BEYOND ECONOMIC SUBSTANCE: INTERROGATING THE FULL IMPACTS OF THIRD-PARTY RELATIONSHIPS IN TAX SHELTER CASES

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I. INTRODUCTION

The evaluation of relationships between actors is an important preoccupation across many areas of law.[1] The nature of such relationships and the extent to which they are respected under the law can give rise to significant legal consequences.[2] No less so in tax law. Relationships, interactions, and transactions between taxpayers and other parties are critical in allowing taxpayers to obtain desired tax results.[3] Correspondingly, where the tax law refuses to respect such relationships, adverse tax consequences follow.[4]

Relationships, interactions, and transactions between players are nowhere more critical than in situations involving transactions deliberately entered into to avoid paying taxes, commonly referred to as tax shelter transactions.[5] Shelter transactions represent instances of exceptionally

1. *See, e.g.*, Arthur L. Corbin, *Jural Relations and Their Classification*, 30 YALE L.J. 226 (1921) (presenting a theory of jural relations and of law that underlies current judicial reasoning); Wesley Hohfeld, *Some Fundamental Legal Conceptions As Applied in Judicial Reasoning*, 23 YALE L.J. 16 (1913) (mapping legal interests accompanying various jural interests and relations).

2. *See, e.g.*, Courtney Megan Cahill, *(Still) Not Fit to Be Named: Moving Beyond Race to Explain Why 'Separate' Nomenclature for Gay and Straight Relationships Will Never be 'Equal'* 97 GEO. L.J. 1155, 1191-1205 (2009) (describing consequences of separately defined relationship statuses in family law); Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009) (describing detrimental effects of relationships created through securitization).

3. *See generally* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955); Eisner v. Macomber, 252 U.S. 189 (1920) (early cases setting out income realization requirement).

4. *See, e.g.*, I.R.C. § 267 (2006) (related party attribution rules); I.R.C. § 318 (2006) (rules for constructive ownership of stock).

5. In order to further discussion, this Article uses the terms "tax shelter" or "aggressive tax planning" broadly, to include transactions entered into to avoid taxes, whether they actually have been determined to cross the line between acceptable and unacceptable tax planning. The term is not used in a statutory or technical sense to denote actual litigation outcomes. *Contra* I.R.C. § 6700 (2006) (defining "tax shelters" for the purpose of imposing monetary penalty); I.R.C. § 7408 (2006) (authorizing injunctions against conduct relating to tax shelters). Of course, the academic literature itself evinces a lack of agreement with respect to even the threshold question of what a tax shelter really is. *See, e.g.*, U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS (1999), *available at* http://www.ustreas.gov/offices/tax-policy/library/ctswhite.pdf (setting out common characteristics of corporate tax shelters); Deborah H. Schenk, *Foreword: Symposium on Corporate Tax Shelters Part I*, 55 TAX L.

aggressive relationship formation, and in many shelter transactions one sees taxpayers purposefully creating and entering into contracts and relationships with tax-exempt entities, tax-indifferent foreign entities, insurance companies, banks, and other entities in order to generate favorable tax consequences.[6] Sometimes courts respect these purposefully formed relationships and transactions and sanction their tax-minimization endeavors.[7] Other times, they are not given weight.[8] In order to distinguish between those transactions and relationships that deserve respect and those that do not, tax law has developed significant doctrines that inquire into the "substance," "risk," or "purpose" of such transactions and relationships. These judicially originated "anti-abuse" doctrines include the substance-over-form doctrine, the sham transaction doctrine, the business purpose doctrine, and, perhaps most prominently, the recently codified economic substance doctrine.[9]

This Article argues that the tax law's traditional focus on whether a transaction holds enough "risk" or "economic substance" to be respected is insufficient in meeting the full range of challenges presented by the sophisticated, interlocking, and often hidden relationships that underlie tax planning today. It argues that the fundamentally relational character of tax planning has important impacts on the shape and outcome of tax shelter

REV. 125 (2002) (comparing James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 158-59 (2002), *with* David P. Hariton, *Response to "Old 'Brine' in New Bottles" (New Brine in Old Bottles)*, 55 TAX L. REV. 397, 399 (2002) (construing Eustice, *supra* note 5)). At the same time, it is clear that those transactions that cross the line (as well as some that come close but do not) are viewed by many as problematic, revenue-reducing, and unfair. *See, e.g.*, David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222 (2002) ("[T]ax planning, all tax planning, not just planning associated with traditional notions of shelters, produces nothing of value."). *But see* Leo Katz, *In Defense of Tax Shelters*, 26 VA. TAX REV. 799 (2007) (defending tax shelters by analogy to agenda manipulation).

6. *See* cases cited *infra* notes 7 and 8 (examples of tax shelter cases decided by courts). Thus, tax shelter transactions represent the extreme end of a continuum. While this Article focuses on this extreme case, much of the relational analysis set forth herein is also applicable to non-shelter tax transactions.

7. *See, e.g.*, Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 2004), *aff'd in part, rev'd in part and remanded by* 436 F.3d 431 (4th Cir. 2006) (district court granted summary judgment in favor of the taxpayer under the sham transaction doctrine); United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001) (reversing tax court and holding for taxpayer); Consol. Edison Co. of N.Y. v. United States, 90 Fed. Cl. 228 (2009) (holding that a "lease-in, lease-out" transaction qualified for rental, interest, and transaction cost deductions).

8. *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998) (determining partnership transaction did not have sufficient economic substance to be respected for tax purposes); Wells Fargo & Co. v. United States, 91 Fed. Cl. 35 (2010) (concluding "sale-in, lease-out" transaction lacked objective economic substance).

9. In this Article, the term "judicial anti-abuse doctrines" includes the recently codified economic substance doctrine.

litigation beyond the question of whether a transaction or relationship has "substance." In trying to understand the full range of impacts of relationships and interactivity between taxpayers and other parties in how tax shelter cases get litigated, this Article's normative critique and proposed solutions build upon the emerging body of literature that pays explicit attention to the relational underpinnings of tax transactions.[10]

Given the pervasive and growing importance of relationships with facilitative, friendly, and accommodating third parties in tax shelter transactions, explicit probing of the full significance of these parties in determining outcomes in shelter cases has been surprisingly sparse.[11] There has been a good deal of commentary on the adequacy of judicially applied anti-abuse doctrines in addressing the tax shelter problem, and some of this commentary, of course, *implicitly* addresses the more obvious aspects of how relationships and transactions with third parties come into play in determining whether a transaction is an abusive tax shelter.[12]

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10. *See* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 697-700 (2007) [hereinafter Lederman I] (arguing that substantive federal tax law can be improved by increased use of "structural constraints" in situations where third parties have an incentive to collude with taxpayers in promoting noncompliance); Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PA. L. REV. 1181 (2008) [hereinafter Raskolnikov, *Relational Tax Planning*] (discussing informal agreements between taxpayers and counterparties designed to eliminate market risk by substituting for it a different kind of relational risk and suggesting reforms to address the problem of what the author calls "relational tax planning"); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601 (2007) [hereinafter Raskolnikov, *The Cost of Norms*] (addressing the unintentional tax benefits stemming from informal transactions based on tacit understandings between players); Jay A. Soled, *Third-Party Civil Tax Penalties and Professional Standards*, 2004 WIS. L. REV. 1611 (2004) (evaluating third-party tax penalties and professional standards and suggesting reforms that emphasize accountability of both third parties and tax professionals). *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-968, TAX GAP: IRS CAN IMPROVE EFFORTS TO ADDRESS TAX EVASION BY NETWORKS OF BUSINESSES AND RELATED ENTITIES (2010), *available at* http://www.gao.gov/new.items/d10968.pdf [hereinafter GAO REPORT ON NETWORK TAX EVASION] (discussing effects of networks of related entities in facilitating tax evasion).

11. *But see* sources cited *supra* note 10.

12. *See, e.g.*, Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005) (suggesting a new approach to the tax shelter problem, based on the general disallowance of noneconomic losses); Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 TAX NOTES 969, 970 (2007) (arguing that the lower court's application of the economic substance doctrine cannot be reconciled with Supreme Court precedent and is inconsistent with rules of statutory interpretation); Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389 (2010) (arguing that economic substance doctrine should be replaced by inquiry into congressional intent); Assaf Likhovski, *The Story of Gregory: How are Tax Avoidance Cases Decided?*, *in* BUSINESS TAX STORIES 89-132, (Steven A. Bank & Kirk J. Start eds., 2005) (using the Supreme Court's reasoning in the landmark tax case *Gregory v. Helvering*, 293 U.S. 465 (1935), as a backdrop for discussing how courts address matters of tax avoidance); Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 VA. TAX REV. 783, 784-85 (2008) (focusing on the problems caused by the economic substance

However, the powerful and perverting effects of third-party relationships on judicial applications of existing anti-abuse doctrines beyond the question of risk or substance have received less attention in the literature.[13] The failure of the tax literature to deeply explore and theorize third-party relationships stands in marked contrast to other areas of law, where relationships between legal persons have been subject to intense, even voyeuristic, scrutiny.[14] This gap in the tax literature is especially problematic because relationships and interactions underlying sophisticated shelter transactions tend to be complex, non-intuitive, hidden from lay view, and difficult to understand.

One possible reason for this gap is that, judicial anti-abuse doctrines aside, discourses that emphasize the content of our substantive tax rules as discrete phenomena have been privileged over discourses analyzing the underlying relationships and interactions between taxpayers and third parties that facilitate the abuse of these rules. More public light needs to be shed upon the deeply transactional nature of the tax rules in order to remedy this imbalance so that all of the effects of transactional tax relationships receive scrutiny commensurate with their importance and commensurate with the attention received by relationships in other areas of law. This Article argues that the best ways to shed such light are (1) to encourage explicit judicial narratives about relationships in tax planning in order to facilitate transparency and counteract the dominating effects of rules-based and sanctions-based discourses,[15] and (2) to adequately police

doctrine's reliance on pretax analysis and proposing new framework for testing objective economic substance); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697 (2009) (arguing that judicial anti-abuse tests are insufficient and putting forth a test that looks directly at the purposes of the relevant laws); David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88 (2002) (analyzing the effects of the business purpose doctrine and the economic substance doctrine "as changes to the marginal elasticity of taxable income"). Of course, the economic substance doctrine has now been codified in statutory form. 26 U.S.C.A. § 7701(o) (West 2010).

13. *But see supra* note 10 and accompanying text (examining examples of articles in which these matters have been discussed).

14. *See, e.g.*, Goodridge v. Dep't of Pub. Health, 798 N.E.2d 941, 954 (Mass. 2003) (stating that "[i]n a real sense, there are three partners to every civil marriage: two willing spouses and an approving State . . . . While only the parties can mutually assent to marriage, the terms of the marriage—who may marry and what obligations, benefits, and liabilities attach to civil marriage—are set by the Commonwealth.").

15. "Rules-based" refers to accounts that focus on the content of the substantive tax rules and how to prevent their abuse. *See* sources cited *supra* note 12 and accompanying text (providing examples of literature discussing abuse prevention strategy utilizing broadly rules-based approaches). "Sanctions-based" denotes the tax literature focusing on the importance of disclosure, reporting, public shaming, and penalties as means to curb abusive tax shelter transactions. *See, e.g.*, Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629 (2009) (proposing that overdisclosure under current tax shelter disclosure law should be countered proactively by penalties and other

the boundaries of important judicial doctrines from the warping effects of aggressive relationship formation. Accordingly, this Article offers two proposals designed to achieve these goals.[16]

Part II lays a descriptive, analytical foundation for understanding the roles and significance of third-party relationships in tax planning. First, it defines and explains the parameters of what this Article means when it talks about "relationships," "transactions," and "third parties." Next, it describes in detail some of the roles that relationships with third parties play in tax planning, and in particular, in tax shelter transactions.[17] This description seeks to broadly emphasize the transactional-relational quality of tax planning for the non-tax reader; it is also an explicit attempt to raise consciousness about the presence of the aggressive and sophisticated, yet often hidden, relationships that underlie tax planning.[18] Finally, Part II points to a number of "form-friendly" features of tax law that have encouraged and facilitated increasing participation of third parties over time and that have made it more difficult to adequately evaluate their participation.[19] Part III discusses the ultimate inadequacy of traditional

means); Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863 (2004) (analyzing the effects, function, and symbolism of alternative sanctions imposed by Congress on taxpayers who take advantage of the Internal Revenue Code); Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733 (2010) [hereinafter Lederman II] (finding that some taxpayer information reporting laws and proposals are more effective than others in improving compliance).

16. The analysis set forth in this Article is applicable to those tax shelter cases that involve third parties such as lease stripping cases, equipment leasing transactions, and others. *See, e.g.*, AWG Leasing Trust v. United States, 592 F. Supp. 2d 953, 961 (N.D. Ohio 2008) (sale-in/lease-out transaction); CMA Consol., Inc. v. Comm'r, T.C.M. (RIA) 2005-16 (2005) (multiparty lease stripping transaction).

17. *See infra* Part II.A.

18. I am deliberately borrowing the term "consciousness raising" as used in critical scholarship. Part of the project of this Article is to raise consciousness about the central role of aggressive relationality in enabling abusive tax planning, so that such relationality gets as much scholarly and critical exposure as relationships in other areas of law, such as family law. *See generally* Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757, 1784-87 (2003) (discussing functions of narrative in critical race theory); Aaron A. Dhir, *Towards a Race and Gender-Conscious Conception of the Firm: Canadian Corporate Governance, Law and Diversity*, 35 QUEEN'S L.J. 569, 583 (2010) (discussing use of narrative as a "tool of consciousness-raising" in the construction of corporate law and governance); Mae Kuykendall, *No Imagination: The Marginal Role of Narrative in Corporate Law*, 55 BUFF. L. REV. 537, 541 (2007) (concluding that using narrative to reform corporate law is not "fruitful" because corporate law is abstract in nature); Jeannie Suk, *The Trajectory of Trauma: Bodies and Minds of Abortion Discourse*, 110 COLUM. L. REV. 1193, 1203 (2010) ("The term [consciousness raising] and the activity took seriously the psychological concept of repression wherein something that is hidden from consciousness could and should be brought to light by talking about it.").

19. *See infra* Part II.B.

analyses of "risk" or "substance" in evaluating the full effects of relationality in tax planning transactions. First, it provides a brief summary of the traditional judicial doctrines commonly applied in shelter cases (such as the economic substance doctrine) and explains how these doctrines are, at their core, concerned with relationship analysis.[20] It then demonstrates that while many courts do implicitly or explicitly evaluate relationships as part of applying these doctrines, certain features of tax law's development have, in effect, inhibited the efficacy of the traditional doctrines in assessing and evaluating third-party transactions and relationships. As such, there remain areas in which such judicial evaluations of relationships can be improved, both in content and in expression.[21] Part IV identifies two additional important impacts of third-party relationships and participation in the litigation of tax shelter transactions, namely, adverse impacts on transparency and observability, and obfuscatory impacts on the actual substantive content of judicial doctrine. Finally, Part V sets forth two normative proposals to mitigate the harmful effects associated with third-party relationships that have been identified in this Article: (1) judicial application of a rigorously implemented and clearly expressed "oppositional-choice" analysis, and (2) judicial rehabilitation of the business purpose doctrine from the confusion caused by increasing (and increasingly complex) taxpayer relationships. The proposals set forth in this Article are designed (1) to encourage more consistent and accurate judicial determinations of when and whether to respect relationships between taxpayers and third parties, (2) to raise awareness about the importance of third parties in tax planning by encouraging explicit and transparent judicial and litigant narratives about such relationships, (3) to encourage fairer and more consistent outcomes in tax shelter litigation, and 4) to discourage taxpayers from engaging in the aggressive formation of relationships that serve only to drain the fisc.

At the core, the central issue addressed in this Article—that is, the question of how to identify, understand, and manage the hidden effects and consequences of relationship creation between legal persons, both humans and non-humans—is not a problem confined to tax law. Rather, it is a concern that pervades many other areas of law, including bankruptcy, securities, family, immigration, commercial, and corporate law.[22] The ease

20. *See infra* Part III.A.

21. *See infra* Parts III.B, III.C.

22. *See, e.g.,* Theresa A. Gabaldon, *Assumptions About Relationships Reflected in the Federal Securities Laws*, 17 WIS. WOMEN'S L.J. 215 (2002) (looking at the role of relationships in securities law); Robert A. Prentice, *Stoneridge, Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611 (2008) (discussing liability under Securities Exchange Act of 1934 § 10(b) of "collateral" third parties that aid and abet securities fraud); *see also* Stoneridge Inv. Partners v. Scientific-Atlanta, 552 U.S. 148 (2008) (holding that a corporation's vendors and customers could not be liable as primary actors for purposes of

and speed with which contemporary commercial and other relationships are formed, with or without underlying substance, and the potentially detrimental effects of such relationship formation, make it a question of particular urgency today.

II. THE ROLE OF RELATIONSHIPS IN TAX SHELTER CASES

Before venturing further, it is important to define what this Article means in speaking about "third parties," "relationships," and "transactions." This Article uses the term "third parties" generally to mean persons separate from the taxpayer.[23] What does it mean for a person to be "separate" from the taxpayer? To take an easy baseline, the Internal Revenue Code (the "Code") contains provisions that disallow tax consequences generated by certain transactions between "related" parties, or that attribute ownership to or from one person based on a relationship with another person.[24] This Article is primarily concerned with those relationships between parties not already explicitly covered by the Code attribution rules. Loosely speaking, this means non-taxpayer parties whose transactional consequences have not been specifically disallowed by application of such related-party statutory provisions but whose interactions may present problems nonetheless.[25] Of course, some such "third parties" may be "more unrelated" to the taxpayer than others, and the boundaries between related and unrelated parties are not always entirely clear. For example, if an individual taxpayer holds significant shares in a corporation, and that corporation does business with another corporation in which that individual taxpayer also holds shares, the two corporations would be "third parties" under this Article's rubric, even though there is

investor's Securities Exchange Act of 1934 § 10(b) securities fraud action, notwithstanding their deceptive conduct); Regents of Univ. of Cal. v. Credit Suisse First Bos. (U.S.A.), Inc., 482 F.3d 372 (5th Cir. 2007) (finding Merrill Lynch not liable for aiding and abetting Enron by buying Nigerian barges to allow Enron to book millions in earnings and cash flow on Enron's promise to repurchase).

23. The term "third party," of course, begs the question of who the "second party" is. In this Article's parlance, the "second party" is the IRS, who the taxpayer faces in litigation. Non-taxpayer counterparties are hence "third parties" in the sense that they are players other than the taxpayer and the IRS.

24. *See, e.g.*, I.R.C. § 267 (2006) (denying deductions for losses from sales of property between certain "related" persons, including siblings, parents and their children, and individuals and corporations more than 50% of whose stock (by value) is owned by such individual); I.R.C. § 318 (2006) (rules for constructive ownership of stock).

