Evaluating Tax Avoidance Practices: Risk of Loss

Jeremy Lingenfelser
Quinnipiac University
275 Mount Carmel Avenue
Hamden, CT 06518-1908, USA.
E-mail: Jeremy.Lingenfelser@quinnipiac.edu

Abstract

In the constant flow of the federal tax scheme numerous backwaters have developed as havens for delaying or dodging taxation. Many of these pools have the stench of illegality emanating strongly from the stagnant tax avoidance purpose present in the motives for the transactions that pull the money out of the nation's tax coffers. However, other pools are fed with freshwater from the spring of new business opportunities inherent in the transactions. As courts have struggled with defining the legitimacy (and illegitimacy) of these various tax shelters they have developed numerous standards and tests to determine if they are legitimate. This paper looks at these standards and concludes that the only important defining feature for determining whether a shelter is legitimate is the risk of loss.

The Problem

The internal revenue code defines a tax shelter as:

1. a partnership or other entity (such as a corporation or trust);
2. an investment plan or arrangement; or
3. any other plan or arrangement, if its significant purpose is to avoid or evade federal income tax.[1]

Avoiding and delaying payment of taxes has been held to be basically the same as avoiding taxes.[2] Almost universally these delaying tactics are added into the IRC definition. Most texts on the subject utilize a basic definition of a tax shelter; any transaction that delays payment of taxes for more than four years.[3] However, the definition does little to let us know whether or not the shelter or its transactions will be respected. Further, the United States relies on tax payers to self assess their taxes. Thus, if they structure their transactions in order to minimize tax exposure, it will be difficult to even expose it as a shelter, whether or not this transaction is later respected or not, as not all sheltering transactions are improper[4]. In an attempt to minimize this fact, Congress passed the mandatory reporting requirements on tax shelters. This attempt has shed some light on this dark corner of the tax system.[5] This law does not address the legitimacy of the shelters; rather it only mandates reporting. One might think that passing this law would drive tax shelters further underground. However, a quick search for tax shelters will find multiple advertisements.[6] After all of these requirements, one would assume that every tax shelter advertised is legitimate. Quite the contrary, many advertised shelters, if challenged by the internal revenue service would fail the basic tests. Further, there is extreme confusion about the legitimacy of any tax shelter. This fact stems from the myriad of judicial standards utilized to determine legitimacy of any particular transaction. Only through analyzing all of these standards can we understand the need for a simple standard that meets the problem of both the regulators and the taxpayers. Further, we work from the premise that the standards developed must be easily applicable to numerous different taxation events. Predictable outcomes are highly preferable to more erratic systems. Finally, any system that can be encompass various doctrines will be preferable to numerous doctrines currently in existence.

A Brief History

Before evaluating the various legal doctrines, it is important look at a history of the income tax in order to gain a perspective in the development of the law. The origin of the income tax, and therefore income tax shelters, is found in the Sixteenth Amendment to the United States Constitution.[7]

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[1] I.R.C. § 6662(d)(2)(C)(ii)
[2] See Brodsky, Edward (1985), *A Practical Guide to Tax Shelter Litigation*, New York, Law Journal Seminars-Press. Pg 1-1.
[3] *Id.*
[4] *See Helvering Infra.*
[5] I.R.C. § 6662
[6] A search for "Legitimate Tax Shelters in the United States" conducted in the search engine at www.google.com on December 1, 2009 yielded 27,900 results. Similar results occurred at other search engines.
[7] The Sixteenth Amendment was passed in 1913 in response to *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 429 (1895)(invalidating 1893 Income tax on grounds that it was a direct tax in violation of Article I of the Constitution).

Problems with compliance were almost immediate. Tax fraud was so rampant that by 1919, Daniel C. Roper, Commissioner of Internal Revenue, established the Special Intelligence Unit in order to investigate the widespread fraud.[8]

The original investigators were six postal inspectors, known for their ability to combat mail fraud. It quickly became a nationally known agency, probably reaching its zenith with the conviction of Public Enemy Number One, Al Capone.[9] Tax reduction took center stage again under Harry Truman. Several government employees were caught up in criminal investigations alleging that they were attempting to reduce the tax liabilities of influential persons or "tax fixing."[10] This reinvigorated the service and its focus on prosecuting tax evasion schemes. In the 1960's Attorney General Robert Kennedy and IRS Commissioner Mortimer Caplin developed a joint IRS tax force, with the mission to combat tax evasion. Their efforts led to many numerous successful prosecutions.[11] All of these prosecutions for tax fraud were the result of criminal behavior that could not be prosecuted successfully with other sections of the code. The Internal Revenue Service was still not aggressively targeting tax sheltering tax activity.[12]

The 1970s saw a more aggressive Internal Revenue Service. The highlight of the decade was the conviction of Vice President Spiro Agnew for tax evasion.[13] The 1970's also saw questionable deductions for bribery to foreign officials.[14] The 1970's also saw the beginning of aggressive investigation of tax shelters. Of the more famous investigations is Operation Trade Winds, an investigation of United States tax shelters in the Bahamas. This investigation led to an important Supreme Court decision, *United States v. Payner*.[15] The Internal Revenue Service was utilizing resources seeking out tax sheltering activities and attempting to collect on behalf of the United States. These activities would only continue into 1980's. The 1980's saw a further focus on tax evasion and income sheltering. Among these was the Business Opportunity Project. This investigation focused on business owners who evaded taxes by either skimming profits or sheltering taxes through phony deduction.[16] More important to the tax shelter history is the Tax Haven-Offshore Bank Project. Overseas tax havens were being utilized by tax shelter promoters in an attempt to illegally hide income overseas and the IRS sought to repatriate the income.[17] This problem persists although there have been continual efforts to battle these practices.[18]

Although growth was strongest in the 1970s, the 1980s also saw an explosion in partnership tax shelters. The Bond and Option Sales Strategy, also known as BOSS was in its heyday and the government began enacting legislation to combat the loss in revenue from this tax haven.[19] The government had made it clear that it would attempt to go after these shelters. It is extremely interesting that the government has never deemed these tax shelters "illegal." Rather, it constantly refers to tax shelters that are not respected as "abusive." Although this may seem to be semantics, it may illustrate the core of the problem, that the activities engaged in to reduce taxes by even the disregarded tax shelters comply directly with tax law. This might be the only area of the income tax where compliance with the intent is more important than compliance with the statutory language.

