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Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability

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THE BUSINESS PURPOSE DOCTRINE: THE EFFECT OF MOTIVE ON FEDERAL INCOME TAX LIABILITY

INTRODUCTION

Tax avoidance "by means which the law permits" traditionally has been viewed as a legal right.[1] For forty-five years, however, the Commissioner of Internal Revenue (Commissioner) has probed taxpayers' business motives, often with the blessing of courts.[2] This has led to the development of the business purpose doctrine, which permits the Commissioner to ignore tax benefits for certain transactions motivated by tax avoidance or non-business purposes.[3] Although the doctrine arose in the context of reorganizations,[4] it was extended rapidly to other areas.[5] Recently, it has been discussed as a "perva-

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1. Gregory v. Helvering, 293 U.S. 465, 469 (1935); *accord*, Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir.), *cert. denied*, 296 U.S. 641 (1935).

2. Recent cases considering a business purpose requirement include: TSN Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir. 1980); Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980); Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); Stice v. United States, 540 F.2d 1077 (5th Cir. 1976); Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950); Wachovia Bank & Trust Co. v. United States, 499 F. Supp. 615 (M.D.N.C. 1980); Dwyer v. United States, 439 F. Supp. 99 (D. Or. 1977), *rev'd on other grounds*, 622 F.2d 460 (9th Cir. 1980); Clement v. United States, 580 F.2d 422 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979); Basic Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977); Rothschild v. United States, 407 F.2d 404 (Ct. Cl. 1969); Schenk v. Commissioner, 41 T.C.M. (CCH) 455 (1980); Serbousek v. Commissioner, 36 T.C.M. (CCH) 479 (1977); Wrenn v. Commissioner, 67 T.C. 576 (1976). *See generally* Gunn, *Tax Avoidance*, 76 Mich. L. Rev. 733 (1978); Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 Mich. L. Rev. 1021 (1953); Summers, *A Critique of the Business-Purpose Doctrine*, 41 Or. L. Rev. 38 (1961).

3. Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 Howard L.J. 693, 714-17 (1978); Summers, *supra* note 2, at 40-41. Business purpose is usually considered the exclusive alternate motive to tax avoidance. Rice, *supra* note 2, at 1044. *But see* Commissioner v. Wilson, 353 F.2d 184, 187 (9th Cir. 1965) (required business purpose for reorganization despite absence of tax avoidance motive). Although the motive test may be required by statute rather than developed by courts, *see* I.R.C. §§ 269, 302(c), 306(b)(4), 532, this Note primarily addresses situations in which no statutory basis exists.

4. Bittker, *supra* note 3, at 715. Gregory v. Helvering, 293 U.S. 465 (1935), the case to which the business purpose doctrine is usually attributed, involved a reorganization motivated by tax avoidance. *Id.* at 467.

5. Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950) (extended the doctrine to all statutes that describe commercial transactions).

sive judicial doctrine" in tax law.[6] When and how the doctrine should be applied, however, is still the subject of controversy.[7]

The Internal Revenue Code (Code) provides the Commissioner with broad discretionary powers to determine taxable income.[8] These powers may be insufficient, however, to deal with tax consequences that result from the literal application of tax statutes, but thwart legislative intent. In such instances, a court may apply judicial doctrines, such as the business purpose doctrine, to implement a perceived legislative intent.[9]

This Note examines the justification of the business purpose doctrine as a judicial doctrine. It compares and contrasts the business purpose doctrine with the related substance over form doctrine[10] and argues that lower courts have misapplied the business purpose doctrine by failing to give proper consideration to legislative intent.[11] It concludes that the doctrine should be applied only in limited circumstances.

1. Business Purpose and Substance Over Form

A. *Substance Over Form*

A doctrine often associated with the business purpose doctrine is the substance over form doctrine.[12] This doctrine is often applied to

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6. Bittker, *supra* note 3, at 693, 714-17.

7. Rice, *supra* note 2, at 1046. *See generally* Summers, *supra* note 2. Even in reorganizations, courts are not certain how to apply the business purpose doctrine. *Compare* Rafferty v. Commissioner, 452 F.2d 767, 770 (1st Cir. 1971), *cert. denied*, 408 U.S. 922 (1972) *with* Estate of Parshelsky v. Commissioner, 303 F.2d 14, 21 (2d Cir. 1962). The court in *Parshelsky* found a sufficient business purpose for a reorganization in the shareholder's desire to bequeath different parts of his business to different legatees. *Id.* at 21. The court in *Rafferty* found insufficient as a business purpose the shareholder's desire to bequeath different parts of his business to his sons and daughters, 452 F.2d at 770-71, and, criticizing *Parshelsky*, held that an investment purpose of a shareholder is not, by itself, sufficient to satisfy the business purpose test. *Id.* at 770.

8. *E.g.*, I.R.C. §§ 269, 446(b), 482; *see* Commissioner v. Hansen, 360 U.S. 446, 467 (1959).

9. *See, e.g.*, Bazley v. Commissioner, 331 U.S. 737, 739, 744 (1947); Helvering v. Le Gierse, 312 U.S. 531, 542 (1941); Gregory v. Helvering, 293 U.S. 465, 467, 469-70 (1935).

10. *See* Bittker, *supra* note 3, at 722; Rice, *supra* note 2, at 1041-46.

11. One commentator refers to the business purpose doctrine as a "doctrine of last resort, invoked only where no more concrete and measurable principle is available to lend respectability to the decision of the court." Rice, *supra* note 2, at 1044. Another commentator suggested in 1961 that the influence of the doctrine was declining. Summers, *supra* note 2, at 38. The vast majority of the cases discussed in this Note, however, have been decided since 1961. *See* cases cited note 2 *supra*.

12. This Note defines substance over form broadly to include arguably discrete doctrines such as the sham doctrine, *e.g.*, Knetsch v. United States, 364 U.S. 361, 366 (1960); Commissioner v. Court Holding Co., 324 U.S. 331, 333-34 (1945);

transactions motivated by tax avoidance,[13] may be aimed at tax abuse,[14] and affects tax consequences in ways similar to the business purpose doctrine.[15] Although courts intermingle and confuse the doctrines,[16] they are analytically discrete,[17] and analysis of the distinctions is necessary for proper application.

When a court perceives that the substance of an event lies within the intended reach of a statute, but that the form of transaction takes the event outside that reach, the court may ignore the form and apply the law to the substance of the event.[18] This doctrine is variously applied to torts,[19] contracts,[20] wills,[21] antitrust,[22] and other areas of law.[23] It justifies piercing the corporate veil,[24] ignoring the ostensible creation of a trust,[25] disregarding meaningless intermediate steps in a

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Griffiths v. Commissioner, 308 U.S. 355, 357-58 (1939); Goodstein v. Commissioner, 267 F.2d 127, 131 (1st Cir. 1959); *see* Bittker, *supra* note 3, at 703-13; Rice, *supra* note 2, at 1027-28; Comment, *Tax Avoidance Use of the Interest Deduction*, 45 Tex. L. Rev. 1218, 1228 (1967) [hereinafter cited as *Interest Deduction*], and the step transactions doctrine. *E.g.*, Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 655-57 (5th Cir. 1968) (citing Rev. Rul. 61-119, 1961-1 C.B. 395 (1961)); Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588, 591 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939); American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); *see* Bittker, *supra* note 3, at 717-723; Comment, *Step Transactions*, 24 U. Miami L. Rev. 60, 66 (1969). *See generally* Gutkin, *Step Transactions*, 9 N.Y.U. Inst. Fed. Tax. 1219 (1950); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. Inst. Fed. Tax. 247 (1954). The substance over form doctrine is applied when the court determines that the legal formalities of a transaction do not reflect the actual events or lack economic substance. *See* Knetsch v. United States, 364 U.S. 361, 364-66 (1960).