25. Of course, a relationship may be "disrespected" for the purposes of one section of the I.R.C. but not for purposes of another. *Compare* I.R.C. § 318 (2006), *with* I.R.C. § 544 (2006) (both setting out rules for determining stock ownership). *See also* Glenn E. Coven, *The Affinity Provisions of the Internal Revenue Code: A Case Study in Nonsimplification*, 45 TENN. L. REV. 557 (1978) (studying the complexities of the attribution rules of the tax code).

some relationship between them. Thus, this Article uses the term "third parties" somewhat heuristically, rather than strictly definitionally, to denote the broad universe of non-taxpayer parties with whom the taxpayer transacts.

This Article uses the term "transactions" to refer to the discrete agreements and contracts entered into between the contracting parties. Correspondingly, it uses the term "relationships" more broadly to include *both* discrete transactions (if any) *and* the larger relational context underlying such discrete transactions. In other words, the "relationship" between the parties includes both the actual agreements, contracts, and deals (if any) entered into between them as well as intangibles such as:

- relational statuses existing outside of the transaction (such as "friend," "colleague," "relative," "employer," or "prospective client");
- legal statuses existing outside of or taken on as a result of the transaction (such as "ex-husband" and "ex-wife," "buyer" and "seller," or "lessor and lessee"); and
- the ongoing responses, emotions, incentives, behaviors, and actions of the parties toward one another over time as a result of prospective, one-time or ongoing dealings.

Thus, the concept of relationships and relationality used in this Article encompasses formalized legal relationships but is also supra-legal. It reflects the notion that legal transactions entered into between parties contribute to, and are part of, the "relationship" that exists between them but that such "relationship" is more than just the sum total of the extant legal contracts.

Having defined its key terminology, the remainder of this section describes—for the non-tax specialist but also as a deliberate reminder to the tax specialist—the roles and significance of third parties in tax shelter transactions. First, it broadly outlines the functions performed by third parties in tax planning transactions and describes the evolution of such third-party participation. It then describes some features of tax law that facilitate and encourage increasing third-party involvement, and argues that the growing involvement of third parties makes it all the more urgent that third-party relationships be scrutinized and evaluated in a systematic way that goes beyond current doctrine.

A. The Roles Played by Third-Party Relationships in Shelter Cases

It is no secret that transactions between taxpayers and third parties are essential in triggering tax consequences.[26] This is true not just in shelter

26. *See* Comm'r v. Glenshaw Glass, 348 U.S. 426 (1955) (setting forth the realization

cases but throughout tax law.[27] In most cases, it is a transaction or agreement between two or more parties that leads to tax consequences.[28] For example, where an employee is paid a wage by her employer, it is the act of the employer's payment to the employee that triggers tax realization and the gross income inclusion.[29] On the other hand, imputed income[30] has not historically been subject to federal income tax.[31] The exclusion of imputed income may be explained on adminstrability, compliance, or critical grounds;[32] it can also be explained by the non-interactive or non-relational character of imputed income payments, particularly as compared to the (taxable) treatment of barter transactions.[33] In other words, barter exchanges, which are interactive transactions between two parties, are taxable; imputed income, which lacks this relationally generated character, is not.[34] This transactional-relational character of tax law is a highly important feature, one that should be obvious but is often left

requirement); Eisner v. Macomber, 252 U.S. 189 (1920) (giving weight to the element of severability for income realization).

27. As previously noted, abusive shelter transactions merely represent particularly egregious applications of such relationality.

28. *See* MARVIN CHIRELSTEIN, FEDERAL INCOME TAXATION 75 (11th ed. 2009) ("[B]ecause the realization requirement exists, the income tax is a tax on *transactions* instead of being a tax on income in the economic sense."). *But see* Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969) (finding cash in a piano seven years after it was purchased did not require another party's participation to generate income).

29. I.R.C. § 61 (2006).

30. Imputed income is income that may be "imputed" to a person due to her consumption of goods and services for which she does not receive actual payments. Common examples include imputed rent for the consumption of one's personal residence, and imputed service income for household chores performed.

31. Benjamin v. Hoey, 139 F.2d 945 (2d Cir. 1944) (holding that, when a stockbroker paid commissions into a partnership on transactions for his own account, the share of those commissions payable to him as a partner did not count as income); Morris v. Comm'r, 9 B.T.A. 1273, 1278 (1928) (holding that a taxpayer's imputed income from the portion of the building it used itself rather than renting was not subject to tax and adding that "[i]t is obvious that [the farmer's produce is] comparable to the rental value of a private residence, which has never been regarded as income or as a factor in the determination of tax liability").

32. *See* Nancy C. Staudt, *Taxing Housework*, 84 GEO. L.J. 1571, 1573-74 (1996) ("A recognition of the importance of women's work, regardless of the setting, would more accurately reflect women's valuable contributions to the economy. Once formally recognized, society is likely to value nonmarket housework activities similarly to market activities, thereby entitling women to social welfare benefits that are currently tied only to waged labor in the market.").

33. *Compare* Rev. Rul. 79-24, 1979-1 C.B. 60 (barter income is included in gross income), *with Morris*, 9 B.T.A. 1273 *and Benjamin*, 139 F.2d 945. *See also supra* notes 30-31 and accompanying text; *cf.* Lederman I, *supra* note 10 (discussing roles third parties play in helping with "verifiability" and "enforceability").

34. Mere "imputed income" has not historically been taxed, and precedent suggests it could not be taxed. BURKE & FRIEL, TAXATION OF INDIVIDUAL INCOME, at 30 (8th ed. 2007); *see also supra* notes 30-31 and accompanying text.

unmentioned.[35]

The fact that, most often, it is a transaction between two separate persons that triggers tax consequences means that the actions and existence of third parties are tremendously important in generating said tax consequences. This is the case both in the non-shelter context as well as in cases involving abusive tax planning (the role played by third parties in abusive tax shelter cases being simply an exceptionally aggressive extension of the usual role of such parties in generating tax consequences). Yet the discourses of tax law and tax shelter cases tend to focus on the substantive content of the statutory provisions allowing such transactions, often at the expense of scrutinizing the underlying roles of third-party players that allow the transactions to happen in the first place.[36]

In fact, third parties play vital roles in generating tax consequences.[37] These roles can be broken down into three overlapping functions: a realization function, a financing function, and a stripping/diversion function. While third parties play other roles in shelter cases, these three roles make up the majority of the functions that third parties play.[38]

1. The Realization (or Timing) Function

It is well known that the realization requirement is one of the most central concepts in tax law.[39] Simply put, the realization requirement, the

35. *But see* Lederman II, *supra* note 15, at 1735, 1738-39 (pointing out that asymmetric information between government and taxpayer is a "core problem" for tax enforcement, and discussing the effectiveness of information reporting by third parties in narrowing the tax gap); Raskolnikov, *Relational Tax Planning*, *supra* note 10, at 1199-1201 (examining how individuals use "relational tax planning" to avoid adverse tax consequences); Raskolnikov, *The Cost of Norms*, *supra* note 10, at 642 (addressing efficiency costs of informal arrangements in interactions between taxpayers).

36. For example, much of the literature concerns itself with the proper statutory interpretation of tax provisions in the face of abusive transactions that fit within the literal terms of those provisions. *E.g.*, Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004); Steven Dean & Lawrence M. Solan, *Tax Shelters and the Code: Navigating Between Text and Intent*, 26 VA. TAX REV. 879 (2007); McCormack, *supra* note 12, at 703, 706-07. *But see* sources cited *supra* note 10.

37. Not all shelter transactions involve the aggressive participation of third parties and this Article does not so claim. For example, some avoidance transactions may take place between taxpayers and entities wholly owned by the taxpayers. Such a transaction is not a transaction with a "third party" in the same sense as a tax planning transaction with an unrelated actor. *See, e.g.*, Higgins v. Smith, 308 U.S. 473 (1940) (discussing deduction of loss for sale of securities to corporation wholly owned by taxpayer).

38. For example, the participation of third parties may also enable taxpayers to convert ordinary income into capital gain or vice versa, thereby performing a transformation function. *E.g.*, TSN Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir. 1980); Mayer v. United States, 285 F.2d 683 (9th Cir. 1960); Glass v. Comm'r, 87 T.C. 1087 (1986).

39. Helvering v. Bruun, 309 U.S. 461 (1940) (early case delineating types of possible

meaning of which is hard to pin down, generally requires some kind of event or transaction in order to trigger the income inclusion, loss deductibility, or other tax consequences.[40] It is a fundamental tenet of tax law that appreciation, accretion, or decline in value, without more, will not generally trigger tax consequences.[41] For example, if an individual owns a painting purchased for $200 in 2001, and the painting increases in value to $2,000 in 2010, the individual will not be taxed on the $1,800 appreciation absent a sale, exchange, or other disposition of the painting.[42] Such disposition in effect provides the "realization" required in order to trigger the tax consequences.[43]

Third parties are instrumental in determining the timing of the realization event that is required to trigger tax consequences or benefits. In the above example, the individual would need to sell the painting to a buyer in order to trigger income inclusion in a given tax year—she can hardly sell the painting to herself. The Code also contains rules that apply in various situations to circumscribe the tax consequences of transactions between certain parties considered by the tax law to be insufficiently separate from the taxpayer.[44] Thus, the tax law in effect imposes an unspoken requirement that the taxpayer must generally transact or interact with a sufficiently separate "other" person in order to trigger the taxable event.[45]

This transactional or interactive function of third parties in providing the realization event required to trigger tax consequences is clearly observed in tax shelter cases. In cases as early as the Supreme Court's 1935 decision in *Gregory v. Helvering*, taxpayers have attempted to use persons "separate" from themselves to enter into transactions that trigger favorable tax consequences.[46] In today's transactions, the rather blatant use

realization events); *Eisner*, 252 U.S. at 209, 211-12, 214 (holding that a dividend in the form of additional stock is not a realized gain for tax purposes).

40. *See* CHIRELSTEIN, *supra* note 28, at 73-75 ("Our tax system does not reach mere changes in property value . . . .").

41. *See* Eustice, *supra* note 5, at 142 ("Taxpayers' ability to select which gains or losses are to be recognized for tax purposes, and when that event is to occur, is a common theme in many tax shelter transaction planning scenarios."). Of course the realization rule is not a universal tax law tenet, and is undercut in certain circumstances by alternative timing rules, such as the mark-to-market accounting rules. *See* I.R.C. § 475 (2006) (mark-to-market accounting rules for securities dealers). Conversely, not all realization events will trigger recognition. *See, e.g.*, I.R.C. § 351 (2006) (general non-recognition rule for certain asset transfers to corporations).

42. *See* sources cited *supra* notes 39-41 and accompanying text.

43. *Id.*

44. *E.g.*, I.R.C. § 267 (2006) (disallowing deduction for losses on sale or exchange of property between certain related taxpayers); I.R.C. § 318 (2006) (describing relationships creating attribution in stock ownership). *See also Gregory*, 293 U.S. at 469 (discussing use of newly incorporated corporation in transaction to reduce tax liability).

45. *See generally* CHIRELSTEIN, *supra* note 28, at 73-75.

46. 293 U.S. 465. In that case, the individual taxpayer was the sole owner of a

of the wholly owned or controlled corporation in early cases such as *Gregory v. Helvering* has in many cases been replaced by the use of unrelated (or less obviously related) third-party intermediaries and counterparties.[47] However, the fact that these transactions are designed to contain the "friction" necessary to create realization events by involving other "persons" has remained constant. For example, in *Compaq Computer Corp. v. Commissioner* and *IES Industries, Inc. v. United States*, cases that involved the purchase of American Depository Receipts *cum* dividend and their almost immediate sale *ex* dividend, the participation of third-party sellers and buyers of the ADRs were what allowed the losses and tax credits at issue to be generated.[48] Similarly, in the consolidated option-straddle tax shelter cases, the broker-dealers who transacted with the taxpayers to buy or sell options allowed the ordinary losses and long-term capital gains to be generated in the first place.[49] The realization function played by third parties can be observed in numerous other tax shelter cases.[50] In short, the realization function played by third parties in shelter and non-shelter cases means that third-party participation significantly impacts the *timing* of the income inclusion or loss generation, in the sense that such third-party participation can determine *when* income is realized or other tax consequences triggered.[51]

2. The Financing Function

Another important function often played by third parties in shelter and non-shelter cases is the financing function. The financing function

corporation ("Oldco"), which owned securities with a built-in gain. The taxpayer incorporated a new corporation ("Newco") and caused Oldco to transfer the securities to Newco. Newco was liquidated just a few days later and distributed the securities to taxpayer in complete liquidation. This transaction transformed what would have been ordinary income from Oldco's sale of securities and distribution of proceeds into capital gain.

47. *E.g.*, Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

48. IES Indus. v. United States, 253 F.3d 350 (8th Cir. 2001); Compaq Computer Corp. v. Comm'r, 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

49. *Glass*, 87 T.C. 1087. These were cases in which the taxpayers entered into straddle transactions for options and futures and subsequently "closed out" these transactions by buying and selling identical offsetting positions. The overall goal was to convert ordinary income into long-term capital gains and generate ordinary losses.

50. *See* Knetsch v. United States, 364 U.S. 361 (1960) (involving insurance company); Coltec Indus. v. United States, 454 F.3d 1340 (Fed. Cir. 2006) (involving third-party banks); *Consol. Edison Co. of N.Y.*, 90 Fed. Cl. at 234 (use of separate phases accounting enabled by transaction with third party changed timing of income recognition); *Black & Decker*, 436 F.3d 431 (involving third-party buyer of BDHMI stock).

51. *See Compaq Computer Corp.*, 277 F.3d at 784; *IES Indus.*, 253 F.3d at 352-56. *See also* I.R.C. § 1091 (2006) (wash sale rules).

overlaps with the realization function in the sense that both go to gain or loss recognition. For analytical purposes, I address the financing function separately as affecting the *amount* of gain or loss recognition or other tax benefit, rather than its timing.

The amount of money or other consideration paid by the third party in a transaction obviously has an important tax impact.[52] For example, in a basic scenario, the price paid on a sale of property to a third party in relation to the property's basis will determine the amount of gain or loss to be recognized on the transaction.[53] This is, of course, no less true in tax shelter cases.[54] The magnitude of the amount paid, financed, or contributed by a third party in a shelter transaction can cause large amounts of gain or loss to be recognized, often in excess of true economic losses.[55] For example, in *Coltec Industries v. United States*, the *de minimis* amount paid by third-party banks for the stock of a Coltec subsidiary in relation to the taxpayer's claimed tax basis in that stock allowed the taxpayer to claim an almost $380 million loss on the sale of those shares to the banks.[56] The taxpayer sought to use those losses to offset approximately $241 million in gains for that tax year and to carry forward the balance.[57] Thus, the amount "financed" by the third-party banks worked in conjunction with the taxpayer's basis-inflation transactions among its subsidiaries to generate the desired tax consequences (which were ultimately denied).[58]

Another example of a third party serving a financing function was in the contingent installment sales ("CINS") shelter cases. These were cases in which the taxpayers sought the application of the contingent installment sales regulations to offset domestic partner capital gains.[59] In the CINS cases, the third-party foreign bank contributed millions of dollars to a partnership in which it had partnered with a domestic corporation seeking to offset large amounts of capital gain.[60] The capital invested by the bank was critical in allowing the partnership to make sizeable investments in short-term private placement notes, which were then exchanged for cash

52. *See* I.R.C. § 61 (2006) (defining gross income).

53. *See generally* I.R.C. § 1001 (2006) (rules for determining gain or loss); I.R.C. §§ 1011-12, 1016 (2006) (rules pertaining to basis of property).

54. *See Black & Decker*, 436 F.3d 431 (case in which taxpayer paid $561 million to subsidiary in exchange for subsidiary's stock and assumption of $560 million contingent liability, sold shares to "unrelated" third-party trust benefitting former employee of taxpayer for $1 million, and claimed $560 million capital loss).

55. *See* sources cited *supra* notes 53-54. The importance of valuation studies and opinions in constructing shelter cases confirms this point. *See* I.R.C. § 6700(a)(2)(B), (b) (2006) (penalty for gross valuation overstatements).

56. 454 F.3d at 1345.

57. *Id.* at 1343-45.

58. *Id.* at 1345.

59. *E.g., ACM P'ship*, 157 F.3d 231.

60. *E.g., id.* at 238-39.

and LIBOR notes to trigger the application of the ratable basis recovery rule in the CINS Treasury regulations.[61] In short, the contribution of large amounts by the foreign partner ultimately allowed large amounts of capital losses to be triggered, thereby achieving the desired capital gains offset (which was disallowed).[62] The foreign bank's role in the CINS transaction is a prime example of the financing role played by third parties in shelter and non-shelter tax transactions.

3. The Stripping / Diversion Function

A third function that third parties serve is that of "stripping" or diverting certain types of tax items (and their corresponding consequences) to those taxpayers able to absorb them at the least tax cost. A simple case of income diversion might involve a gift of interest-bearing securities by a parent in a higher income bracket to a child in a lower income bracket who is likely to be taxed at a lower rate.[63] Diversion of income, losses, or other tax attributes is a widespread phenomenon in the tax shelter area and is often performable by virtue of third-party assistance. For example, the diversion function of third parties is observable (alongside the financing function) in the CINS cases discussed above.[64] A central feature of the CINS partnership transactions was the initial allocation of gain to the foreign bank partner (the tax-indifferent party) followed by the allocation of losses—after the exit of the foreign bank from the partnership—to the domestic partner seeking to use those losses to offset capital gains.[65] Thus, the combined actions of the third-party foreign bank—providing the requisite financing and making a timely exit—allowed the losses to be diverted to the party seeking to utilize them. In this way, third parties help to accomplish the desired *location* of tax items, such as losses.

The stripping function of third parties in shelter cases is also observable in "lease stripping" shelter transactions. For example, in *Andantech L.L.C. v. Commissioner*, an equipment sale-leaseback stripping transaction, the taxpayer partnership (whose interests were originally held by foreign individuals) purchased equipment from a seller and leased it back to the seller, receiving a stream of rental income.[66] The partnership then sold the rental income stream to a third-party bank, effectively "stripping" the rental income from the equipment and accelerating its

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61. *E.g., id.* at 239-40.
62. *E.g., id.* at 247-48. *Accord supra* notes 53-54 and accompanying text.
63. I.R.C. §§ 1, 61, 102(a) (2006).
64. *See supra* notes 59-61 and accompanying text.
65. *E.g.*, *ACM P'ship*, 157 F.3d at 239, 242-43.
66. 331 F.3d 972, 973 (D.C. Cir. 2003), *aff'g in part* 83 T.C.M. (CCH) 1476, 1480, 1491-94 (2002).

recognition to the year in which Andantech's partners were foreign and therefore tax indifferent.[67] Subsequently, 98% of the partnership interests were sold to a domestic taxpayer, thereby enabling the new domestic partner to utilize the tax attributes (depreciation deductions).[68] The new domestic partner would be able to take advantage of these tax attributes without having to recognize income because the income recognition had been accelerated upon the sale of the rent stream to the banks,[69] causing it to have hit the tax return of the tax-indifferent foreign partners.[70] Hence, in *Andantech* and other lease stripping cases, the third-party bank's participation triggered acceleration of the income stream, allowing the tax benefits to be enjoyed by the domestic partner while the income was diverted to a tax-indifferent party. The *Andantech* case illustrates the stripping/diversion function of third parties and shows how the stripping function works in conjunction with the realization and financing functions of such third parties to trigger desired tax consequences. This diversion role of third parties can be seen in lease stripping cases and various other types of cases.[71]

B. Third-Party Relationships in Context: Understanding Their Proliferation

The foregoing discussion illustrates the critically important role that third-party participants play in triggering desired tax consequences. The roles of third parties today are more important than ever. As others have noted, the nature of contemporary tax shelter transactions has undeniably changed as compared to pre-1986 shelters,[72] and the roles played by third

67. *Id.* at 973, *aff'g in part* 83 T.C.M. (CCH) at 1480, 1494-95.