[8] Found at the IRS Website on the World Wide Web located at http://www.irs.gov/compliance/enforcement/article/0,,id=107469,00.html Last visited on Dec. 20, 2009.
[9] Id.
[10] Grunewald v. United States, 353 U.S. 391 (1957)(case dismissed as statute of limitations on the crimes had run prior to prosecution).
[11] Among those prosecuted were Tony Accardo, See *United States v. Accardo*, 298 F.2d 133 (7th Cir. 1962)(conviction for violation of I.R.C. 7206(1), reversed for prejudicial media publicity); Johnny (Dio) Dioguardi, See *United States v. Dioguardi*, 428 F.2d 70 (2nd Cir.), cert. denied, 400 U.S. 825 (1970)(conspiracy and tax evasion convictions); and Anthony Dichiarinte, among others. See *United States v. Dichiarinte*, 385 F.2d 333 (7th Cir. 1967), cert. denied sub nom. *Mastro v. United States*, 390 U.S. 946 (1968).
[12] This is not to say that there were no tax evasion prosecutions in the 1960's. Among notable non mob related prosecutions are George Raft, who pleaded guilty of tax evasion, Buddy Rich, who pleaded guilty to willful failure to file tax returns. However, these were still not complex prosecutions of tax evasion techniques, or illegal tax shelters
[13] NY Times, October 1978, available online at http://www.nytimes.com/learning/general/onthisday/big/1010.html last viewed on Dec. 20, 2009.
[14] As it was not a crime at the time, Congress responded in 1977 with the Foreign Corrupt Practices Act.
[15] *United States v. Payner*, 447 U.S. 727 (1980)(holding that evidence seized illegally oversees could be utilized in the underlying tax evasion case).
[16] History of criminal tax prosecutions, IRS website on the World Wide Web located at http://www.irs.gov/compliance/enforcement/article/0,,id=107469,00.html Last visited on Dec. 20, 2009.
[17] See IRM § 9265.8 (Apr. 3, 1986)(rules emplaced to assist with the project).
[18] The most recent example of this battle is the agreement between the United States and Swiss bank USB, releasing names of various U.S. taxpayers with money sheltered illegally.
[19] This time period saw the at risk rules added in 1978, which were extended in 1981. Perhaps more importantly, the Tax Equity and Fiscal Responsibility act (TEFRA) passed in 1984. See a discussion of these *Infra.*

In response to the aggressive stance by the government, promoters developed new, more intricate tax shelters; among these was the notorious Son of BOSS. This variant of the now defunct BOSS shelter has proven especially difficult for the Service in attempting to combat. However, in recent years most courts have found for the Service in Son of BOSS cases. As we have seen there is a tension between promoters of tax shelters and the Service. Promoters constantly push the envelope in order to maximize their clients tax advantages while the Service pushes back, attempting to ensure equitable distribution of the tax burden.

This game of cat and mouse is governed by a loose set of ill defined principals. This paper attempts to look at these rules and concludes that there is a simple rule to follow to determine if the shelter will be respected. The issue becomes what is legal tax avoidance and what is abusive tax evading? As Justice O'Connor recently stated, quoting Judge Learned Hand,

> As executor of Williametta Day's Estate, it was entirely appropriate for Carlton to seek to reduce the estate taxes. And like all taxpayers, Carlton was entitled to structure the estate's affairs to comply with the tax laws while minimizing tax liability. As Learned Hand observed with characteristic acerbity; '[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here, was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of [estate] taxes, as it certainly was. *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934) (citations omitted), aff'd, 293 U.S. 465, (1935).'[20]

However compelling the arguments by these influential judges are, they still beg the question, what tax is due and why are some activities tax evasion and others mere avoidance through lawful means? It is exactly this controversy that the courts have struggled mightily with over the years. The discussion of what is legal avoidance and unacceptable evasion is a concept that even the writers of the I.R.C. seem to get confused. I.R.C. § 269 seems to equate avoidance with evasion[21] whereas I.R.C. § 482 only discusses evasion.[22] The aforementioned tax shelter statute appears to assume that at least some reportable shelters, tax avoidance vehicles, are acceptable under the code.[23] So there is not even a consistency with the language utilized to discuss this subject. It is quickly apparent why this area of tax law is oft litigated and highly disputed in the courts.

However, these concepts do appear to be quite clear. Tax evasion requires actual malice; knowledge that one should pay more taxes but for the fact that he has entered into a dubious scheme of transactions to avoid a legitimate tax due. On the other hand, avoidance is the lawful organization of affairs in order to comply with the tax code and minimize the burden of taxation. The avoidance only becomes evasion if there is some sort of slight of hand or deception utilized to confuse the tax collector from understanding the true nature of the transaction. This definition is actually spelled out in the Internal Revenue Manual. It states clearly that taxpayers can attempt to minimize taxes by legal means. However, the definition continues on to highlight the positive acts required in evasion. Among the listed acts specifically mentioned are misrepresentations, willful omissions, and other acts designed to hide the real nature of the transaction.[24]

However, every instance of prosecution and success by the Service has been met by a new and more complicated avoidance scheme.[25] This game of cat and mouse continues as the taxpayers continue to look for the clear backwater to avoid the sting of taxation, while the Service attempts to clear out the swamps and return the funds into the stream of the Treasury.

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[20] *United States v. Carleton*, 512 U.S. 26, 35-6 (1994)(O'Connder J. concurring in the judgment)

[21] I.R.C. § 269 (a).

[22] I.R.C. § 482.

[23] I.R.C. § 6662.

[24] IRM 9.1.3.3.2.1 (Avoidance Distinguished from Evasion) (May 15, 2008) "Avoidance of taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible. The distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent. He/she shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events or to make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular investigation may show that an alleged partnership was not, in fact, established and that one or more of the alleged partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would be an instance of attempted evasion"

[25] Although there are many examples of this, perhaps the most obvious is the BOSS shelters of the 1970's and early 1980's and their progeny, the Son of BOSS in the early 1990's into the early 2000's.

If intent is the guide, as the regulation tells us it is, how is this manifested? This has never been clearly articulated, although some judicial tests have developed to attempt to discern this perilous line. First is the doctrine of willful blindness. The reasoning for the willful blindness rule was articulated by the 9th Circuit in *United States v. Jewell.* The Court stated "The substantive justification for the rule is that deliberate ignorance and positive knowledge are equally culpable. The textual justification is that in common understanding one "knows" facts of which he is less than absolutely certain. To act "knowingly," therefore, is not necessarily to act only with positive knowledge, but also to act with awareness of the high probability of the existence of the fact in question.