13. *See, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331, 333 (1945).

14. *See generally* Bittker, *supra* note 3, at 703-13.

15. Gregory v. Helvering, 293 U.S. 465 (1935), is cited as both a "business purpose" and a "substance over form" case. *See* W. Andrews, Federal Income Taxation of Corporate Transactions 114-16 (2d ed. 1979).

16. *See* Bittker, *supra* note 3, at 722. *See generally* Rice, *supra* note 2, at 1041-48.

17. The business purpose doctrine is derived from an interpretation of the Internal Revenue Code. Gregory v. Helvering, 293 U.S. 465, 469 (1935). It is unique to tax law. By contrast, the substance over form doctrine is found in other areas of law.

18. *See* note 12 *supra*.

19. *See* H. Henn, Handbook of the Law of Corporations § 146 (2d ed. 1970) (piercing the corporate veil to create shareholder liability for corporate activity).

20. *See* J. Calamari & J. Perillo, The Law of Contracts, §§ 2-1, 2-2 (2d ed. 1977) (lack of intent to create contract may control despite formal contractual agreement).

21. *See* T. Atkinson, Handbook of the Law on Wills § 42 (2d ed. 1953) (testamentary nature of living trusts).

22. *See* L. Sullivan, Handbook of the Law of Antitrust § 114, at 328 (1977) (related corporations treated as independent firms).

23. R. Paul, *Restatement of the Law of Tax Avoidance*, in Studies in Federal Taxation 66-73 (1937).

24. *See* note 19 *supra*.

25. *See* note 21 *supra*.

series of integrated transactions,[26] consolidating substantive steps in such a series,[27] or voiding a contract.[28] In tax law, it has been used to justify voiding reorganizations,[29] negating the assignment of income,[30] recharacterizing the sale or transfer of property between related parties,[31] recharacterizing sale and leaseback arrangements,[32] disallowing the deduction of interest,[33] and disregarding the separate corporate entity.[34]

There are various bases for applying the doctrine in tax cases. Generally, congressional intent in enacting the specific section of the Code is considered.[35] The principle is so pervasive, however, that even if legislative history and other traditional sources of statutory interpretation do not contain discussion of substance over form, a preference for substance may be presumed.[36] For example, the Supreme Court, without specific statutory support, has presumed that Congress intended a tax deductible loss to be a substantive economic loss,[37] an interest deduction to be derived from a transaction having economic substance,[38] a sale and leaseback to be distinct from a financing agreement,[39] control of income to constitute receipt,[40] and, in general, economic and factual reality to control tax consequences.[41] This presumption often receives the implicit or express approval of Congress.[42] It is rebutted only when Congress imposes strict formal rules that favor form over substance.[43]

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26. Perkins v. Standard Oil Co., 395 U.S. 642, 647-48 (1969).

27. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74, 80 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

28. *See* note 20 *supra*.

29. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

30. Helvering v. Horst, 311 U.S. 112, 114-20 (1940) (Court determined that income rather than income producing property had been assigned).

31. Commissioner v. Court Holding Co., 324 U.S. 331, 333-34 (1945).

32. Frank Lyon Co. v. United States, 435 U.S. 561, 581-84 (1978).

33. Knetsch v. United States, 364 U.S. 361, 365-66 (1960).

34. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943).

35. *See, e.g.*, Knetsch v. United States, 364 U.S. 361, 365-66 (1960); Gregory v. Helvering, 293 U.S. 465, 468-69 (1935).

36. *See, e.g.*, United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950); Griffiths v. Helvering, 308 U.S. 355 (1939). The *Cumberland* opinion merely contains the relevant statute in a footnote, 338 U.S. at 452 n.1, and the Court in *Griffiths* finds congressional intent with no explicit statutory support. 308 U.S. at 358.

37. Higgins v. Smith, 308 U.S. 473, 476 (1940).

38. Knetsch v. United States, 364 U.S. 361, 364-66 (1960).

39. Frank Lyon Co. v. United States, 435 U.S. 561, 573-74 (1978); Helvering v. F.& R. Lazarus & Co. 308 U.S. 252, 254-55 (1939).

40. Corliss v. Bowers, 281 U.S. 376, 378 (1930).

41. Frank Lyon Co. v. United States, 435 U.S. 561, 582 (1978).

42. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 365 [hereinafter cited as 1954 Senate Report], *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 5006

The substance of a transaction is determined by inquiring into facts, not motive.[44] Motive analysis, however, is often used as an aid in interpreting equivocal facts,[45] and a tax avoidance motive will often be found before a transaction is characterized as without substance.[46] This frequent correlation of tax avoidance motive and lack of substance is not, however, evidence of a common identity. For example, assume that one's purpose for incorporating is to benefit from the corporate tax rate structure, a tax avoidance motive. Despite this motive, if the corporation has economic vitality, corporate tax rules apply, and the substance over form rule is satisfied.[47] Conversely, assume one incorporates to limit legal liability and, incidentally, acquires the benefits of the lower corporate tax. If the corporation has no real substance, the substance over form rule permits the Commissioner to disregard the corporate form and tax corporate income directly to the corporation's shareholders, despite the absence of a tax avoidance motive.[48] Although no Code section codifies a substance over form rule,[49] mere formalism aimed at thwarting the intended effect of a Code section may be ignored.[50] Because the concept per-

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(implicitly approving decisions in Harrison v. Schaffner, 312 U.S. 579 (1941), Helvering v. Horst, 311 U.S. 112 (1940), and Lucas v. Earl, 281 U.S. 111 (1930)); 1954 Senate Report, *supra*, at 48, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4679 (adopting objective tests based on the rule of Kimbell-Diamond Milling Co. v. Commissioner, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951) into I.R.C. § 334(b)(2)).

43. *See* Posey v. United States, 449 F.2d 228, 234 (5th Cir. 1971) (strict application of I.R.C. § 333).

44. *See* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454-56 (1950); Blueberry Land Co. v. Commissioner, 361 F.2d 93, 99 n.21 (5th Cir. 1966); Maysteel Prods. Inc. v. Commissioner, 287 F.2d 429, 431 (7th Cir. 1961).

45. R. Paul, *supra* note 23, at 152.

46. *See, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Gregory v. Helvering, 293 U.S. 465, 469-70 (1935).

47. Foglesong v. Commissioner, 621 F.2d 865, 869 (7th Cir. 1980); *see* National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

48. Paymer v. Commissioner, 150 F.2d 334, 337 (2d Cir. 1945); *see* National Carbide Corp. v. Commissioner, 336 U.S. 422, 438-39 (1949); Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.10 (4th ed. 1979); D. Kahn & P. Gann, Corporate Taxation and Taxation of Partnerships and Partners 89-110 (1979).

49. Numerous statutes, however, enunciate a tax avoidance test. *See, e.g.*, I.R.C. § 269 (acquisitions made to evade or avoid income tax); *id.* § 302(c)(2) (distributions in redemption of stock); *id.* § 306(b)(4) (dispositions of certain stock).