68. *Id.* at 973-74, *aff'g in part* 83 T.C.M. (CCH) at 1480, 1495-96.

69. Note that the banks were performing a realization/timing function as well as a financing function.

70. *Andantech*, 331 F.3d at 974, *aff'g in part* 83 T.C.M. (CCH) at 1480, 1498.

71. *See, e.g.*, United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001) (taxpayer was able to divert revenue from excess value charges collected from customers to its offshore subsidiary by making insurance payments to a third-party insurance company; insurance company collected commission, excise taxes, and fees, and sent remainder of insurance payments to taxpayer's Bermuda subsidiary under reinsurance contract); *CMA Consol., Inc.*, T.C.M. (RIA) 2005-16 (another equipment lease stripping case).

72. Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1776 (1999) (discussing characteristics of the post-1986 tax shelter market and arguing that "[t]he new corporate tax shelter is much more sophisticated and complex than its 1980s predecessor," and that "[i]t is also much more aggressive in its interpretation of the tax law"); Chirelstein & Zelenak, *supra* note 12, at 1951-52 (noting that pre-1986 shelters were of the same general type with "virtually all involv[ing] the creation of artificial (noneconomic) losses for passive investors through the combination of tax preferences . . . and interest expense deductions" and comparing this to contemporary tax shelters, which are

parties in these transactions have evolved as well. A key shift in contemporary tax shelter transactions is the increasing involvement of participants such as tax-exempt entities and foreign entities, and the increasingly diverse nature of such participation.[73] More of this participation is occurring by way of flow-through entities, and such third-party participation increasingly serves to arbitrage between different sets of tax rules, including tax rules governing non-U.S. taxpayers and the tax rules of other countries.[74] Furthermore, as others have argued, those who stand to make large profits are more aggressive in structuring, marketing, and promoting shelter transactions.[75] These developments have arguably been fueled by advancements in telecommunications and technology, which have also made it easier for persons to interact, negotiate, and form relationships with other parties and to enter into relationships and

"considerably more varied in design—and in the Code provisions they exploit"); McCormack, *supra* note 12, at 703, 706-08 (contrasting relative homogeneity of early shelter transactions with the complexity, diversity, numerosity, aggressiveness, and "rapid proliferation" of current shelters); Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 83-95 (2006) (describing how the tax shelter market "took off" in the decade after 1986).

73. *See, e.g.*, Eustice, *supra* note 5, at 145 (noting "the frequent insertion of 'tax indifferent parties' into the transaction, whose role it is to absorb the unfavorable tax aspects of" transactions using derivative instruments and stating that "this unlikely ménage of players is brought together by the promoter for the sole purpose of generating the sought-after tax benefits for the corporate 'investor'"). *See also* Bankman, *supra* note 72, at 1777 (listing as one of the characteristics of the "new" corporate tax shelter that "the shelter involves a domestic corporation and a person in the zero tax bracket," and noting that "[m]ost commonly, the zero-bracket taxpayer is a foreign person not subject to U.S. tax, but Native American Tribes, domestic corporations with unusable net operating losses, and exempt organizations have also been used"); Eustice, *supra* note 5, at 147 (stating that there seems to be "no magic bullet, or stake-in-the-heart solution" to the tax shelter problem because "[t]he current deals are too diverse");.

74. *See* sources cited *supra* notes 72–73 and accompanying text. *See also* GAO REPORT ON NETWORK TAX EVASION, *supra* note 10 (studying the problem of network-based tax evasion).

75. *See, e.g.*, Eustice, *supra* note 5, at 146 (describing the "stunning profitability of these corporate shelter transactions for their promoters"); McCormack, *supra* note 12, at 708 ("[T]he players in the new tax shelter battles are both enumerative and aggressive. Those who market current tax shelters . . . do so in a bullish manner because of the lucrative nature of the business."). *See also* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON GOVERNMENTAL AFFAIRS, 108TH CONG., REP. ON U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS (Comm. Print 2003) ("[T]he development and sale of potentially abusive and illegal tax shelters have become a lucrative business in the United States, and professional organizations like major accounting firms, banks, investment advisory firms, and law firms have become major developers and promoters. The evidence also shows that respected professional firms are spending substantial resources, forming alliances, and developing the internal and external infrastructure necessary to design, market, and implement hundreds of complex tax shelters, some of which are illegal and improperly deny the U.S. Treasury of billions of dollars in tax revenues.").

transactions that enable the avoidance of taxation.[76] The increased presence of actors looking to facilitate the creation of formal relationships means greater markets and opportunities for relationship formation between taxpayers and third parties.

There are two legal developments that have played a particularly important role in facilitating the growing use and importance of third-party participation in aggressive tax planning.

1. Evolution in the Laws of Entity Classification

Most significantly, developments over time in the law of entity formation and classification have contributed to the ease with which taxpayers are able to form relationships (and choose the form of such relationships) with others. Under current law, eligible "business entities" are allowed to choose whether to be classified for tax purposes as a partnership or as an association taxable as a corporation.[77] This ability to elect one's entity classification for tax purposes resulted from the IRS's 1996 adoption of the so-called check-the-box regulations.[78] These regulations generally provide that eligible taxpayers may elect their federal tax classification by filing IRS Form 8832 and checking the appropriate box.[79]

The choice of whether to be classified as a corporation or as a partnership is a significant one for tax purposes because corporations and partnerships are treated differently under the Code. Generally speaking, corporations are subject to double taxation at both the entity and the shareholder level, while partnerships are not subject to an entity-level tax

76. *See generally* Aldo Forgione, *Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age*, 26 SEATTLE U. L. REV. 719 (2003) (noting the increased ability for tax avoidance due to technological advances and the advent of e-commerce, and proposing reform based on a "market country" concept).

77. Treas. Reg. §§ 301.7701-3(a), -2(b); IRS Form 8832. Business entities classified *per se* as corporations are not eligible to make the election. Treas. Reg. §§ 301.7701-3(a), -2(b). The term "business entities" also does not include entities classified as trusts under Treas. Reg. § 301.7701-4 or subject to a special tax regime under the Code. *Id.* § 301.7701-2(a). Eligible "business entities" that do not make an explicit election are classified by default as either corporations or partnerships, depending on whether that entity is a domestic or a foreign entity, and depending on whether all of its owners have limited liability. Treas. Reg. § 301.7701-3(b). For "business entities" with a single owner the choice is between disregarded entity and corporate classification, rather than partnership or corporate classification. Treas. Reg. §§ 301.7701-3(a), -3(b)(1)(ii), -3(b)(2)(i)(C). For purposes of analyzing taxpayer relationships with third parties, this discussion focuses on entities with more than one owner (i.e., the partnership vs. corporation distinction).

78. Treas. Reg. §§ 301.7701-2, -3 (as adopted by T.D. 8697, 1997-1 C.B. 215). These regulations, which were proposed in May and finalized in December 1996, became effective January 1, 1997.

79. Treas. Reg. §§ 301.7701-2(b), -3(a).

and are taxed instead on a flow-through basis.[80] With respect to shelter transactions, the use of partnerships enables a host of opportunities for tax avoidance. First, partnership classification has the potential to allow parties to allocate income items to a tax-indifferent party and loss items to a partner most able to use these losses, thus opening up avoidance possibilities.[81] In addition, partnership classification may allow a partner to use the losses generated from the activities of the partnership to offset income from other sources.[82] The use of partnership losses to offset other income can be seen in a number of tax shelter cases.[83] Furthermore, the fact that the check-the-box elective entity classification system was also made applicable to foreign entities has opened up new opportunities for tax planning in the cross-border context.[84]

The use of partnerships in tax planning certainly did not begin with adoption of the check-the-box regulations.[85] These regulations were merely

80. *Compare* I.R.C. §§ 11(a), 61(a)(7) (2006), *and* I.R.C. § 301 (2006) (effectuating corporate double taxation), *with* I.R.C. § 701 (2006) (taxation of partnerships).

81. Under the provisions of Subchapter K, the income, loss, deductions, credits, and other tax items of a partnership are generally taken into account at the partner level, and may be allocated in accordance with the partnership agreement, provided the allocation has "substantial economic effect." I.R.C. § 704 (2006). *See also* Santa Monica Pictures, LLC v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (illustrating use of partnership structure to generate losses for the appropriate partner).

82. STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 7 (Comm. Print 1997) [hereinafter, JCT REVIEW OF ENTITY CLASSIFICATION] (noting that one reason for preferring pass-through tax treatment is that "owners may wish to use losses generated by the business to offset income from other sources"). *See also* Leandra Lederman, *A Tisket, A Tasket: Basketing and Corporate Tax Shelters*, 88 WASH. U. L. REV. 557 (2011) (proposing to segregate corporate taxpayers' passive and active income in order to prevent use of offsetting losses).

83. *See, e.g.*, Sala v. United States, 613 F.3d 1249, 1250 (10th Cir. 2010); *ACM P'ship*, 157 F.3d 231; *Santa Monica Pictures*, 89 T.C.M. (CCH) 1157.

84. Treas. Reg. §§ 301.7701-3(a), -3(b)(2). Various commentators have argued that electivity of corporate, partnership, or disregarded entity status make it easier for taxpayers to avoid income inclusion under the Subpart F "controlled foreign corporation" rules, allow taxpayers to get tax savings by getting rid of deferral, and permit taxpayers greater leeway to utilize foreign tax credits. *See, e.g.*, JCT REVIEW OF ENTITY CLASSIFICATION, *supra* note 82, at 19 n.32 (citing Reuven Avi-Yonah, *To End Deferral As We Know It: Simplification Potential of Check-The-Box*, 74 TAX NOTES 219, 219-20 (1997)); Harvey Mogenson & David Benson, *IRS Issues Final Check-the-Box Regs—Tax Simplification Creates Planning Opportunities*, 13 TAX NOTES INT'L 2159 (1996)). *See also* Heather Field, *Checking In On "Check-The-Box"*, 42 LOY. L.A. L. REV. 451, 487-91 (2009) (discussing problems and concerns pertaining to application of the check-the-box system in the international context).

85. *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS § 85.3.1 (4th ed. 2003) (noting increase in partnership tax shelters in the 1970s); ARTHUR B. WILLIS, JOHN S. PENNELL & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 19.01[3] (6th ed. 1997) (discussing "substantial growth in large syndicated tax shelters as limited partnerships" in the 1970s); Eustice, *supra* note 5, at 138 (noting that "the entity status issue . . . has been through many phases before reaching its current state of nearly unlimited entity selectivity").

the culmination of shifts over time that gradually made it easier for taxpayers to enter into formal relationships with other persons, regardless of the substance of those relationships.[86] Prior to the check-the-box regulations, taxpayers could ensure that an entity would be classified as a corporation rather than a partnership by satisfying the "corporate resemblance" test set forth in the so-called *Kintner* regulations, the Treasury Regulations in effect at that time.[87] However, by eliminating the need to meet the factors set forth in the *Kintner* regulations, these regulations have had the effect of allowing favorable entity classification status to be obtained more cheaply, simply, and with more certainty. This has made entity-based tax planning less risky and more palatable for risk-averse players and less sophisticated players.[88] Indeed, the Joint Committee on Taxation has noted that the "check-the-box" regime has had the effects of eliminating or reducing transaction costs, lowering compliance costs, enhancing entity-choice availability for taxpayers other than the well-advised or sophisticated, indirectly affecting the substance of tax rules that are dependent on an entity's classification, and generally making tax planning easier.[89] Thus, the implementation of "check-the-box"

86. Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, *in* BUSINESS TAX STORIES 295 (Steven A. Bank & Kirk J. Stark eds., 2005) (describing the history behind the rise of limited liability company statutes and the eventual adoption of the check-the-box regulations).

87. *See generally* Treas. Reg. §§ 301.7701-1 to -3 (as adopted by T.D. 6503, 1960-2 C.B. 409 and amended by T.D. 8697). In *Kintner v. United States*, 107 F. Supp. 976, 979 (D. Mont. 1952), *aff'd* 216 F.2d 418 (9th Cir. 1954), the federal district court and the Ninth Circuit determined that an association of medical professionals that had more corporate than non-corporate characteristics was taxable as a corporation for federal tax purposes. The IRS subsequently adopted the "corporate resemblance" approach of *Kintner* in regulations issued in 1960. The *Kintner* regulations set forth six "major characteristics ordinarily found in a pure corporation": (i) associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests, and stated that an entity with more corporate than non-corporate characteristics would be treated as a corporation. *Id.* In performing this analysis, the *Kinter* regulations disregarded characteristics common to both corporate and non-corporate entities. Treas. Reg. § 301.7701-2(a) (citing Morrissey v. Comm'r, 296 U.S. 344 (1935)).

88. Field, *supra* note 84, at 471-74 (discussing the benefits of increased certainty and simplicity).

89. JCT REVIEW OF ENTITY CLASSIFICATION, *supra* note 82, at 2 (stating that regulations "simplify and liberalize the entity classification rules, thereby enhancing the ability of the owners of a business entity to choose to be treated as a partnership for tax purposes."); *id.* at 17-18 ("The principal impact is that taxpayers may now choose with greater simplicity and lower compliance costs whether they will pay two levels of tax on business income under the corporate tax rules, or whether they will pay only one level of tax under the partnership tax rules . . . . The check-the-box regulations facilitate transactions that could not usually be done (or could be done only in a convoluted or expensive manner) under prior law, but now may be accomplished more simply, efficiently or cheaply."); *id.* at 21 (discussing "the indirect effect of broad electivity . . . on other tax rules whose application is dependent on

has allowed taxpayers to more easily enter into formal relationships with other parties that generate desired tax consequences, and to do so with more certainty. The evolution of tax law's approach to entity classification is arguably more broadly reflective of the growth in the number of planning options for the formation of business entities generally.[90]

2. The Multiple-Party Presumption of *Frank Lyon Co. v. United States*

Developments in the laws of entity formation and classification aside, another factor has also contributed to the growing significance of taxpayer relationships with third parties over time. The Supreme Court's suggestion, in its seminal 1978 *Frank Lyon* decision,[91] that that case was distinguishable from the transaction in *Helvering v. Lazarus & Co.*[92] based on the existence of multiple parties,[93] has caused the existence of third parties in tax-planning transactions to be viewed more enthusiastically by practitioners than might otherwise have been the case.[94] *Frank Lyon* concerned a multi-party sale-leaseback transaction and was a case in which the tax transaction admittedly "took shape according to [the third-party

the taxpayer's tax status"). *See also* STAFF OF JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 183-85 (Comm. Print 2005) [hereinafter JCT, OPTIONS TO IMPROVE TAX COMPLIANCE] (describing the regulations as having "created some unintended tax-avoidance opportunities as applied to foreign entities" and noting that "the expressly elective approach of the current regulations has removed some frictions that may have acted as a brake on some of the tax planning involving the classification of entities"); Field, *supra* note 84, at 471-96 (discussing how well the check-the-box system has met the goals of simplicity and administrability, efficiency and reduction of transaction costs, and flexibility/neutrality).

90. *See generally* Hamill, *Story of LLCs*, *supra* note 86; Charlie Cray & Lee Drutman, *Corporations and the Public Purpose: Restoring the Balance*, 4 SEATTLE J. SOC. JUST. 305 (2005).

91. 435 U.S. 561 (1978).

92. 308 U.S. 252 (1939).

93. *Frank Lyon*, 435 U.S. at 575-76 ("The present case, in contrast [to *Lazarus*], involves three parties . . . the presence of the third party, in our view, significantly distinguishes this case from *Lazarus* and removes the latter as controlling authority.")

94. *See* Hoffman F. Fuller, *Sales and Leasebacks and the Frank Lyon Case*, 48 GEO. WASH. L. REV. 60, 81 (1979) (cautioning that sale-leaseback transactions "should not be limited to two parties; a third-party lender should be involved"); Bernard Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075, 1087-88 (1981) (asserting that in distinguishing multiparty transactions from two party transactions, "the Court's opinion does nothing but signal tax lawyers that clients seeking tax shelter should never travel in pairs"). The presence of purposefully secured third-party participation has encountered varying degrees of respect from courts. *See also Consol. Edison Co. of N.Y.*, 90 Fed. Cl. at 267, 270-72, 338 (making numerous references to the *Frank Lyon* "multiple-party transaction" standard). *Compare* Bussing v. Comm'r, 88 T.C. 449 (1987) *with* Newman v. Comm'r, 902 F.2d 159 (2d Cir. 1990).

bank's] needs."[95] In *Frank Lyon*, the third-party bank had originally sought to construct a new building for its headquarters and banking facility.[96] However, state and federal banking laws and regulations prevented the bank from financing, constructing, and owning the proposed building itself.[97] This led the bank to enter into the sale-leaseback transaction at issue with the taxpayer and a finance agency, whereby the taxpayer (Lyon) would own the building and deduct depreciation, rent, and other expenses on its tax return, while including in income rent received from the bank.[98] Under this set of circumstances, the Supreme Court held that the transaction should be respected for tax purposes and distinguished the case from *Lazarus* on the ground that that case only involved two parties.[99] As others have noted, *Frank Lyon* has wrongly established a presumption of respect toward transactions employing multiple unrelated party relationships, as distinct from transactions not involving multiple parties, and has encouraged the formal use of unnecessary parties in tax transactions.[100] This has somewhat undercut the effectiveness of the traditional anti-abuse doctrines.

In sum, the evolution of tax law's approach to entity classification into its present form, and the lingering effects of the *Frank Lyon* presumption, suggest that increasingly aggressive and complex third-party participation is here to stay. As argued further in Part III, these two factors have also served to inhibit the effectiveness of traditional judicial doctrines like substance-over-form or economic substance in adequately dealing with aggressive and increasingly sophisticated relationship formation between taxpayers and third parties. They have accomplished this by introducing new and more complex ways for persons to form written and unwritten relationships with each other and by making relevant considerations that

95. *Frank Lyon*, 435 U.S. at 561, 563, 576.

96. *Id.* at 563.

97. *Id.* at 563-64. As described in the Court's opinion, the bank's original plan had to be abandoned because (1) under Arkansas law, the bank was only allowed to pay a limited amount of interest on the debentures it wanted to issue in order to finance construction and this interest limitation would cause the debentures not to be marketable; and (2) state and federal regulatory approval would be required in order for the bank to invest in premises of a certain value relative to the bank's capitalization, and the bank had been informed that such approval would not be forthcoming. *Id.*

98. *Id.* at 561.

99. *Id.* at 564, 583-84 ("[W]here, 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.").

