. However, in the absence of an all or nothing plan, predictions are more uncertain. An independent series of steps may occur simultaneously or in rapid succession, enabling the taxpayer to claim that he is engaged in negotiations or has a lawyer on retainer to achieve several independent objectives, each of which could be pursued on its own if the others have to be abandoned. Recognizing the potential for dispute, the courts have used three tests or standards to determine when and how to apply the step-transaction doctrine: (1) end result test, (2) interdependence test, and (3) binding commitment test. In many cases, the courts apply all three tests because the boundaries of the tests are not distinct, but, instead, overlap.

**End Result Test**

The most far-reaching test under the step-transaction doctrine looks to the end result of a series of transactions for economic substance. Separate transactions will be consolidated into a single transaction if it appears that they are component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. In essence, the test insures that "a given result at the end of a straight path is not made a different result because [it was] reached by following a devious path." In *Gregory v. Helvering*, the Supreme Court described the step-transaction doctrine in end result terms as...

> a mere device which put[s] 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 the business or any part of the business, but to transfer a parcel of corporate shares.

The end result test is based upon the assumption that a given end result should have the same tax effect, whether achieved directly or through several intervening steps. In a number of rulings involving reorganizations, the Service has ruled that...

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79 Security Industrial Ins. Co. v. United States, 702 F.2d 1234, 1244-45 (5th Cir. 1983).
81 *Minnesota Tea*, 302 U.S. at 613.
82 *Gregory*, 293 U. S. at 465.
the transitory existence of a corporation involved in a reorganization is to be
disregarded for purposes of determining the tax consequences of the transaction.
These rulings looked to the substance or end result of the transaction to determine
tax treatment. 83

Mutual Interdependence Test

Under the mutual interdependence test, the court must ascertain whether the
individual transactions are "so interdependent that the legal relationship created by
one transaction would have been fruitless without a completion of the series". 84 The
test focuses on the relationship between the steps, rather than on their end result.
Each step is examined separately to determine whether it has a reasonable economic
justification for standing alone, or whether its success depends on successful
completion of each of the other steps.

A number of cases have cited or used the mutual interdependence test to apply
the step-transaction doctrine. 85 For example, where an entity acts as a conduit, having
no business purpose of its own and merely acting to secure the taxpayer's literal
compliance with the applicable provisions of law, mutual interdependency is almost
always cited as justification for invoking the step-transaction doctrine. 86 Conversely, intermediate transactions that add nothing to the completed affair and
represent only transitory phases of an arrangement may escape the step-transaction
doctrine because of the lack of mutual interdependency. 87 The IRS, describing both
the end result and mutual interdependence tests, holds that "threshold steps" will not
be subject to the step-transaction doctrine when:

[s]uch preliminary activity results in a permanent alteration of a
previous bona fide business relationship. Thus, the substance of each
of a series of steps will be recognized and the step transaction doctrine
will not apply, if each such step demonstrates independent economic
significance, is not subject to attack as a sham, and was undertaken for
valid business purposes and not mere avoidance of taxes. 88

Binding Commitment Test

The third and most restrictive test for applying the step-transaction doctrine

84 Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1980).
86 West Coast Marketing, 46 T.C. at 32.
87 Alabama Asphaltic Limestone, 315 U.S. at 179.
is the binding commitment test formulated by the Supreme Court in *Commissioner v. Gordon*. This test permits application of the step-transaction doctrine where the taxpayer is subject to an obligation or a binding commitment to pursue the successive steps in a series of transactions. The difficulty in applying the test arises because of the greater certainty required to determine whether a transaction spanning several tax years should be consolidated.

The situation in *Gordon* involved a corporation's distribution of all or a controlling amount of stock in a controlled corporation pursuant to a reorganization under Section 355. The issue was whether a distribution of 57 percent of the stock of the controlled corporation in one year could be combined with a distribution of the remaining 43 percent of the stock two years later for purposes of satisfying the 50 percent control requirement. The Court refused to combine the transfers, and thus found nonrecognition treatment under Section 355 inapplicable, because there was no binding commitment to take the latter steps when the initial steps were taken. In the Court's view, "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the latter steps."90

Subsequent decisions have somewhat limited the application of the binding commitment test. In *King Enterprises, Inc. v. U.S.*, the Court of Claims held that the Supreme Court did not intend for the binding commitment test to affect the application of the step-transaction doctrine in other types of transactions, and that *Gordon* must be limited to its facts. Other courts also have reviewed the binding commitment test and concluded that the lack of a binding commitment should be determinative only in cases involving multi-year transactions, and that in other situations, the presence or absence of a binding commitment is only one factor to consider in applying the step-transaction doctrine.92

**Substance or Form: Which Prevails and Who May Successfully Invoke the Doctrine?**

The IRS, rather than the taxpayer, normally invokes the substance versus form issue and argues that the substance of the transaction should override its form. Occasionally, however, the rules are reversed, with the IRS contending that the taxpayer should be bound by the form in which the transaction was cast, and the taxpayer arguing that the substance of the transaction differs from its form and should control. Thus, whether substance or form will prevail, and who may successfully invoke the substance over form doctrine, depends upon the facts of the case and the court's view of these facts.