When such awareness is present, "positive" knowledge is not required."[26] This doctrine allows courts a tool to find the intent necessary for evasion when there is no evidence that states the taxpayer met the malice aforethought requirement of evasion. Next is the requirement of an affirmative action. I.R.C. § 7201 requires that there be an affirmative action.[27] In *United States v. Meek*, the 10th Circuit held that a failure to act did not meet this requirement.[28] Thus, to go from avoiding to evading, one must do something to positively bring about the lighter tax burden for the knowledge of evasion to be present.[29] It is apparent from this cursory look at the definitions involved that the average, unsophisticated taxpayer could run afoul of the law by being too "aggressive" and yet be certain that his actions in no way violated the letter of the law. This uncertainty is unacceptable and is the primary reason that a clear coherent standard must be implemented.

There are numerous judicial doctrines that have been developed in attempt to clarify the morass, however, we will first evaluate the statutory attempts, before wading into the judicial foray. Perhaps the most important statutory scheme developed to provide clarity to the avoidance versus evasion dilemma was the 1976 code which included the "at risk" loss rules.[30] Congress' intent was to limit a taxpayer's ability to take a loss to the amount of money actually "at risk." In this rule, Congress attempted to, in a limited way, come to the conclusion that this paper reaches, namely, that all that matters in determining whether a transaction is legitimate or not is the actual risk of loss. However, these rules were instituted for a limited range of activities and only under certain circumstances. These actions limited the affect of the law. Although Congress extended the reach in both 1978 and 1981, in was not until 1982 that Congress would again pass far reaching legislation. The Tax Equity and Fiscal Responsibility Act (TEFRA) was the next major foray into the breech.[31] Among TEFRA's numerous provisions were elements defining partnership transactions and the way they were to be adjudicated. This provided a roadmap to the Service on how to proceed in complex litigation against the numerous partnership shelters being promulgated. These rules were mostly procedural in nature, not actually changing the rules of the game, but defining the process in which they were to be officiated.

In 1984 Congress first required tax shelters to be registered.[32] Although this added the aforementioned definition of shelters, neither this law nor the IRC defined the term "abusive tax shelter," or any similar term. Further, it required that "potentially abusive" shelters keep lists of their participants. However, the enforcement of this provision could only occur if the underlying shelter was deemed abusive, giving the actually statute little real force. Thus, although helpful in adding penalties to abusive shelters, this did little to define what an abusive shelter was. Later laws stiffened penalties, changed some minor rules, or specifically targeted certain shelters, the courts have been left with the burden of deciding which shelters are abusive and evading taxes, and which are legitimate transactions with the confines of the law.

Judicial Doctrines

This brings us to the various judicial doctrines. One notable text on the subject lists five separate judicial doctrines when determining if the transaction will be respected for tax purposes.[33]

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[26] 532 F2d 697, 700 (9th Cir.) (en banc), cert. denied, 426 US 951 (1976).

[27] The actual language states "Any person who willfully attempts in any manner to evade or defeat any tax.." It is this "any manner" that requires an affirmative action.

[28] 998 F2d 776, 779 (10th Cir. 1993).

[29] *See United States v. Romano*, 938 F2d 1569, 1573 (2d Cir. 1991); *United States v. Masat*, 896 F2d 88, 98 (5th Cir. 1990), appeal after remand, 948 F2d 923 (5th Cir. 1991), cert. denied, US, 113 S. Ct. 108 (1992); *United States v. Eaken*, 17 F3d 203, 206–207 (7th Cir. 1994); *United States v. Voorhies*, 658 F2d 710, 715 (9th Cir. 1981).

[30] From the Internal Revenue Website, found on the world wide web at http://www.irs.gov/pub/irs-utl/i.b_-_history_of_shelters.pdf last viewed on Dec. 15, 2009.

[31] From the Internal Revenue Website, found on the world wide web at http://www.irs.gov/pub/irs-utl/i.b_-_history_of_shelters.pdf last viewed on Dec. 15, 2009.

[32] *Id.*

[33] Donaldson, Samual A. (2007), *Federal Income Taxation of Individuals; Cases, Problems and Materials* (2nd ed.), St. Paul; Thompson West. Pg 730-34

A thorough look through cases may find that judges use any, all, or even other means to determine whether or not to respect the shelter as a legitimate tax avoidance or an abusive or evasive transaction. Before delving into these doctrines, it is important to note that these various doctrines are only implemented with the Service decides that the taxpayer in fact complied with the letter of the applicable tax law. If the taxpayer failed to comply with the law as written, the Service would rely on the technical arguments in order to prevent the advantageous consequences for the taxpayer.[34] The first of the five is the doctrine of substance over form. Perhaps first utilized in the 1920's by the court, this doctrine has long been at the core of judicial doctrines around taxation.[35]

The doctrine has evolved and comes in many forms, but was perhaps best articulated in *Gregory v. Helvering*.[36] In *Gregory*, the petitioner entered into a series of transactions in order to reduce the amount of ordinary income and increase the amount of capital gains for the favorable capital gains rate.[37] Petitioner formed a new company and transferred 1000 shares of Monitor, shares that she wanted distributed to her, into the new company. She claimed that this was a reorganization under then existing tax code and therefore not a taxable event. Later, when that new company dissolved, leaving her with the shares of the Monitor in the liquidation, she claimed she was to be taxed at the more favorable capital gains rate.[38] Of the transaction in question, the court was quick to point out that it did on its face meet the technical requirements of the law. However, the court continued to state

> "In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, *though conducted according to the terms of subdivision (B),* was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[39]

Thus the court held that because the sole motivation surrounding the transaction was an attempt to utilize the tax system in order to get a more favorable tax treatment on the transaction, the actual substance rather than the form of the transaction would govern the tax consequences of the transaction. It is important to note further that the Court did not believe that it was undermining the principle that a taxpayer should be able to organize his affairs in order to minimize taxes.[40] Despite this, and the admission that the taxpayer followed the letter of the law, the Court finds that the taxpayer avoided taxation through an abusive tax scheme. The Court gives no clear guidance over what would constitute an acceptable transaction in a future case. Had the new company conducted a legitimate transaction other than the transfer of stock, such as completing a sale of real estate, would that have made the transaction acceptable? It is clear from the case that if the intent of the taxpayer is to solely avoid taxation and the form of an otherwise acceptable transaction disagrees in essence with the substance of the transaction, this conflict will make the transaction void and the substance of the transaction will take precedence over the form. There is no guidance on how to measure that intent and conflict. This standard demands numerous judicial decisions reaching conclusions in order to find the limits of what a taxpayer can and cannot do in order for his transactions to be respected by the Service.