100. *See, e.g.*, Fuller, *supra* note 94; Wolfman, *supra* note 94, at 1099-1100 ("A Supreme Court opinion ought not become the basis for tax lawyers to make a laughingstock of the Court as they now do when quite routinely they add unnecessary third parties to financing transactions in order to qualify for the shelter of *Frank Lyon*.").

offset the analytical force of the lens that has traditionally been applied to interrogate transactions for "risk" or "substance."

III. JUDICIAL ANTI-ABUSE ANALYSIS AND ITS LIMITATIONS

Judicial anti-abuse analysis is relationship analysis. However, traditional judicial anti-abuse analysis cannot be the sum total of how we confront relationality in tax planning. Part III.A shows that relationship analysis is an integral (albeit often unspoken) part of judicial anti-abuse analysis. Parts III.B and III.C examine the challenges facing courts in dealing with third-party relationality in applying anti-abuse doctrines and discuss how judicial treatments of third-party relationships can be improved.

A. Judicial Doctrines as Relationship Analysis

Anti-abuse doctrines play a critical role in judicial evaluations of tax shelter cases.[101] In addition to judicial anti-abuse rules, there are also statutory and regulatory anti-abuse rules that may apply to shelter transactions.[102] However, for a variety of reasons, judicial anti-abuse rules have enjoyed more widespread application and have been more successful in curbing abusive shelter transactions.[103] Therefore, the focus of this Article is on the judicial anti-abuse doctrines (including the recently codified economic substance doctrine).

The judicial anti-abuse doctrines—which include the substance-over-form doctrine, the sham transaction doctrine, the step-transaction doctrine, the business purpose doctrine, and the economic substance doctrine—are related and overlapping judicial doctrines that are applied by courts to deny favorable tax consequences in tax-driven transactions.[104] These doctrines are often applied in situations where the transaction satisfies the literal

101. *See generally* BITTKER & LOKKEN, *supra* note 85, at ¶ 4.3 (discussing pervasive judicial doctrines); YORAM KEINAN, 508 TAX MGMT., THE ECONOMIC SUBSTANCE DOCTRINE (BNA 2007); JEFFREY H. PARAVANO & MELINDA L. REYNOLDS, 798 TAX MGMT., TAX SHELTERS § I.B (BNA 2003).

102. *See, e.g.*, I.R.C. §§ 269; 482 (2006); Treas. Reg. § 1.701-2 (partnership anti-abuse regulation).

103. PARAVANO & REYNOLDS, *supra* note 101, § I.B ("[S]tatutory and regulatory [anti-abuse] rules have generally been less effective than the judicial doctrines."). Some of these reasons include vagueness, overbreadth, and unrealistic burdens of proof. *Id.* §§ I.B.2 & I.B.3.

104. *See generally*, KEINAN, *supra* note 101, §§ III-IV. While these doctrines have traditionally been common law doctrines, the economic substance doctrine was recently codified by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029 (March 30, 2010), as the new 26 U.S.C.A. § 7701(o) (West 2010). *See also* discussion *infra* Part IV.B.

letter of the statute but leads to unintended or "too good to be true" tax results. The application of these doctrines by courts is sometimes confusing. Courts may apply more than one doctrine to deny tax benefits in any one case.[105] And applications of the doctrines have not been consistent across courts and circuits.[106]

Probably the most discussed, debated, and applied of the judicial anti-abuse doctrines is the newly codified economic substance doctrine.[107] By way of background, the economic substance doctrine is a widely applied doctrine that, like the other judicial anti-abuse doctrines, originated in common law. In its common law incarnation, it had two main components or "prongs"—one objective and the other subjective.[108] The subjective, "business purpose" component generally held that a transaction engaged in solely for tax avoidance, and for no independent non-tax business purpose, would not be recognized as valid.[109] The other prong of the contemporary economic substance doctrine, the so-called objective prong, had several different formulations, all of which asked in one way or another whether the transaction resulted in a meaningful change in the taxpayer's economic position.[110] The economic substance doctrine in its uncodified form was not uniformly applied across circuits—while some courts considered the test to be a disjunctive one, others viewed the two prongs as conjunctive.[111] Still other courts applied a unitary sham test in determining whether economic substance exists.[112]

After extensive debate and various legislative proposals, Congress finally codified the economic substance doctrine in the Health Care and Education Reconciliation Act of 2010 as a conjunctive, two-part test

105. KEINAN, *supra* note 101, at A-1 n.9 (citing JCT, OPTIONS TO IMPROVE TAX COMPLIANCE, *supra* note 89, at 14); *see also e.g.*, *Andantech*, 83 T.C.M. (CCH) 1476 (applying the step transaction doctrine, sham transaction doctrine, and substance over form doctrine).

106. KEINAN, *supra* note 101, at A-1.

107. *See infra* notes 108-114.

108. KEINAN, *supra* note 101, at A-41.

109. The business purpose prong developed out of another long-standing judicial doctrine, the business purpose doctrine. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 469 (1935); Brooke v. United States, 468 F.2d 1155, 1158 (9th Cir. 1972); Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949). After *Frank Lyon* was decided in 1978, the business purpose doctrine was incorporated into the present-day, two-pronged economic substance doctrine to form the subjective prong of the two-pronged, economic substance test. *Frank Lyon*, 435 U.S. 561 (1978); *see also* Rice's Toyota World v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) (stating that a transaction will be treated as "a sham" if "the taxpayer was motivated by no business purposes other than obtaining tax benefits . . . and that the transaction has no economic substance because no reasonable possibility of a profit exists").

110. KEINAN, *supra* note 101, at A-43.

111. *Id.* at A-42.

112. *Id.*

requiring the transaction to "change[] in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position" *and* that "the taxpayer ha[ve] a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[113] The effects of this doctrine's codification will be further discussed in Parts IV and V of this Article.[114]

Aside from the economic substance doctrine, courts also apply other related judicial doctrines, such as the substance-over-form doctrine and the sham transaction doctrine. As its name suggests, the substance-over-form doctrine holds that in situations where the substance of a transaction is different from its form, substance controls.[115] In such situations, courts may re-characterize the transaction in accordance with its actual substance, leading to tax consequences different than those desired by the taxpayer.[116] The sham transaction doctrine is a doctrine similar to the economic substance doctrine in that it basically asks whether the way a transaction has been structured comports with underlying economic realities.[117]

While these anti-abuse doctrines can be confusing, overlapping, and inconsistently applied, they all are, at their core, concerned with evaluating the merits of the chosen form of suspect transactions.[118] And, as discussed

113. 26 U.S.C.A. § 7701(o) (West 2010) (applicable to transactions entered into after March 30, 2010). The newly enacted provision contains special rules for situations in which the taxpayer relies on profit potential, and for treatment of fees, foreign taxes, and state and local taxes. *Id.* § 7701(o)(2).

114. In particular, see discussion *infra* Part IV.B.

115. *See, e.g.*, *Gregory*, 293 U.S. 465; *In re* CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002).

116. *See, e.g.*, Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939) (applying substance over form in leasing case). For a more in-depth discussion of such recharacterization in the context of leasing, see Shu-Yi Oei, *Context Matters: The Recharacterization of Leases in Bankruptcy and Tax Law*, 82 AM. BANKR. L.J. 635 (2008).

117. This is, at least, what the "sham in substance" doctrine does. Like the economic substance doctrine, the "sham in substance doctrine" has different variations across courts. *Compare* Falsetti v. Comm'r, 85 T.C. 332, 347 (1985) (defining "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"), *with* Friedman v. Comm'r, 869 F.2d 785, 792 (4th Cir. 1989) ("A 'sham' transaction is one that has no economic effect other than the creation of tax losses."), *and Rice's Toyota World*, 752 F.2d at 91 ("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."). In contrast, the "sham-in-fact" standard looks at transactions that may have been "papered" but that never actually occurred. *See* Kirchman v. Comm'r, 862 F.2d 1486, 1492 (11th Cir. 1989) ("Shams in fact are transactions that never occur . . . . Shams in substance are transactions that actually occurred but which lack the substance their form represents.").

118. *See* Martin J. McMahon, Jr. *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 206 (2001) ("One of the common threads in the corporate tax shelter cases is that the transactions that have been scrutinized under the business purpose, economic substance, and sham transaction doctrines,

in Part II, what are the transactions but a series of tax events planned and taking place using relationships and interactions between taxpayers and third parties?[119] Since most shelter transactions cannot occur absent third-party cooperation and participation, the evaluation of such transactions under commonly applied judicial doctrines is an inherently relationship-evaluative exercise. Correspondingly, one might say that it is precisely because aggressive (and technically Code-compliant) relationship formation is a feature of abusive tax planning transactions that anti-abuse doctrines probing the realities of these relationships exist in the first place.

Put even more strongly, insofar as transactional tax planning largely consists of arranging a transaction (or series of transactions) that yields a good tax result, and insofar as transactions normally need third parties in order to happen, it is very, very hard to do transactional tax planning without the involvement of third parties. This means that it is virtually impossible to separate our judgments about the merits of a transaction from our judgments about the relationships that make the transaction possible. When one says that a tax transaction is a "shelter" or is "abusive" or is "lacking substance" or is a "sham," underlying such statements is a commentary about the "false" or "contentless" or "sham" nature of the *relationships* and *relational events* occurring in the transaction, whether judges realize this or not and whether their commentary on the underlying relationships is explicit or not.

The relationship-evaluative component of judicial anti-abuse doctrines may appear obvious but must not be taken for granted. The need to make explicit the relationship interpretation element of judicial shelter analysis is particularly acute at the present time because, for the reasons discussed in Part II, aggressively formed and substance-lacking relationships with third parties have become much more widespread than at the time the judicial anti-abuse doctrines were developed by the courts.[120] That is, the judicial doctrines *as applied* in today's shelter environment are faced with much more aggressive relationality than the judicial doctrines *as conceived*.[121] As discussed, reasons for this may include increased promoter activity, better technology, and more easily manipulable entity formation and classification rules. The willingness or ability of judges to use judicial anti-abuse doctrines to adequately interrogate increasingly aggressive relationality is therefore not a foregone conclusion. Thus, raising

and which have been found to be lacking, are transactions outside the ordinary course of the taxpayer's business.").

119. *See* discussion *supra* Part II.

120. *See Frank Lyon*, 435 U.S. 561; *Gregory*, 293 U.S. 465; *Rice's Toyota World*, 752 F.2d 89; Weinert's Estate v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961); BITTKER & LOKKEN, *supra* note 85, § 4.3 (citing United States v. Phellis, 257 U.S. 156, 168 (1921)); KEINAN, *supra* note 101, at A-5 to A-9. *See also* sources cited *supra* notes 72-73.

121. *See* sources cited *supra* note 120.

awareness and posing questions about what courts in shelter cases are and should be doing in applying long-standing judicial doctrines is both timely and necessary.[122]

B. Limitations of the Current Approach

So, is there anything really wrong with simply continuing to apply present judicial anti-abuse doctrines in analyzing relationships in shelter cases, particular since many courts do already appreciate that the nature of a third-party relationship determines whether a given transaction (or series of transactions) contains the requisite risk or substance to be respected?[123] Despite the apparent adequacy of the current approach, this Article contends that it is in fact inadequate, for two important reasons.

1. The Ultimate Artificiality of the Economic Substance Analysis

Far from being a complete solution to the problem of complex and hidden relationality, the economic substance and sham transaction doctrines are ultimately artificial constructs that do not go far enough. This is not news. Recent scholarship has acknowledged their limitations in new ways, pointing out, for example, that the "framing" of a tax transaction has important impacts on case outcomes.[124] That is, construing "the transaction" narrowly as being the discrete part of the deal that creates the tax minimization opportunity can lead to a finding of lack of economic substance, while framing it more broadly as including the larger business deal may lead to the opposite result.[125] Once the effects of a transaction's "frame" in changing outcomes of shelter litigation are recognized, it becomes clear that the anti-abuse doctrines are not all-powerful.

The "framing" construct can also be applied longitudinally: embracing the concept of a "deal" or transaction to "minimize taxes" and trying to determine whether that discretely framed deal holds the potential

122. This is no less true now that the economic substance doctrine has been codified and the "objective prong" standard adopted in the new statute asks whether "the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position." 26 U.S.C.A. § 7701(o)(1)(A) (West 2010). Though the new provision does not mention relationships, relationship evaluation is implicit, because whether there is the requisite "meaningful change" depends, of course, on the dynamics of the relationships underlying the tax transactions.

123. *See infra* notes 128–137 and accompanying text. Other scholars seem to agree. *See* Raskolnikov, *Relational Tax Planning*, *supra* note 10, at 1258, 1261-62.

124. David Hariton, *The Frame Game: How Defining the "Transaction" Decides the Case*, 63 TAX LAW. 1 (2009).

125. *Id.* at 4, 7-14 (providing examples of courts characterizing transactions utilizing either broad or narrow perspectives and holding accordingly).

for "pre-tax profit" or "economic effects" necessarily involves delineating an artificial "end point" to the tax deal. In the context of long-term and continuing relationships between the players, however, it is doubtful that such an end point actually exists. The relationship between the players may well proceed to take on further dimensions and may involve other (future) contracts and understandings beyond the discretely and artificially framed "tax deal" in a manner that undercuts the apparent economic effects or profit potential in the instant "deal." The effects of such future contracts and understandings might not be adequately taken into account under current doctrine.

What can be done about the problem of continuing relationships and their effects beyond the boundaries of an instant tax litigation (conceptualized as a discrete transaction or series of transactions with a clear end point)? From a commercial standpoint, the answer, unfortunately, is very little, given the realities of a market economy. What can and should be done from a taxing standpoint is to lay a framework to increase judicial awareness of the possibility of ongoing relationships undercutting discrete-transaction findings of substance. The solutions offered in Part V of this Article go some way toward accomplishing this.[126] Suffice it to say, at this juncture, the judicial anti-abuse doctrines are not cure-alls for aggressive relationality.

2. Uneven Applications of Doctrines and Overriding Effects of the *Frank Lyon* Presumption

As hinted at in Part II, another key problem facing courts in their analysis of aggressive relationality is that the presumption in favor of respecting transactions between multiple parties that was created by *Frank Lyon Co. v. United States* still resonates in case law today.[127] However, notwithstanding the *Frank Lyon* presumption, it is clear that third-party relationships actually have *indeterminate* significance for purposes of evaluating whether a transaction has "substance." The mere existence of a third-party relationship can suggest any number of things, and thus, in the end, may not tell us enough about the bona fides of a transaction, absent further analysis.

Conceptually speaking, this almost certainly has to be true. Since desired tax consequences in shelter (and non-shelter) arrangements are mostly generated through transactions between parties, and since transactions are based upon relationships with third parties and not all

126. *See* discussion *infra* Part V.A.
127. *Frank Lyon*, 435 U.S. at 583-84. *See also supra* Part II.B (discussing impacts of the *Frank Lyon* decision on creation of multiple-party transactions); Wolfman, *supra* note 94, at 1099-1100 (discussing the scope and applicability of *Frank Lyon*).

transactions hold up in court, it follows that not all taxpayer-created relationships with third parties deserve validation. So, for example, a relationship or transaction with a third party in a shelter transaction could be construed as an arm's length relationship suggesting genuineness.[128] On the other hand, the third party could simply have been inserted as a "straw" or a "mule" to create the illusion of a *Frank Lyon*-type multiple-party transaction.[129] The eventual determination of whether a shelter transaction has substance depends largely on which of these polar opposite interpretations a court adopts.[130]

Also, a transaction with a third party might well display the types of "practical economic effects" necessary for a transaction to be respected.[131]

128. *Frank Lyon*, 435 U.S. at 583-84 ("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."); *id.* at 580 ("Lyon [(the taxpayer)] is not a corporation with no purpose other than to hold title to the bank building. It was not created by [the bank] or even financed to any degree by [the bank]."). *See also United Parcel Serv. of Am.*, 254 F.3d at 1018 (noting the existence of a "real insurance policy" between UPS and an unrelated third-party insurer); *IES Indus.*, 253 F.3d at 355 ("[T]hese were not transactions conducted by alter-egos of IES or straw entities created by IES simply for the purpose of conducting ADR trades . . . . All of the parties involved . . . were entities separate and apart from IES, doing legitimate business before IES started trading ADRs and (as far as we know) continuing such legitimate business after that time . . . . Each trade was an arm's-length transaction: 'what was actually done is what the parties to the transaction purported to do.'") (internal citations omitted)); *Compaq Computer Corp.*, 277 F.3d at 784 (acknowledging the *IES Industries* approach to third parties, but adding its own analysis of third parties and the existence of risk); *Newman*, 902 F.2d at 163 (2d Cir. 1990) (finding it "relevant that the parties were independent of each other"); Mukerji v. Comm'r, 87 T.C. 926, 968 (1986).

129. *See, e.g.*, *Bussing*, 89 T.C. at 1051 (disregarding the presence of a third-party corporation (Sutton) in a complex sale-lease back transaction, characterizing that party's presence as "not an ownership interest" but rather as that of a "straw man" designed to make the transaction look like a multiple-party transaction to bring the case under the *Frank Lyon* rubric and denying the taxpayer's motion for reconsideration). *See also id.* at 1054 ("Sutton's president perceived Sutton's role solely to be that of a middleman required to qualify the transaction for Federal tax purposes."); *id.* at 1055 ("As Sutton's president testified, Sutton was inserted into the transaction solely to make the transaction appear as a multiple-party transaction for Federal tax purposes . . . . Sutton's blink-of-an-eye interest in the transaction must be disregarded."); *Bussing*, 88 T.C. at 457-58 (noting that "Sutton was inserted in the transaction . . . to facilitate the appearance of satisfying the 'at risk' provision of section 465 and to make the transaction appear to be a genuine multiple party transaction for purposes of applying *Frank Lyon*," and finding that the transaction was "not a genuine multiple-party transaction, but a . . . sale-leaseback pursuant to which the respective lease and debt obligations flow between only two parties").

130. *Compare IES Indus.*, 253 F.3d at 355-56 (finding trades at issue were at arm's length and between unrelated parties; taxpayer wins), *with Bussing*, 89 T.C. at 1055-56 (finding third party disregarded as "straw man"; taxpayer loses).

131. In applying the economic substance doctrine, some courts have asked whether the

On the other hand, such practical economic effects could be illusory, or could be undercut by unwritten understandings or relationships that escape the gaze of the observer.[132] A transaction with a third party might create genuine risk for the taxpayer, suggesting the presence of economic effects or substance.[133] On the other hand, third-party transactions and agreements may have been used to eliminate risk.[134] Finally, the fact that a transaction has taken place between putatively unrelated parties might suggest that the pricing of the deal (which, of course, impacts the amount of tax benefits realized)[135] was at arm's length and at fair value.[136] However, as a result of

transaction has any "economic effects other than the creation of tax benefits" or "practical economic effects." *E.g.*, *Kirchman*, 862 F.2d at 1492; Hutchinson v. United States, 90-2 USTC 50,573 (D. Or. 1990). "Practical economic effects" generally means the existence or creation of real legal obligations as a result of the transaction. *Hutchinson*, 90-2 USTC at 85,965-66; *see also* Sochin v. Comm'r, 843 F.2d 351, 354 (9th Cir. 1988); Thompson v. Comm'r, 631 F.2d 642, 646 (9th Cir. 1980). Applying this formulation of the doctrine, courts can and have analyzed the presence of unrelated party obligees as a feature that suggests or creates the requisite economic effects. *See, e.g.*, *United Parcel Serv. of Am.*, 254 F.3d at 1018 ("The kind of 'economic effects' required to entitle a transaction to respect in taxation include the creation of genuine obligations enforceable by an unrelated party.").

