Per Se Economic Substance

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Per Se Economic Substance

The economic substance doctrine is used by the IRS and courts to distinguish legal tax avoidance from tax evasion. More specifically, executive and judicial bodies use this doctrine to revoke statutorily compliant tax benefits that arise from transactions that lack, beyond such tax benefits, both a subjective business purpose and an objective economic effect. The most common tool for measuring the objective economic effect of a transaction is the pre-tax profit test. However, disagreement among courts and scholars applying this test has led to taxpayer uncertainty and accusations of reverse-engineered opinions.

In this Comment, I reevaluate and propose an alternative, tiered approach to measuring the objective economic effects of a transaction. I begin by outlining the origin of the economic substance doctrine, including Judge Learned Hand’s insistence that the doctrine balance taxpayer certainty with the judicial attempt to ascertain the reality of a transaction. With this historico-economic framing in mind, I next evaluate three approaches to measuring the objective economic substance of a transaction: the predominately used pre-tax profit test as well as two leading variations proposed by scholars—Michael Knoll’s implicit taxation regime and Charlene Luke’s comparables test. Because all three of these tests, applied on their own, fail to balance taxpayer certainty with ascertaining the reality of a transaction, I propose an alternative framework for measuring the objective economic substance of a transaction.

Borrowing from antitrust and corporate law, I suggest a three-stage analysis in which certain transactions are subject to a “per se” test, some are subject to a “quick look” (or intermediate scrutiny) test, and others are subject to a “rule of reason” (or entire fairness) analysis. I argue that this tiered analysis will mimic the results of antitrust and corporate law by lowering litigation costs and increasing party certainty. Throughout this Comment, I use the recent circuit split regarding the inclusion of foreign tax expenses in the calculation of pre-tax profit—articulated in Bank of New York Mellon Corp. v. Commissioner, 801 F.3d 104, 118 (2d Cir. 2015)—but my analysis effectively addresses all objective economic substance concerns for essentially all scrutinized transactions.
I. INTRODUCTION

I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.

—Judge Learned Hand

Almost no one likes to pay taxes; almost everyone does whatever they can legally (and cost effectively) to avoid taxes; and almost no one likes a tax cheat. Thus, while most are comfortable with others paying only their “fair share,” certain tax avoiders are consistently scrutinized by the public for their elaborate tax planning—most commonly politicians and large businesses.

The IRS and courts have been granted the task of distinguishing the tax cheat from the tax avoider—a task that has proven difficult since the inception of the tax code. When accomplished “by means


6. See Paul Sullivan, Navigating Between Tax Avoidance and Evasion, N.Y. TIMES (Feb. 11, 2013), http://www.nytimes.com/2013/02/12/business/crossing-the-line-between-tax -avoidance-and-evasion.html; see also, e.g., Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935). See generally William Joel Kolarik II & Steven Nicholas John Wlodychak, The Economic Substance Doctrine in Federal and State Taxation, 67 TAX LAW. 715 (2014). In many ways, one might say the IRS finds itself in the seat of a logic student exploring counterexamples. That is, the IRS explores the sea of transactions that facially comport with the tax code, finds those that are suspect, and inquires, despite their facial comportment with the code, whether such comportment defeats the purpose of the code. Tax law appropriately
which the law permits,” tax avoidance is an indubitable “legal right.” Yet, “the law” is not limited to the code itself. Recognizing that “[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every [tax evasive] device” and that “[a] strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences,” courts have developed multiple tools to detect sham transactions used for no other purpose than tax evasion. The economic substance doctrine (ESD) is one of the most prominent of these tools.

Generally, the ESD is used by courts to revoke statutorily compliant tax benefits arising from transactions that, beyond such tax benefits, have no subjective business purpose and no objective economic effect. Courts and scholars disagree over the details of

lends itself to such logical analysis. See, e.g., P.J. Fitzgerald, Law and Logic, 39 NOTRE DAME LAW. 570, 573 (1964) (utilizing a tax law example for logical analysis).

7. Gregory v. Helvering, 293 U.S. 465, 469 (1935) (“The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”).

8. ASA Investerings P’ship v. Comm’r, 201 F.3d 505, 513 (D.C. Cir. 2000).


10. Kolarik & Wlodychak, supra note 6, at 760–63 (describing the sham transaction doctrine, business purpose doctrine, substance over form doctrine, and step transaction doctrine).

11. See id.

12. See Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) (“Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.”); Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 24 (1st Cir. 2016); Bank of N.Y. Mellon, 801 F.3d at 115 (“[W]e consider: 1) whether the taxpayer had an objectively reasonable expectation of profit, apart from tax benefits, from the transaction; and 2) whether the taxpayer has a subjective non-tax purpose in entering the transaction.”); Salem Fin., Inc. v. United States, 786 F.3d 932, 950 (Fed. Cir. 2015); Compaq Comput. Corp. v. Comm’r, 277 F.3d 778, 784 (5th Cir. 2001); IES Indus. v. United States, 253 F.3d 350, 354 (8th Cir. 2001); James v. Comm’r, 899 F.2d 905, 908–09 (10th Cir. 1990) (quoting Sochin v. Comm’r, 843 F.2d 351, 354 (9th Cir. 1988)) (inquiring “whether the transaction had any practical economic effects other than the creation of income tax losses”); Rice’s Toyota World, Inc. v. Comm’r, 752 F.2d 89, 92–94 (4th Cir. 1985) (holding that to treat a transaction as a sham, the court must find (1) that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction and (2) that the transaction has no economic substance because no “reasonable possibility” of a profit exists); Joseph Bankman, The Economic Substance Doctrine, 74 S. CAL. L. REV. 5, 10–12 (Nov. 2000); Kolarik & Wlodychak, supra note 6, at 721–23, 750–51. But see ACM P’ship v. Comm’r, 157 F.3d 231, 247 (3d. Cir. 1998) (examining whether
the ESD, generally forming four areas of debate. First, when should the ESD be applied? Second, how should the objective economic effects of a transaction be determined? Third, what constitutes a sufficient subjective business purpose for entering a transaction? And fourth, should the objective and subjective prongs of the ESD be applied disjunctively, conjunctively, or balanced as factors in an overall inquiry into the economic substance of the transaction?

the transaction “fell ‘outside the plain intent of the statute’”). See generally Amanda L. Yoder, Note, One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine, 75 Mo. L. Rev. 1409 (2010). But see I.R.C. § 7701(o)(1) (2016) (laying out a conjunctive test for economic substance, requiring both a subjective business purpose and objective economic effect).

13. For example, one of the petitioner’s first arguments in Bank of N.Y. Mellon was that the ESD was not applicable to the transaction at issue “because the congressional purpose of the foreign tax credits—to prevent double taxation—is clear, [and] a court should never be able to question a taxpayer’s use of the credits under the [ESD].” Bank of N.Y. Mellon, 801 F.3d at 113. Note that the Second Circuit dismissed this argument, claiming: (1) the argument focused on the form of the transaction over the substance; (2) the ESD is intended to provide courts with a “‘second look’ to ensure that particular uses of tax benefits comply with Congress’s purpose in creating that benefit”; (3) there is no support for the proposition that “foreign tax credits, by their nature, are not reviewable for economic substance”; (4) the recent codification of the ESD did not create any exemption for foreign tax credits; and (5) the IRS specifically stated that Structured Tax Advanced Repackaged Securities (STARS) transactions were to be examined under the ESD. Id. at 113–14. Codification of the ESD left open the question to which transactions the ESD was supposed to apply, beginning with the statement “in the case of any transaction to which the [ESD] is relevant . . . .” I.R.C. § 7701(o)(1). Some scholars still argue that the doctrine is inapplicable to particular transactions, including the recently disputed STARS transactions discussed below. See, e.g., Jasper L. Cummings, Jr., The Supreme Court’s Economic Substance Doctrine Opinion, 149 Tax Notes 1295, 1295–97 (Dec. 7, 2015).

14. For example, there is currently a circuit split regarding the issue of whether foreign tax expenses should be utilized in this determination. Compare Santander, 844 F.3d at 24, and Bank of N.Y. Mellon, 801 F.3d at 118, and Salem Fin., 786 F.3d at 950, with Compaq, 277 F.3d at 784, and IES, 253 F.3d at 354. Further, there remains a larger debate as to what constitutes the objective prong. See infra Section III.A.1 for a more in-depth discussion of this debate.

15. See Bankman, supra note 12, at 26–29. Note, however, that courts’ analyses of the subjective prong of the ESD has been “largely subsumed” by the business purpose doctrine. Kolarik & Wlodychak, supra note 6, at 761–62 (citing ACM P’ship, 157 F.3d at 247). Therefore, the relevant debate over this prong would likely be found within those debates on the substances of the business purpose doctrine.

16. See Kolarik & Wlodychak, supra note 6, at 724; Robert Thornton Smith, Business Purpose: The Assault upon the Citadel, 53 Tax Law. 1, 26–27 (1999). The type of test applied is potentially dependent upon the court. The Second Circuit explains their application of “the test is not a rigid two-step process with discrete prongs; rather, we employ a ‘flexible’ analysis where both prongs are factors to consider in the overall inquiry into a transaction’s practical economic effects.” Bank of N.Y. Mellon, 801 F.3d at 115. In contrast, the Fifth Circuit does not describe its test in detail but utilizes the term “or” when laying out the two prongs. Compaq, 277 F.3d at 781 (quoting a disjunctive test as stated in Rice’s Toyota, 752 F.2d at 91). Codification appears to have attempted to settle this dispute in favor of a conjunctive test.
Given the highly debated nature of each of these questions, it is easy
to see how a code that is focused on precision and clarity can quickly become unwieldy.