50. *See* Knetsch v. United States, 364 U.S. 361, 367 (1960); Gregory v. Helvering, 293 U.S. 465, 470 (1935).

vades the statutory scheme of the Code, applying this doctrine without reference to specific legislative history is always justifiable.[51]

B. *The Business Purpose Doctrine*

The common law basis for the substance over form rule contrasts sharply with the basis of the business purpose doctrine. Unlike the substance over form doctrine, the business purpose doctrine is not generally pervasive, nor is it pervasive in tax law. The Supreme Court case generally cited as the origin of the business purpose doctrine is *Gregory v. Helvering*.[52] The Court in *Gregory*, however, dealt only with reorganizations and found support for a business purpose test in the language and history of Code section 112(g).[53] The Supreme Court has never recognized, except by inference, that the business purpose test might merit application in situations other than reorganizations.[54] In fact, in *United States v. Cumberland Public Service Co.*,[55] the Court expressly refused to require a business purpose when a corporation that had received an offer to purchase assets liquidated and distributed those assets to shareholders, who sold the distributed assets.[56] The Court maintained that a finding of a major tax avoidance motive was not a sufficient basis for attributing to the corporation the sale by the shareholders.[57] It held that tax consequences flow from tax provisions.[58]

The business purpose doctrine represents an attempt by the courts to implement a perceived legislative intent.[59] No basis exists for finding an intent by Congress to require a business purpose for all transactions having tax consequences.[60] Therefore, justification for a busi-

51. In Knetsch v. United States, 364 U.S. 361 (1960), the Court implied that unless the plain meaning of the statute requires the Court to emphasize form, it will apply the substance over form doctrine. *Id.* at 367.

52. 293 U.S. 465 (1935); *see* B. Bittker & J. Eustice, *supra* note 48, ¶ 16.21; D. Kahn & P. Gann, *supra* note 48, at 710.

53. 293 U.S. at 467-69.

54. Numerous substance over form cases discuss motive. *See* notes 44-46 *supra*. Nonetheless, the Court has been consistent in its use of motive as merely evidence of the substance of a transaction. *See* notes 44, 46 *supra* and accompanying text.

55. 338 U.S. 451 (1950).

56. *Id.* at 454-56.

57. *Id.* at 455.

58. *Id.* at 455-56.

59. *See* note 9 *supra* and accompanying text.

60. *See* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454-56 (1950); Foglesong v. Commissioner, 621 F.2d 865, 873 (7th Cir. 1980); Quinlivan v. Commissioner, 599 F.2d 269, 273 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); Mann v. Commissioner, 483 F.2d 673, 680 (8th Cir. 1973); Wachovia Bank & Trust Co. v. United States, 499 F. Supp. 615, 621-22 (M.D.N.C. 1980); Dwyer v. United States, 439 F. Supp. 99, 102 (D. Or. 1977), *rev'd on other grounds*, 622 F.2d 460 (9th Cir. 1980); May v. Commissioner, 76 Tax Ct. Rep. (CCH) No. 2 (1981); Bush Bros. v. Commissioner, 73 T.C. 424, 437-39 (1979), *appeal docketed*, No. 80-1158 (6th Cir. Feb. 29, 1980).

ness purpose doctrine must be derived from the Code section to be applied.[61] A doctrine that is derived from a code section should be supported by reference to legislative history, predecessor statutes, prior interpretation of the statute, or related statutes on the same matter.[62] Moreover, the business purpose test must be viewed in light of the congressional preference for certainty of tax consequences[63] and the acknowledged uncertainty of applying a tax avoidance motive test.[64]

II. Application of the Business Purpose Doctrine

Although lacking Supreme Court precedent as a judicial doctrine applicable to areas other than reorganizations, the business purpose doctrine has flourished in recent years.[65] The Second Circuit first extended the doctrine to corporate distributions and, in dicta, to all "tax statute[s] [that] describe commercial . . . transactions."[66] More recently, the Commissioner has argued that business purpose is necessary or motive determinative in transactions involving the distribution of corporate dividends,[67] interest deductions,[68] the prepay-

61. *See* Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976); Goldstein v. Commissioner, 364 F.2d 734, 742 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950); Basic Inc. v. United States, 549 F.2d 740, 749 (Ct. Cl. 1977); Wrenn v. Commissioner, 67 T.C. 576, 582-85 (1976).

62. The general rule for interpreting a code is that one may resort to legislative history, predecessor statutes, prior interpretations, or other statutes on the same matter. 1A C. Sands, Sutherland's Statutes and Statutory Construction § 28.10 (4th ed. 1972) [hereinafter cited as Sutherland].

63. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 33, 39 [hereinafter cited as 1954 House Report], *reprinted in* [1954] U.S. Code Cong. & Ad. News 4021, 4058, 4064; 1954 Senate Report, *supra* note 42, at 41-42, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4672.

64. 1954 Senate Report, *supra* note 42, at 41-42, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4672; 1954 House Report, *supra* note 63, at 32, *reprinted in* [1954] U.S. Code Cong & Ad. News at 4057.

65. *See* note 6 *supra* and accompanying text.

66. Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950). For an in-depth review of "business purpose" cases prior to 1960, see Rice, *supra* note 2, at 1041 n.66. *See generally* Summers, *supra* note 2, at 30. In this context, business purpose may mean any non-tax avoidance motive. *See* Rothschild v. United States, 407 F.2d 404, 408-13 (Ct. Cl. 1969).

67. Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950); TSN Liquidating Corp. v. United States, 77-2 U.S. Tax. Cas. (CCH) ¶ 9741, at 88,523-27 (N.D. Tex. 1977), *rev'd*, 624 F.2d 1328 (5th Cir. 1980); Basic Inc. v. United States, 549 F.2d 740, 749 (Ct. Cl. 1977); Bush Bros. v. Commissioner, 73 T.C. 424, 437 (1979), *appeal docketed*, No. 80-1158 (6th Cir. Feb. 29, 1980); *see* I.R.C. § 316. The application of the doctrine to the facts of *Transport Trading* has often been criticized. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 Yale L.J. 440, 452 (1968).

ment of feed,[69] gifts and leaseback,[70] the forgiveness of debt,[71] the assignment of income,[72] and installment sales.[73] An examination of the various fact patterns and the relevant sections to which the business purpose test has been applied, however, demonstrates its incorrect application as a pervasive judicial doctrine without appropriate concern for legislative intent.

A. *Corporate Distributions*

A business purpose has been required when shareholders of a closely held corporation receive distributions prior to selling their corporate stock.[74] Such a distribution from subsidiary to parent was treated by the Court of Claims as part of the purchase price paid by a third party purchaser of the shareholder's stock in *Basic Inc.* v. *United States.*[75] Citing the subsidiary's lack of business purpose for the distribution, the court held that the distribution was not within the meaning of dividend in Code section 316(a)(1).[76]

The requirement of a business purpose for corporate distributions lacks support. This reasoning has been criticized by commentators,[77]

68. Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); *see* I.R.C. § 163. *Goldstein* does not require an actual business purpose, but does set a "purposive activity" standard. 364 F.2d at 741. This is a variation of the business purpose test. *See* Rothschild v. United States, 407 F.2d 404, 408 (Ct. Cl. 1969).