132. *See, e.g.*, *AWG Leasing Trust*, 592 F. Supp. 2d at 985-90 (finding that the way the economics of the deal were set up meant that there was very little chance that the third-party participant would exercise the "service contract" option, and that this effectively amounted to an almost certain exercise by the third party of the "fixed purchase option"); *ACM P'ship*, 73 T.C.M. (CCH) at 2194 (discussing all the reasons taxpayer considered the foreign bank counterparty to be "well suited" and "friendly" as a partner). *See also* Raskolnikov, *Relational Tax Planning*, *supra* note 10, at 1199 (risk analysis of tax planning's use of unwritten understandings); *cf. Frank Lyon*, 435 U.S. 581-82 (rejecting the government's position–which looked at taxpayer's presence on counterparty's board of directors and other factors as suggesting that the counterparty was the true owner of the property–as "theorizing").

133. One of the ways courts may analyze a third party's participation is to look at the risk created or taken on in the transaction. In this regard, transactions with third-party participants may be seen as holding more risk. *See, e.g.*, *Compaq Computer Corp.*, 277 F.3d at 783-84, 787 (finding that despite the parties' attempts to minimize risk of loss, sufficient risk existed; relying in part on the fact that the transaction occurred in an open market between independent parties where prices could change, rather than "in an environment controlled by Compaq or its agents"). The relationship between "practical economic effects" and "risk of loss" can be seen, for example, in the Eleventh Circuit's opinion in *United Parcel Serv.*, 254 F.3d at 1018.

134. *E.g.*, *AWG Leasing Trust*, 592 F. Supp. 2d at 981, 983-85; *Wells Fargo*, 91 Fed. Cl. at 48-50, 53-54 (2010).

135. *See supra* Part II.A.2.

136. *See, e.g.*, *Newman*, 902 F.2d at 163 (observing that there was "no question" that the independent parties "dealt at arm's length"); *Krause*, 99 T.C. 132 (denying limited partnership investors' deductions for losses incurred from partnership investments where debt obligations of the partnerships were not based on arm's length transactions and resulted from excessive amounts paid for technology licenses). Correspondingly, some courts have viewed transactions between related parties with suspicion as not having been negotiated at arm's length. *See, e.g.*, E. I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979) (finding IRS's reallocation under I.R.C. § 482 of substantial part of foreign

incentives to collude (see Part IV.A), this is not always the case.[137]

The potentially opposite significance(s) of a third party's presence or actions in shelter cases means that it is impossible to evaluate whether a transaction has substance without looking in great detail at the nature of the relationship between the third party and the taxpayer. And, as discussed, the relationship between the taxpayer and third party extends beyond the boundaries of the transaction(s) at issue to include the legal and non-legal statuses and actions of the parties at present and over time.

The good news, in terms of the ability of judicial doctrines to handle increased relationality, is that the case law shows that judges are capable of applying, and are in fact applying, these analytically opposite constructs in the context of deciding tax shelter cases.[138] Moreover, these constructs and analyses are often discussed and applied by judges in the process of applying anti-abuse doctrines.[139] This shows that courts do recognize that they are performing analysis of third-party relationships when determining whether certain arrangements have "substance" and should be respected.

The bad news is that courts are not fully consistent in their evaluations of third-party relationships, both in terms of transparency of process and depth of analysis.[140] While many courts do implicitly or explicitly consider the analytical impacts of third-party relationships in applying the judicial anti-abuse doctrines to determine whether a transaction has substance, not all courts apply a consistent methodology or a consistent degree of attention to making such evaluation.[141] This may reflect the continued

subsidiary's income to parent was not unreasonable); *contra* U.S. Gypsum Co. v. United States, 452 F.2d 445 (7th Cir. 1971), *aff'g in part* 304 F. Supp. 627 (N.D. Ill. 1969) (holding administrative ruling allocating income between parent and subsidiary on ground that shipping rates charged by subsidiary to parent was not arm's length was unreasonable, arbitrary, and capricious).

137. *See* Lederman I, *supra* note 10, at 724-33 (distinguishing "zero sum" situations from situations involving "manufactured surplus").

138. *See supra* notes 128–137.

139. *See supra* notes 128–137.

140. *See, e.g.*, *U.S. Gypsum*, 452 F.2d at 448 ("Whether the district court addressed itself to precisely the proper issue [i.e., the question of whether pricing was at arm's length] is not free from doubt.").

141. *Compare United Parcel Serv. of Am.*, 254 F.3d 1014 *and Frank Lyon*, 435 U.S. 561 (cases in which presence of third party seemed to be enough), *with ACM P'ship*, 73 T.C.M. (CCH) at 2214 (rejecting taxpayer's argument that "all partnership transactions were negotiated at arm's length, priced at fair market value, conducted in accordance with standard commercial practices, and had practical effects wholly apart from their tax consequences"), *Boca Investerings P'ship*, 314 F.3d at 632 (rejecting taxpayer's contention that it was sufficient that "the parties 'intended to, and did, organize Boca as a partnership to share the income, expenses, gains and losses from Boca's investments'"), *and Wells Fargo*, 91 Fed. Cl. at 49 (noting that pricing was not at "fair market value" despite appraisal, but that the taxpayer, appraisers and arrangers had colluded to increase the property's valuation in order to maximize tax benefits).

resonance of the *Frank Lyon* presumption in favor of respecting transactions between multiple unrelated parties.[142]

For example, in *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), the Eleventh Circuit relied on the *Frank Lyon* presumption and ignored the reality of the underlying relationships between the parties in reversing the tax court and holding for the taxpayer.[143] As part of its package-shipping business, United Parcel Service ("UPS") collected "excess value charges" ("EVCs") from customers in exchange for insuring package values in excess of $100.[144] UPS decided to lessen its tax liability by restructuring its excess value insurance program to have an overseas affiliate, Overseas Partners, Ltd. ("OPL"), provide the insurance, instead of UPS providing the insurance itself.[145] To execute its plan, UPS purchased an insurance contract from a third-party insurer, National Union, paying as the premium the EVCs collected from UPS customers.[146] National Union assumed the risk of damage to shipments in excess of $100.[147] National Union then entered into a reinsurance contract with OPL, the UPS overseas affiliate almost all of whose shares were held by UPS shareholders.[148] Under the reinsurance contract, National Union paid to OPL the EVC premiums it had been paid by UPS, minus commissions, fees, and excise taxes.[149] In this way, UPS was able to avoid reporting revenue from the EVCs on its tax return.[150]

The Eleventh Circuit reversed the tax court holding and held for UPS.[151] After noting that the "economic effects" required for a transaction to be respected "include the creation of genuine obligations enforceable by an unrelated party," the court noted that the "real insurance policy" between UPS and National Union was "a genuine obligation" and that the "reinsurance treaty" between National Union and OPL, "while certainly reducing the odds of loss," did not "completely foreclose the risk of loss because reinsurance treaties . . . are susceptible to default."[152] Finally, the court noted that even if National Union were to be disregarded as a "conduit," it was still true that OPL was "an independently taxable entity that [was] not under UPS's control" and that "UPS really did lose the

142. *See supra* Part II.B.2.
143. *United Parcel Serv. of Am.*, 78 T.C.M. (CCH) 262.
144. *Id.* at 1016.
145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.* at 1017.
151. *Id.* at 1016.
152. *Id.* at 1018.

stream of income it had earlier reaped from excess-value charges."[153]

The *United Parcel Service* decision is a classic example of a court respecting a multiple-party transaction without adequate further analysis. The fact that the court explicitly relied on *Frank Lyon* in its analysis supports this Article's observation that the *Frank Lyon* presumption acts as a countervailing force that undermines the effectiveness of judicial anti-abuse doctrines in the battle to probe the true substance of a transactional relationship.[154] The *United Parcel Service* court also did not fully assess the realities of the underlying relationship between the parties to the transaction, most notably by treating OPL as an "independent" entity when in reality it was controlled by UPS shareholders who were also employees and thus were extremely unlikely to default on the reinsurance contract.[155] The court's inability (or unwillingness) to see past a relationship that was, on the surface, an arm's length one, and to examine the true substance of what the connections between the taxpayers and the holders really meant, demonstrates the inadequacy of the traditional doctrines in probing the full extent and impact of such relationships. What is needed is a more robust approach to interrogating relationality, beyond the mere analysis of pre-tax profit, "genuine obligations," business motivations, or risk.

It bears mentioning that the *United Parcel Service* dissent agreed with the majority with respect to the need for "economic effects other than the creation of tax benefits" but disagreed with the majority's risk assessment, correctly finding that the insurer's exposure to risk of loss was "infinitesimal" and that the transaction therefore lacked economic substance or business purpose.[156] Thus, the dissent appeared to make a more thorough and accurate analysis of the actual economics of the relationship between the parties than the majority opinion. If the *United Parcel Service* court had placed less reliance on the *Frank Lyon* case and had performed a more relationally attuned analysis, perhaps it would have reached a more economically rational conclusion.

In summary, the failure of certain courts to closely scrutinize the relationships underlying a transaction is problematic because the indeterminate significance of third-party relationships in shelter cases demands an in-depth analysis of such relationships, notwithstanding *Frank Lyon*'s suggestion otherwise.[157] While it is encouraging that the tools for evaluating relationships are embedded in judicial anti-abuse doctrines and

153. *Id.* at 1019.

154. *Id.* at 1018 (citing *Frank Lyon*, 435 U.S. at 582-83). The *United Parcel Service* court could instead have conducted a more comprehensive analysis of the risk of loss and might well have concluded that this risk was negligible had it done so. Another example of a court applying the *Frank Lyon* presumption is *IES Industries*, 253 F.3d at 355-56.

155. *United Parcel Serv.*, 254 F.3d at 1019.

156. *Id.* at 1021 (Ryskamp, J., dissenting).

157. Wolfman, *supra* note 94, at 1087-88.

are frequently applied, more consistent and closer scrutiny of today's sophisticated, hidden, and increasingly complex relationships is required in applying these doctrines.

C. *The Importance of Judicial Narratives*

It may also be argued that just because some courts are not explicitly discussing third-party relationships in their opinions, this does not mean that they are not sufficiently considering and analyzing these relationships. From a results-oriented perspective, the fact that the IRS has emerged victorious in several major tax shelter cases may prove that there is no issue.[158] However, there are three problems with this line of thinking. First, it is clear from looking at cases like *United Parcel Service* and *IES Industries* (both taxpayer victories) that the *Frank Lyon* presumption in favor of respecting transactions with unrelated parties is alive and well, notwithstanding the actual content of the underlying relationships.[159] Second, it is no secret that the complexity of the subject matter and the realities of asymmetric information and unbalanced resources between the parties in litigation (that is, the taxpayer and the IRS) mean that it is not a trivial matter for courts to appreciate the full extent and implications of the third-party relationality that goes on in shelter cases. This suggests that more can be done to enhance judicial comprehension.[160] This point is developed further in Part IV.A.[161] Finally, in addition to concerns about analytical consistency, concerns about transparency are also important because the opaqueness of complex relationships, when paired with the lack of explicit judicial discussion, renders such relationships less visible than relationships and their effects in other legal spheres.[162] Rather than perpetuating dominant rule-based discourses and sublimating discourses

158. Of course, the IRS has not always emerged the victor in the past, and it is unlikely that the Service will win all battles in the future. *See* Steve R. Johnson, *Tax Shelters: Up Off the Canvas?*, 29 A.B.A. SEC. TAX'N NEWS Q. NO. 2, at 1 (2010) (outlining the back-and-forth history of tax shelter battles between taxpayers and the IRS, and noting that "a pendulum moves in one direction only for a space, after which it reverses its course").

159. *See supra* Part II.B.2 (discussing *Frank Lyon* presumption and its effects); *see also supra* notes 140-156 and accompanying text (discussing subsequent case law that reflects the *Frank Lyon* presumption).

160. *See, e.g.*, Wolfman, note 94, at 1092 (noting "inadequacy of the government's advocacy"); *id.* at 1100 ("In an environment of infinitely diverse and complex transactions governed by an arcane Code, the Court cannot devote the time necessary to become expert."). *See also* sources cited *infra* note 228 and accompanying text (discussing information and other asymmetries between taxpayer and IRS).

161. *See* discussion *infra* Part IV.A. (discussing adverse impacts of third-party relationships on transparency and observability).

162. *See supra* note 14 and accompanying text (contrasting, as an example, scrutiny of same-sex marriages).

about the relational nature of tax planning, judges and judicial opinions should help increase transparency and awareness around the use of relationships in tax planning by bringing discussions and evaluations about this relationality into plain sight.

* * * * *

To sum up the discussion thus far: judicial anti-abuse analysis is, at its core, relationship analysis. Judicially applied doctrines (such as the economic substance doctrine) do contain the constructs necessary to analyze and evaluate third-party relationships. And many courts are applying these constructs to deeply probe the nature and content of relationships between taxpayers and other persons in deciding shelter cases. Yet problems remain with our current applications of these anti-abuse rules.

First, judicial anti-abuse doctrines are fundamentally artificial and limited constructs. They are particularly weak in analyzing relationships that last over time and span beyond the discretely defined tax deal that is before the courts. Furthermore, judicial evaluations of complex relationships between parties vary in robustness. In particular, some courts appear still to be swayed by the *Frank Lyon* presumption of respecting relationships if they are between unrelated parties. These factors are compounded by the existence of information asymmetries that favor sophisticated taxpayers at the expense of courts and the IRS and the evolution of the legal and societal landscape that has rendered the relationships being evaluated much more complex than they were when the judicial doctrines were originally conceived. As a result, in determining whether a transaction has substance, some judicial investigations of relationships remain inadequate.

Finally, even where judges do implicitly scrutinize third-party relationships in a thorough manner, judicial narratives about the nature and complexity of such relationships are lacking. Explicit judicial discussions of the relationships that facilitate tax transactions, and explanations of the analytical steps courts are taking in parsing such relationships, are important. Such discussions and explanations should be encouraged because they have the power to raise public awareness about the roles of relationality in sophisticated tax planning and encourage judicial accountability.[163]

163. *See* discussion *infra* Part V.A. (advocating for explicit judicial narratives concerning relationality).

IV. TWO OTHER HARMS OF THIRD-PARTY RELATIONSHIPS: EVIDENTIARY CONCEALMENT AND THE WARPING OF DOCTRINE

In addition to their vital importance in determining whether a given transaction has sufficient substance or risk to be respected, the presence of third parties in tax shelter transactions have two other distinct impacts on the outcome and process of tax shelter litigation. First, far from indicating transparent dealings, such relationships may, in fact, create incentives that detract from what courts and others are able to observe in litigated shelter cases, leading to decreased transparency and altered litigation outcomes. Second, the increased role and presence of third parties has led to doctrinal confusion in the application of the economic substance inquiry in shelter cases, resulting in actual, unintended modifications of the doctrine in ways that ultimately compromise their effectiveness. Specifically, it has led to confused applications of the business purpose prong of the economic substance inquiry. This confusion is particularly pronounced in the context of pass-though entities.

A. Potentially Adverse Impacts on Transparency and Observability

An important way in which relationships with third parties may impact process and outcomes in shelter litigation is through the effects that such relationships may have on what judges, counsel, commentators, and other spectators are able to observe in a tax shelter case. As discussed, it is tempting to assume that the presence of third parties in a transaction is a more "favorable" fact than if the transaction were between, say, a parent and a controlled subsidiary, on the theory that the deal is somehow more transparent.[164] However, this is not always the case. As other scholars have pointed out, even in the non-shelter context, not all third-party relationships are structured in ways that incentivize openness and transparency; in some situations, third parties have a clear incentive to collude with a taxpayer to facilitate tax avoidance.[165] In general, however, the way in which third-party relationships affect the pragmatics of actual tax shelter litigation has been underexplored in the academic literature.

In the context of tax shelter litigation, it is important to realize that parties with whom a taxpayer has a personal relationship or an ongoing

164. *See, e.g.*, *United Parcel Serv. of Am.*, 254 F.3d 1014 (wherein court made just such an assumption).

165. *See, e.g.*, Lederman I, *supra* note 10, at 724 ("In a multitude of contexts, third parties may actually foster evasion, colluding with the taxpayer in abusive transactions."); *see also* Phillip A. Curry, Claire Hill & Francesco Parisi, *Creating Failures in the Market for Tax Planning*, 26 VA. TAX REV. 943 (2007) (discussing ways the government can cause the tax planning market that exists between participants to fail).

business relationship (or who *hope* to have such a relationship) may have an incentive to cooperate with the taxpayer in presenting a tax transaction in the best possible light. For example, a counterparty to a shelter transaction that has an ongoing business relationship with the taxpayer might be reluctant to cooperate with the IRS, in order to preserve that ongoing relationship. Such incentives that detract from cooperation may create problems for commentators, observers, and decision makers in shelter cases, even in situations where cooperating third parties are performing fairly innocuous functions.[166] So, for example, a third party with an interest in preserving an ongoing relationship may be reticent to provide evidence that a tax-driven deal was contemplated before a certain time, if such evidence undercuts the factual narrative the taxpayer is attempting to present at trial. These dynamics may have consequences for a court's ability to determine the true motivations underlying a transaction or the existence of planning or premeditation with respect to a transaction. Stated differently, motivations associated with ongoing relationship creation and maintenance, *even with respect to relationships between supposedly arm's length parties*, may undermine the interest in robust discovery and disclosure of all relevant facts in trial proceedings.[167]

The impact of cooperative and ongoing relationships between the taxpayer and third-party participants may, for example, show up in a third party's less-than-forthcoming response to being subpoenaed in a shelter case.[168] Such third parties are required to respond to subpoenas of documents or persons. However, incentives of a third party to collude or cooperate with a taxpayer (or to support the factual narrative put forth by the taxpayer in the interests of ongoing goodwill) may put added pressure on the subpoena issuer to be extremely nuanced in determining how the subpoena should be crafted and what documents or information to demand. Such incentives may also create difficulties for the Service in eliciting information from third-party witnesses called under the subpoena.[169] Such third-party resistance in effect forces the subpoena issuer or witness

166. Even third parties serving relatively innocuous functions that have an interest in preserving longer-term business relationships (e.g., sellers and buyers of property in a transaction) might have an incentive to be less than forthcoming with information.

167. *But cf.* Lederman II, *supra* note 15, at 1739 ("[I]nformation reporting is of most use where the possibility of collusion is relatively small. This suggests that contexts involving parties who generally act at arm's length . . . are more suitable for information reporting than are contexts involving related parties (such as family members).").