In this Comment, I address the second debate: how should
courts assess whether a transaction has an objective economic effect beyond its tax benefit? Often, courts use the pre-tax profit test to make this assessment. Yet disagreement persists over how pre-tax profit should be measured. For example, circuit courts have

First, the statute explicitly uses the term “and” when laying out the two prongs of the test. I.R.C. § 7701(o)(1). Second, soon after enactment of the statute, the IRS issued the following statement: “The IRS will challenge taxpayers who seek to rely on prior case law under the
common-law [ESD] for the proposition that a transaction will be treated as having economic substance merely because it satisfies either section 7701(o)(1)(A) [the objective prong] . . . or 7701(o)(1)(B) [the business purpose prong].” I.R.S. Notice 2010-62, Interim Guidance Under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010, I.R.B. 2010-40 (Oct. 4, 2010), https://www.irs.gov/irb/2010-40_IRB. Yet it remains highly questionable whether this interpretation makes economic sense. As pointed out by the Second Circuit, as well as numerous commentators, there are plenty of situations in which a business may not earn some minimum profit to justify an economic reality but may still be worthy of the foreign tax credit given its strong subjective purpose. Salem Fin., 786 F.3d at 949–50 (citing Daniel N. Shaviro & David A. Weisbach, The Fifth Circuit Gets It Wrong in Compaq v. Commissioner, 94 TAX NOTES 511, 515 (2002)). See generally Terrance O’Reilly, Economics & Economic Substance, 9 FLA. TAX REV. 755 (2010); Smith, supra note 16, at 26–27.

17. See, e.g., Santander, 844 F.3d at 23–24; Bank of N.Y. Mellon, 801 F.3d at 115; Salem Fin., 786 F.3d at 950; Compaq, 277 F.3d at 784; Shriner v. Comm’r, 889 F.2d 724, 725–26 (8th Cir. 1990); Rice’s Toyota, 752 F.2d at 91. It is also worth noting that the pre-tax profit test was adopted in the recent codification of the economic substance doctrine. I.R.C. § 7701(o)(2)(A) (“The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.”). But see O’Reilly, supra note 16, at 792 (claiming that section 7701(o) only “refers to a ‘meaningful’ change in economic position, and suggests that pretax profit is not the only indication of such a change”). While section 7701(o) does not replace the common law ESD, to learn more about the details regarding its adoption and implications the reader should see generally Jerald David August, The Codification of the Economic Substance Doctrine, Part I, BUS. ENTITIES, Sept.–Oct. 2010, at 4; Jerald David August, The Codification of the Economic Substance Doctrine, Part II, BUS. ENTITIES, Nov.–Dec. 2010, at 4; Richard M. Lipton, ‘Codification’ of the Economic Substance Doctrine – Much Ado About Nothing?, 112 J. TAX’N 325 (2010); Charlene D. Luke, The Relevance Games: Congress’s Choices for Economic Substance Gamemakers, 66 TAX LAW. 551 (2013).

recently split on how foreign tax expenses should be included in this calculation. Likewise, courts and scholars dispute the boundaries of a suspect transaction as well as how much pre-tax profit is sufficient to demonstrate an objective economic effect. The unsettled nature of these disputes entails taxpayer uncertainty and accusations of reverse-engineered decisions.

On a more theoretical level, scholars often question the underlying assumption of the pre-tax profit test, namely that “the economics of a transaction are readily separable from its tax components,” and have demonstrated that this assumption can often lead to inaccurate results. Thus, variations on, and alternatives to, the pre-tax profit test have been proposed by various scholars in this field.

The leading two alternatives are Michael Knoll’s variation on the pre-tax profit test that takes into account implicit taxes and Charlene Luke’s proposal to look beyond the pre-tax profit calculation and assess the objective economic substance of a suspect transaction by examining its risk and after-tax return in comparison to other transactions. Both of these alternatives have the

19. Compare Santander, 844 F.3d at 23–24, and Bank of N.Y. Mellon, 801 F.3d at 118, and Salem Fin., 786 F.3d at 950 (holding that foreign tax expenses should be included in the calculation of pre-tax profit), with Compaq, 277 F.3d at 784, and IES, 253 F.3d at 354 (holding that foreign tax expenses should be excluded from the calculation of pre-tax profit). See also Lipton, supra note 18, at 34.


21. That is, that the courts will essentially use the doctrine to strike down the tax benefits of transactions they simply do not like. See, e.g., Cummings, supra note 13, at 1295, 1299, 1303 (alleging that the Second Circuit, in its recent opinion, exercised “license to turn every code section into a search for a congressional purpose” in order to criticize a tax structure it simply didn’t like); Jasper L. Cummings, Jr., Economic Substance Doctrine Defense Plan, 130 TAX NOTES 953 (Feb. 21, 2011); Jasper L. Cummings, Jr., Circular Cash Flows and the Federal Income Tax, 64 TAX LAW. 535, 634 (2011); Lipton, supra note 18, at 32.


23. See generally Knoll, supra note 22.

24. See generally Luke, supra note 22. Luke’s proposal may be said to be an extension of David P. Hariton, When and How Should the Economic Substance Doctrine Be Applied?, 60 TAX L. REV. 29, 53–54 (2006) (looking specifically at the “unique economic risk” of a transaction). But see O’Reilly, supra note 16, at 792 (contrasting Hariton’s test, examining “whether the taxpayer incurs unique economic risk by entering into the transaction that is itself substantial in relation to the amount of tax benefits in question,” with Luke’s test, examining “whether the after-tax return on the suspect transaction [is] substantially higher than the return on economically comparable market transactions” (alteration in original) (citations omitted)).
advantage of accounting for complexities that remain uncaptured by the pre-tax profit test. Unfortunately, however, both have the disadvantage of increasing taxpayer uncertainty by creating more variables and relying on sophisticated market analyses.25

I believe a solution to this problem comes from the tiered analyses of corporate and antitrust law. Both fields have been developed to increase litigation certainty while accommodating numerous variables and sophisticated analyses.26 This was (and is) done by creating a tiered analysis that deals with some situations using a per se rule and others with more fairness-style analyses. While the structure and fluidity of antitrust law may typically be considered antithetical to the rigidity of the tax code,27 I believe the taxpayers and courts would benefit from a similarly tiered framework for applying the ESD.

Borrowing from these fields of law, I suggest a three-stage analysis to assess the objective economic substance of a transaction. First, I suggest a simplified version of the pre-tax profit test be applied to all suspect transactions to determine whether they per se satisfy, or per se fail to satisfy, the objective economic substance prong. Should a suspect transaction not fit within these per se boundaries, a “quick look” test applying Knoll’s implicit taxation regime should be used to determine the likelihood of a pre-tax profit. Finally, should the transaction fail to qualify for the “quick look” analysis, Luke’s comparables test should apply in a manner similar to the “rule of reason” analysis in antitrust law—allowing courts full freedom to assess the fairness of unusual, unique transactions. As explained below, this framework would increase taxpayer certainty in a manner similar to the manner in which the per se/fairness framework has increased litigation certainty within antitrust and corporate law.28

I will proceed as follows. In Part II, I provide a brief history of the development of the ESD, highlighting Judge Learned Hand’s

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25. See infra Sections III.B, C. Further, Luke’s comparables test would likely lead tax courts to a situation similar to Seventh Amendment judge or jury cases, where courts are left to simply pick between similarly analogous transactions. See infra Section III.C.

26. See infra Part IV.


28. See infra Part IV.
concern for balancing taxpayer certainty against a highly deterministic tax code’s “self-defeating” nature. In Part III, I discuss the current circuit split regarding how to allocate foreign tax expenses within the pre-tax profit test as well as general criticisms of the test. I then turn to Knoll’s implicit taxation regime and Charlene Luke’s comparables test and discuss how each accounts for missing components of the pre-tax profit test, but also how each fails to resolve the problem of taxpayer uncertainty. Finally, in Part IV, borrowing from antitrust and corporate law, I propose a framework for determining objective economic substance that would increase taxpayer certainty while accounting for the weaknesses of the pre-tax profit test.

II. A BRIEF HISTORY OF THE ECONOMIC SUBSTANCE DOCTRINE: JUDGE HAND’S COMPETING CONCERNS

In 1928, certain shareholders of the Monitor Securities Corporation were sitting pretty; Monitor stock had appreciated considerably, and those shareholders who bought low had an opportunity to sell high. United Mortgage Corporation was one such shareholder. Yet its sole owner, Mrs. Gregory, had a problem: if she had United directly sell the shares, United would owe significant taxes on the profits from the sale, and Gregory would be required to pay additional taxes on any dividends United paid to her. Thus, Gregory devised a plan: incorporate a new Delaware corporation, Averill, and have United transfer the Monitor shares to it. Three days later, Gregory liquidated Averill, received the Monitor shares in the liquidation, and promptly sold them. Gregory paid only modest taxes on the sale of the Monitor shares, offsetting her gains by utilizing a special benefit in the tax code for shares that are “distributed, in pursuance of a plan of

29. See supra note 19.
31. Id.
33. Id.
34. Id.
reorganization.”35 The Commissioner objected to Gregory’s characterization of the transaction as a “reorganization,” but the Board of Tax Appeals upheld the tax benefit as deriving from “real” transactions.36 The Second Circuit heard Gregory’s appeal, and writing for the majority, Judge Learned Hand acknowledged the reality of Gregory’s transactions as well as a taxpayer’s right to lower her taxes as much as possible.37 Yet Judge Hand held that a corporate “reorganization” that failed to realize any profit, except “[t]o dodge the shareholders’ taxes,” was inconsistent with the history and purpose of the statute defining the term.38 The Supreme Court affirmed Judge Hand’s opinion, and thus, the ESD was conceived.39

Over the next twenty years, Judge Hand became frustrated with the broad use of purposive statutory interpretation within the ESD as other judges struck down transactions Judge Hand felt had a business purpose.40 For example, Judge Hand chided Judge Arundell and the Supreme Court in an internal memorandum regarding a later tax avoidance case, stating:

I have a feeling in my bones that the Supreme Court would support this tax saying that the transaction was a “sham” and letting it go at that. . . . We shall never get any order in this subject if we rest in the word “sham” or in such meaningless chatter as that of Arundell here.41