69. Stice v. United States, 540 F.2d 1077, 1081 (5th Cir. 1976); Clement v. United States, 580 F.2d 422, 427-28 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979); Rev. Rul. 75-152, 1975-1 C.B. 144 (1975), *superseded and expanded*, Rev. Rul. 79-229, 1979-2 C.B. 210 (1979); *see* I.R.C. §§ 162, 446(b). Section 162 expenses must of course be business expenses. I.R.C. § 162(a). In the rulings, however, business purpose is required for the timing of an admittedly legitimate business feed purchase.

70. Mathews v. Commissioner, 520 F.2d 323, 325 (5th Cir. 1975) (deductibility of lease payments; business purpose requirement for gift as well as for rental payment), *cert. denied*, 424 U.S. 967 (1976); Serbousek v. Commissioner, 36 T.C.M. (CCH) 479, 482 (1977) (same); *see* I.R.C. § 162.

71. Dwyer v. United States, 439 F. Supp. 99, 102 (D. Or. 1977), *rev'd on other grounds*, 622 F.2d 460 (9th Cir. 1980); *see* I.R.C. § 61.

72. Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309, 1313 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980); *see* Dwyer v. United States, 439 F. Supp. 99, 102 (D. Or. 1977), *rev'd on other grounds*, 622 F.2d 460 (9th Cir. 1980); I.R.C. § 61.

73. Wrenn v. Commissioner, 67 T.C. 576, 584-85 (1976); *see* Bunker v. Commissioner 38 T.C.M. (CCH) 736, 739 (1979); I.R.C. § 453.

74. *See* note 67 *supra.*

75. 549 F.2d 740, 743, 749 (Ct. Cl. 1977).

76. *Id.* at 749; *see* I.R.C. § 316(a)(1).

77. D. Kahn & P. Gann, *supra* note 48, at 121. One commentator attempted to explain *Basic* as a step transaction case. Ditkoff, *Intercorporate Dividends and Legitimate Tax Avoidance*, 4 J. Corp. Tax. 5, 14 (1977). For an example of a step transaction in this area, see Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185, 1194-96 (5th Cir. 1970) (distribution treated as a step in a sale; distinguished in TSN Liq-

rejected by the Fifth Circuit,[78] and is inconsistent with a recent Tax Court decision.[79] The Court of Claims cited only substance over form cases.[80] Furthermore, there is no direct statutory support for

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uidating Corp. v. United States, 624 F.2d 1328, 1333-35 (5th Cir. 1980), as applying a substance over form rule), *cert. denied*, 401 U.S. 939 (1971).

78. TSN Liquidating Corp. v. United States, 624 F.2d 1328, 1336 (5th Cir. 1980). It is not clear whether the court in *TSN* rejects the application of the business purpose doctrine to corporate distributions, or merely rejects the test as applied in *Basic*. *TSN* also involved a pre-sale distribution of a dividend in kind from a subsidiary to a parent. The distribution was at the buyer's insistence. *Id.* at 1329-30. The tax consequences were an 85% tax-free receipt of dividend income, as in *Basic*, and a lower capital gain on sale of the subsidiary. *Id.* Although this split could be analyzed in terms of a shareholder business purpose requirement versus a corporate business requirement for the distribution, *see* note 7 *supra* (similar split in reorganization), *TSN* emphasized the substance over form nature of the question, 624 F.2d at 1331-32, and pointedly distinguished its facts from those of a substance over form case, Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1951). 624 F.2d at 1333-34. *Basic* and *TSN* are also somewhat distinguishable because, in *Basic*, the taxpayer declined an alternate transaction for tax reasons, 549 F.2d at 745; in *TSN* the taxpayer had no alternative transaction available. 624 F.2d at 1330. Tax consequences, however, were merely a factor that Basic Inc. considered in rejecting a sale of assets and selecting a distribution in kind and sale of stock. 549 F.2d at 745-46. Arguably, the business purpose doctrine does not apply to taxpayers choosing between transactions producing identical results. Bittker, *supra* note 3, at 711-13; Rice, *supra* note 2, at 1040-41. A taxpayer is not legally required to maximize tax. Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (L. Hand, J., dissenting). Whatever the doctrine's validity, it should never apply when a taxpayer selects between alternate transactions, such as sale of stock and sale of assets, that have different practical consequences. *See* B. Fox & E. Fox, Business Organizations, Corporate Acquisitions and Mergers § 27.01 (1981).

79. *See* Bush Bros. v. Commissioner, 73 T.C. 424 (1979), *appeal docketed*, No. 80-1158 (6th Cir. Feb. 29, 1980). In *Bush Bros.*, a plurality of the Tax Court held that the non-recognition rule of I.R.C. § 311(a) applied to dividends in kind, did not apply to a distribution motivated by tax avoidance. 73 T.C. at 437. Five judges dissented, however, and four of them specifically rejected application of the business purpose rule. *Id.* at 440-42 (Chabot, J., dissenting); *id.* at 443 (Nins, J., dissenting). Furthermore, a six-judge concurring opinion maintained that application of the business purpose rule would conflict with Supreme Court precedent. *Id.* at 439 (Tannewald, J., concurring). The concurring opinion held that facts, not motive, were determinative and applied a substance over form rule. *Id.* at 439-40 (Tannewald, J., concurring); *see* notes 45-47 *supra* and accompanying text. Thus, 11 of the court's 16 judges rejected application of the business purpose doctrine to a corporate distribution.

80. Basic Inc. v. United States, 549 F.2d at 743, 746, 749 (citing Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935); Steel Improvement & Forge Co. v. Commissioner, 314 F.2d 96 (6th Cir. 1963); Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950)). To the extent that it has any meaning outside the reorganization area, *Gregory* is a substance over form case. *See* notes 44-46 *supra*. *Court Holding* is clearly a substance over form case. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454 n.3. *Steel Improvement* is a step transaction case. *See* Basic Inc. v. United States, 549 F.2d 740, 749 n.7 (Ct. Cl. 1977); *cf.* Rev. Rul. 75-493, 1975-2 C.B. 109 (tax treatment on substance over form question). *Transport Trading* has been strongly criticized. *See* note 67 *supra*.

the conclusion that a business purpose is required under section 316(a).[81] Although Congress did not discuss a motive test under section 316, it did consider and enact motive tests in the pertinent Code subchapter on corporate distributions and adjustments, Subchapter C.[82] Congress specifically considered the impact of substance over form and business purpose cases prior to enacting the subchapter.[83] Congress enacted motive tests when deemed necessary. More often, Congress enacted objective tests to determine tax consequences.[84] In fact, the purpose of numerous changes made to the subchapter in 1954 was to eliminate the uncertainty of poorly defined judicial doctrines.[85] Thus, this application of a business purpose test to distributions is not justified by reference to congressional intent and creates the kind of uncertainty Congress preferred to eliminate.

B. *Interest Deductions*

The business purpose doctrine also has been applied by lower courts to interest deductions.[86] The Supreme Court requires that a transaction creating an interest deduction possess economic substance.[87] The question, therefore, is whether economic substance mandates a business purpose. Economic substance has been defined by some courts as the possibility of profit or the risk of loss to the borrower.[88] This interpretation is reasonable because an economic

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81. *See* Basic Inc. v. United States, 549 F.2d 740, 749 (Ct. Cl. 1977). In its discussion of the case the court mentions the section only once, in the conclusion. *Id.*

82. *See, e.g.*, I.R.C. § 302(c)(2)(B)(ii) (tax avoidance test applied to redemption); *id.* § 306(b)(4) ("transactions not in avoidance"). *But see* Supreme Inv. Corp. v. United States, 468 F.2d 370, 377 (5th Cir. 1972) (interpreted I.R.C. § 334(b)(2) test of stepped up basis for assets received as objective and applied despite a taxpayer's tax avoidance motive).