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90 *Id.*
91 Redding v. Commissioner, 71 T.C. 597 (1979); *McDonald's* 688 F.2d 520; *Security Industrial*, 702 F.2d 1234.
Extreme Positions Taken by Courts

The courts provide two extremes for the substance versus form issue. At one end of the spectrum, taxpayers are told that the IRS can cut through the red tape if it wishes, but that it is equally free to leave them entangled in the form they select. The traditional elements of the legal principle of estoppel support the judicial refusal to permit taxpayers to repudiate their own handiwork. Correcting the prior years' returns of the taxpayer and other parties to the transaction may be administratively difficult, and perhaps impossible, because of faded memories and expiring statutes of limitation. But, even when no irretrievable waves have been set in motion, the courts may deny a taxpayer the right to use the substance over form doctrine. Justifying such a position, the Second Circuit states:

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

At the opposite extreme, many cases hold that the substance over form doctrine is a two-way street, open to the taxpayer as well as the IRS. Justifying this attitude, the Ninth Circuit states: "One should not be garroted by the tax collector for calling one's agreement by the wrong name." In a similar way, the Supreme Court permitted taxpayers to repudiate a tax-oriented contract on showing that its form conflicted with economic reality despite the IRS's willingness to accept the contract as written. The case involved an effort to shift liability for social security taxes on the wages of musicians from bandleaders to ballroom operators by vesting the latter with rights under a standard union contract that were not intended to be enforced. Despite a denial of the employment realities, the IRS was willing to accept the agreement, perhaps because the ballroom operators were more responsible taxpayers than the bandleaders. However, the Supreme Court allowed the operators to repudiate the fictitious employer-employee relationship.

Between these two extremes are cases that allow taxpayers to escape the forms selected by them, but impose a more stringent burden of proof than is normally applied in tax cases. Describing this middle ground, the Tax Court states that "the so-called 'two-way street' seems to run downhill for the Commissioner and uphill for the taxpayer". For example, when the sales price of a going business is allocated by the parties among its assets (e.g., inventory, depreciable assets, noncompete covenant), some courts permit a repudiation of the agreed allocation by the buyer or
seller only on "strong proof" of its failure to reflect economic reality. However, the Third Circuit has allowed the taxpayer to repudiate the allocation only on showing that it was induced by mistake or fraud.

Abstruseness Extends to Ancillary Principles

The abstruse nature of the courts' decisions on substance versus form is equally applicable to the ancillary principles. The First Circuit has held that the business purpose test is not "controlled by whether in a particular case it is to the advantage of [the IRS] or of the taxpayer. . . ." Additionally, the Tax Court has criticized the IRS for going too far in attacking a transaction for lack of business purpose, and the Fifth Circuit has made it clear that the transaction will be respected even if the taxpayer has a tax avoidance purpose. Despite these hints of flexibility, case law generally does not support a taxpayer who wants to disavow the form of a transaction for lack of business purpose. The courts are well aware that a business purpose generally is devised in the offices of the taxpayer's tax advisers, and to allow the taxpayer to produce documentation of business purpose at will would undermine the entire purpose of the test. For example, a taxpayer may want a reorganization transaction to be taxable in order to receive a step-up in asset basis or to recognize a loss. In such instances, the courts have not been swayed by taxpayers who argue that the transaction should be taxable because of a lack of business purpose.

Much of the difficulty in interpreting the arm's-length versus self-dealing cases comes from the courts' tendency to simultaneously invoke other principles. For example, many of the cases in which the business purpose test is applied involve parties not having adverse economic interests, and thus, may not be dealing at arm's-length. Whether the overriding concern of the court is self-dealing or lack of business purpose cannot be discerned.