Judge Hand understood that purposive statutory interpretation did not adequately balance “the taxpayer’s need for certainty and the self-defeating rationale” of strict reliance on the code.42 That is,

35. Id.
36. Id.
37. Id.
38. Id. at 811.
40. Kolarik & Wlodychak, supra note 6, at 733–35 (describing Judge Hand’s reasoning and opinion in Chisholm v. Comm’r, 79 F.2d 14 (2d Cir. 1935)).
41. Id. at 734 (quoting Learned Hand Memorandum, Hand Papers, File No. 194-10 (on file with the Harvard Law School Library)).
42. Id. at 742.
left unchecked, purposive statutory interpretation could lead to unpredictable, reverse-engineered opinions.\footnote{43}

Thus, dissenting in his final tax avoidance case, Judge Hand proposed an alternative test that avoided purposive statutory interpretation.\footnote{44} In \textit{Gilbert}, a generally unsuccessful company often received additional investments from one of its shareholders (Gilbert), and his wife, “that were structured as loans.”\footnote{45} When the company liquidated, Gilbert and his wife accordingly “claimed bad debt deductions on their 1948 joint income tax return.”\footnote{46} Yet the Tax Court found that the transactions were not “bona fide loans” and, thereby, struck the bad debt deductions.\footnote{47}

On appeal, the majority remanded the case back to the Tax Court to determine whether the investments satisfied the court’s \textit{sua sponte} definition of “debt.”\footnote{48} Judge Hand, however, argued that the term “debt” was clear from precedent.\footnote{49} Thus, instead of resting the case on the meaning of a term, Judge Hand proposed the following question: “When the petitioners decided to make their advances in the form of debts, rather than capital advances, did they suppose that the difference would appreciably affect their beneficial interests in the venture, other than taxwise?”\footnote{50} This question focused the inquiry of the ESD on the economic effects of the transaction, rather than the purpose of the statute providing the tax benefit.\footnote{51}

\begin{itemize}
\item \footnote{43} \textit{Id.}
\item \footnote{44} \textit{Gilbert}, 248 F.2d at 412 (Hand, J., dissenting).
\item \footnote{45} Kolarik & Wlodychak, \textit{supra} note 6, at 736.
\item \footnote{46} \textit{Id.}
\item \footnote{47} \textit{Gilbert}, 248 F.2d at 402.
\item \footnote{48} \textit{Id.} at 406 (requiring that the “funds were advanced with reasonable expectations of repayment” in order to constitute “debt”).
\item \footnote{49} \textit{Id.} at 410–11 (Hand, J., dissenting).
\item \footnote{50} \textit{Id.} at 412 (citations omitted). Kolarik & Wlodychak summarize Judge Hand’s rule as follows: “[W]hen [a] taxpayer could have accomplished the same goals through an alternative transaction, [a] taxpayer must show an ’appreciable economic effect beyond the tax consequences.’” Kolarik & Wlodychak, \textit{supra} note 6, at 749 (quoting \textit{Gilbert}, 248 F.2d at 412 (Hand, J., dissenting)).
\item \footnote{51} Stated another way, Judge Hand’s test presumes that the purpose of any statute providing a tax benefit for a particular transaction is that the transaction have some economic effect outside of the tax benefit.
\end{itemize}
Three years after *Gilbert*, the Supreme Court adopted Judge Hand’s proposal, quoting directly from his dissent.52 Further, in *Knetsch*, the Supreme Court implicitly separated the subjective business purpose and objective economic effects inquiries, applying a rudimentary version of the pre-tax profit test.53 The inquiries would later be formally separated in *Frank Lyon*,54 the last case in which the Supreme Court applied the ESD. This dearth of any word from the Supreme Court, despite clear inconsistencies among the circuit courts, reinforces the difficult task faced by courts applying the ESD. In the end, Judge Hand’s attempt to balance “taxpayer certainty” against a highly deterministic code’s “self-defeating” nature resulted in a test that has focused on the objective economic effects of the transaction.55 In Part III, I articulate the various tests applied by courts and proposed by scholars and analyze whether they adequately accomplish the balance sought by Judge Hand.

III. APPROACHES TO ASSESSING OBJECTIVE ECONOMIC SUBSTANCE

Generally, most courts apply some variation of the pre-tax profit test to assess the objective economic substance of a transaction.56 That said, debates among courts and scholars continue to

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52. *Knetsch* v. United States, 364 U.S. 361, 366 (1960). Quoting Judge Hand in the Court’s holding, Justice Brennan states, “*Knetsch*’s transaction with the insurance company did ‘not appreciably affect his beneficial interest except to reduce his tax.’” *id.*


54. Rice’s Toyota World, Inc. v. Comm’t, 752 F.2d 89, 91 (4th Cir. 1985) (holding that *Frank Lyon* required a “two-pronged inquiry to determine whether a transaction is, for tax purposes, a sham” and that “[t]o treat a transaction as a sham, the court must find [(1)] that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and [(2)] that the transaction has no economic substance because no reasonable possibility of a profit exists”); see Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) (“Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.”). But see Kolarik & Wlodychak, *supra* note 6, at 750 (“*Frank Lyon* is similar to the methodology developed by Judge Hand in *Gilbert* and adopted and extrapolated upon by the . . . Supreme Court in *Knetsch*,” and thus, “[f]rom that perspective, . . . adds little to the evolution of the judicial doctrines that stem from *Gregory*.”).

55. See *supra* text accompanying note 42.

56. See *supra* note 17. The Federal, First, and Second Circuits have facially diverged from solely relying on pre-tax profit, holding that the objective prong determination
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flourish regarding the measurement of pre-tax profit as well as the accuracy of the test based on its underlying assumptions. This has led to taxpayer uncertainty and accusations of reverse-engineered opinions. In response, scholars have proposed variations on, and replacements to, the objective economic substance inquiry—the leading two of which are Knoll’s implicit taxation regime and Luke’s comparables test. As argued below, while both of these proposals account for nuances uncaptured by the pre-tax profit test, both fail to fully consider the effects on taxpayer certainty as emphasized by Judge Hand.

“requires both a calculation of pre-tax profit and a consideration of the transaction’s overall economic effect.” Bank of N.Y. Mellon Corp. v. Comm’r, 801 F.3d 104, 119 (2d Cir. 2015) (“The objective economic substance inquiry . . . does not end at profit, as a legitimate transaction could conceivably lack economic profit. The Supreme Court has indeed cautioned: ‘There is no simple device available to peel away the form of [a] transaction and to reveal its substance.’ A court should also look to the overall economic effect of the transaction in determining objective economic substance. In conducting this inquiry, we agree with the Tax Court that ‘[e]conomic benefits that would result independent of a transaction do not constitute a non-tax benefit for purposes of testing its economic substance.’”) (citations omitted)); Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 23–24 (1st Cir. 2016); Salem Fin., Inc. v. United States, 786 F.3d 932, 950 (Fed. Cir. 2015). Yet it remains unclear what is meant by “overall economic effect” beyond either a pre-tax profit or a subjective business purpose. That is, these circuits point to transactions involving “nascent technologies” as examples of transactions that may lack pre-tax profit but likely have an economic effect beyond tax purposes. See Bank of N.Y. Mellon, 801 F.3d at 119 (quoting Salem Fin., 786 F.3d at 950) (“Transactions involving nascent technologies, for instance, often do not turn a profit in the early years unless tax benefits are accounted for. To brand such transactions as a sham simply because they are unprofitable before tax benefits are taken into account would be contrary to the clear intent of Congress.”). Yet transactions involving “nascent technologies” would likely satisfy the subjective prong of the ESD, examining the “business purpose” of the transaction, and are therefore justified without producing some type of pre-tax profit. That is, I find the “nascent technologies” argument to more significantly weigh for disjunctive, and against conjunctive, versions of the ESD; c.f. discussion of conjunctive/disjunctive debate, supra note 16. Some other circuits have refrained from distinguishing between the objective and subjective prongs of the ESD, asking the general question of “whether the transaction had any practical economic effects other than the creation of income tax losses.” James v. Comm’r, 899 F.2d 905, 908–09 (10th Cir. 1990) (quoting Sochin v. Comm’r, 843 F.2d 351, 354 (9th Cir. 1988)). Yet, in examining the “practical economic effects” of a transaction, these circuits will typically include an examination of either a business purpose or a demonstration of pre-tax profit. See James, 899 F.2d at 907–10; Sochin, 843 F.2d at 353–56. Thus, courts applying the ESD almost universally rely on some version of the pre-tax profit test.

57. See supra notes 18–20.
58. See supra note 21.
59. See supra notes 23–24.
A. The Pre-tax Profit Test

Generally, the pre-tax profit test recognizes that a transaction that results in an appreciable profit to the taxpayer, beyond its tax benefits, has objective economic substance. This test is often criticized for three reasons: (1) it is unclear how pre-tax profit should be measured; (2) it is unclear how much pre-tax profit is necessary to satisfy the test; and (3) it assumes “the economics of a transaction are readily separable from its tax components,” leading to inaccurate conclusions. I describe and address each of these criticisms below.

1. Measuring pre-tax profit

Measuring the pre-tax profit of a transaction is essentially a task of defining transaction boundaries. Courts have generally taken a practical approach to this task, “taking into account factors such as chronology, formal and informal agreements, and relationships among the parties.” If a particular transaction fits relatively well with other sets of transactions that are part of the regular business operations of the company, courts are more likely to link the two. Yet if that particular transaction appears to be simply an unrelated investment, it is unlikely to be linked to any other transaction.

60. There is considerable debate over what constitutes “appreciable,” as described below in criticisms of the pre-tax profit test. See Luke, supra note 22, at 794–96. One articulation was given by the Tax Court, finding a “de minimis gain” insufficient. Sheldon v. Comm’r, 94 T.C. 738, 767 (1990). For a more in-depth discussion, see supra Section III.A.1.

61. See Luke, supra note 22, 793 (“[T]he pre-tax profit viewpoint requires courts to consider not only actual pre-tax profit but pre-tax profit potential.”).