168. *See* I.R.C. § 7456 (2006) (subpoena powers of U.S. Tax Court). *See also* TAX CT. R. 147 (subpoena rules for the U.S. Tax Court); FED. R. CIV. P. 45 (subpoena rules for federal district courts); CL. CT. R. 45 (subpoena rules for the Court of Federal Claims); GERALD A. KAFKA & RITA A. CAVANAGH, LITIGATION OF FEDERAL CIVIL TAX CONTROVERSIES ¶ 1.08[2] (comparing U.S. Tax Court's nationwide subpoena rule with more circumscribed rule for federal districts courts and the court of federal claims).

169. *See generally* sources cited *supra* note 168.

examiner to be extra careful in detailing the requested documents or testimony, even assuming 100% honesty on the part of the responder.[170] This is not a good thing because subpoenas of non-taxpayer parties are an important tool used to obtain information about the surrounding context and relationships in a tax litigation proceeding and to verify taxpayer claims.[171] Third-party reticence in information sharing can increase litigation costs, waste resources, and exacerbate already existing information asymmetries and disparities in resource availability between the IRS and the taxpayer.[172]

The impact of a third-party relationship on the amount of information to which judges and the IRS have access in tax litigation, and on how such information is filtered and presented, is hard to quantify. The evidence for this is buried in the experiential knowledge of tax litigation practitioners and is for the most part hidden from the purview of academic scholars. However, as any experienced tax litigator knows, the impact of such relationships is undeniable. The motivations of parties in relation to each other and the litigants' assessments of the likelihood and ease of obtaining evidence from various players are significant factors in how a case gets presented and litigated. Indeed, such hidden motivations play a vital role in determining *whether* a case gets litigated. Difficulties in obtaining information from third-party participants to a transaction may lead to a greater likelihood of pre-trial settlements or a more generous settlement in favor of taxpayers than might otherwise occur.[173]

In sum, the broader question raised by the presence of ongoing relationships with third parties, beyond the notion of "substance," is how judges can possibly be sure that the record that they are observing and the narratives to which they are privy (and upon which the litigants no doubt base their litigation and settlement strategies) are complete, fair, and reflective of all of the incentives underlying the transaction. Furthermore, how can they be certain that the record accurately describes all of the events that actually took place between the parties to a transaction?[174] The

170. *See generally* sources cited *supra* note 168.

171. *See generally* sources cited *supra* note 168.

172. Lederman II, *supra* note 15; David Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331 (2006) (discussing "structural imbalance" between government and private tax bar in terms of information, expertise, and numbers, and proposing solutions).

173. The nature of the relationships between the parties, whether they are competitive or cooperative and whether collaboration or collusion is present, may, for example, impact matters of trial strategy, including which witnesses get called, whether expert witnesses are used, and which arguments are emphasized. *See generally* John Herbert Tovey, *Preparing a Federal Income Tax Case for Trial*, 20 AM. JUR. TRIALS 255 (1973).

174. As discussed in Part IV.B.2, *infra*, in *ASA Investerings*, the tax court seemed aware that the third-party foreign bank participant sought to strengthen its relationship with the corporation seeking to offset its gains by participating in the tax shelter transaction at issue. 76 T.C.M. (CCH) 325, 327 (1998) (noting that "ABN and [taxpayer] already had a lending

existence of these evidentiary issues may adversely impact a court's ability to properly apply traditional doctrines and thus may compromise their ability to fully evaluate the facts and the merits of the tax deal. To make fully informed judgments about what they are seeing, judges need to understand the hidden dynamics of the underlying relationships between the parties to a transaction. Some relationships facilitate transparency and honest disclosure; others demonstrate the reverse incentives.[175] In cases where the relationships impede cooperation at trial, particularly where judges are unaware of these relationships, this has the potential to detract from the soundness of the ultimate holding or other resolution of the case. To this point, courts have not yet come up with a systematic approach to guard against these problems.

B. Impacts on the Content of Judicial Doctrine: Obfuscation of Doctrine

Taxpayer relationships with third parties have also had problematic impacts on the content of substantive doctrine. Most notably, the proliferation of these relationships, and the evolving forms they take, have created confusion in the application of the business purpose analysis in tax transactions. At one extreme, some courts have moved toward relying on the business motivations, profit potential, economic effects, and risk of the unrelated party participants, rather than the taxpayers themselves, in determining whether a transaction has economic substance.[176] At the other extreme, others have held that the business purpose of non-taxpayer parties has no relevance in determining whether a transaction should be respected for tax purposes.[177] In cases involving pass-through entities, courts have had particular difficulty distinguishing between the taxpayer and the third-party participant in determining whose business motivations should "count."[178]

relationship, but ABN believed it could strengthen that relationship by participating in the venture and being a compliant partner"); ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 514 n.6. *See also* Raskolnikov, *Relational Tax Planning*, *supra* note 10, at 1258 ("Courts are already more suspicious of tax benefits arising from relationships that have higher levels of trust."). The question is whether courts are also aware that the nature of the underlying commercial dynamics between the parties also has effects on the procedural and evidentiary aspects of tax shelter trials.

175. This point has been argued by other scholars. *E.g.*, Lederman I, *supra* note 10.

176. *See Newman*, 902 F.2d at 163 (crediting non-tax motivation of third-party trucking company).

177. *See* Coleman v. Comm'r, 16 F.3d 821, 828 (7th Cir. 1994) (finding the non-taxpaying party's motivation not relevant).

178. *See* discussion *infra* Part IV.B.2.

1. Confusion in Whether to Allow Bootstrapping of Unrelated Party Business Motivations

An extreme example of a case that has moved toward "counting" the third party's business purposes in finding that a transaction had substance is *Newman v. Commissioner*.[179] In *Newman*, the individual taxpayer claimed an investment tax credit ("ITC") based on his ownership of a tractor-trailer truck, which was used by a third-party trucking company.[180] The legal issue boiled down to whether the taxpayer had leased the truck to the trucking company (in which case the taxpayer would not have been entitled to the ITC) or whether the relationship was one of owner-independent contractor.[181] The court applied the economic substance inquiry in making its determination.[182] In analyzing whether there existed the requisite non-tax business purpose for engaging in the transaction, the court found that despite the tax court's finding that the *taxpayer* was not motivated by non-tax considerations, this did not compel the legal conclusion that the transaction lacked a business purpose.[183] Instead, the court characterized the *Frank Lyon* decision as holding that "as long as one party is motivated by non-tax considerations, even if it is not the taxpayer, the form of the agreement will satisfy [the business purpose] factor."[184] The court proceeded to find that the third-party trucking company had non-tax motivations for entering into the transaction, and that the business purpose requirement was therefore satisfied.[185] This tendency to take third-party business purposes into account has been echoed elsewhere.[186]

The bootstrapping of third-party business purposes described in this Part is arguably another echo of the *Frank Lyon* over-reliance on the motivations and participation of unrelated parties.[187] At the same time, not all courts have allowed such bootstrapping. Some have treated the business purposes of a third party as irrelevant in determining whether a transaction had substance for tax purposes. For instance, in *Coleman v. Commissioner*, a sale-leaseback case, the court ignored the business motivations of the seller-lessee (which claimed that it entered into the transaction because of

179. 902 F.2d 159 (2d Cir. 1990), *vacating* 56 T.C.M. (CCH) 748 (1988).
180. *Id.* at 160.
181. *Id.* at 162.
182. *Id.* at 163 (citing *Frank Lyon*, 435 U.S. at 583-84 (1978)).
183. *Id.* at 163.
184. *Id.* (citing *Frank Lyon*, 435 U.S. at 576).
185. *Id.*
186. *See* discussion *infra* Part IV.B.2. *See also* Reply Br. of Resp't at 291-93, Santa Monica Pictures, L.L.C. v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (No. 6163-03) (citing and applying *Newman*, 902 F.2d 159); *cf. Wells Fargo*, 91 Fed. Cl. at 83 (finding a non-tax business purpose lacking by examining effects on both taxpayer and counterparty).
187. *See* discussion *supra* Part II.B.2.

cash needs to remain financially viable), noting that the relevant motive was that of the lessor-partnership of which the taxpayer was a partner.[188] This is the opposite of the approach taken by the courts in *Newman* and *Frank Lyon*, which allowed the taxpayer in those cases to "borrow" business purpose from third parties in order to meet the requirements of economic substance.[189]

2. Confusion in Application to Pass-through Entities

The business purpose analysis runs into related difficulties in cases involving pass-through entity taxpayers. In such situations, the question that arises is whether the business purpose analysis should occur at the entity level or at the level of the respective owners of the entity. For example, if the entity is a partnership, and if the analysis looks at the partners of the partnership, bootstrapping might inadvertently occur because the partners may include both the party ultimately attempting to minimize its tax liability or claim a tax benefit and a facilitating "third party" partner.[190]

The contingent installment sales cases, which were constructed to shelter capital gains of corporate taxpayers by employing the operation of the contingent installment sales regulations, provide an example of the inconsistency and confusion that comes with evaluating a third-party relationship's impact on the business purpose analysis.[191] An examination of these cases shows that even within the same "family" of tax shelter cases, different courts give the motivations of these participants different weights in determining the bona fides of a given transaction. As discussed in Part II.A,[192] these transactions involved the formation of a partnership between a domestic and a foreign partner.[193] Using contributions from the partners, the partnership would purchase property (private placement notes), hold it for a short period of time, and then sell the property in exchange for a large, immediate cash payment and small future contingent payments (LIBOR notes).[194] This sale of private placement notes for cash

188. 16 F.3d 821, 828 (7th Cir. 1994) ("Although [the seller-lessee's] motive appears genuine, we place little significance on this factor because [the lessor limited partnership's] motive is the relevant one.").

189. *Frank Lyon*, 435 U.S. at 576-78; *Newman*, 902 F.2d at 163.

190. *See, e.g.*, *ACM P'ship*, 157 F.3d 231 (partners were a company seeking to generate capital losses and a "facilitating" Dutch bank).

191. *Id.*; *Boca Investerings*, 314 F.3d 625; *Saba*, 273 F.3d 1135; *ASA Investerings*, 201 F.3d 505.

192. *See supra* notes 59-62 and accompanying text.

193. *Boca Investerings*, 314 F.3d at 628; *Saba*, 273 F.3d at 1136; *ASA Investerings*, 201 F.3d at 506; *ACM*, 157 F.3d at 234-35.

194. *Boca Investerings*, 314 F.3d at 628-29; *Saba*, 273 F.3d at 1138; *ASA Investerings*,

and LIBOR notes would trigger the application of the ratable basis recovery rule in the regulations.[195] This rule would allow present year gain to be allocated to the foreign partner, while future yearly losses would be allocated to the domestic partner to offset that domestic partner's gains from other activities after the foreign partner's withdrawal from the partnership.[196] Merrill Lynch, the promoter, was involved not merely in structuring the transactions but also in seeking out the foreign partner, ABN Bank based in the Netherlands, to participate in the transaction, and matching willing taxpayers with ABN Bank.[197]

The CINS courts were inconsistent in how they applied the business purpose prong of the economic substance doctrine with respect to the participation of ABN Bank. For example, in *ASA Investerings*, the tax court found that the partnership (ASA) was a sham partnership, focusing on ABN Bank's lack of business purpose rather than on AlliedSignal, the entity seeking to offset its gains. The tax court first determined that the issue was "whether AlliedSignal and ABN intended to join together in the present conduct of an enterprise."[198] The court then found that the partnership was not a true partnership because the partners had "divergent business goals"—AlliedSignal's goal was to generate capital losses, while ABN Bank's "sole purpose" for entering into the partnership was "receiving its specified return."[199] The court proceeded to look more closely at ABN's participation, noting that "ABN [had no] profit potential beyond its specified return and did not have any intention of being

201 F.3d at 508; *ACM*, 157 F.3d at 235-36.

195. I.R.C. § 453 (2006); Temp. Treas. Reg. § 15a.453–1(c)(3)(i) (1981).

196. *Boca Investerings*, 314 F.3d at 627; *Saba*, 273 F.3d at 1136; *ASA Investerings*, 201 F.3d at 507—08; *ACM*, 157 F.3d at 237.

197. *Saba*, 273 F.3d at 1136, 1138; *ASA Investerings*, 201 F.3d at 508; *ACM*, 157 F.3d at 235, 235 n. 5; Saba P'ship v. Comm'r, Nos. 1470-97, 1471-97, 1999 WL 974834, at *4, *8-9 (U.S. Tax Ct. Oct. 27, 1999); *ASA Investerings*, 76 T.C.M. (CCH) 325, 326-27 (1998); *ACM P'ship*, 73 T.C.M. (CCH) 2189, 2194. The CINS cases represent a set of tax shelter transactions whose success is dependent upon the participation of unrelated party participants. *See supra* notes 59-62 and accompanying text. There were two clear junctures at which unrelated party participation was instrumental in triggering the desired tax consequences. First, the acquisition of the private placement notes from unrelated parties and their almost immediate sale to other unrelated parties partially in exchange for a contingent instrument was the triggering tax event that allowed the Section 453 regulations to be applied in the first place. Second, the participation and subsequent withdrawal of a tax neutral foreign partner (ABN Bank) in each of these partnerships was essential in order for the gain from the PPN-for-cash-and-LIBOR-notes exchange to be allocated to that foreign partner with the subsequent loss being allocated to the taxpayer trying to offset its capital gains. The analysis of third parties by the CINS courts focused on the second juncture rather than the first: the participation of ABN Bank, the tax neutral foreign partner.

198. *ASA Investerings*, 76 T.C.M. (CCH) at 333 (citing Comm'r v. Culbertson, 337 U.S. 733, 742 (1949) and Maiatico v. Comm'r, 183 F.2d 836, 838 (D.C. Cir. 1950)).

199. *Id.*

AlliedSignal's partner."[200] The court also noted that "ABN would not bear any loss relating to the PPN sale" and "ABN was a compliant and accommodating party, which was chosen for the venture because it was willing to serve at AlliedSignal's direction."[201] By focusing on ABN Bank, the court concluded that these features were "contrary to the characteristics of a bona fide partnership" and that the partnership was therefore a sham entity.[202]

Even though it ultimately affirmed the tax court's determination that the partnership was a sham and that the parties did not intend to join together to conduct non-tax avoidance business activities, the court of appeals in *ASA Investerings* found it "curious" and "puzzling" that the tax court's focus was on ABN's intentions. The appeals court found this curious because "the absence of a nontax business purpose was even clearer for AlliedSignal" and "AlliedSignal . . . was the driving force and . . . focused on tax minimization to the virtual exclusion of ordinary business goals."[203] Thus, unlike the tax court, the appeals court thought that the focus of the sham partnership inquiry should be on AlliedSignal, the corporation seeking to offset its capital losses, rather than ABN Bank, the foreign partner.

Inconsistency regarding which party to look at in evaluating business purpose was also evident in *Boca Investerings*.[204] In determining whether the partnership was a sham entity, the court of appeals in *Boca Investerings*, like the courts in *ASA Investerings*, looked for the existence of a nontax business purpose.[205] However, the *Boca Investerings* court appeared confused over which party to look at in evaluating the existence of such business purpose. On the one hand, the court implied that the existence of nontax business purposes should be determined at the partner level, looking at the needs and intentions of both partners.[206] On the other hand, the court's analysis of whether a nontax business purpose existed focused on American Home Products (AHP)—the partner seeking to offset capital losses.[207] After analyzing AHP's business purposes, the appeals

200. *Id.*
201. *Id.* at 334-35.
202. *Id.* at 335.
203. *ASA Investerings*, 201 F.3d at 513, 515.
204. *See generally Boca Investerings*, 314 F.3d 625.
205. *Id.* at 630 ("As we noted in *Saba Partnership*, '*ASA* makes clear that the absence of a nontax business purpose is fatal to the argument that the Commissioner should respect an entity for federal tax purposes.'") (internal quotation marks omitted).
206. *Id.* at 631-32 ("In order to satisfy the legal test for this type of partnership, the district court must have found a non-tax business purpose need for the partnership in order to accomplish the goals of the partners.").
207. *Id.* at 631 ("Without a finding on the business need for the partnership from AHP's standpoint in this transaction, the judgment under review cannot stand.").

court found that the partnership in question was a sham entity.[208] By way of comparison, the district court in *Boca Investerings* looked at the intentions of both AHP and ABN Bank in determining that the partnership was not a sham.[209]

Just as they disagreed with regard to which entity's motivations and economic effects to focus on in determining whether a CINS partnership was a sham, the CINS courts also failed to agree as to whether the applicable analysis to these transactions should be a "sham entity" analysis or a "sham transaction" analysis. While some of the CINS courts applied a "sham entity" analysis, others applied a "sham transaction" analysis, and some applied both.[210] The CINS courts even appeared to disagree on whether the sham entity and sham transaction analyses yielded different results.[211]

The determination of whether to apply a "sham transaction" or a "sham entity" analysis is significant because application of the sham entity analysis allowed some CINS courts to look through the entity to the intentions of the partners in determining whether the entity was a sham. For example, the fact that it was performing a sham entity analysis led the *ASA Investerings* tax court to look at the divergent business goals of ABN and AlliedSignal.[212] Notably, the district court in *Boca Investerings*, which performed both a sham transaction and a sham partnership analysis, seemed

208. *Id.* at 631-32 ("AHP's participation in the partnership defies common sense from an economic standpoint, since it could have purchased the PPNs and the LIBOR notes directly, and avoided millions in transaction costs . . . . In this case, there is no evidence of any need for AHP to enter into the . . . partnership with the newly-minted Addiscombe and Syringa in order to invest in the LIBOR notes and PPNs.").

209. *Boca Investerings*, 167 F. Supp. 2d at 369-73 ("AHP would only enter into a partnership with a partner or partners with whom AHP would be comfortable, who had expertise with respect to the financial instruments . . . and who was financially secure. . . . While [the ABN Bank SPCs] hedged their share of the interest-rate risk with respect to the LIBOR Notes outside the Partnership, this did not affect the sharing of such risk among the partners.").

210. The appeals court in *Boca Investerings*, and the tax court and appeals court in *ASA Investerings*, applied a "sham entity" analysis. *Boca Investerings*, 314 F.3d at 630; *ASA Investerings*, 201 F.3d at 512; ASA Investerings P'ship v. Comm'r, 76 T.C.M. (CCH) 325, 333-34 (1998). The tax court and appeals court in *ACM Partnership* and the tax court in *Saba Partnership* applied a "sham transaction" analysis. *ACM P'ship*, 157 F.3d at 245; *Saba*, at *41-*42; *ACM P'ship*, 73 T.C.M. (CCH) 2189, 2214-15 (1997). The district court in *Boca Investerings* applied both a "sham entity" and a "sham transaction" analysis. *Boca Investerings*, 167 F. Supp. 2d at 364. The appeals court in *Saba Partnership* remanded, on the theory that both analyses needed to be considered. *Saba*, 273 F.3d at 1140-41.

211. *Compare ASA Investerings*, 201 F.3d 505, 512, 512 n.4 ("Although the Tax Court said that it would not consider whether the *transactions* at issue lacked 'economic substance' . . . its decision rejecting the bona fides of the *partnership* was the equivalent of a finding that it was . . . a sham."), *with Saba*, 273 F.3d at 1140 ("All parties agree that the sham transaction and sham partnership approaches yield different results.").