Thus, this doctrine does not provide clarity. Further, it is only applicable to transaction with no real substance. There have been numerous decisions under this doctrine, both for and against the taxpayer, as well as statutory changes to support and define it. This doctrine does not meet the standards for an ideal tax doctrine. Specifically, the doctrine only claims to protect against transactions that are in substance of one tax transaction but are manipulated in form through artful maneuvering into another type of tax transaction for a perceived tax advantage. In essence this doctrine eliminates transactions that have no real purpose other than the form in an attempt to change one taxable transaction into another non taxable or tax-preferable taxed transaction. There are numerous situations not covered. In the end, the Service will only know about the transactions if they are reported.

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[34] Korb, Donald L. "The Economic Substance Doctrine In The Current Tax Shelter Environment." Jan. 25, 2005. Found on the I.R.S. web site on the World Wide Web at http://www.irs.gov/pub/irs-utl/economic_substance_(1_25_05).pdf last viewed on Dec 12, 2009.
[35] See *United States v. Phellis*, 257 U.S. 156, 168 (1921)
[36] *Gregory v. Helvering*, 293 U.S. 465 (1935), affg *Helvering v. Gregory*, 69 F.2d 809 (2nd Cir. 1934)
[37] *Id.* at 467
[38] *Id.*
[39] *Id.* at 470 (italicized emphasis added). The italicized text highlights that the taxpayer in this instance complied completely with the statute.
[40] *Id.* at 469.

Further, only if the taxpayer is obvious about the transaction, as the taxpayer in *Gregory*, will the Service be able to prosecute under this doctrine. More sophisticated taxpayers have called for more sophisticated doctrines.

The Step Transaction Doctrine[41]

The next judicial doctrine that will be discussed is the step transaction doctrine. Very similar to the doctrine of substance over form, the step transaction doctrine treats a series of formally separate steps as a single transaction to determine what truly was happening as a taxable event.[42] This doctrine has also been discussed in many cases. One notable case is *Security Industry Insurance Company v. United States.*[43]

In *Security Industry Insurance* the taxpayer company engaged in a series of transaction in order to acquire insurance companies. Through the series of transactions Security Insurance, the taxpayer, ended up with the moneys that were once in the target's tax free policy surplus account. The District Court had decided with the taxpayer that the transactions resulted in the taxpayer maintaining the surplus accounts as the transactions were conducted in accordance with the requirements of the reorganization statutes.[44]

However, the Fifth Circuit Court held that the District Court had failed to consider the Step Transaction Doctrine and ruled that the moneys in the account were subject to taxation because of the acquisitions.[45] In so ruling, the Court articulated the various standards for utilizing the step transaction test. There are three possible tests utilized by various courts in order to determine if the step transaction doctrine is applicable.[46] The first such test is the end results test. Under this test ""purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[47] Thus, if the end result is reached through a round about means in order to achieve tax advantages, the steps will be disregarded and the tax consequences of a single transaction will be reinstated.

Another test as to when to utilize the step transaction doctrine is the interdependency test.[48] This test focuses on the fact that "the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series"[49] Basically this test revolves around whether any of the steps could be taken without the others for an independent purpose. If none of the steps would have been completed for another reason, then the interdependence of the transactions is reason to treat them as one. Once treated as one, the tax consequences from the one transaction are calculated without regard to the intended consequences of the various steps. Thus, if the steps are implemented in order to gain advantageous tax benefits, these will be lost if the steps are disregarded through the interdependency test of the step doctrine.

The third test is the binding commitment test.[50] This test, enunciated by the Supreme Court in *Commissioner v. Gordon*, requires the steps to be ignored only when there is a binding commitment to complete the rest of the steps.[51] This test is quite restrictive as it will only allow the steps to be ignored when once the first step is taken, the rest must follow like dominos. However, if applicable, it too would lead to all of the individual steps being ignored and the tax consequences of the transaction as a whole to be determined as one transaction instead of the individual steps of the transaction. Although there are three different standards depending on the circuit, the central purpose of the doctrine is ensuring substance over form.[52] This returns us to the cases in that line of the tax doctrine.

For the most part the cases of the Step Transaction doctrine apply to corporate reorganization cases. Although this doctrine may apply to other types, its applicability is fairly limited.

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[41] For a more thorough review of the Step Transaction Doctrine *see* Silverman, Mark J. *Recent Developments in the Step Transaction Doctrine,* SR022 ALI-ABA 1671 (Oct. 2009).
[42] Donaldson *Supra.*
[43] *Security Indus. Ins. Co. v. U.S.,* 702 F.2d 1234 (5th Cir. 1983).
[44] *Id.* at 1236.
[45] *Id.* at 1237.
[46] *Id.* at 1244.
[47] *Id.* at 1244 (quoting *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct.Cl.1969)).
[48] *Id.* at 1245.
[49] *Id.* (quoting Paul & Zimet, *Step Transactions, in Selected Studies in Federal Taxation* 200, 254 (2d Ser.1938), quoted in *King Enterprises*, 418 F.2d at 516. See also *Redding*, 630 F.2d at 1177; *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir.1949), cert. denied, 339 U.S. 920, 70 S.Ct. 622, 94 L.Ed. 1344 (1950); 3 J. Mertens, *The Law of Federal Income Taxation* § 20.161 (Doheny ed. 1981)).
[50] *Id.*
[51] *Commissioner v. Gordon*, 391 U.S. 83, 88 S.Ct. 1517, 20 L.Ed.2d 448 (1968).
[52] *Security Indus. Supra.* at 1245.

As discussed earlier, an ideal doctrine would be applicable to as many different transaction types, thus this is a less than ideal doctrine. Further, with three different standards for its applicability, it is not the clearest standard. It only gets more confusing when looking at a transaction that may or may not be respected. It has just enough similarities with the Substance Over Form Doctrine that it is understood in conjunction in those line of cases. Therefore it is not the clear solution needed in this line of cases.