62. See supra note 18.


64. Luke, supra note 22, at 798; see also Knoll, supra note 22, 834–35.

65. See Bankman, supra note 12, 13 (commenting that the broader the boundaries of the transaction, the more likely non-tax attributes will be found within it).

66. See id. at 18–20.

67. Luke, supra note 22, at 806–07 (“Financing and hedging arrangements that are directly implicated by such factors should be considered part of the suspect transaction. Hedging and financing unrelated to the transaction should not be taken into account, although these agreements may well have some bearing on the actual risks and profitability of the suspect transaction.” (footnote omitted)).


69. Id.
Further, there are clear divides regarding what courts are to include in the calculation of pre-tax profit. For example, the Second Circuit recently articulated its split with the Fifth and Eighth Circuits, holding that foreign tax expenses should be included in the pre-tax profit calculation when foreign tax credits are at issue.70 I summarize both Compaq and Bank of New York Mellon, two cases that are representative of this split, below. The debate between these two cases provides a foundation for my proposed framework in Part IV.

In 1992, Compaq sold some of its investment stock, recognizing a significant long-term capital gain of more than $230 million.71 Soon thereafter, Compaq was contacted by Twenty-First Securities Corporation (Twenty-First) with a proposed transaction to offset this gain.72 The proposed transaction was relatively simple: (1) purchase Royal Dutch Petroleum Company (Royal Dutch) American Depository Receipts (ADRs),73 cum dividend;74 (2) collect the dividend; and (3) sell the Royal Dutch ADRs, ex dividend.75 Figure 1 diagrams this transaction.

70. Bank of N.Y. Mellon Corp. v. Comm’r, 801 F.3d 104, 118 (2d Cir. 2015).
71. Compaq Comput. Corp. & Subsidiaries v. Comm’r, 113 T.C. 214, 215 (1999), rev’d, 277 F.3d 778 (5th Cir. 2001). Note that the transaction at issue in this case was substantially similar to that in IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001); therefore, I only present the facts from Compaq.
72. Compaq, 113 T.C. at 215.
73. As explained by the Tax Court, an ADR . . . is a trading unit issued by a trust, which represents ownership of stock in a foreign corporation that is deposited with the trust. ADR’s [sic] are the customary form of trading foreign stocks on U.S. stock exchanges . . . . The ADR transaction involves the purchase of ADR’s “cum dividend”, [sic] followed by the immediate resale of the same ADR’s “ex dividend”. [sic]
74. “‘Cum dividend’ refers to a purchase or sale of . . . an ADR share with the purchaser entitled to a declared dividend.” Id. at 215-16.
75. “‘Ex dividend’ refers to the purchase or sale of . . . an ADR share without the entitlement to a declared dividend.” Id. at 216.
Figure 1. Compaq Royal Dutch ADRs Transaction

Compaq rapidly executed this transaction twenty-three times within approximately one hour. 76 “The aggregate purchase price was” approximately $887.6 million, “cum dividend.” 77 In total, the “blended price per share equaled the actual market price plus the net dividend.” 78 “[T]he aggregate sales price was” approximately $868.4 million, “ex dividend.” 79 Trades were only executed “if the prices . . . were within the range of the current market prices.” 80 The fees for the purchase were approximately $1.5 million. 81 After the sale, Compaq reported a capital loss of $20.7 million. 82 Compaq’s gross dividend was approximately $22.5 million; however, approximately $3.4 million was withheld for Netherlands tax, leaving Compaq with approximately $19.2 million net dividend. 83

76. Id. at 217–18.
77. Id. at 217.
78. Id.
79. Id.
80. Id. at 218.
81. Id.
82. Id. at 219.
Compaq “claimed a foreign tax credit of” approximately $3.4 million "for the income tax withheld and paid to the Netherlands Government.” The Commissioner challenged the availability of the foreign tax credit to Compaq because Compaq failed to demonstrate the underlying transaction had any economic substance. That is, the Commissioner argued that Compaq’s foreign tax expenses should be included in the calculation of its pre-tax profit. Thus, taking the difference between its net dividend and its capital loss under the Commissioner’s view, Compaq had no pre-tax profit and simply suffered a loss of $1.5 million. Compaq responded that its foreign tax expenses should not be included in the calculation of its pre-tax profit. Under such a rule, Compaq’s pre-tax profit would be the difference between its gross dividend and its capital loss, approximately $1.9 million. The Tax Court rejected Compaq’s argument, but the Fifth Circuit reversed, holding that foreign tax expenses should not be included in the pre-tax profit calculation.

Both the Fifth and Eighth Circuits justified this holding under the common law principle that “[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.” That is, the withholding of foreign tax was “no different from an employer withholding and paying to the government income taxes for an employee.” In addition, the Fifth Circuit further reasoned that “[i]f the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction’s net cash flow, tax law effects should be counted when they add to cash flow.” That is, “[t]o be consistent, the analysis should either count all tax law effects or not count any of them.”

84. Compaq, 113 T.C. at 219.
85. See id. at 220.
86. Id. at 222–23.
87. Id.
88. Id. at 221–22.
89. Id.
90. Id. at 222.
93. IES Indus., Inc. v. United States, 253 F.3d 350, 354 (8th Cir. 2001); see Compaq, 277 F.3d at 783.
94. Compaq, 277 F.3d at 785.
95. Id.
Yet, fifteen years later, the Federal, First, and Second Circuits have held—contrary to the Fifth and Eighth Circuits—that foreign tax expenses should be included in the pre-tax profit calculation.96 Before providing the reasoning of these circuits, I summarize the facts involved in the transaction at issue in Bank of New York Mellon.97

In 2001, the Bank of New York Mellon (BNY)98 was contacted by Barclays Bank (Barclays), and entered into a highly complex “Structured Trust Advantaged Repackaged Securities” (STARS) transaction.99 There were essentially five steps to structuring the STARS transaction: (1) “BNY contributed $6.46 billion of assets” to Real Estate Investment Trust (REIT) Holdings; (2) BNY then organized an InvestCo, and REIT Holdings invested the BNY assets as well as additional real estate holdings in exchange for 100% ownership of InvestCo and the InvestCo’s assumption of all REIT Holdings’ liabilities; (3) BNY organized a DelCo and the InvestCo capitalized the DelCo with almost all of the InvestCo’s assets in exchange for preferred shares; (4) BNY then formed a trust, registered in London and managed in New York, that issued four classes of preferred shares and received investments in assets and shares from both the InvestCo and the DelCo; and, finally, (5) BNY organized a NewCo with the InvestCo as its sole owner.100 “In sum, the above steps moved approximately $7.86 billion in net assets into DelCo and the trust.”101

By registering the trust in the United Kingdom instead of the United States, “the trust’s income [was] subject to U.K. taxation.”102 In exchange, “Barclays agreed to pay BNY a monthly amount equal to half of the U.K. taxes BNY expected to pay on the trust’s

96. Bank of N.Y. Mellon Corp. v. Comm’r, 801 F.3d 104, 118 (2d Cir. 2015). The Federal and First Circuits have agreed with the Second Circuit. See Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 19 (1st Cir. 2016); Salem Fin., Inc. v. United States, 786 F.3d 932, 950 (Fed. Cir. 2015).
97. Because all three circuits were dealing with similar STARS transactions, I limit my exposition to simply the facts of Bank of New York Mellon to avoid redundancy.
98. At the time, the Bank of New York Mellon was the Mellon Financial Corporation. Bank of N.Y. Mellon Corp. v. Comm’r, 140 T.C. 15, 16–17 (2013), aff’d, 801 F.3d 104 (2d Cir. 2015).
99. Id.
100. Id. at 18–20.
101. Id. at 20. See Appendix (Diagram A) for a diagram used by the Tax Court to describe the structure of the STARS transaction.
income.” Barclays “purchased shares in the trust . . . for $1.5 billion, effectively making a loan in that amount to BNY for the duration of STARS through the trust structure.” “BNY [would] repay the loan by purchasing Barclays’s trust units for approximately $1.5 billion at the end of five years” with a “monthly interest rate . . . equal to one-month LIBOR plus 30 basis points, minus the aforementioned monthly tax-spread.” As the Second Circuit summarized:

Throughout the five-year duration of the STARS transactions, the trust made monthly distributions of income via a circular, multi-step process. First, BNY distributed funds from its income-earning assets to the trust, and the trust set aside 22% of its income to pay U.K. taxes. With most of the remaining income, the trust made monthly . . . distributions to a Barclays account that was “blocked,” meaning Barclays could not access the funds or control the account. Barclays immediately returned these distributions to the trust each month, and the trust then distributed the funds to BNY, beginning the cycle again.

To clarify this transaction, the Federal Circuit provides the following hypothetical that traces “$100 of trust income through the distribution cycle.”

The Trust income was subject to U.K. taxation at a 22 percent rate. Therefore, $22 for every $100 of Trust income was set aside for payment of the U.K. taxes, leaving the Trust with $78 after the U.K. tax payment. Because of its nominal equity interest in the Trust, Barclays was also taxed on the Trust income under U.K. law at a corporate tax rate of 30 percent, or $30 for every $100 of Trust income. Barclays, however, was able to claim a $22 U.K. tax credit for the $22 of tax paid by the Trust as an “imputation credit” that partially offset the higher corporate tax imposed on the Trust’s distributions. As a result, Barclays effectively paid $8 in U.K. tax.

The Trust distributed the after-tax amount of $78 of Trust income to the Barclays Blocked Account, from which that sum was immediately re-contributed to the Trust. Under U.K. law,
Barclays was able to treat the re-contributed $78 as a “trading loss,” thereby claiming a trading loss deduction. At the 30 percent tax rate, that deduction was worth $23.40. Barclays’ $8 U.K. tax liability was then completely offset by the $23.40 tax deduction, leaving Barclays with a net tax benefit of $15.40.