212. *ASA Investerings*, 76 T.C.M. (CCH) 325, *rev'd*, 201 F.3d 505.

to take a different approach for each analysis.[213] In its sham partnership analysis, the district court in *Boca Investerings* looked at the intents of and relationships between all of the partners, including the ABN subsidiaries.[214] On the other hand, in its sham transaction analysis, the court looked at profitability and business purpose almost exclusively from American Home Products' point of view.[215] Therefore, the type of analysis the court chooses to undertake apparently has a significant effect.

* * * * *

The confusion in "business purpose" jurisprudence, both in cases involving pass-through entities and in other cases, is concerning. Such inconsistencies present uncertainty as to the parameters of the business purpose doctrine and which version of the business purpose analysis the courts will apply. They also suggest that rogue versions of the doctrine may evolve and be applied in inaccurate ways as third-party participation in avoidance transactions continues to grow and change. Such inaccuracies, even subtle ones, may undermine the doctrine's effectiveness in accurately evaluating the transactions and relationships between taxpayers and third parties—the very relationships the doctrine is meant to probe.

V. BEYOND ECONOMIC SUBSTANCE: TWO PROPOSALS TO ADDRESS THE IMPACTS OF TAXPAYER RELATIONSHIPS IN SHELTER CASES

Thus far, this Article has summarized the integral roles played by relationships and dealings with third parties in the structuring of tax transactions and has shown how existing judicial anti-abuse doctrines that are applied in shelter cases are, at core, concerned with evaluation of such relationships. However, this Article has also shown that judicial anti-abuse doctrines are not cure-alls, that judicial analyses are not uniformly robust, and that even courts that perform detailed analyses could do better by providing explicit discussions and narratives analyzing such effects. The inadequate application of the traditional doctrines that probe the substance, the risk involved, or the economic effects of tax minimization transactions is exacerbated in part by two factors: the continuing resonance of the *Frank Lyon* presumption and the increasing ease of forming more complex and sophisticated entities and relationships.[216]

Furthermore, this Article has shown that the presence of third-party relationships in shelter cases causes two other problems: (1) adverse

213. *Boca Investerings*, 167 F. Supp. 2d at 364.
214. *Id.* at 367-74.
215. *Id.* at 374-81.
216. *See* discussion *supra* Parts II.B, III.B.

impacts on evidentiary transparency that circumscribe the narratives to which courts and other commentators have access in tax litigation proceedings and that compromise judicial ability to fully evaluate the factual realities of the transactions at issue; and (2) doctrinal obfuscation (and correspondingly, subtle modification) in applications of the traditional anti-abuse doctrines to complex, relationship-driven transactions.

To remedy these issues, this section presents two normative proposals. First, courts should apply a carefully constructed oppositional choice analysis in evaluating third-party relationships and their consequences in tax shelter cases in order to offset the problems associated with lack of transparency and asymmetric information. Such an analysis will help strengthen traditional doctrines in their analysis of ongoing relationships between players. It will also help alleviate the evidentiary problems caused by non-transparent relationships and their accompanying incentives. Second, courts should rehabilitate the business purpose doctrine from the doctrinal confusion caused by increasingly complex relationships between taxpayers and others. This can help prevent courts from applying traditional doctrines in unintended and unanticipated ways that weaken their ultimate effectiveness.

A. The Need for an Explicitly Expressed, Oppositional-Choice Analysis of Taxpayer Relationships

The need for a "deeper look" at the meanings and effects of relationships between taxpayers and third parties, in terms of both substance and procedure, is central to this Article's first proposal. So, too, is the need for clear judicial expression of their evaluations of these relationships. As other scholars have argued, the content of judicial opinions is significant for reasons other than simply determining the outcome of a case.[217] Judicial opinion writing in tax shelter cases can and should play an active role in guiding judicial choice and in shedding light upon the nuances of relationships in shelter cases.

Since it is generally not feasible to ban business transactions and relationship formation outright on an *ex ante* basis,[218] this Article suggests a

217. *See* Susan Bandes, *Searching for Worlds beyond the Canon: Narrative, Rhetoric, and Legal Change*, 28 LAW & SOC. INQUIRY 271, 281 (2003) ("The [judicial] aura of authority and inevitability is achieved largely by the very refusal to acknowledge alternative viewpoints."); Chad M. Oldfather, *Remedying Judicial Inactivism: Opinions as Informational Regulation*, 58 FLA. L. REV. 743, 747 (2006) ("[J]udicial opinions serve as a form of informational regulation of judicial behavior."). *See also* Alex Geisinger, *A Belief Change Theory of Expressive Law*, 88 IOWA L. REV. 35 (2002) (articulating a "belief change" theory of how law affects social norms and discussing law's "expressive" function).

218. Some provisions have been enacted to discourage third-party participants from

"best practices" approach to analyzing and speaking about the relationships that are formed. This Article proposes that when making decisions in shelter transactions involving third-party relationships, courts should explicitly recognize the ultimate indeterminacy of *any* transaction or relationship, whether between unrelated parties or not. Courts can do this by treating the decisional matrix confronting them as a choice between which of two diametrically opposite analytical possibilities is more apposite. For example, a judicial intuition that a transaction occurred at arm's length should only be allowed to hold sway after a corresponding determination that the parties did not collude in setting prices and did not have the incentive to do so. Likewise, a judicial determination that a transaction with a third party reflects the existence of genuine obligations should only be made after a clear determination that there are no unwritten understandings that undercut the existence of such economic effects.

In other words, this Article suggests that courts should make determinations regarding relationships and transactions between taxpayers and third parties by employing an explicitly expressed oppositional-choice process. Such a process would involve a court asking a list of "back-and forth" questions in determining the true substance of a relationship and making its decision. The questions asked should be organic, tailored to the specific situation presented, and adjusted to accommodate the changing realities of the shelter market. For example, the analysis could look like this:

Legitimizing:	Is this a genuine transaction between multiple parties that are unrelated?
Detractive:	If there are third parties involved in the transaction, do they merely serve as straws or mules to give the transaction a credible flavor?
Legitimizing:	Do the transactions, relationships, and agreements between the taxpayer and the third party reflect the existence of genuine obligations that have economic effects?
Detractive:	Are the legal obligations or economic effects we think we observe undercut by unwritten understandings or side agreements that may not be obvious to the observer?

engaging in abusive tax planning transactions. *See, e.g.*, I.R.C. § 4965 (2006) (imposing an excise tax on certain tax-exempt entities entering into prohibited shelter transactions); I.R.C. § 6652(c) (2006) (imposing penalties on tax-exempt entity for failure to disclose participation in certain prohibited transactions).

Legitimizing:	Did the transactions, relationships, and agreements between the parties result in a shifting in benefits and burdens of ownership, and does the new owner take on risk?
Detractive:	Is there any evidence of countervailing factors (such as offsetting transactions) that undercut burden shifting or eliminate the risks of ownerships?
Legitimizing:	Was the pricing of the transaction at arm's length and at fair value?
Detractive:	Is there evidence of collusion or price setting between the parties? Is there any suggestion that pricing was set to achieve a certain level of tax benefits?
Legitimizing:	Were the agreements and prior relationships between taxpayer and third party transparently presented, readily accessible, and observable to the administrative and/or judicial fact finder?
Detractive:	Do the taxpayer and third-party players have an incentive to misrepresent, hide, or withhold information from the judicial fact finder, such that we should look at the facts presented to us with a suspicious eye?

In this manner, making a realistic determination of the true nature or the real economics of a third party's participation would require judges to overcome increasing transactional complexity and existing presumptions of respect toward unrelated party transactions. They would also need to perform a considered analysis of the underlying historic and continuing commercial, business, or personal relationships and transactions between the taxpayer and third parties, and to come to an in-depth understanding of what behaviors are incentivized by these relationships. In doing so, the analysis deliberately takes on an implicit forward and backward looking dimension.

The process and results of the above oppositional-choice analysis should be made an explicit part of judicial opinions by introducing a mandatory new section as part of the factual description provided in the opinion text. This notion of modifying judicial opinion format is not new and has been suggested elsewhere.[219] The notion is also not outrageous.

219. *See* Oldfather, *supra* note 217, at 748, 794-801 (arguing that format of judicial opinions should be modified to include "'framing arguments'–party-generated statements of the issues before the court" in order to facilitate better regulation of judicial behavior).

After all, judges already customarily included certain sections in their opinion—such sections most often include a summary of prior proceedings, a summary of the facts, a statement of the legal issue, a summary of the applicable doctrine, and the like. Making a slight change in opinion format and coverage in order to facilitate more thorough fact finding on a critical matter should not be difficult or controversial.

It should be noted that the last two "oppositions" in the oppositional-choice analysis described above are of particular importance. They extend the inquiry to the question of how underlying and hidden relationships affect transparency and disclosure in order to remedy the potential evidentiary imbalances discussed in Part IV.A. As that Part points out, third-party relationships can have serious effects on these matters.[220]

To sum things up, engaging in this back-and-forth analysis between legitimizing and detractive interpretations, and expressly including the process and results of such analysis in the opinion text, serves a number of purposes.[221] First, it aids judicial analysis. It forces courts to pay close attention to the relationships underlying a shelter transaction in the first place instead of being overly influenced by how a transaction (particularly a transaction between unrelated parties) is papered and presented, giving courts a better chance not to be led astray by one-sided accounts and information asymmetries.[222] It also gives courts a better chance of understanding how the ongoing nature of some relationships may impact the determination of whether a transaction has substance or is a sham. Balanced relationship analysis and the crafting of explicit expository opinions by lower courts also aids appellate review, providing appeals courts with a more solid and transparent framework for understanding the relationships underlying appealed shelter cases.[223] An oppositional-choice approach to relationship analysis is also useful because it mirrors the way in which evidence is discovered and introduced into the record in tax litigation.[224] Typically, the taxpayer (and third parties in the taxpayer's

220. *See supra* Part IV.A.

221. Some of the goals, purposes, and functions of judicial explication are explored in related literature concerning the roles and goals of judicial opinion writing. *See* Bandes, *supra* note 217, at 281 ("[J]udicial narratives are under tremendous pressure to be hegemonic."); Oldfather, *supra* note 217, at 795 ("Conceiving of opinions as a form of informational regulation both invites and facilitates consideration of how the opinion device might be modified to direct judicial behavior."); Patricia M. Wald, *The Rhetoric of Results and the Results of Rhetoric: Judicial Writings*, 62 U. CHI. L. REV. 1371 (1995) (discussing reasons for, constraints on, principles underlying, and techniques associated with judicial writing).

222. Wolfman, *supra* note 94, at 1076.

223. My thanks to Jason Reichlyn for highlighting this point.

224. *See generally* TAX CT. R. PRAC. P. 70-104 (2010) (discovery rules generally applicable to proceedings of the United States Tax Court). *See also* I.R.C. § 7453 (2006); FED. R. CIV. P. 26-53 (discovery and trial rules generally applicable in the federal district

corner) will endeavor to put forth the most legitimizing spin possible on the record and the IRS will introduce maximally detractive interpretations of the same transaction.[225] Courts are left with the difficult task of sorting out the conflicting relationship depictions of already complex transactions that each side tries to present. By engaging in an oppositional-choice analysis, courts will be better able to appreciate and evaluate the existence, strength, and veracity of the arguments and counterarguments put forth by the parties, instead of being unduly swayed by the point of view put forward by one side.

In addition, such an approach has the potential to change the behavior of players even in times leading up to a tax trial. If the parties to a tax case (i.e., taxpayer, third parties, and IRS) know that courts will always be looking deeply and in an analytically oppositional way at the content of third-party relationships, this can have the effect of encouraging more robust discovery and disclosure at the administrative and trial level, thereby ameliorating some of the transparency and observability problems pointed out in this Article. For example, this could encourage more aggressive and thorough subpoenaing and questioning of counterparties in tax cases, which could, in turn, have the effect of discouraging potential counterparties from "helping out" in transactions that lack substance in the first place. And, if parties are aware, *ex ante*, that courts will be exploring a broad range of analytical possibilities with respect to the relationships before them (not just the narrow economic effects of the present transaction), this may even have the effect of imposing costs that serve to discourage third parties from entering into the most aggressive kinds of relationship formation to begin with.

Finally, adopting an oppositional choice analysis that is explicitly expressed in judicial opinions has the effect of harnessing judicial decision-making as a tool for educating the public and raising awareness about the nature and extent of underlying relationships between taxpayers and third parties and their significance in facilitating shelter transactions. As previously noted, a problem with observing relationship formation and transactions between parties in the commercial context in general, and in the tax shelter context in particular, is the hidden nature, complexity, and non-intuitiveness of the (non-human) legal personages, contracts, and the relationships that arise between them.[226] This concealment and complexity

courts).

225. *See* Wolfman, *supra* note 94, at 1075 (describing the Supreme Court's reliance in tax cases "on the validity of a basic assumption of the adversary process: that strong and effective advocates bring the issues into focus and marshal the strongest arguments for each side, thus educating the Court and helping it reach the best result"). As noted, this adversary process is often, in fact, fraught with information and power asymmetries. *See supra* notes 160, 172 and accompanying text.

226. *See, e.g.*, Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM.

is particularly stark as compared to the more "obvious" interactions between easily observable human persons. Indeed, the question about the proper relationship that should exist between the human and non-human legal persons (and the proper treatment of each) is arguably one of the important questions of our time.[227] The problems of concealment and non-intuitiveness are often exacerbated by information and other asymmetries between the taxing authority (and the public) and the sophisticated taxpayer in the tax litigation context.[228] If the idea is to prevent abusive tax planning, then stimulating public, judicial, administrative, and legislative awareness about the underlying complex commercial relationships that so often facilitate such planning can only be a good thing.

Judicial adoption of an oppositional choice analysis of third-party relationships will help achieve all three of the stated goals. A judicial solution is required because judges are in the best position to facilitate narratives and explanations of the relationships between parties and to raise awareness about the effects of relationality in shelter transactions. Because the significance of third-party relationships extends beyond the traditional economic substance assessment and encompasses issues of evidentiary transparency, behavioral incentives, and the need for raising awareness, a statutory or regulatory solution by itself is insufficient.

Yet the question remains: should judges in tax cases be charged with making in-depth evaluations of the business and commercial relationships between third parties? On the one hand, given the importance of third-party relationships in affecting the timing, amount, and location of tax benefit realization, it is hard to see why not. Arguably, analyzing the merits of a claimed relationship is precisely what courts are doing in situations where they apply so-called "factors" tests.[229] On the other hand, there are contravening administrative and philosophical considerations. Probing the nuances of underlying relationships can be labor-intensive, time consuming, and an ill-suited use of scarce judicial expertise and

BANKR. L.J. 253 (2009) (arguing that the erosion of the "doctrine of secret liens" led to an "opaque credit environment" that contributed to the financial crisis of 2008).

227. *See generally* Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010) (protecting political spending by unions and corporations as free speech under the First Amendment).

228. *See* Rostain, *supra* note 72, at 83-95 (describing role of private tax bar in growth of tax shelters); Schizer, *supra* note 172, at 331 (noting that tax shelters "also derive from a structural imbalance in our tax system" whereby "the private tax bar outmatches its counterpart in government"); Wolfman, *supra* note 94, at 1076 (noting that, in the *Frank Lyon* litigation, "[t]he weakness of government counsel was no match for the strength of taxpayer counsel" and urging "serious reconsideration" to the "assumptions" of the "adversary system" and "process").

229. *See Levine v. Comm'r*, T.C.M. (RIA) 2005-86 (2005) (applying factors test in determining whether taxpayer was common law employee or independent contractor, for purposes of determining deductibility of pension play contribution).

resources.[230] Underlying relationships that extend beyond the transaction at issue may also be difficult to discern based on the record, which would most likely be focused on the discrete tax avoidance transaction being litigated. And, ultimately, probing the underlying commercial relationships between the parties might require too much independent judicial investigation. The question of how thoroughly judges should look into the underlying relationships between third parties also raises philosophical issues: ultimately, this question implicates the broader issue of how closely, and in what circumstances, courts should scrutinize and intervene in contracts between the parties to a private transaction at all.[231] This is hardly a question limited to tax law adjudication.[232]

Despite these countervailing considerations, however, this Article contends that judges in tax cases absolutely should inquire more explicitly into the business and personal relationships between the taxpayer and the third party. Tax law is fundamentally concerned with probing the true economics and substance of transactions rather than accepting their form at face value,[233] and tax shelters raise serious problems of social justice in that they thwart attempts to raise revenue and create revenue leakage.[234] Insofar as we want to discourage the formation of sham relationships acceptable in form but lacking substance, this overriding concern with substance—a

230. *See generally* Oldfather, *supra* note 217, at 768-79 (discussing the "crisis of volume" affecting federal appellate courts and the effects on court performance); Stephen Reinhardt, *Whose Federal Judiciary is it Anyway?*, 27 LOY. L.A. L. REV. 1 (1993) (arguing for increase in size of judiciary); William M. Richman & William L. Reynolds, *Elitism, Expediency, and the New Certiorari: Requiem for the Learned Hand Tradition*, 81 CORNELL L. REV. 273, 277 (1996) (arguing that size of judiciary needs to be increased to cope with effects of increasing caseloads).

231. *See* Lochner v. New York, 198 U.S. 45, 53 (1905) (ruling that New York statute "interferes with the right of contract between the employer and employees, concerning the number of hours in which the latter may labor in the bakery of the employer"). *See also* Richard E. Levy, *Escaping Lochner's Shadow: Toward a Coherent Jurisprudence of Economic Rights*, 73 N.C. L. REV. 329, 333-42 (1995) (describing "the pattern of reinvigoration and retreat" in Supreme Court's economic rights jurisprudence); David A. Strauss, *Why Was Lochner Wrong?*, 70 U. CHI. L. REV. 373, 375 (2003) (criticizing the *Lochner* court for "treat[ing] freedom of contract as a cornerstone of the constitutional order and systematically undervalued reasons for limiting or overriding the right").

232. *See In re* LTV Steel Co., 274 B.R. 278, 285-86 (Bankr. N.D. Ohio 2001) (determining that securitized receivables were part of debtor's estate; rejecting characterization of attempted securitization transaction as a "true sale"). *See generally* Robert A. Fogelson, *Toward a Rational Treatment of Fraudulent Conveyance Cases Involving Leveraged Buyouts*, 68 N.Y.U. L. REV. 552, 554 (1993) (arguing that "since the judicial inquiry employed in constructive fraudulent conveyance/LBO cases is driven as much by equity as by law, bankruptcy courts should be free to fashion a creative equitable remedy in order to better balance the competing interests of lenders and unsecured creditors").

233. *See supra* Part III.A (describing doctrines that do this).

234. *See supra* note 5.

concern central to tax analysis—more than offsets philosophical concerns surrounding the freedom to contract. In fact, the underlying assumption that contracts between the unrelated parties to a market transaction are somehow worthier of respect by their very nature is exactly the type of assumption that should be interrogated with the deep and explicit analysis suggested by this Article.