83. 1954 Senate Report, *supra* note 42, at 48-49, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4679-80.

84. *See, e.g., id.* at 44, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4675. Objective rules of attribution were promulgated to prevent tax avoidance. A special rule for dividend in kind was promulgated to prevent tax avoidance. *Id.* at 46, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4677.

85. *Id.* at 41-42, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4672. *But see* I.R.C. § 306(b)(4) (tax avoidance test applies); note 82 *supra* and accompanying text.

86. Lifschultz v. Commissioner, 393 F.2d 232, 234 (2d Cir. 1968); Goldstein v. Commissioner, 364 F.2d 734, 742 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); Rothschild v. United States, 407 F.2d 404, 414 (Ct. Cl. 1969). *But see* Bridges v. Commissioner, 325 F.2d 180 (4th Cir. 1963) (interpreting Knetsch v. United States, 364 U.S. 361 (1960)) (applying beneficial interest test); *Interest Deduction*, *supra* note 12, at 1232-33, 1238 (discussing *Bridges*).

87. Knetsch v. United States, 364 U.S. 361 (1960); *see* Coors v. United States, 572 F.2d 826, 832 (Ct. Cl. 1978) (describes *Knetsch* as a "sham" case). *See generally* notes 35-38 *supra* and accompanying text.

88. Bridges v. Commissioner, 325 F.2d 180, 184-85 (4th Cir. 1963); Wachovia Bank & Trust Co. v. United States, 499 F. Supp. 615, 619-22 (M.D.N.C. 1980); *see*

transaction involves more than the maintenance of the status quo. When the Court formulated the economic substance test for interest,[89] it expressly "put aside" a finding by the lower court that the transaction was motivated by tax avoidance.[90] The Court described the case as a "sham"[91] and called the underlying transaction a "fiction."[92]

The Second Circuit, however, requires purposive activity or an expectation of profit.[93] In *Goldstein v. Commissioner*,[94] a taxpayer with an extraordinary increase in income for one year took out a large loan. The loan was structured to provide a pre-tax loss and a tax benefit greater than that loss.[95] The Second Circuit, conceding that the transaction was not a sham,[96] focused exclusively on the taxpayer's purpose and adopted a variation of the business purpose test for interest deductions.[97] This analysis is incorrect.

The legislative history on this point was scant.[98] The Second Circuit conceded that Code section 163 did not require interest to be a business expense, ordinary and necessary, or even reasonable.[99] Nonetheless, the court found an underlying and unsupported notion of congressional intent to encourage purposive activity.[100]

Recent legislative history in this area is more enlightening and supports rejection of the business purpose doctrine.[101] In 1969, Congress, amending the Code to prevent tax avoidance devices,[102] limited

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Interest Deduction, *supra* note 12, at 1232-33. Of course, normal commercial use of borrowed funds will imbue the transaction with substance. *See id.* at 1241.

89. Knetsch v. United States, 364 U.S. 361, 366 (1960).

90. *Id.* at 365.

91. *Id.* at 366.

92. *Id.* at 365-66.

93. Goldstein v. Commissioner, 364 F.2d 734, 741-44 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967); *see* Lifschultz v. Commissioner, 393 F.2d 232, 234 (2d Cir. 1968); Rothschild v. United States, 407 F.2d 404, 415-16 (Ct. Cl. 1969). The court in *Goldstein* implied that purposive activity is anything other than tax avoidance. 364 F.2d at 741.

94. 364 F.2d 734 (2d Cir. 1966).

95. *Id.* at 736-38.

96. *Id.* at 742.

97. *Id.* at 741-42.

98. The court recognized the importance of examining Congressional intent, *id.* at 741, and admitted that the provision, I.R.C. § 163(a), was extremely broad and that any intent was difficult to ascertain. 364 F.2d at 741. It then proceeded to articulate with specificity the intent underlying the provision. *Id.*

99. *Id.*; 4A J. Mertens, Law of Federal Income Taxation § 26.01 (1979 rev. ed.).

100. 364 F.2d at 741-42.

101. *See* Wachovia Bank & Trust Co. v. United States, 499 F. Supp. 615, 621-22 (M.D.N.C. 1980).

102. S. Rep. No. 552, 91st. Cong., 1st Sess. 1-2, 13-14 , *reprinted in* [1969] U.S. Code Cong. & Ad. News 2027, 2027, 2039-40; H.R. Rep. No. 413, 91st Cong., 1st Sess. 1-2, 8-10, 71-73, *reprinted in* [1969] U.S. Code Cong. & Ad. News 1645, 1645-46, 1653-54, 1718-19.

the deduction for investment interest to $25,000 with adjustments, in a single year.[103] In 1976, Congress further considered abuse in this area[104] and again demonstrated its preference for objective tests. It further lowered the deduction for investment interest[105] and established objective rules for permitting deductions for prepaid interest.[106] A motive test was neither considered nor proposed.[107]

C. *Prepaid Feed*

Prepaid feed costs are deductible under Code section 162(a)[108] as "ordinary and necessary [business] expenses"[109] of farming. Courts require that the purchase serve a business purpose before allowing the deduction.[110] Some courts, however, have accepted the argument that the prepayment must also serve a business purpose.[111] More-

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103. Tax Reform Act of 1969, Pub. L. No. 91-172, § 221, 83 Stat. 574 (codified at I.R.C. § 163(d)).

104. S. Rep. No. 938, 94th Cong., 2d Sess. 3-4, 9, *reprinted in* [1976] U.S. Code Cong. & Ad. News 3439, 3440, 3445-46; H.R. Rep. No. 658, 94th Cong., 2d Sess. 4, 8-9, *reprinted in* [1976] U.S. Code Cong. & Ad. News 2897, 2898-99, 2903-04.

105. The limitation on investment interest was lowered from $25,000 to $10,000. Tax Reform Act of 1976, Pub. L. No. 94-455, § 209, 90 Stat. 1542-43 (codified at I.R.C. § 163(d)(1)(A)).

106. *Id.* § 208, 90 Stat. 1541-42 (codified at I.R.C. § 461(g)).

107. A proposed limitation on personal interest was rejected by the House in conference. H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 417-18, *reprinted in* [1976] U.S. Code Cong. & Ad. News 4118, 4128-29. Even without these additional provisions, the Commissioner had the statutory power to prevent the abusive use of the interest deduction in *Goldstein* and similar cases. I.R.C. § 446(b) provides that if the method of accounting does not clearly reflect income, the Commissioner may recompute taxable income. *See* Sandor v. Commissioner, 62 T.C. 469, 481 (1974), *aff'd per curiam*, 536 F.2d 874 (9th Cir. 1976).

108. I.R.C. § 162(a). Farmers have been accorded the right to deduct currently the cost of purchasing feed for livestock for over 60 years. United States v. Catto, 384 U.S. 102, 110 n.13 (1966). Although this is a factor a court may consider in determining the validity of a current deduction for the cost of feed, Van Radan v. Commissioner, 71 T.C. 1083, 1108 (1979), *appeal docketed*, No. 79-7486 (9th Cir. Sept. 18, 1979), it does not directly affect the central question of this Note, that is, whether any justification for adopting a business purpose test exists.