In the example, the Bx payment that Barclays paid to [the plaintiff], which was predetermined to be equal to 51 percent of the Trust’s U.K. tax payments, would be approximately $11. Barclays would then deduct the $11 Bx payment from its U.K. corporate taxes, which at the 30 percent tax rate yielded another tax benefit worth $3.30. The net benefit to Barclays, for every $100 in Trust income, was thus $7.70, based on U.K. tax credits and deductions . . . .

For its part, [the plaintiff], having paid the $22 U.K. tax on the Trust income, would claim a foreign tax credit of $22 for the entire amount of the Trust’s U.K. taxes. However, having received the $11 Bx payment from Barclays, [the plaintiff] would have a net gain of $11.\textsuperscript{108}

\textit{Figure 2} diagrams this tracing of $100.\textsuperscript{109}

\textsuperscript{108} Salem Fin., Inc. v. United States, 786 F.3d 932, 938 (Fed. Cir. 2015).

\textsuperscript{109} For a more complete discussion with a corresponding diagram of the transaction, see generally Bank of N.Y. Mellon Corp. v. Commissioner, 140 T.C. 15, 18-20 (2013).
Once again, the Commissioner argued that foreign taxes should be included in the calculation of pre-tax profit, and the Tax Court accepted this argument, despite the Fifth and Eighth Circuits’ holdings. Applying the hypothetical above, “for every $100 of trust income, [BNY] incurred $22 of foreign tax expense and only $11 in income,” resulting in “an $11 net loss” and, therefore, a pre-tax loss. BNY appealed, arguing that the Second Circuit should adopt the holding of the Fifth and Eighth Circuits and exclude foreign tax expenses from the pre-tax profit calculation. Doing otherwise, BNY argued, would “fictionalize[] the transactions, including the costs . . . but not the corresponding income.” Yet the Second Circuit rejected BNY’s argument and affirmed the holding of the Tax Court for two reasons. First, relying on the Tax Court’s analysis, the Second Circuit considered foreign taxes to be “the same as any other transaction cost.” Second, “excluding the

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110. Id. at 35 n.9.
112. Id. at 118.
113. Id.
114. Id. at 121–22.
115. Id. at 117 (citation omitted).
economic effect of foreign taxes from the pre-tax analysis would fundamentally undermine the point of the economic substance inquiry,” namely “to remove the challenged tax benefit and evaluate whether the relevant transaction makes economic sense.”116

The Federal Circuit also heavily criticized the holding of the Fifth Circuit in Compaq, claiming the ADR “transactions [at issue in that case] produced no real economic profit.”117

[T]he fact that the transactions produced a net gain to the taxpayer after taking both the foreign taxes and the foreign tax credit into account says nothing about the economic reality of the transactions, because all tax shelter transactions produce a gain for the taxpayer after the tax effects are taken into account— that is why taxpayers are willing to enter into them and to pay substantial fees to the promoters. The critical question is not whether the transaction would produce a net gain after all tax effects are taken into consideration; instead, the pertinent question[] is whether the transaction has real economic effects apart from its tax effects . . . .118

Thus, this circuit split regarding the inclusion of foreign tax expenses within the pre-tax profit calculation turns on one’s view of the purpose of the pre-tax profit test. Inclusion is disfavored because the test would no longer be “pre-tax.” Yet exclusion is disfavored because the test examines the profit after the foreign tax credit, the tax benefit in question, has been applied.

In Part IV, I explain how my proposed framework for analyzing objective economic substance readily accounts for both views by handling the inclusion of foreign taxes differently at different stages of the analysis. For now, I discuss this circuit split simply as an example of a significant difference in the measurement of pre-tax profit by different courts. This difference has led to taxpayer uncertainty and accusations of reverse-engineered opinions.119

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116. Id. (citation omitted).
117. Salem Fin., Inc. v. United States, 786 F.3d 932, 948 (Fed. Cir. 2015). Note that the First Circuit did not dwell on the arguments relating to the inclusion of foreign tax expenses, except in the sense they clarified that Old Colony did not involve foreign taxes. See Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 24 n.11 (1st Cir. 2016).
118. Salem Fin., 786 F.3d at 948 (footnote omitted).
119. See, e.g., Cummings, supra note 13, at 1295; Lipton, supra note 18, at 32.
2. How much pre-tax profit?

A second area of dispute regards how much pre-tax profit is necessary to satisfy the pre-tax profit test. Luke presents, and criticizes, the two major approaches courts take to answering this question. I briefly respond to each of her criticisms below, arguing that they should not dissuade the use of at least a preliminary pre-tax profit test.

The first approach taken by courts does not stipulate a particular level of pre-tax profit but simply requires “that the expected pre-tax profit bear a reasonable relationship to the expected tax benefits.” In other words, the pre-tax profit cannot be “infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions.” Luke criticizes this standard for two reasons.

First, Luke claims this standard invites the court to examine “the taxpayer’s subjective motive” and “speculat[e] about contingencies.” Specifically, Luke argues that comparing pre-tax profit with tax benefits will provide courts more leeway “to ensure a fair result given the implication of . . . moral turpitude attach[ed] to the taxpayer’s conduct when the tax shelter label is applied.”

Yet Luke’s criticism applies to any generally non-precise rule; moreover, her proposed comparables test is likely subject to the same critique. That is, while it is certainly true that consideration of the “moral turpitude” of the “tax shelter label” may color a court’s analysis of whether a sufficiently reasonable relationship exists between the amount of pre-tax profit and the amount of tax benefits, it is unclear whether this danger of subjectivity outweighs the desirable leeway given to courts to efficiently engage in the pre-tax profit analysis.

120. See Luke, supra note 22, at 795–97; see also Bankman, supra note 12, at 23–26.
122. Id. at 795 (citing Rice’s Toyota World, Inc. v. Comm’r, 752 F.2d 89, 94 (4th Cir. 1985)).
125. Id. at 796.
126. Id. (footnote omitted).
127. See infra Section III.C.
Second, Luke argues that this proposal’s “comparison of pre-tax profit to tax benefits introduces a new avenue for speculation—expected net tax benefits.”128 Without guidance on making this comparison, Luke argues it is unclear how a court should respond to taxpayers’ claims “that they reasonably anticipated much lower tax benefits.”129 Yet the fact that courts have historically not examined expected net tax benefits does not necessarily imply that courts cannot handle such arguments. Further, given that courts already separately calculate expected pre-tax profit from expected after-tax profit, it is likely that a calculation of expected net tax benefits would be nothing more than the difference between the expected after-tax profit and the expected pre-tax profit.

The second approach Luke criticizes suggests “that the reasonably anticipated pre-tax profit exceed some minimum amount—generally, the rate on no- or low-risk investments.”130 For example, courts could use “Treasury bills and notes” to “establish[] the required pretax rate of return.”131 Luke criticizes this proposal for two reasons.132

First, Luke claims that such a standard “could cause taxpayers inefficiently to take on extra risk in order to ensure that the return on a transaction clears the minimum profit potential hurdle.”133 Yet any profit-related transaction involves risk, especially if it involves questionable tax planning. Thus, Luke is essentially arguing that the possibility of increased risk should deter us from adopting a clear rule, without explaining the likelihood of such increased risk or how much of an increase would actually take place. Without such a demonstration, her criticism loses its teeth.

Second, Luke claims that “sophisticated taxpayers would still find it easy to add pre-tax profit to a particular transaction and ‘then hedge out of the associated risks in ways that could not readily be identified,’” causing the requirement to become essentially

129. Id.
130. Id. at 795 (citing Bankman, supra note 12, at 24–25).
133. Id.
trivial. Yet it is likely such hedging would be traceable, as it would require the taxpayer to “contribute enough net equity to assure [sic] that there will be significant net profit.” If a court observed such a large contribution within the transaction, they would likely be able to exclude it from the boundaries of the transaction subject to the pre-tax profit calculation.

In total, Luke’s criticisms of methods for determining the level of pre-tax profit should not entirely dissuade courts from using this test. In their analysis, rather, courts could simply use “Treasury bills and notes” to “establish[] the required pretax rate of return.” With significantly little risk and highly public rates of return, such investments provide a clear standard for tax planners.

3. Readily separable economics assumption

The main criticism of the pre-tax profit test is aimed at the test’s “assumption that the economics of a transaction are readily separable from its tax components.” According to Luke, this assumption relies on “the intuition that financial assets and transactions are priced without regard to individual tax consequences” and “runs counter to principles of tax capitalization and efficient markets.” Essentially, examining pre-tax profit without accounting for implicit taxation will likely lead to inaccurate results because an implicit tax or subsidy may be embedded within the costs of a transaction.

To fully understand this criticism, consider the following hypothetical Knoll presents to introduce the concept of implicit taxation:

Consider a taxpayer who holds a (riskless) zero-coupon corporate bond that she purchases for $1000 and that pays $1100 at maturity in exactly one year. The interest on such a bond is included by the taxpayer in her income. Thus, if a taxpayer purchases for $1000 a corporate bond that pays $1100 at maturity, the taxpayer includes

134. Id. at 797 (footnote omitted) (quoting David P. Hariton, When and How Should the Economic Substance Doctrine Be Applied?, 60 TAX LAW REV. 29, 49 (2006)).
137. See id.
139. Id. at 799.
140. See Knoll, supra note 22, at 838.
$100 interest in her income. If she is taxed at 40 percent, she pays $40 in tax and is left with $1060 after tax. Such a taxpayer earns 10 percent interest before tax and 6 percent interest after tax on her investment. Alternatively, if the taxpayer purchases a municipal bond, [the tax code provides that] she does not have to include the interest she receives in income. If such a bond has the same terms (and is also risk free), the taxpayer receives $1100, pays no tax and so ends up with $1100, which is $40 more than she has with the corporate bond. Expressed differently, she receives 10 percent both before tax and after tax with the municipal bond compared to 10 percent before tax and 6 percent after tax with the corporate bond. Thus, if both investments are available to the taxpayer, the taxpayer will prefer the municipal bond.