B. A Necessary Rehabilitation of the Business Purpose Doctrine

In addition to adopting an explicitly oppositional-choice analysis, the evaluation of business purpose as part of judicial anti-abuse analysis needs to be reconsidered. As shown in Part IV.B, the application of the business purpose prong of the economic substance doctrine has been inconsistently developed and applied with respect to third parties. The confusion in third-party jurisprudence is of particular significance in situations where the taxpayer lacks a valid business purpose but is seeking to "bootstrap" the business purpose of the third party in order to satisfy the requirement.[235] And the roles that third-party business purposes play are especially inchoate in the context of pass-through entities or ventures, or in evaluations of whether an entity, rather than a transaction, is a sham.[236]

The rehabilitation recommended by this Article has two aspects: first, courts should clarify that the only situations in which the business motivations of a third party can possibly be bootstrapped are situations where the third party is actually prevented by law or by regulation from conducting the transaction in the non-abusive way suggested by the court. Second, in situations involving relationships entered into through pass-through entities, courts need to adopt a realistic view of which legal person is the taxpayer. That is, in determining whose business purposes to "count," the deciding factor is not whose name is on the pleading (or who "owns" the entity listed) but rather whose tax liability is ultimately being minimized. Both of these aspects of the proposed doctrinal rehabilitation

235. Situations where the taxpayer concededly possesses a business purpose but a third-party participant in the transaction lacks a business purpose also raise interesting questions. Recent scholarship has focused on the effects of how "the transaction" is framed. This scholarship argues that the framing of a transaction as either broadly or narrowly defined has the capacity to affect a finding of economic substance or business purpose. *See* Hariton, *supra* note 124. *See also* Gray Jennings, *Economic Substance and the Taxpayer's Purpose*, 127 TAX NOTES 535, 537 (2010) (suggesting that "the common law of economic substance be framed so that a step has economic substance if the taxpayer's purpose for the step is to contribute to realizing a nontax objective of the taxpayer"). Along these lines, in situations where, as a threshold matter, the taxpayer is initially thought to have a business purpose but the third party does not, re-framing the transaction to include only the part of the transaction designed to minimize taxes may lead to an outcome in which neither the taxpayer nor the third party is found to have a non-tax business purpose.

236. *See supra* Part IV.B.2.

must take place in dialogue with the changes to the economic substance doctrine resulting from its recent codification by the Health Care and Education Reconciliation Act of 2010.[237]

1. Adoption of an "Actual Prevention" Standard

Should bootstrapping of third-party business purpose be permitted to salvage transactions where the taxpayer lacks a business purpose? This is apparently permissible under the logic of *Frank Lyon*.[238] However, the recent and much-debated[239] codification of the economic substance doctrine has arguably rendered such bootstrapping impermissible.[240] New § 7701(o), which is titled a "[c]larification of [the] economic substance doctrine," contains the following general rule:

> (1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
>
> > (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> >
> > (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[241]

The term "transaction" is defined to include "a series of transactions."[242] However, the term "taxpayer" is not defined by statute. At first blush, the wording of Code Section 7701(o)(1)(B) suggests that the focus of the business purpose analysis should be on whether "the taxpayer"

237. *See* Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067-68 (2010) (applying to transactions entered into after March 30, 2010).

238. *See Frank Lyon*, 435 U.S. at 576 (suggesting that the taxpayer need not be motivated by non-tax considerations as long as the other party to the agreement is so motivated). *See also Newman*, 902 F.2d at 163 (applying the reasoning in *Frank Lyon* in taking third-party motivations into account).

239. *See* Jeremiah Coder, *News Analysis: Will Economic Substance Codification Be Worth It?*, 127 TAX NOTES 16 (Apr. 5, 2010) (discussing practitioners' criticisms of the Health Care and Education Reconciliation Act of 2010); Jeremiah Coder, *Panelists Divided on Effects of Economic Substance Codification*, 127 TAX NOTES 252 (Apr. 19, 2010) (summarizing some practitioners' differing thoughts on the effects of the codification of economic substance in the Health Care and Education Reconciliation Act of 2010); Monte Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 TAX NOTES 289 (Apr. 19, 2010) (discussing the Health Care and Education Reconciliation Act of 2010 and identifying several areas in which guidance is needed); Jennings, *supra* note 235.

240. Health Care and Education Reconciliation Act § 1409(a), 124 Stat. at 1067-68 (applying to transactions entered into after March 30, 2010).

241. 26 U.S.C.A. § 7701(o)(1) (West 2010).

242. 26 U.S.C.A. § 7701(o)(5)(D) (West 2010).

has a "substantial purpose" for engaging in the transaction, and that the analysis should therefore not take into account the motivations of third parties. However, this formulation may merely beg the follow-up question: does helping a third party fulfill a non-tax business purpose in a way that happens to yield favorable tax consequences for the taxpayer/helper constitute a "substantial purpose (apart from Federal income tax effects)" of the taxpayer/helper for purposes of Code Section 7701(o)(1)(B)? The answer is not clear and probably will not be clear until such a fact pattern actually comes before the courts.[243]

In light of this uncertainty, this Article proposes a simple threshold rule: since adverse judicial decisions in tax shelter cases amount to denying one set of claimed tax results and reallocating tax items in accordance with the "true substance" of the transaction, the third party's business purposes should only be considered if the third party is *actually prevented* by legal or regulatory requirements from entering into the "true substance" transaction suggested or envisioned by the court.

Frank Lyon would arguably satisfy this standard: in *Frank Lyon*, the tax transaction was a sale-leaseback transaction, but the Eighth Circuit ruled that the benefits and burdens taken on by the taxpayer were "too insubstantial" to cause taxpayer to be the true owner of the bank building.[244] Logically, the "true substance" of the transaction was that the bank owned the building. However, the bank was "actually prevented" by Arkansas law from owning the building.[245] Under the proposed rule, the bank's business purposes could be considered. *Newman*, on the other hand, would not satisfy the test because the non-tax business purposes motivating the trucking company consisted merely of "financial reasons" and a concern with making "the best decision for [the] company" and these "financial reasons" basically amounted to a mere business preference to leave the trucks at issue off of the trucking company's balance sheet.[246] The mere business preference in Newman is distinguishable from the express disallowance by state and federal laws and regulations in *Frank Lyon*.[247]

This Article does not suggest that a legitimate non-tax business purpose exists under § 7701(o) in every case in which a taxpayer has no non-tax business purposes but is assisting a third party that is being thwarted by legal or regulatory constraints. Some such situations may still be found to fail the business purpose requirement, depending on the facts

243. *Cf. ASA Investerings*, 201 F.3d at 514 n.6 ("[T]he desire to aid another party in tax avoidance is no more a business purpose than actually engaging in tax avoidance.").

244. *Frank Lyon*, 536 F.3d at 754, *rev'd* 435 U.S. 561.

245. *Id.* at 563-64.

246. *Newman*, 902 F.2d at 163.

247. *Compare Frank Lyon*, 435 U.S. at 563-64, *with Newman*, 902 F.2d at 163.

and circumstances surrounding the transaction.[248] The standard proposed by this Article is, rather, a threshold requirement, albeit a high one. However, a high standard is appropriate because situations where the taxpayer does not have a business purpose and is seeking to "latch on" to a third party's purposes in order to vindicate a transaction already represent a marginal case. A rule that accepts the mere fact of third-party business *preferences* as sufficient to endow such substance would open the door to jurisprudential uncertainty and taxpayer abuses.

2. A Realistic Approach to Relationships Via Pass-Through Entities

In addition to setting a high bar for determining which third-party business purposes suffice, courts also need to formulate a more consistent and nuanced analysis of whose business purposes "count" in the context of relationships intermediated through pass-through entity taxpayers. In other words, courts should seek a consistent answer to the question, "Who is the taxpayer?" for purposes of applying the business purpose inquiry to pass-through entities.

In this regard, it should be noted that the recent codification of the economic substance doctrine does not help answer the "Who is the taxpayer?" question.[249] As discussed, the "business purpose" prong of the new provision requires that "*the taxpayer* has a substantial purpose (apart from Federal income tax effects) for entering into such transaction" in order for the transaction to have substance, and the term "taxpayer" is not defined in the statute.[250] Therefore, in situations where "the taxpayer" is a pass-through entity such as a partnership, it is still an open question whether the existence of a business purpose should be determined at the entity level or on the partner/member level on a look-through basis.

This Article argues that "the taxpayer" should be read in a commonsense way to mean the party that ultimately is seeking to minimize its tax liability or to utilize the tax benefit, whether or not such goal is accomplished through a pass-through entity (or chains of pass-through entities). Correspondingly, the party listed on the litigation pleading or the case name is not necessarily "the taxpayer" for purposes of the business purpose inquiry. Other members or partners of the listed party should be considered "third parties," rather than taxpayers, for purposes of the

248. For example, this would be the case if the third party satisfies the "actual prevention" test but the transaction lacks economic substance; or, for example, if it is found that satisfaction of the "actual prevention" was specifically engineered by the taxpayer.

249. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067-68 (2010) (applying to transactions entered into after March 30, 2010).

250. 26 U.S.C.A. § 7701(o)(1)(B) (West 2010) (emphasis added); *see supra* text accompanying notes 240-243.

analysis.

For example, in *ACM Partnership*, the entity named as the taxpayer in the litigation was the partnership (the pass-through entity) itself.[251] The partners in that partnership were the corporate parent entity seeking to offset its capital losses, the facilitating third-party foreign bank, and a subsidiary of the promoter, Merrill Lynch.[252] The fact that the partnership was the named taxpayer gave rise to confusion with respect to whose business purposes deserved attention, particularly in cases where a "sham entity" (rather than a "sham transaction") analysis was applied. The application of a "sham entity" analysis in some of those cases in effect provided the courts with a pathway to looking at the intentions of both of the partnership's partners in assessing the existence of a business purpose, rather than focusing, as it should have, on the party seeking the favorable tax consequences.[253] Under the standard proposed in this Article, "the taxpayer" would in all circumstances be considered to be the U.S. corporate partner seeking to minimize tax liability, while the facilitating tax-indifferent foreign bank would be considered a third party.

It might be argued that looking at the third party's business purposes in the pass-through context is justified. After all, in entering into a partner relationship with the tax avoider, the third party in some sense becomes "less unrelated" to the tax avoider than before. If the partnership is a bona fide partnership, then perhaps taking the third-party partner's business purposes into account is justified. However, framing the issue this way is circular logic—this approach allows the question of whether a partnership is a "sham entity" to be answered, in part, based on the motivations of the third-party partners. Nevertheless, whether the third party is a true partner (and hence whether its motivations should be considered in the first place) fundamentally depends on the bona fides of the partnership relationship. In other words, deciding in advance to allow bootstrapping of the third-party participant's business purposes in effect begs the question that the business purpose inquiry is supposed to answer. Because of this circularity, it is clear that looking to a third party's business purpose in the pass-through context is not a solid and independent enough analytical ground upon which to construct a consistent judicial anti-abuse approach. The question of how much (or whether) to treat a third-party partner's business purpose as no different from the taxpayer entity's business purpose should really be treated as a secondary and dependent decisional node, one that is contingent upon a separate initial assessment of whether the partnership relationship at issue is a sham.

The approach proposed by this Article accords with common sense

251. *ACM P'ship*, 157 F.3d 231.
252. *Id.* at 233-39.
253. *See* discussion *supra* Part IV.B.2.

and realism, and is the correct one for two reasons. First, the alternative approach (i.e., allowing third-party business motivations to be considered by looking through the pass-through entity) attaches undue weight upon the judicial determination of whether to apply the sham entity or the sham transaction doctrine, or some other anti-abuse doctrine. That is, a judicial choice to apply a sham entity analysis effectively opens the door wide to crediting third-party partner business purposes by providing judges with more cover to do so, whereas a choice to apply a different type of analysis tends not to have that effect. The fundamental purpose of applying the judicial anti-abuse doctrines should be to probe deeply and consistently the economic realities surrounding a tax motivated transaction.[254] Applying an anti-abuse jurisprudence that privileges third-party business purposes to a greater or lesser extent based on which sham analysis is applied (and that does not realize the consequences of its approach) defeats this overarching purpose.

Second, the approach of allowing partner-level business purposes to "count" also places too much weight on the question of which entity gets named as the taxpayer-petitioner in litigation. This determination is dependent, in part, on which entity's tax return the IRS has examined in the administrative proceedings below, which is in turn dependent on the structure of substantive and compliance-related tax law (which may not have been formulated with this particular issue in mind).[255] For example, the Code's rules for examination of partnership returns generally require a partnership-level determination of the partnership's tax items (income, loss, deductions, credits, etc.) for the sake of administrative convenience.[256] These rules were adopted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") in order to address the administrative and logistical problems associated with separate examinations of each partner's returns.[257] Once the partnership-level determination has been made, each partner uses that partnership-level determination in computing that partner's separate

254. *See, e.g.*, *Santa Monica*, 89 T.C.M. (CCH) at 1190 (describing the judicial anti-abuse doctrines as "particularized judicial doctrines" that were "developed" by courts "[i]n applying . . . general legal principles" of examining substance and statutory intent); *see also* United States v. Ingredient Tech. Corp., 698 F.2d 88, 94 (2d Cir. 1983) ("[I]t is immaterial whether we are talking about 'substantial economic reality,' 'substance over form,' 'sham' transactions, or the like; rather the question is whether under the statute and regulations here involved the transaction affects a beneficial interest other than the reduction of taxes." (internal citations omitted)).

255. INTERNAL REVENUE SERVICE, PARTNERSHIP AUDIT TECHNIQUE GUIDE (2002), *available at* http://www.irs.gov/businesses/partnerships/article/0,,id=134688,00.html.

256. I.R.C. § 6221–34 (2006) and accompanying Treasury Regulations; *see also* MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 8.17 (2009) (describing partnership examination procedures).

257. Pub. L. No. 97-248, 96 Stat. 324 (codified as I.R.C. §§ 6221-6234 (2006)).

tax liability.[258] So, for example, if the IRS examined the return of a corporate taxpayer (C) and the corporate taxpayer was a partner in a partnership (P), the IRS would generally need to make adjustments to the P's information return under the TEFRA rules in order for those partnership items to eventually "hit" C's tax return. In a subsequent litigation, the named petitioner would then be P, even though the ultimate adjustment sought is to C's tax picture.[259]

It is not clear that courts (particularly non-specialist courts) are aware of the effects of technical rules (such as the TEFRA rules) and other structural features of IRS administrative proceedings on the broader outcomes of later tax controversy proceedings, including tax shelter cases. This is problematic. If judges adopt a jurisprudence that accords weight to a third-party partner's business purpose just because the petitioner in litigation is the pass-through entity (as opposed to the entity ultimately seeking to enjoy the tax benefit), this would amount to even greater weight being put on the rules governing audits and examinations of returns. This early-stage administrative or congressional decision (which may be based on rules enacted to meet completely unrelated policy goals)[260] would then have the effect of hamstringing the Treasury or Department of Justice in later litigation by unintentionally transforming a third-party participant into a party "related" to the taxpayer. This certainly was not the intention of procedural rules such as the TEFRA rules.[261]

In sum, for purposes of applying the business purpose analysis, courts should apply the commonsense guiding principle that the taxpayer—the legal person whose business purposes should "count"—is the entity seeking to minimize its tax liability. The relevant question is not which party's name is on the pleading but rather which party is ultimately seeking the tax benefit of the transaction. The party who ultimately reaps the tax benefits should be the party whose business purposes are analyzed front and center. Other entities or facilitating partners are in effect third-party facilitators for purposes of the business purpose analysis. Their motivations should only be taken into account in the narrow set of circumstances outlined in Part V.B.1 above (i.e., where the substance suggested by the court is actually prevented from occurring by legal or regulatory requirements). Such an approach is particularly critical in an environment where chains of entities and parties may be used in effectuating a tax avoidance transaction.

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258. I.R.C. § 6222; *see also* SALTZMAN & BOOK, *supra* note 256, ¶ 8.17 (describing the "unified administrative and judicial proceeding" created by TEFRA).

259. *E.g.*, *ACM P'ship*, 157 F.3d 231.

260. The TEFRA rules were most likely not enacted with impacts on judicial anti-abuse doctrines in mind. *See Section of Taxation Proposal as to Audit of Partnerships*, 32 TAX LAW. 551 (1979).

261. *Id.*

VI. CONCLUSION

The relational character of tax planning has important impacts on the structure and outcome of tax shelter litigation beyond the question of whether a transaction has economic substance. Tax law's traditional focus—through long-standing anti-abuse doctrines—on assessing the risk or economic substance of a tax transaction is inadequate in managing the full extent and impacts of the complex commercial and personal relationships that underlie tax shelter transactions. We are just starting to grapple with the full effects of such relationships in facilitating tax evasion.[262] This Article has summarized the things we know and do so far, described why these concepts and measures are inadequate, raised additional concerns about relationality, and suggested some avenues for reform.

First, this Article discussed the inadequacies of the traditional anti-abuse analyses in probing the bona fides of a tax transaction, arguing that courts have encountered difficulties for three primary reasons: (1) the fundamentally indeterminate character of third-party relationships, (2) certain features of tax doctrine that facilitate complexity and that suggest a presumption of respect toward unrelated party transactions, and (3) the inherent artificiality and limitations of the doctrines being applied. It therefore argued that more explicit and consistent judicial evaluations of and discussions about such relationships are required. In addition, this Article has pointed out two other important impacts that relationships with third parties have in shaping tax shelter litigation: (1) adverse impacts on evidentiary transparency and observability in tax trial proceedings, and (2) obfuscatory impacts and warping of the content and application of substantive doctrine.

To remedy these problems, this Article has offered two normative proposals designed to change judicial and taxpayer behavior: (1) judicial application of a clearly and rigorously implemented and explicitly discussed "oppositional-choice" analysis, and (2) judicial rehabilitation of the business purpose doctrine from the confusion caused by the complexities of taxpayer relationality by applying the doctrine in a common-sense way. Adoption of these proposals will encourage more accurate judicial determinations of when and whether to respect relationships between taxpayers and third parties, help raise public consciousness about the detrimental effects of relationship formation in the shelter context, discourage taxpayers from engaging in aggressive relationship formation, and help preserve and encourage proper application

262. *See* GAO REPORT ON NETWORK TAX EVASION, *supra* note 10 (September 2010 report discussing effects of networks of related entities in facilitating tax evasion and discussing barriers that IRS faces in coping with this "network tax evasion").

of long-standing judicial doctrines in the face of constantly changing and ever more complex transactions and relationships between persons.

Understanding, describing, and circumscribing the full extent and impact of the relationality that underlies aggressive tax planning—beyond the mere application of current substantive doctrine—is tremendously important. Discourses that emphasize the content of our substantive tax rules as discrete phenomena have too long been privileged over discourses analyzing the underlying relationships that facilitate the use and abuse of these rules. Furthermore, underlying assumptions that we bring to the table may lull us into believing that we are aware of these relationships and are adequately considering and assessing their impacts. Unfortunately, the opposite is true. Since relationships between legal persons are the "life blood" that allows tax consequence-generating transactions to occur at all, it is imperative that such relationships—and our present approaches toward them—be confronted and interrogated in full.