109. Clement v. United States, 580 F.2d 422, 426 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979) (quotations omitted); *see* I.R.C. §§ 162(a), 446(b).

110. Clement v. United States, 580 F.2d 422, 426-27 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979).

111. Stice v. United States, 540 F.2d 1077, 1081-82 (5th Cir. 1976); Clement v. United States, 580 F.2d 422, 432 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979); *see* Rev. Rul. 75-152, 1975-1 C.B. 144, *superseded and expanded*, Rev. Rul. 79-229, 1979-2 C.B. 210. The entire business purpose analysis of Rev. Rul. 75-152 was incorporated into Rev. Rul. 79-229. Unless otherwise indicated, the Revenue Ruling discussed will be 79-229. In addition to requiring a business purpose, the Rulings require the payment to be more than a mere deposit and not materially to distort income. The deposit test relies on the theory that "expenses paid or incurred" in I.R.C. § 162(a) do not include refundable deposits. Shippy v. United States, 199 F.

over, the Commissioner has attempted, unsuccessfully to date, to define business purpose narrowly to exclude prepayment that protects against price increases when alternate protection exists.[112] This argument proposes a more costly alternative rule[113] that requires a taxpayer to select the business transaction that maximizes taxes.

The Commissioner has cited some weak judicial precedent,[114] but no direct statutory support, for requiring a business purpose for the timing of a prepaid feed deduction. The relevant Code sections, 162(a) and 446(b), require only that the expense be ordinary and necessary, and that the method of accounting clearly reflect income.[115]

Supp. 842, 844 (D.S.D. 1961), *aff'd*, 308 F.2d 743 (8th Cir. 1962); Lillie v. Commissioner, 45 T.C. 54, 63 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966). The material distortion test is expressed in I.R.C. § 446(b). Clement v. United States, 580 F.2d 422, 430-31 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979).

112. Private Letter Ruling No. 8015046 (Dec. 31, 1979). The ruling rejected two Tax Court cases that had accepted the desire to fix the future cost of feed as a business purpose, Van Raden v. Commissioner, 71 T.C. 1083, 1096-1101, *appeal docketed*, No. 79-7486 (9th Cir. Sept. 18, 1979); Haynes v. Commissioner, 38 T.C.M. (CCH) 950, 952 (1979), and argued that the taxpayers' business purposes could have been as well served by the practice of hedging or forward contracting. The letter ruling defined hedging as purchasing futures contracts that rise in value as the cash price of feed rises, thus offsetting any increase in price. The ruling described forward contracting as the purchase of an actual contract for future delivery of grain.

113. Bittker, *supra* note 3, at 711-13; *see* Rice, *supra* note 2, at 1040; *cf.* Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir.) (L. Hand, J., dissenting) ("[N]obody owes any public duty to pay more than the law demands."), *cert. denied*, 331 U.S. 859 (1947).

114. Rev. Rul. 75-152, 1975-1 C.B. 144 (1975) (citing Shippy v. United States, 308 F.2d 743 (8th Cir. 1962); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); Lillie v. Commissioner, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966); Ernst v. Commissioner, 32 T.C. 181 (1959)). *Cravens* and *Ernst* were decided for the taxpayer. 272 F.2d at 901; 32 T.C. at 186-87. Additionally, the Commissioner has repudiated *Cravens* in Private Letter Ruling No. 8015046 (Dec. 31, 1979), and the Tax Court has cited it as a case refuting the business purpose doctrine. Schenk v. Commissioner, 41 T.C.M. (CCH) 455, 458 n.3 (1980). *Lillie*, relying on *Shippy*, expressly adopted the deposit theory. 45 T.C. at 63. Similarly, the prepayment in *Shippy* was a "deposit." 308 F.2d at 746. Subsequent cases approving the Revenue Rulings also have been decided on theories other than the business purpose doctrine. Stice v. United States, 540 F.2d 1077, 1079, 1081 (5th Cir. 1976) (deposit theory); Clement v. United States, 580 F.2d 422, 430-31 (Ct. Cl. 1978) (distortion of income theory), *cert. denied*, 440 U.S. 907 (1979).

115. I.R.C. § 162(a), permitting the deduction of "ordinary and necessary [business] expenses," says nothing about the timing of payments. *See* Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*, 53 Tex. L. Rev. 1119, 1169-72 (1975). I.R.C. § 446(b) has been applied to transactions such as income, American Auto. Ass'n v. United States, 367 U.S. 687, 688 n.1 (1961) (applying I.R.C. § 41 (1939), predecessor to I.R.C. § 446), which is taxable regardless of purpose, *see* I.R.C. § 61, and to interest deductions. Sandor v. Commissioner, 62 T.C. 469, 476-79, *aff'd per curiam*, 536 F.2d 874, 875 (9th Cir. 1976). No business purpose is required for the interest deduction. Van Raden v. Commissioner, 71 T.C. 1083, 1102-03 (1979), *appeal docketed*, No. 79-7486 (9th Cir. Sept.

A business purpose test, in effect, requires a business purpose for the method of accounting.[116]

No congressional intent to create this effect can be found.[117] Although prepayment can be abused, Congress has recently discussed and provided objective standards to determine what constitutes abuse.[118] Section 464(a) limits the deduction for prepaid feed and other farm expenses incurred by a "farming syndicate," a carefully defined type of tax shelter.[119] The legislative history of this objective test is replete with discussion of what Congress considered abuse, but does not support a tax avoidance motive test.[120] Moreover, the amendment of section 464(a) was directed at syndicates formed for the sole purpose of exploiting tax deductions intended for farmers.[121] Implicitly, the use of such deductions by most farmers was not deemed abusive.

Statutory support for requiring a business purpose for prepayment of feed is ambiguous at best, and the legislative history reveals no such congressional intent. Tax legislation controlling the timing of deductions is comprehensive[122] and includes sections directed at

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18, 1979). Although an appropriate basis for the distortion of income test, Dunn v. United States, 468 F. Supp. 991, 994 (S.D.N.Y. 1979), I.R.C. § 446(b) does not support a business purpose test. *See* Mann v. Commissioner, 483 F.2d 673, 680-81 (8th Cir. 1973); note 111 *supra*.

116. The Commissioner accepts the validity of the deduction, but argues that it should be deferred. Rev. Rul. 79-229, 1979-2 C.B. 210. The result would be a change from a cash to an inventory method of accounting. Van Raden v. Commissioner, 71 T.C. 1083, 1108 (1979), *appeal docketed*, No. 79-7486 (9th Cir. Sept. 18, 1979).

117. *See* Mann v. Commissioner, 483 F.2d 673, 680 (8th Cir. 1973). *Mann* rejected the business purpose doctrine prior to publication of the Revenue Rulings. The appropriateness of a business purpose test has been termed "arguable," Van Raden v. Commissioner, 71 T.C. 1083, 1112 (1979) (Tannenwald, J., concurring), *appeal docketed*, No. 79-7486 (9th Cir. Sept. 18, 1979), and the Tax Court has declined to recognize it. Schenk v. Commissioner, 41 T.C.M. (CCH) 455, 458 (1980). The Tax Court also has been reluctant to challenge a taxpayer's allegation of a business purpose. Frysinger v. Commissioner, 39 T.C.M. (CCH) 1287, 1292 (1980); Heinold v. Commissioner, 39 T.C.M. (CCH) 685, 689 (1979); Van Raden v. Commissioner, 71 T.C. 1083, 1096-101 (1979), *appeal docketed*, No. 79-7486 (9th Cir. Sept. 18, 1979). *See generally* Ward, *supra* note 115, at 1173-77.