Of course, other taxpayers will also prefer the municipal bond to the corporate bond. As long as the terms were the same, no taxpayers (with positive tax rates) will want to hold corporate bonds. All will prefer to hold municipal bonds. Thus, we can expect competition among investors and issuers to drive down the interest rate on municipal bonds and drive up the interest rate on corporate bonds. To keep things simple, assume that there is an elastic supply of corporate bonds that pay 10 percent interest (so a decline in demand will not increase their interest rate) and a small and not as elastic supply of municipal bonds. Taxpayers will therefore bid down the interest rate on municipal bonds to 6 percent. At this point, taxpayers in the 40 percent bracket will be indifferent between the two bonds.

Economists use the phrase “implicit tax” to refer to the reduction in the return from holding a tax favored investment. 141

Knoll describes three equivalent methods “to quantify the implicit tax on the municipal bond” in the example above. 142 For simplicity, I provide only the second and third methods:

[T]he implicit tax can be described as the decrease in the payment on the municipal bond at maturity assuming that the municipal bond and the otherwise identical corporate bond cost the same $1000 at issuance. Such a municipal bond will pay $1060 at maturity. Viewed in this manner, the implicit tax is $40. . . . [T]he implicit tax can [also] be described as a reduction in the interest

141. Id. at 833 (footnotes omitted).
142. Id.
rate paid by the municipal bond. Viewed in this way, the implicit tax is a 4 percent reduction in the interest rate, from 10 percent down to 6 percent.\textsuperscript{143}

Thus, without accounting for the implicit taxes or subsidies in a transaction, a calculation of pre-tax profit is likely inaccurate.\textsuperscript{144} That is, without taking into account implicit taxation, the pre-tax profit on the municipal bond in the example above appears equal to that of the corporate bond; yet, after implicit taxes are considered, the municipal bond has a significantly higher return.\textsuperscript{145}

Unlike the criticisms presented by Luke, Knoll’s criticism regarding the measurement of pre-tax profit causes serious reflection. If the straightforward pre-tax profit test inaccurately

\textsuperscript{143}. \textit{Id.} at 834 (footnotes omitted). The first method describes the implicit tax “as the increase in the issue price of the municipal bond, assuming that the municipal bond and the otherwise identical corporate bond pay the same $1100 at maturity.” \textit{Id}. Knoll explains that “[s]uch a municipal bond will cost $1037.74” and that “[v]iewed in this manner, the implicit tax is $37.74.” \textit{Id}. Knoll arrives at these results through the following calculation:

The issue price of a one-year differentially taxed bond, \( P \), is given by the equation:

\[ P = \frac{M (1 - t)}{(1 + r - t)} \]

where \( M \) is the payment at maturity, \( r \) is the after-tax interest rate of the marginal taxpayer (that is to say, the taxpayer who sets the market price of the differentially taxed bond), and \( t \) is the effective tax rate paid by the marginal taxpayer on such a bond. In this example, \( M \) is set at $1100 and \( r \) is 6 percent. For the municipal bond, \( t \) is 0. Accordingly, the issue price of the municipal bond, \( P \), is given by the equation, \( P = \frac{1100}{1.06} \). Thus, $1037.74 \( P \) = $1100/1.06. At an issue price of $1037.74, a holder of a municipal bond earns 6 percent interest after tax. That is to say, $1037.74 \times 1.06 = $1100.

\textit{Id.} at 834 n.53.

\textsuperscript{144}. See \textit{id.} at 838.

\textsuperscript{145}. See \textit{id.} at 833. Knoll provides another example of this miscalculation of pre-tax profit in his discussion of Compaq. See infra Section III.B. In addition, Luke provides an example of the non-equivalence of pre-tax profit calculations that include and exclude implicit taxation:

[\textit{C}onsider a hypothetical bond that is more highly taxed relative to the 10% yield, risk-adjusted benchmark. Assume that the marginal investor is a 30% bracket taxpayer and that a 10% tax surcharge is imposed on the highly taxed bond. For this investor, the after-tax return on the benchmark asset is 7%. In order to obtain the same after-tax yield on the highly taxed bond, the bond would need to yield 11 2/3% -- an implicit tax subsidy of 1 2/3%. If both implicit and explicit taxes are taken into account, the pre-tax yield on the highly taxed bond is 10%. The clientele for transactions or assets carrying implicit tax subsidies will be taxpayers with lower tax brackets than the marginal investors. For example, a 25% bracket taxpayer would earn slightly more on the highly taxed bond than she would on the benchmark. If investing $100, a 25% bracket taxpayer would earn $7.50 after-tax on the benchmark asset and $7.58 (rounded) on the bond carrying the 10% tax surcharge.]

Luke, supra note 22, at 802 (footnotes omitted).
accounts for the profitability of transactions, it loses considerable justification for its application. That said, as proposed in Part IV, I believe this situational inaccuracy fails to warrant discarding the pre-tax profit test. Rather, the pre-tax profit test may be used as a constrained screening mechanism for determining whether further examination of the implicit taxation of the transaction is necessary.

Before suggesting my framework, I discuss Knoll’s proposed implicit taxation regime and Luke’s proposed comparables test as well as the application of each proposal to Compaq. As argued below, because these tests require increased litigation costs, but fail to resolve the problem of taxpayer certainty, I do not believe they should be adopted on their own.

B. Knoll’s Implicit Taxation Regime

Knoll’s proposal is relatively simple: “assess[] pre-tax profit before implicit taxes” to increase the accuracy of the pre-tax profit test. Yet, as explained below, because implicit taxes remain difficult to determine and require a significant market analysis, Knoll’s proposal will likely increase litigation costs without a guaranteed increase in taxpayer certainty. Before demonstrating this result, I summarize Knoll’s application of his implicit taxation regime to Compaq.

Knoll would have affirmed the Tax Court’s finding that Compaq did not have a pre-tax profit, basing his result on an implicit tax analysis rather than a rule that simply included foreign tax expenses. That is, Knoll contends that “Compaq did not pay $887.5 million before tax.” Rather, this price takes into account a “negative implicit tax (implicit subsidy) paid by Compaq that is a direct result of the [Dutch] withholding tax.”

The withholding tax suppressed the cum dividend price of Compaq’s [Royal Dutch] stock by $3.4 million—the amount that Shell subsequently withheld and paid over to the Dutch taxing authorities on Compaq’s behalf. Thus, the amount paid by

146. Knoll, supra note 22, at 843–45.
147. See id. at 839–42.
148. See id.
149. Id. at 839.
150. Id.
Compaq before all taxes (including implicit and explicit taxes, whether positive or negative) for its [Royal Dutch] stock was $890.9 million. Thus, Compaq’s before-tax cost, including expenses ($1.4 million), was $892.3 million. That exceeded its before-tax proceeds of $890.9 million by $1.5 million. Thus, when proper account is taken of implicit taxes, the transactions produced a pre-tax loss, not a pre-tax gain.\textsuperscript{151}

In total, when the Royal Dutch ADRs “went from trading \textit{cum} dividend to \textit{ex} dividend, it also went from trading \textit{cum} withholding tax liability to trading \textit{ex} withholding tax liability.”\textsuperscript{152} To demonstrate this difference was actually included in the price of the ADRs, Knoll analyzes the composition of the market.\textsuperscript{153}

If the market for the [Royal Dutch] ADRs contained many investors who could use the full foreign tax credit, then the market would value the dividend at its gross amount and the price of the stock would have dropped when the stock went \textit{ex} dividend by the gross dividend. Alternatively, if the market contained few investors who could use the foreign tax credit in whole or part, then the market would have valued the dividend at its net amount and the price of the stock would have dropped when it went \textit{ex} dividend by the amount of the net dividend. Moreover, such a tax would have reduced the sale price of the stock before the stock went \textit{ex} dividend by the present value of withholding tax.\textsuperscript{154}

Because “the actual market for [Royal Dutch] ADRs in 1992 was composed of both types of investors,” and “evidence from the market suggests that the investors who paid the Dutch withholding tax, but did not receive any benefit from the tax[,] set the price of [Royal Dutch] ADRs,” Knoll concludes that the price of the ADRs

\textsuperscript{151} Id. (footnote omitted). See Appendix (Diagram B) for a table provided by Knoll, summarizing his result.
\textsuperscript{152} Id. at 841.
\textsuperscript{153} Id. (“For holders of [Royal Dutch] stock who could use the full foreign tax credit and had no problem with the embedded capital loss (because they had capital gains that the losses could offset), the Dutch withholding tax was not detrimental. For such taxpayers, the Dutch withholding tax was offset by a dollar-for-dollar reduction in the tax paid to the U.S. government. Accordingly, such taxpayers valued the dividend at its gross amount. Conversely, for taxpayers who could not make any use of the foreign tax credit, the Dutch withholding tax was a detriment to the full extent of the tax. Accordingly, such taxpayers valued the dividend at its net amount.”).
\textsuperscript{154} Id.
should have only dropped by the net dividend, not the whole dividend. In other words, because the Netherlands tax rate was 15%, the purchase price of the ADRs would have been “equal to market price plus 85% of the gross dividend,” because “the seller was unable to use the U.S. foreign tax credit to offset the Netherlands withholding tax.” Thus, engaging in a sophisticated market analysis, Knoll concludes that because the transaction at issue in Compaq was subject to an implicit subsidy—and therefore, the sale price of the ADRs should have been the net dividend, not the gross dividend—the transaction should have failed the pre-tax profit test.

While Knoll’s implicit taxation regime would theoretically increase the accuracy of the pre-tax profit test, it sacrifices precision and increases litigation costs. That is, the pre-tax profit test utilizes clear boundaries between tax expenses and benefits and the ordinary costs of a transaction. In contrast, Knoll’s implicit taxation regime requires a sophisticated market analysis that requires aggregating behavior among similarly situated taxpayers engaging in similar transactions. This increases the variables within a court’s ESD analysis and, given the probable lack of institutional competence regarding implicit taxation, would lead to greater taxpayer uncertainty and accusations of reverse-engineered opinions.