Business Purpose Doctrine[53]

In order to further enlighten taxpayers as to whether or not their transactions will be respected, the courts have espoused the Business Purpose Doctrine.[54] The Supreme Court has used this many times to look through transactions and ignore their tax consequences.

This doctrine has its foundations in *Gregory v. Helvering* as well.[55] Taken from this case, many courts have expounded and clarified this doctrine. One notable decision is *Wortham Machinery Inc.*[56] In *Wortham* there were two closely held corporations, Wortham Machinery and Madera. Madera was established in an attempt by a few of the principle shareholders to engage in the manufacture of some attachments for some of the construction equipment that Wortham had been engaged in selling.[57] However, when the business did not succeed, perhaps because of undercapitalization, Wortham exchanged 20 of its shares for all the assets of Madera as well as assuming all of the liabilities.[58] As the liabilities were guaranteed by the officers and shareholders of the organization, the Service wanted the transaction treated as a constructive dividend. On the other hand, the shareholders had sought reorganization treatment for the transaction.[59]

The court based its holding on whether or not their was a valid business purpose for the reorganization. It was not enough that the reorganization occurred in the form of the transaction, but the essence of the transaction also had to be a reorganization. As it was a closely held corporation, the court held that these concepts were interrelated and focused on the business purpose of the transaction.[60] In determining whether or not there was a valid business purpose, the court discussed the criteria. Although the court did not list factors, it listed out the actual purposes for the transactions that were under review. The court held that these factors must have a purpose other than that of lowering the taxes and that this business purpose must be proven by the taxpayer, not the Service.[61] Thus, the business purpose doctrine states that the reasons for the transactions cannot be merely tax based. In *Wortham* the Court looked at the factors behind the creation of the company and then the reorganization of the company. The Court evaluated both and decided that nothing had changed in the situation for the reorganization to be needed. Thus, since the business considerations were the same, they could not be the motivating reasoning behind the reorganization.[62]

The business purpose doctrine is mostly limited in focus to corporate reorganizations and similar transactions. Although these reorganizations can be utilized to shelter moneys and transfer underutilized loss carryovers, these shelters are not the most abused area of the tax code. Further, this doctrine is limited in its clarity. Business purpose is understood by the court, but few if any have defined what it means. Some courts have held strikingly similar transactions to either lack or carry a valid business purpose.[63] Thus, the average taxpayer wanting to utilize tax planning to reduce tax exposure and explores business reorganization as an option to achieve this, will have little knowledge as to whether or not its business reorganization plan will be respected for tax purposes. This lack of clarity invites corruption in the tax system of concealing motivations of transactions in the cloud of legitimacy. Lack of a clear doctrine on what purposes will and will not be accepted makes this even less ideal as a methodology for determining the outcome of the transaction.

Finally, it has limited expandability. It can only apply in a corporate setting. It would be difficult to demand individuals to ensure that their actions had a business purpose in choosing to conduct their personal finances. This concept would also denigrate the tax neutrality principles central to the tax code.

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[53] For more information on the Business Purpose Doctrine *see* Bankman, Joseph, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. Rev. 149 (2001).
[54] Donaldson *Supra*.
[55] *Gregory Supra*.
[56] *Wortham Machinery Co. v. U.S.*, 375 F.Supp. 835 (D.C.Wyo. 1974) affd, 521 F.2nd 160(10th Cir.1975).
[57] *Id.* at 837-8
[58] *Id.*
[59] *Id.*
[60] *Id.* at 839.
[61] *Id.*
[62] *Id.*
[63] Compare *Wortham Supra* with *Becher v. C.I.R.*, 22 T.C. 932 (1954), aff'd 221 F.2d 252 (2nd Cir 1955).

Although a fairly straightforward principle, the business purpose doctrine is not expandable, is not clear in its application, and limited in its applicability. It fails to meet the criteria for an ideal solution to the conundrum as to what is an acceptable tax transaction for purposes of sheltering money in the tax system. We must look elsewhere for a more complete doctrine.

Sham Transaction Doctrine[64]

Another doctrine put forth to combat tax shelters is the sham transaction doctrine.[65] This is yet another doctrine with its roots in the substance over form doctrine. This doctrine states that if the transaction is merely a charade in order to reap tax benefits with no other motivation, than the transaction will be ignored. This doctrine was articulated by the Supreme Court in *Knetsch*.[66]In *Knetsch,* the taxpayer bought ten, thirty year maturity annuity savings bonds at a worth $4,000,000 for a price of $4,004,000.[67]

The taxpayer paid $4,000 via a personal check and the remainder of the purchase price was paid for by nonrecourse annuity note loan, secured by the aforementioned security notes of $4,000,000.[68] Each year of the four years that the notes were held, the taxpayer used the interest from the savings bonds to secure further debt to pay the interest of the notes. He then claimed the interest as deductible payment on annuity debt.[69] Had the taxpayer continued this practice to the maturity of the notes, at taxpayer's 90th birthday, the net result would have been a $43 per month annuity.[70] The District Court and the Appeals Court both sided with the Service and disallowed the transactions.

The Supreme Court also held for the Service, and listed the requirements for the sham transaction doctrine. The Court first examined the transaction to determine if there was "indebtedness" as required by the tax code.[71] After looking at the fact that each year he was paying more than he was receiving, the Court evaluated what benefit the taxpayer received for the thousands of dollars in spread on the loans.[72] The Court determined that the taxpayer was not receiving anything of merit, except the tax benefits.[73] After determining this and then looking at Congressional intent behind the law, the Court held that the transaction, although it complied with the letter of the law at the time, did not amount to a real transaction with real risk to the taxpayer, and thus disallowed the interest deductions.[74] The key points to this doctrine appear to be the Court's evaluation of the transactions involved. In this transaction, the taxpayer actually complied with the letter of the law. The insurance company received a considerable profit on the spread. As the dissent notes, this is no different than taking out a mortgage from a bank with which a taxpayer has a bank account.[75] The Court appeared to be troubled by the size of the deduction in comparison to the actual loss realized by the taxpayer. This result leads to uncertainty by taxpayers in whether or not legitimate transactions will be respected for tax purposes.