Determining when and how the courts will apply the step-transaction doctrine probably is the most difficult of all the ancillary principles. In the usual case, the IRS invokes the step-transaction doctrine to require the integration of parts of a single transaction when the form of the transaction does not coincide with economic reality. The taxpayer, however, in limited circumstances, may invoke the step-transaction doctrine if the form of the transaction does not reflect his view of its substance. On this point, the Sixth Circuit states:

The principle that one transaction may not be broken up into various

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99 Ullman v. Commissioner, 264 F.2d 305, 308-09 (2d Cir. 1959).
100 Commissioner v. Danielson, 378 F.2d 771, 775 (2d Cir. 1959).
101 Lewis v. Commissioner, 176 F.2d 646, 648 (1st Cir. 1949).
102 W. P. Hobby v. Commissioner, 2 T.C. 980 (1943).
103 Fender v. United States, 577 F.2d 934 (5th Cir. 1978).
104 Survaunt v. Commissioner, 162 F.2d 853 (8th Cir. 1947).
105 E.g., Crown Cork Int'l, 4 T.C. at 19.
106 E.g., Court Holding, 324 U. S. at 331; Higgins, 308 U. S. at 473.
elements to avoid a tax is not a single, but a double, edged sword, as it also may not be broken into various elements to create a tax.\textsuperscript{107}

**CORNERSTONE OF SOUND TAXATION OR LETHAL WEAPON?**

The intricate nature of the decisions involving the substance over form doctrine and the ancillary principles favors a "lethal weapon" interpretation of the doctrine. Seemingly, the courts decide the issue on an ad hoc basis, reaching a conclusion and then citing those cases that support the conclusion. If a court respects the form of the transaction, it cites cases holding that a taxpayer is free to arrange his affairs in a manner that results in the least taxes.\textsuperscript{108} Conversely, if a court ignores the form of a transaction, it cites cases holding that substance governs form or that the transaction was not at arm's-length, lacked a business purpose, or was part of a series of integrated steps of a single transaction.\textsuperscript{109}

**Finding Certainty in Ad Hoc Decisions**

While the ad hoc nature of the substance over form decisions cannot be ignored, more certainty may exist in this area of tax law than a cursory review of case law suggests. One commentator contends that tax analysts may predict whether a court will respect the form of a transaction by considering the interplay of three factors: (1) the potential characterizations of the substance of the transaction, (2) the existence of a business purpose, and (3) the identity of the party (either the IRS or the taxpayer) challenging the form of the transaction.\textsuperscript{110} Using these factors, four general principles emerge:

1. If the substance of the transaction agrees with its form and no alternative substance for recharacterizing the transaction exists, the courts will respect the form of the transaction.
2. If the substance of the transaction cannot be reconciled with its form, the courts will not respect the form of the transaction.
3. If the substance of the transaction agrees with its form, but the transaction could with equal or less force be recharacterized as having another substance, the courts will respect the form of the transaction.
4. If the substance of the transaction arguably agrees with its form, but more reasonably does not agree with its form, the courts will not respect the form of the transaction in the face of an IRS challenge.

\textsuperscript{107} Buhl v. Kavanagh, 118 F.2d 315, 320 (6th Cir. 1941).
\textsuperscript{108} E.g., United States v. Cumberland Public Service Co., 338 U.S. 451 (1950); Chisholm, 79 F.2d 14 (2d Cir. 1935).
\textsuperscript{109} E.g., Gregory, 293 U.S. 465.
unless the taxpayer has a business purpose for the form of the transaction. If the taxpayer, rather than the IRS, challenges the form of the transaction in this situation, the courts are not likely to ignore the form unless the taxpayer provides strong proof to the contrary. 111

Coping with the Step-Transaction Doctrine

While case law generally supports the four principles stated above, the principles offer little guidance in how to cope with the step-transaction doctrine. Several recent cases, however, indicate that the step-transaction doctrine, as well as the related one of substance over form, may be easier for the taxpayer to overcome than at any time in the past. 112 The IRS seems reluctant to argue its position on the basis of the step-transaction doctrine (favoring instead the more general substance over form doctrine), and the courts appear equally hesitant to apply it where the taxpayer has rigidly adhered to the form of the transactions. 113 Thus, while the step-transaction doctrine has historically caused much anxiety because of its lack of precision, recent cases suggest that it is less threatening—i.e., less of a lethal weapon; and perhaps less of a cornerstone of sound taxation.

CONCLUSION

In applying the tax laws to particular transactions, the IRS and the courts have generally distinguished between form and substance, and asserted that transactions are to be taken at face value for tax purposes only if they (1) are conducted at arm’s-length, (2) are based on a business purpose or reflect economic reality, and (3) integrate all steps in a prearranged plan, rather than give effect to each step as though it were an isolated transaction. These presuppositions or criteria are so pervasive that some interpret them as a preamble to the Internal Revenue Code, describing the framework within which all statutory provisions are to function. Others, however, believe that these judicial presuppositions or criteria are more successful in establishing attitudes and moods than in supplying crisp answers to specific questions, and, thus, consider them merely weapons—usually lethal—in the IRS’s arsenal. The truth probably lies somewhere in between these extremes—i.e., the substance over form doctrine and the ancillary principles of arm’s-length, business purpose, and step-transaction are not only the cornerstones of the federal tax system, but also lethal weapons in the IRS’s arsenal.

111 Id.