155. Id. at 842 (“It might . . . be thought that the market represented an average or midpoint of those investors. Equilibrium, however, in financial markets is determined not by the average, but by the marginal, investor. Because most investors likely would have received either no value or full value on the foreign tax credit, one or the other group of investors likely determined the market price for Shell ADRs when Compaq entered the market in 1992. Moreover, evidence from the market suggests that the investors who paid the Dutch withholding tax, but did not receive any benefit from that tax set the price of Shell ADRs. That is to say, at the margin, prices were set by investors who could not use the withholding tax to offset other taxes. When the Shell ADRs went from trading cum dividend to ex dividend, their price dropped not by the gross dividend, but by the net dividend. The price dropped by only the net dividend because the withholding tax had already depressed the cum dividend price of the ADRs by the (expected present value) of the withholding tax.” (footnote omitted)). Note that Knoll does not provide any citation for his evidence regarding the market for Royal Dutch ADRs. See id.


157. Knoll, supra note 22, at 842.

158. See Bankman, supra note 12, at 15.

159. See Knoll, supra note 22, at 841–42.

160. See id. at 846–47.
C. Luke’s Comparables Test

Generally, Luke’s comparables test asks whether a “suspect transaction yields a return that is substantially similar to [that of a] comparable [legitimate] transaction”; if so, the taxpayer satisfies the objective ESD inquiry. As will be argued below, while this analysis avoids the problematic “assumption that the economics of a transaction are readily separable from its tax components,” it significantly increases the variables involved in the ESD analysis, increasing litigation costs and taxpayer uncertainty. In the end, courts will be forced to choose between the competing parties’ proposed comparables—causing the inquiry to follow a path similar to Seventh Amendment jury or judge cases.

Luke’s comparables analysis approaches any suspect transaction by first applying the four-step comparables test: (1) define the boundaries of the transaction at issue; (2) identify a set of “market comparables” and an “economically equivalent” transaction; (3) calculate the after-tax return on both the transaction at issue and its comparable; and (4) determine whether the after-tax returns are “substantially similar.” If the after-tax returns are similar, then the transaction presumably satisfies the ESD. Yet, should the after-tax returns be sufficiently dissimilar, the presumption that the transaction at issue violates the ESD may be rebutted.

161. Luke, supra note 22, at 805. The test relies on the “‘law of one price’—the idea ‘that if two assets are equivalent in all economically relevant respects, then they should have the same market price.’” Id. at 804 (quoting ZVI BOJIE ET AL., INVESTMENTS 349 (6th ed. 2005)). This law applies “only if the two assets are compared (1) before all taxes, including implicit taxes and implicit tax subsidies, or (2) after all taxes as measured from the viewpoint of the price-setting investors—that is, the marginal investors.” Id. Luke opts for the “after all taxes” option as it already “takes into account implicit taxes and subsidies.” Id.

162. Id. at 798.

163. That is, judges would be presented with a number of proposed comparable transactions and, in attempting to make sense of them, would likely choose the one that was argued best by the parties. See generally STEPHEN C. YEAZELL, CIVIL PROCEDURE 608–13 (8th ed. 2012) (discussing the “historical test” applied to new claims and new procedures, which requires locating a historically analogous claim and asking whether it is the kind of claim that would have had a judge or jury decide the case).

164. Note that, in actuality, steps (1), (2), and (3) would not be separated by a court when engaging in their inquiry. Thus, a court could potentially reverse-engineer their choice between “market comparables” if they knew that one set had a typically lower rate of return than the other.


166. Id. at 802.
by demonstrating the taxpayer belongs to a “naturally occurring tax clientele.” As a catch-all, if no “market comparables” are available to adequately assess the similarity between the after-tax returns, then the court should engage in a pseudo-comparables test and a multi-factor, open-ended analysis of the transaction.

In defining the boundaries of a transaction, Luke would consider the same factors utilized by the pre-tax profit test. To identify “market comparables,” however, the transaction at issue and its comparable must (1) belong to a “reasonably efficient” market which (2) has “reasonably accessible” information available about it. These conditions are required because (1) “in order to exploit the identity of returns on economically equivalent transactions or assets, the market must be relatively well functioning”; and (2) “in order to make the comparison, sufficient access to information about the market must be available.”

After defining the boundaries of the transaction at issue and identifying a set of “market comparables,” Luke’s analysis then requires identifying “economically equivalent” transactions. As Luke explains:

Economic equivalence would be determined by matching up factors that contribute to expected and actual rates of return. The precise identity and weight of the factors that contribute to return variance is the subject of much ongoing scholarship, potentially making economic equivalence seem a problematic method to deny tax benefits. In spite of similar concerns, however, controversial economic models are routinely used in the financial world, for example, in rating portfolio manager performance. In addition, the universe of comparables for a transaction suspected of being a tax shelter may frequently look most similar to the low-risk world of simple debt transactions (with perhaps some remote opportunity of an equity-type gain at the end, included in order to confuse courts). The factors that determine interest rates on simple debt are not especially complicated or controversial (e.g.,

167. Id. at 803.
168. Id.
169. Id. at 806–07; see supra Section III.A.1.
170. Luke, supra note 22, at 809–10. Luke does not provide detail as to the scope of such a category of transactions and whether it would contain significantly more than the market for “safe” comparables.
171. Id. at 809.
loan term, credit considerations, market interest rates, and inflationary expectations), and public information about interest rates is readily available. Even when dealing with more complex debt securities, the factors that contribute to variance in yield to maturity are fairly well settled.172

After identifying any “economically equivalent” transactions, one calculates the after-tax profit of the suspect transaction and the “economically equivalent” transaction173 and determines whether they are substantially similar. If the after-tax returns are not “substantially similar,” then the transaction is presumed to fail the ESD.174

Luke does not explain how dissimilar the returns of the compared transactions must be in order for the transaction at issue to fail her comparables test, but she does provide an example in which a difference of approximately 6% is sufficiently dissimilar.175 Thus, Luke’s criticisms regarding the level of pre-tax profit necessary to satisfy the pre-tax profit test176 may be equally applied to her own comparables test. That is, when comparing the after-tax returns of transactions, it is unclear (1) how much higher an after-tax return must be to no longer be “substantially similar” and (2) whether a taxpayer, with knowledge of the sufficient difference in rates, may structure her transaction to achieve this rate and trivially satisfy the ESD.177

The underlying rationale for Luke’s comparables test is that “a rational taxpayer would not bother with a tax shelter earning an after-tax return that is no better than that available on an economically equivalent market transaction.”178 Yet, as Luke acknowledges, certain tax clienteles may obtain a “higher-than-market return” simply because “of the progressive rate bracket system.”179 Thus, Luke

172. Id. at 809–10 (footnotes omitted).
173. Luke provides an extensive discussion of how after-tax profit would be calculated. See id. at 807–09. Due to limitations on the scope of this Comment, this discussion is omitted.
174. Id.
175. See infra discussion of Luke’s application of her comparables test to Compaq.
176. See supra Section III.A.1.
177. For example, a taxpayer may purposely decrease her revenue in certain areas of the transaction so that she achieves a comparable rate of return when including the tax benefit.
179. Id. at 810.
permits the presumption against a transaction that fails her comparables test to be rebutted by demonstrating that “the high return arose as a result of a ‘naturally occurring’ tax bracket differential.” This demonstration “would require an examination of the tax profiles of the counterparties in the transaction” as well as whether the difference in tax profiles “was pre-engineered in some way.” As will be discussed below, the determination of whether a taxpayer belongs to a “naturally occurring” tax bracket differential is subject to general fairness factors.

Luke also acknowledges that there will be situations in which “market comparables” are unavailable and a pseudo-comparables test becomes more appropriate; for example, her test is entirely inapplicable to “home-grown” tax shelters. In these situations, Luke recommends that courts engage in an “open-ended inquiry” that begins with an examination of the “suggested comparables” and a determination of whether “the claimed benefits arose in an economically meaningful way.” That is, while “the suggested comparables would already have been determined by the court to be unsuitable for the purpose of applying the presumption of the comparables test, they may still provide some indication of the likelihood that the claimed benefits arose in an economically meaningful way.”

In addition to this pseudo-comparables test, a court would also consider “the factors that would go into determining price as between parties operating at arm’s length.”

Other relevant evidence would include: the presence of nontax, market frictions or asymmetries; the ease with which other

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180. Id.
181. Id. at 810–11.
182. See infra discussion of Luke’s application of her comparables test to Compaq.
183. See Luke, supra note 22, at 807, 811–12. Luke comments that “home-grown” tax shelters evade the grasp of the pre-tax profit test. Id. at 807. We assume Luke’s argument is that, because it is difficult to define transaction boundaries of “home-grown” tax shelters, the pre-tax profit test won’t be able to find its start. Yet, assuming some boundaries of the transaction could be defined, it is likely that the pre-tax profit test would have a better chance of addressing “home-grown” tax shelters than her comparables test because one wouldn’t also be required to find a market comparable to assess the transaction.
184. Id. at 811.
185. Id.
186. Id.
taxpayers could have entered into the transaction; the presence or absence of a known tax-shelter promoter; the degree of dependence of the after-tax return on particular tax attributes of the taxpayer or counterparty; the timing and circumstances surrounding the creation of those tax attributes; the degree of leverage and the taxpayer’s out-of-pocket investment; the level of transaction risk; and the pre-tax profit potential.\textsuperscript{187}

Luke applies her comparables analysis to Compaq and, like Knoll, would affirm the Tax Court, holding that the transaction at issue violated the ESD.\textsuperscript{188} Making no alteration to the defined transaction, Luke calculates Compaq’s after-tax rate of return at 9%.\textsuperscript{189} Next, Luke suggests that the “economically equivalent market comparable” of the transaction at issue in Compaq is “a collateralized, short-term loan to [the seller]—or, in more technical terms, . . . a reverse repurchase agreement (reverse repo).”\textsuperscript{190} In determining this “market comparable,” Luke notes because the only risks of the transaction “were the extraordinarily remote possibility that an unrelated third party would break up the cross-sales [or] that [the seller] would default on its obligation to repurchase,” they could be “safely ignored when approaching