118. Tax Reform Act of 1976, Pub. L. 94-455, § 207, 90 Stat. 1536-38 (1976) (codified at I.R.C. § 464); S. Rep. No. 938, 94th Cong., 2d Sess. 51-62, *reprinted in* [1976] U.S. Code Cong. & Ad. News 3439, 3487-98. The Senate was specifically concerned about "[h]igh-bracket taxpayers [who] use farm tax rules to shelter nonfarm income." *Id.* at 54, *reprinted in* [1976] U.S. Code Cong. & Ad. News at 3490.

119. A farm syndicate is a partnership or other farming enterprise in which an interest has been publicly offered, I.R.C. § 464(c)(1)(A), or in which more than 35% of the losses are allocable to limited partners or limited entrepreneurs. I.R.C. § 464(c)(1)(B).

120. *See* note 118 *supra* and accompanying text.

121. *Id.*

122. I.R.C. §§ 446-466.

farmers.[123] The business purpose doctrine, as applied to farmers, intrudes into this congressional tax scheme.

D. *Gift and Leaseback*

Rental payments and other payments for the use of property are deductible as business expenses under Code section 162(a)(3).[124] The Commissioner has argued, and some courts have agreed, that gifts of property in which the grantee leases the property back to the grantor require a non-tax avoidance purpose for the lease payments to be deductible.[125] These cases usually involve intra-family gifts in the form of a Clifford trust.[126]

Direct statutory support for this business purpose test is ambiguous. Code section 162(a)(3) is cited by some courts to support the doctrine and by others to reject it.[127] Some courts have suggested a variation of the substance over form doctrine,[128] permitting the deduction when the gift has economic substance because it actually transfers control.[129]

Only one court has applied a recognized rule of statutory interpretation to the problem, applying objective tests derived from Code sections 671-678 to determine if the gift and leaseback should be rec-

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123. *Id.* §§ 447, 464.

124. *Id.* § 162(a)(3).

125. Mathews v. Commissioner, 520 F.2d 323, 325 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976); Brooke v. United States, 468 F.2d 1155, 1158 (9th Cir. 1972); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965). *But see* May v. Commissioner, 76 Tax Ct. Rep. (CCH) No. 2 (1981) (rejects business purpose requirement of the 5th Circuit in *Mathews*).

126. Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).The income in a Clifford trust is paid to, or on behalf of, a beneficiary; the corpus reverts to the grantor or some other grantee. *See* Quinlivan v. Commissioner, 599 F.2d 269, 270-71 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979). The business purpose test has also been applied to outright gifts. *See* Brooke v. United States, 468 F.2d 1155, 1158 (9th Cir. 1972).

127. *See* Quinlivan v. Commissioner, 599 F.2d 269, 272-73 (8th Cir.) (rejects doctrine), *cert. denied*, 444 U.S. 996 (1979); Mathews v. Commissioner, 520 F.2d 323, 325 (5th Cir. 1975) (supports doctrine), *cert. denied*, 424 U.S. 967 (1976); Perry v. United States, 520 F.2d 235, 239 (4th Cir. 1975) (same), *cert. denied*, 423 U.S. 1052 (1976). *See generally* Serbousek v. Commissioner, 36 T.C.M. (CCH) 479, 481 (1977) (noting the split in the Circuits).

128. *See* Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948); May v. Commissioner, 76 Tax Ct. Rep. (CCH) No. 2, at 2614 (1981); Serbousek v. Commissioner, 36 T.C.M. (CCH) 479, 482 n.8 (1977).

129. *See, e.g.*, Helvering v. Clifford, 309 U.S. 331, 333-37 (1940); Corliss v. Bowers, 281 U.S. 376, 377-78 (1930). These cases deal with the question whether the grantor or beneficiary of a reversionary trust is taxable on the income of the trust.

ognized for tax purposes.[130] This court rejected the business purpose test.[131]

The requirement of a business purpose in gift and leaseback cases is derived principally from a sale and leaseback case.[132] That case relied on Supreme Court precedent[133] that applied the business purpose test to the specific statutory language of section 112(g) of the Revenue Act of 1928,[134] a section neither directly related nor analogous to Code section 162(a)(3),[135] and other substance over form cases[136] that applied a doctrine distinct from the business purpose rule.[137] In addition, the Court's most recent sale and leaseback case emphasizes objective criteria in determining whether leaseback payments are deductible.[138]

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130. Quinlivan v. Commissioner, 599 F.2d 269, 273 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); *see* Note, *Clifford Trusts: A New View Towards Leaseback Deductions*, 43 Alb. L. Rev. 585, 594 (1979) [hereinafter cited as *Clifford Trusts*]. Applying tests derived from related statutes is a suggested rule of statutory construction. *See* Sutherland, *supra* note 62, § 28.10. The analysis used in *Quinlivan* is similar to that applied under I.R.C. §§ 671-678, which delineate rules to determine whether income from a reversionary trust is taxable to grantor or grantee. 599 F.2d at 273; *Clifford Trusts*, *supra*, at 594. These sections supercede the judicial tests created in Helvering v. Clifford, 309 U.S. 331 (1940), *Clifford Trusts*, *supra*, at 585 n.1, and create objective tests. For example, generally the trust must continue more than ten years, I.R.C. § 673(a), certain powers to affect the trust must reside in an adverse or nonsubservient party, *Id.* §§ 674, 675, and the grantor or nonadverse party may not have the power to revoke. *Id.* § 676.

131. Quinlivan v. Commissioner, 599 F.2d 269, 273 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

132. W.H. Armston Co. v. Commissioner, 188 F.2d 531, 533 (5th Cir. 1951); *see* Mathews v. Commissioner, 520 F.2d 323, 324 n.3 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

133. W.H. Armston Co. v. Commissioner, 188 F.2d 531, 533-34 (5th Cir. 1951) (citing Helvering v. Clifford, 309 U.S. 331 (1940); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939); Gregory v. Helvering, 293 U.S. 465 (1935)).

134. Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 818 (current version at I.R.C. § 368).

135. Section 112(g) dealt with reorganizations. *Id.* Reorganizations are not analogous to the ordinary and necessary business expenses of I.R.C. § 162(a). *See* Skenandoa Rayon Corp. v. Commissioner, 122 F.2d 268, 271 (2d Cir.), *cert. denied*, 314 U.S. 696 (1941).

136. W.H. Armston Co. v. Commissioner, 188 F.2d 531, 534 (5th Cir. 1951) (citing Helvering v. Clifford, 309 U.S. 331 (1940); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939)).

137. *See* notes 12-17 *supra* and accompanying text.