In evaluating this doctrine, we first look at if it is clear. Once again, merely complying with the applicable law will not determine if the transaction will be respected. Further, almost identical transactions will not be treated equally. A person with a loan and a mortgage from the same bank will almost certainly have the transaction respected; the annuity contracts in *Knetsch* were not. Therefore, this standard does not provide clarity for the taxpayer. It does appear that this standard could be applicable to almost any type of transaction. Since transactions are almost always required from tax consequences, this standard could be applicable to almost any taxable event. Therefore, this doctrine meets this standard. The doctrine also lacks simplicity. In order to determine the legitimacy of each transaction, the courts must be involved. If the Service questions an individuals transaction, there is little guidance as to whether or not the individuals transactions will be respected. The taxpayer can stress similar transactions that are respected and the Service will point to the doctrines victories in other, similar cases. Despite the fact that it is applicable to most transactions, this doctrine's lack of clarity and simplicity prevents it from being the ideal, uniform standard for evaluating tax shelters. Therefore, there must be a better doctrine that could meet the needs of taxpayers for clarity, simplicity, and uniformity.

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[64] For more information on the Sham Transaction Doctrine *see* Donahue, Paul J., *The Rule of Sheldon v. Commissioner: Is It an Economically Efficient Evolution of the Sham Transaction Doctrine*, 13 Va. Tax Rev. 165 (1993).

[65] *Gregory Supra*.

[66] *Knetch v. United States*, 364 U.S. 361 (1960).

[67] *Id.* at 362.

[68] *Id.* at 362-3.

[69] *Id.* at 363-4.

[70] *Id.* at 364.

[71] *Id.* at 365.

[72] *Id.* at 366.

[73] *Id.*

[74] *Id.* at 366-70.

[75] *Id.* at 370-1. (dissent of Justice Douglas, joined with Justices Whittaker and Stewart)

The Economic Substance Doctrine

This brings us to the final judicial doctrine that we will evaluate, the economic substance doctrine.[76] This also is a progeny of the *Helvering* line of cases, although focusing more on the intent of the taxpayer than the substance over form of the transaction.[77] This doctrine looks at the transaction to see if there is real economic substance behind a transaction in order to determine if the tax attributes of the transaction should be respected. This doctrine has been developed over time in numerous cases. The first part of the test is the threshold question of whether or not the transaction exists.[78] If a transaction is a pure sham the courts will disallow it under the sham transaction test and the economic substance doctrine will not be reached.[79] The purpose of the economic substance doctrine was recently stated by Harvard Law School Professor Bernard Wolfman. He stated "The [economic substance] doctrine has assured us that neither the government nor practitioners will succeed in their roles if they are excessively literal and mechanical in their reading of the statute;

if they fail to read it as part of a statutory scheme through which Congress seeks to accomplish a goal that has breadth and durability."[80] Thus, the purpose of this doctrine is to prevent transactions that may or may not comply with the literal letter of the code from being treated differently than Congress intended. With this as its purpose, we will now look at the application of the doctrine. The doctrine itself requires that a transaction must have substance apart from the tax benefit that the taxpayer seeks.[81] In order to determine if that economic substance exists, some courts have developed a two prong test.[82] The first prong is the subjective intent of the taxpayer's intent upon entering the transaction. The second prong is a look at the objective economic substance of the transaction. [83] Other courts have not adopted the two prong test. These courts have preferred to evaluate whether or not there "whether the transaction had any practical economic effects other than the creation of income tax losses."[84] However, even the courts that accept the two prong test do not agree on its applicability. Some courts have held that if either prong is satisfied, than the transaction has economic substance.[85] Yet others utilize the two prong test as two unique requirements.[86] Thus, depending upon the circuit, the substance of the doctrine may be somewhat different.

If the court does apply the two prong test, each prong has its own requirements. The first prong, the subjective business purpose ""examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved."[87] In determining this courts have utilized numerous criteria. Among them are whether a profit was even possible; whether the taxpayer had a nontax business reason to engage in the transaction; whether the taxpayer, or taxpayer's advisors, considered or investigated the investment scheme or tax shelter, including market risk; whether the taxpayer really committed capital to the transaction; whether the entities involved in the transaction were entities separate and apart from the taxpayer and engaging in legitimate business before and after the transaction; whether all the purported steps were engaged in at arms-length with the parties doing what the parties intended to do; and whether the transaction was marketed as a tax shelter in which the purported tax benefits significantly exceeded the taxpayer's actual investment.[88] Thus, there are a lot of considerations, any of which could tip the scales of justice in favor of the taxpayer or the service.

The second prong, the objective component is similarly unclear. The courts have held that in order to satisfy the objective component, the transaction must have improved the net economic position of the taxpayer.[89]

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[76] *Gregory Supra*.
[77] *See* Bankman, J. *The Economic Substance Doctrine*, 74 S.Cal. L.Rev. 5 (2000).
[78] *See Mahoney v. Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987).
[79] *See, e.g., Lynch v. Commissioner*, 273 F.2d 867, 871 (2d Cir. 1959).
[80] 104 Tax Notes 445 (July 26, 2004).
[81] *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583-84 (1977).
[82] *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993); *ACM P'ship v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998*), aff'g in part and rev'g in part*, T.C. Memo 1997-115, *cert. denied* 526 U.S. 1017 (1999).
[83] *Id.*
[84] Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988).
[85] Such as the 4th Circuit in *Rice's Toyota World, supra* note 7, at 91-92.
[86] Such as the 11th circuit in *United Parcel Service of America v. Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001) (citing *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989)).
[87] *Shriver v. Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990) (*citing Rice's Toyota World, supra* note 7).
[88] *See* Korb Supra; *See also Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *Winn-Dixie, Inc. v. Commissioner*, 113 T.C. 254 (1999*) aff'd, Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002); *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir 1990); *Newman v. Commissioner*, 894 F.2d 560, 563 (2d Cir. 1990); *Salina P'ship v. Commissioner*, T.C. Memo 2000-352 (2000); *Nicole Rose Corp. v. Commissioner*, 117 TC 328 (2001); *IES Industries Inc. v. Commissioner*, 253 F.3d 350, 355-356 (8th Cir. 2001); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990).
[89] *ACM P'ship, supra* note 7, at 248 n.31.