138. Frank Lyon Co. v. United States, 435 U.S. 561, 581-84 (1978); *accord*, La Mair v. Commissioner, 36 T.C.M. (CCH) 1337, 1339-41 (1977). Unlike a gift and leaseback transaction, a sale and leaseback often raises a factual question, whether the sale is actually a method of financing. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 581-84 (1978); Belz Inv. Co. v. Commissioner, 72 T.C. 1209, 1225-29 (1979), *appeal docketed*, No. 80-1149 (6th Cir. Feb. 26, 1980). Motive considerations in a sale and leaseback overlap with the courts' consideration of economic reality. Schaefer v. Commissioner, 41 Tax Ct. Mem. Dec. (CCH) 100, 104 n.13 (1980); Car-

Although Congress has never indicated whether a business purpose is required for the gift in the gift and leaseback context,[139] Congress has considered an analogous problem: whether intra-family gifts of reversionary trusts were taxable to the grantor or grantee.[140] The Court had applied substance over form rules, and the Commissioner had provided objective tests of whether these rules were satisfied.[141] Desiring codification,[142] Congress enacted Code sections 671-678, adopting some of the Commissioner's rules and modifying others.[143] The rules established are objective.[144] Therefore, congressional action in this analogous area seems to indicate that motive is not determinative.

E. *Miscellaneous Contexts*

In an apparent attempt to establish the business purpose doctrine as a pervasive judicial doctrine, the Commissioner recently has proposed its use in additional isolated fact patterns.[145] Disregarding more appropriate doctrines or statutory remedies, the Commissioner has applied the doctrine to void tax benefits resulting from the forgiveness of debt of a closely held corporation by a controlling shareholder,[146] the incorporation of a business by a controlling shareholder and his assignment to that corporation of various contracts,[147]

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roll v. Commissioner, 37 T.C.M. (CCH) 736, 741-42 (1978). The Tax Court has distinguished economic reality from the business purpose test. Serbousek v. Commissioner, 36 T.C.M. (CCH) 479, 482 (1977).

139. *See* Quinlivan v. Commissioner, 599 F.2d 269, 273 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

140. Helvering v. Clifford, 309 U.S. 331, 335-37 (1940).

141. Treas. Reg. §§ 118-39.22(a)-21 to -22 (1952) (commonly known as Clifford Regulations), *superseded by* I.R.C. §§ 671-678; 1954 Senate Report, *supra* note 42, at 86, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4719.

142. *See* note 141 *supra*.

143. 1954 Senate Report, *supra* note 42, at 86-87, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4719; *see* note 130 *supra*.

144. *See* note 130 *supra*; 6 J. Mertens, Law of Federal Income Taxation § 37.41, at 91 (1975 rev. ed).

145. *See* notes 67-73 *supra*.

146. Dwyer v. United States, 439 F. Supp. 99, 102-03 (D. Or. 1977), *rev'd*, 622 F.2d 460 (9th Cir. 1980). As a cash basis taxpayer, the shareholder had never reported the accrued interest as income. By forgiving the debt, he increased the amount available upon liquidation and increased his capital gain under I.R.C. § 331. He had no ordinary income because he never received an interest payment. 439 F. Supp. at 102-03.

147. Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309, 1313 (1976), *rev'd*, 621 F.2d 865, 869 (7th Cir. 1980). The court was influenced by the existence of alternate means of dealing with the alleged tax avoidance. 621 F.2d at 873; *see* Rubin v. Commissioner, 429 F.2d 650, 653 (2d Cir. 1970). For example, I.R.C. § 482 permits the Commissioner to reallocate income between related parties if necessary to avoid the evasion of tax, or to reflect income clearly. 621 F.2d at 873.

and an intra-family installment sale.[145] Although the specific facts in these cases justified the Commissioner's challenge of their tax consequences, and the cases were decided for the Commissioner[149] or remanded for further findings,[150] the Commissioner's business purpose doctrine did not fare well. In two of these cases, the courts rejected its use.[151] The third case, in which the Tax Court apparently adopted a business purpose test,[152] has been distinguished by that court as applying a substance over form test.[153]

The cases discussed represent diverse fact patterns, but have in common the lack of a statutory basis for consideration of motive. They demonstrate the use of the doctrine as a substitute for analysis of facts and application of a more appropriate judicial doctrine or Code section.[154]

CONCLUSION

The use of the business purpose doctrine as a pervasive judicial doctrine lacks support and results in splits in circuits,[155] splits between courts,[156] and inconsistent applications within the same

148. Wrenn v. Commissioner, 67 T.C. 576 (1976). Tax may be deferred on such a sale under I.R.C. § 453. *Cf.* Lustgarten v. Commissioner, 71 T.C. 303, 309-10 (1978) (installment sale to son, control test applied). Intrafamily sales are now governed by I.R.C. §§ 453(e), (g). These new provisions, which adopt a business purpose test, are intended to create no inference for those cases not controlled by them. *See* S. Rep. No. 1000, 96th Cong., 2d Sess. 17, *reprinted in* [1980] U.S. Code Cong. & Ad. News 8340, 8356.

149. Dwyer v. United States, 439 F. Supp. 99 (D. Or. 1977), *rev'd*, 622 F.2d 460 (1980), was decided in favor of the taxpayer in the district court. *Id.* at 102. The Commissioner's alternative argument based on the assignment of income theory was also rejected. *Id.* at 102. This theory was accepted by the Ninth Circuit, however, which found that the taxpayer had sufficient control over the income for this doctrine to apply. 622 F.2d at 462-63; *see* note 129 *supra* and accompanying text; *cf.* Braddock Land Co. v. Commissioner, 75 Tax Ct. Rep. (CCH) No. 26 (1980) (substance over form analysis applied to similar facts). Wrenn v. Commissioner, 67 T.C. 576 (1976), was also decided for the Commissioner.

150. *See* note 147 *supra*.

151. Foglesong v. Commissioner, 621 F.2d 865, 869 (7th Cir. 1980); Dwyer v. United States, 439 F. Supp. 99, 102 (D. Or. 1977), *rev'd on other grounds*, 622 F.2d 460 (9th Cir. 1980).

152. Wrenn v. Commissioner, 67 T.C. 576, 584 (1976).

153. *See* Goodman v. Commissioner, 74 T.C. 684, 709 (1980); Weaver v. Commissioner, 71 T.C. 443, 454 (1978) (distinguishing *Wrenn* as a case in which the installment sale did not transfer control), *appeal docketed*, No. 79-1587 (6th Cir. June 22, 1979). *See generally* Roberts v. Commissioner, 71 T.C. 311 (1978), *appeal docketed*, No. 79-7277 (9th Cir. Apr. 27, 1979); Pityo v. Commissioner, 70 T.C. 225 (1978); Rushing v. Commissioner, 52 T.C. 888 (1969), *aff'd*, 441 F.2d 593 (5th Cir. 1971). In these cases, which concerned installment sales to intra-family trusts, the Tax Court applied a control test. *See* notes 129, 148 *supra* and accompanying text.

154. *See* notes 147, 149, 153 *supra*.

155. *See* notes 86, 127 *supra* and accompanying text.

156. *See* notes 78, 127-28 *supra* and accompanying text.

court.[157] The doctrine should be applied when Congress requires it, not when a court determines that a "deal is too good to be true."[158] For tax loopholes that remain unplugged, the appropriate remedy is "application of the Congressional thumb, not the court's."[159]

Harry Waizer

157. *See* Quinlivan v. Commissioner, 599 F.2d 269, 273 n.4 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); notes 152-53 *supra* and accompanying text.

158. Basic Inc. v. United States, 549 F.2d 740, 745 (Ct. Cl. 1977) (quotations omitted).

159. Fabreeka Prods. Co. v. Commissioner, 294 F.2d 876, 879 (1st Cir. 1961) (footnote omitted).