There are different measures utilized in order to determine if this has happened. One of the more common is whether or not there is legitimate and realistic expectation of pre-tax profit.[90] Despite this requirement, an investment does not need to actually be profitable, as even the best investments sometimes lose money.[91] According to the tax court, a solid standard for determining whether or not the potential for profit exists is whether a reasonable businessman in the particular industry would participate in the investment.[92] In lieu of this ability to make a profit, the courts have also recognized that a taxpayer may enhance their economic position in other meaningful ways. [93] This factor is a realization that there are other considerations other than mere profit that will result in an improved position in the marketplace. Some examples of this would be the formation of a corporation or a partnership, although these events by themselves are not always respected.[94] Thus, the courts are not confined to mere profitability as a measure of the second prong. This test lacks clarity. It is unclear whether or no the test is applicable to any particular transaction.

Even if it is applicable, it is not certain what form of the test is applied. Even if the two pronged test is applied, will both or just one of the prongs be required? This doctrine is completely unclear. Despite being unclear, it is generally applicable to almost any transaction. It can be utilized in both the corporate, partnership, and individual capacities. It is quite adaptable to different situations. If properly defined, it could be rather simple to decide. However, as the courts have defined it, there uncertainty behind the tests leaves a taxpayer uncertain how to define key aspects of the test. Despite the possibility of simplicity, as currently composed, this doctrine lacks simplicity. By lacking simplicity and clarity, despite being adaptable, this is less than the ideal doctrine. Now that we have examined all of the doctrines widely considered applicable, we are left with no judicial doctrines applicable to all transactions; that provide simplicity and clarity to taxpayers. Perhaps there is a better way at the core of the current judicial doctrines.

A New Approach

With all of these various judicial doctrines and numerous applicable laws and regulations, there must be a better standard for the courts to utilize. In evaluating all of the doctrines, the one universal theme to acceptance for any transaction is risk of loss. If utilizing the risk of loss the fairest result will be reached with the least uncertainty in the tax system. First I will explain how the system would work and then evaluate the cases already discussed in order to demonstrate the clarity and fairness of this system. The risk of loss doctrine would require a three part test. First, the court will determine if the letter of the law has been complied with. This is a threshold question. However, it will differ from the other doctrines in that if the letter of the tax law has been followed, the transaction will be deemed to have occurred for tax purposes. This does not mean that the affects that the taxpayer would like will be realized. This will only occur if the next two prongs bring about that result.

Next, the court would evaluate the taxpayer's economic position both before and after the transaction. In order for the transaction to be respected, the taxpayer must have a measurable increase in his risk of loss. In measuring this risk, the court must utilize tangible documentation that would have been available to the taxpayer at the time. Mere perceived risk of the taxpayer would be inadequate if there was no substantial facts to back up the perception. It is that difference that is the measure of the tax consequences. Risk of loss will be defined as the total amount that the taxpayer could lose on a transaction. The transaction will be inclusive of all related business dealings that arise out of the same business goal. In many reclassification transactions, attempting to turn capital gain or loss into ordinary gain or loss, there will be no additional risk. This measurement will be simple in that if the same money is at risk, there is no additional risk of loss. This doctrine will prevent complicated abusive tax shelters such as the BOSS shelters or the Son of Boss, as there is no actual risk of loss to the taxpayers on these shelters.

This measure is similar to the measure of the doctrine of economic substance. The difference is that it is not an all or nothing game. Any difference will be respected, but the tax consequences will be limited to that difference. Thus, if there is only $10,000 difference in the risk positions, that is the only deduction or reclassification of the transaction that can occur. Measurement of this risk will be essential to this new theory. Thus, a taxpayer must utilize Generally Accepted Accounting Principles (GAAP) if they are a business, partnership, or other non single taxpayer entity. The verifiable calculations involved in risk analysis will be accepted.

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[90] *See, e.g., Gilman v. Commissioner*, 933 F.2d 143, 146 (2d Cir. 1991).
[91] *Abramson v. Commissioner*, 86 T.C. 360 (1986).
[92] *Cherin v. Commissioner*, 89 T.C. 986, 994 (1987).
[93] *See Knetsch Supra,* note 7.
[94] *Gregory v. Helvering*, 293 U.S. 465 (1935); *ACM P'ship, supra* note 7, at 249.

For the individual taxpayer and the sole proprietorships, decisions involving risk must be documented, and the courts should give deference to the taxpayer's perceived risk. While evaluating risk, the court should assess other troublesome areas of the tax code. One notable area is foreign tax consequences. If the risk of loss s reduced by advantageous foreign tax treatment, this theory would reduce the United States tax benefit, thus moving the tax motivations for multinational corporations more tax neutral.

This will prevent the taxpayer from utilizing the variations of international tax codes to his or her advantage at the expense of the United States treasury. Further, it will prevent foreign governments from changing their laws in order to lure businesses into transactions that will generate business in their countries that will end up being subsidized by the United States. Finally, it will make the international tax system slightly more neutral. This doctrine has many advantages to those discussed previously. First, it is preferable to the all or none doctrine in that it allows the taxpayer to claim that a minimal transaction will have at least a minimal tax consequence. Since it is not a zero sum game, both sides will be more likely to settle as the stakes will be lower.

Next, it respects tax neutrality. The only aspect of the transaction that has tax consequences is the amount that represents new risk. This prevents tax consequences from being the primary factor in financial transaction as transactions that fail to risk new money will not generate new tax losses. Thus the tax code will no longer be utilized as tool to facilitate transactions that would otherwise never be made.

This move towards tax neutrality will improve the economy as there will be less distortions in the economy. Waste occurs every time a transaction is entered into that does not attempt to improve the business or personal interest of the parties involved, excepting the tax circumstances. Eliminating this waste will reduce the distortions that the current system invites. Evaluating the transactions in the cases that we have already discussed we see that the results would either be similar or, in some cases, even more fair, for both the taxpayer and the government. First, let us look at the central case for most of the doctrines, the *Helvering* case.[95] Under the new doctrine, the taxpayer would meet the first prong. She complied with the letter of the law. She could be certain that she was in compliance. When we evaluate the second prong we identify the first problem, there is no additional risk. The same money from the taxpayer is invested in the transaction, so the gain cannot change character. Thus, the exact same outcome would result.[96]

Despite the same outcome resulting, this risk of loss doctrine is still better. Instead of uncertainty about the whether or not the characterization would be respected there is no doubt it will not be respected. The taxpayer would not expend all of the effort and create all of the fictitious entities because she would know that without additional risk the character of the gain cannot change. Further, even with additional risk, the recharacterization will be limited to the amount of additional risk. The next case that we will evaluate is the *Knetsch* case.[97] The Court debated over whether or not to allow this transaction and finally disallowed it. Under the new doctrine, the transactions would be respected under the first prong. The taxpayer clearly complied with the tax code provisions. Once again, the taxpayer runs afoul of the second prong. However, it is not an all or nothing decision. There is a spread of 1% interest on the two notes. That spread will allow an interest deduction in that amount as there is real risk of loss on that percentage. If the notes are in affect and never mature, the taxpayer would lose that amount. Thus, the tax consequences would reflect the economic reality. This result would not only address the concerns that the transactions resulted in disproportionately large tax deductions, but also the dissents concern that there were some legitimate reasons for entering into a transaction.[98]

This decision would move the tax code towards the more neutral result. Taxpayers could still enter into the transactions if they had legitimate reasons for creating such spreads for non tax reasons and still enjoy the tax consequences on that money that they had legitimate risk. Further, there would be no such creature as a sham transaction; either the transaction complies with the code or it does not. The only argument would be what the risk of loss is. In the *Knetsch* case, the result under this doctrine would be highly desirable.

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[95] *Helvering Supra.*
[96] It should be noted that the court held that if there was a business purpose of the newly created business unit, the transaction would have been respected. (at 267). However, it is these inconsistencies that this doctrine seeks to eliminate. Thus, business purpose will not be important to the test.
[97] *Knetsch Supra.*
[98] *Id.* at dissent.

Finally, let us test this new doctrine against a modern tax shelter, a Son of BOSS transaction.[99] We will look at two cases, one that the government won and one that the taxpayer prevailed. First, we will look at *Jade Trading*.[100] In this case the taxpayer entered into a series of spread transactions and moved the options and the liabilities through various closely held partnerships and LLC's in order to mask the true offsetting nature of the transactions.[101] The taxpayer claimed compliance with the tax law in not calculating contingent liabilities added to the partnership when calculating his outside basis. Thus, when the money was removed from the partnership it was done so without tax.[102] The Court held that this was a sham transaction under the sham transaction doctrine and thus completely disregards the entire transaction for tax purposes.[103] Further, the taxpayers had a 40% substantial undervaluation penalty.[104]

Applying the risk of loss doctrine to this case the taxpayer would once again be correct in noting that he was in compliance with applicable tax laws. However, the transactions would not have the affect that he desires. Instead of looking at the transactions individually, the transactions would be looked at on a whole to see if there was additional risk of loss.

As there is no additional risk of loss because the options and the contingent liabilities offset each other, the taxpayer would see minimal if any tax consequences to his entire transaction. Thus the taxpayer would know that he would not receive the benefit desired and he would seek to invest his money in a more advantageous business venture. This doctrine will reach the correct conclusion with much less confusion. This should reduce the number of cases coming before the courts. This case in particular would not most likely not have been argued as there is little doubt that there is little risk because of the tax advantages that the taxpayer is arguing that he is entitled to receive. Thus, the government would be spared the expense of prosecuting this case and the taxpayer would know the outcome prior to engaging in such a transaction.

In another, similar case in which the taxpayer won, In *Sala v. United States*, the Court allowed a Son of BOSS tax shelter transaction to maintain its favorable tax attributes.[105] In reaching its conclusion that the entire transaction would be allowed for its tax attributes, the court utilized the sham transaction doctrine, the step transaction doctrine, and the business purpose transaction.[106] As the court looked through each of the doctrines, the court decided that since the overall business plan had some business purpose other than tax avoidance, the entire transaction would be allowed.[107] This conclusion resulted despite noting that the contingent liabilities would greatly reduce the taxpayer's overall tax burden. If the transactions discussed in the case were evaluated with the risk of loss doctrine a quite different result would be reached. First, the entire transaction at would pass the first prong of the test. The transaction did comply with the tax law. When looking at the second prong, the taxpayer would not be able to take the ample deductions that he was allowed to take in the all or nothing approach.

Further, the result mentioned for the Son of Boss cases would be applicable to any of the basis shifting shelters.[108] Partnerships moving money to and from foreign jurisdictions would have the form of their transactions disrespected if there was no risk. Basis shifting as a tax planning strategy would cease to be a planning tool as this doctrine would pierce all such transactions. The risk of loss doctrine will result in clarity in the handling of tax cases so that taxpayers will know what the ramifications of their actions are. First, they will can figure out whether or not the transactions comply with the tax laws. They know how much money is at risk, so they will know the maximum amount of tax benefit the transaction will yield. Thus, this doctrine provides the clarity that many of the other judicial doctrines are lacking.

Further, it is a fairly simple test to apply. Figuring out the total amount of possible loss is a relatively easy mathematical computation. Where the numbers may be less than clear, there are incentives on both sides to meet in the middle to avoid the cost of litigation.

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[99] The Son of BOSS is a tax shelter that utilizes partnership law as well as options and bond trading strategy to generate artificially high tax losses through complex transactions.
[100] *Jade Trading, LLC. v. United States*, 80 Fed. Cl. 11 (2007).
[101] *Id.* at 12.
[102] *Id.*
[103] *Id.* at 94.
[104] On this note there is a split in the circuits. Some other Circuits, such as the Ninth, hold that there is no substantial undervaluation penalty as the value of the partnership was accurately reported. They reason that the true error is not undervaluation but misstatement of basis.
[105] *Sala v. United States*, 552 F.Supp.2d 1167 (D. Colo. 2008).
[106] *Id.*
[107] *Id.* at 1196.
[108] *See* I.R.S. Notice 2001-45 *Basis Shifting Tax Shelter*; *See also* Utz, Stephen *Determining a Partner's Share of Unrealized Receivables at the Liquidation of the Partner's Interest*, 78 Taxes 37 (Oct. 2000).

Thus, it is not only simpler, it leads to judicial efficiency.

Finally, it promotes tax neutrality. Complex tax schemes will be avoided as the risk will be evaluated beyond the mere compliance. Further, the other doctrines will not be needed as this doctrine would incorporate each of them. Both neutrality and simplicity are accomplished by this doctrine. As this doctrine simplifies the compliance requirements, clarifies the results, and promotes tax neutrality, this doctrine should be adopted by the courts to consider future tax transactions. Further, applying this doctrine to cases would also promote fairness. For all of these reasons this doctrine should be adopted as the only judicial doctrine involving legitimacy of tax shelters and tax motivated transactions.