\textsuperscript{187} Id. at 812.
\textsuperscript{188} Id. at 821–22 (citing Knoll, supra note 22, at 839).
\textsuperscript{189} Id. at 822 (“Compaq reported a $20.7 million capital loss, which at a uniform 34% rate would yield $7 million of tax savings. Although Compaq would have to pay tax of $7.7 million to the U.S. government and $3.4 million to the Netherlands on the gross dividend of $22.5 million, it would receive a $3.4 million foreign tax credit for the taxes paid to the Netherlands. Thus, the total post-tax return amount was $1.1 million. Compaq only invested $20.7 million (at most) of its own money. While it may seem appropriate to compute the rate of post-tax return on this amount, in order to make a rate comparison between Compaq’s suspect transaction and economically equivalent transactions, the investment base should be the $887.6 million ADR purchase price (even though most of this was borrowed). With the larger base, the total after-tax return is approximately 0.124%, but this is the return over a five-day period. If Compaq continued to earn the same rate over a year-long period, the annual return would have been approximately 9%.” (footnotes omitted)).
\textsuperscript{190} Id. at 823 (“In a reverse repo, a buyer/lender purchases securities for cash from a seller/borrower. The parties agree that at the end of some stated time period—a matter of days or weeks—the seller/borrower will buy the securities back from the original buyer/lender at a set price reflecting an interest component (the repo rate). Reverse repos carry some risk of default, which increases with the length of time the transaction is held open. The value of collateral mitigates this risk and affects the overall return.” (footnotes omitted)).
the problem of locating an economically equivalent market comparable.”

With a “market comparable” in hand, Luke then determines that the typical rate of return of a “reverse repo” is somewhere between approximately 2.02% and 2.16%. Because, in Luke’s view, this rate is not substantially similar to a return of 9%, the transaction presumptively fails the ESD.

With a presumption of no economic substance established, the burden shifts onto Compaq to demonstrate that their high rate of return “was the result of Compaq being a member of a naturally occurring tax clientele for these ADRs.” Relying on a discussion by Professors Klein and Stark, Luke believes that Compaq would be unable to make such a demonstration. That is, “the rule at issue in Compaq was one tied to the arbitrary decision to tax dividends to the owner on the record date.” Thus,

[the Compaq arbitrage opportunity seems to have arisen because the two parties valued the dividend differently. . . . Indeed, any investor subject to any tax rate should find the Compaq transaction attractive, as long as it is allowed to deduct the capital loss that arises from the sale of the stock ex-dividend.]

Luke further points to the following “factors weighing against the possibility” that Compaq belonged to a “naturally occurring” tax clientele: “the prearranged nature of the Compaq transaction[;] the ‘purchase’ of the transaction through a tax shelter promoter”; “the use of one of the promoter’s clients as the counterparty”; and

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191. Id.
192. Id. at 823–24 (“Treasury securities are commonly used as collateral, and data on repo rates for non-treasury securities is difficult to obtain. One substitute is the ‘general collateral rate,’ which is the term used for the highest repo rate available at a particular time on treasuries. ‘The overnight general collateral rate is commonly near the federal funds rate.’ For the time period at issue in Compaq, the overnight federal funds rate was an annualized return of between 3.07% and 3.28%. Applying a 34% tax rate would give a range of 2.02% to 2.16%. The five-day term would increase the return, but it is doubtful that any increase would bring it into substantial proximity to Compaq’s annualized 9% after-tax return.” (footnotes omitted)).
193. Id. at 824.
194. Id.
195. Id.
196. Id.
197. Id. (citation omitted).
“[t]he preciseness of the match” between Compaq’s payment price and the ADR market price plus net dividend.\textsuperscript{198}

Luke notes that, “[o]f course, Compaq did not know that the counterparty would be the same on both the purchase and the resale of the ADRs, and it may not have viewed the transaction as in substance a ‘reverse repurchase agreement.’”\textsuperscript{199} Yet she claims that Compaq’s ignorance of the substance of the transaction “points more toward failure of objective economic substance than otherwise.”\textsuperscript{200} That is, “[a]t a minimum, Compaq certainly knew it had left the details of the transaction in the hands of a promoter of tax avoidance shelters.”\textsuperscript{201} Thus, the transaction at issue in \textit{Compaq} fails Luke’s comparables test, and thereby violates the ESD, because it has a rate of return that is not substantially similar to that of a “reverse repo,” and Compaq did not belong to a “naturally occurring” tax clientele.

While Luke’s comparables analysis avoids the problematic “assumption [of the pre-tax profit test] that the economics of a transaction are readily separable from its tax components,”\textsuperscript{202} it significantly increases tax-planning and litigation costs and taxpayer uncertainty. First, tax-planning costs would increase because not only would parties be required to investigate the market of their own transaction, as in \textit{Knoll}’s implicit taxation regime, but they would also be required to scour the sea of potential “comparable” transactions as well as determine whether the market of their own transaction was “reasonably efficient” with “reasonably accessible” information available about it. Likewise, litigation costs would increase substantially, as parties would need to spend significant amounts of ink distinguishing and comparing various transactions.

This increase in litigation would likely lead to taxpayer uncertainty and accusations of reverse-engineered decisions. Taxpayers would find themselves in a situation similar to litigants in Seventh Amendment judge or jury cases, proposing flower

\begin{flushright}
198. \textit{Id.} at 824–25.
199. \textit{Id.} at 825.
200. \textit{Id.}
201. \textit{Id.}
202. \textit{Id.} at 798.
\end{flushright}
transactions that match their own in a garden of weeds. Further, given the likelihood that suspect transactions examined by the ESD are arranged by a third-party “tax shelter promoter” and are thus likely “home-grown,” it is difficult to predict the likelihood that Luke’s comparables test will even be applicable to those transactions that raise questions of economic substance.

Where no “market comparable” exists, Luke provides no reason to believe her pseudo-comparables test will be reliable. Likewise, leaving the inquiry open to a multi-factored, “open-ended” analysis provides no constraints on courts from engaging in reverse-engineered decision-making.

In the end, Luke’s attempt to avoid the problematic “assumption that the economics of a transaction are readily separable from its tax components” leads to significantly increased tax planning costs, litigation costs, and taxpayer uncertainty. Likewise, while not to the same extent, Knoll’s implicit taxation regime would likely increase litigation costs without increasing taxpayer certainty. To resolve these concerns, I propose an alternative three-stage analysis, borrowing from antitrust law. It reduces litigation costs by preserving the level of taxpayer certainty that comes with a straightforward pre-tax profit test while accounting for the test’s accuracy problems for special cases.

IV. PRE-TAX PROFIT AS A PER SE RULE: AN ANTITRUST ANALOGY

My proposal begins by attempting to resolve the circuit split regarding the inclusion of foreign tax expenses. Borrowing from antitrust law, I suggest a three-stage analysis that distinguishes the analysis required for per se valid, and per se invalid, transactions from those that require an increased level of scrutiny. This

203. The Seventh Amendment cases apply a historical analysis of whether a jury would have been used for the type of issue before the court when the Constitution was drafted. See generally YEAZELL, supra note 163, at 608–13.

204. See supra note 12 (listing tax cases where a third-party promoter is involved).

205. That is, the pseudo-comparables test rests on the assumptions of a “reasonably efficient” market with “reasonably accessible” information about it, which increase the reliability of the comparables test. See supra text accompanying note 170.


207. See supra Section III.A.1.
proposed test may be generalized to address all transactions subject to the ESD.

The dispute in the circuit split cases described above is whether foreign tax expenses should be included in the pre-tax profit calculation. As mentioned above, the resolution of this dispute rests on one’s view of the pre-tax profit test; namely, whether it is simply intended to measure the profit of a transaction before taking into account any tax benefits, or whether it is intended to determine the profitability of a transaction before a tax benefit is granted. It is clear both sides agree that if a transaction is profitable, even when foreign taxes are included, then it satisfies the objective ESD. Likewise, if a transaction is unprofitable, even when foreign taxes are excluded, it fails the objective ESD. Under my proposal, the former is a per se valid transaction under the objective ESD and the latter is a per se invalid transaction under the objective ESD. That is, this is the first-stage of the objective ESD analysis. Before describing the next two stages, I briefly summarize the antitrust framework to which my proposal analogizes.

Within antitrust law, to determine whether a violation of section 1 of the Sherman Act has occurred—i.e., a “contract, combination . . . , or conspiracy, in restraint of trade”—courts have developed a per se/rule of reason framework. An example of a per se violation is price-fixing among competitors, which has almost always been condemned in its various forms. Courts deem price-fixing to be a per se violation because the various versions of price-fixing are typically significant restraints on trade and because a per se rule is able to heavily deter behavior like the restraint in question. That is, recognizing price-fixing as a per se violation of the Sherman Act is unlikely to produce Type I errors and efficiently makes use of a court’s resources. Judge

208. See supra Section III.A.1.
209. See supra Section III.A.1.
210. See generally Bank of N.Y. Mellon Corp. v. Comm’r, 801 F.3d 104 (2d Cir. 2015).
211. See id.
Posner has also suggested that there should be instances of per se legal restrictions on trade, such as “purely vertical restrictions on distribution.”

In contrast, when it is alleged that multiple firms have engaged in exclusionary conduct such as predatory pricing or a refusal to deal, the court engages in a much more extensive analysis that takes into account multiple factors indicating the anticompetitive and procompetitive effects of the firm’s behavior. This analysis, referred to as the “rule of reason,” is utilized to avoid Type I errors for conduct that may simply be vigorously competitive. Yet, because of the high costs associated with engaging in the extensive market and contract analyses within the rule of reason framework, courts have sometimes applied a “quick look” framework. This framework may label conduct as presumptively restraining trade by resting on a relatively simple market analysis or the “experience” of the court. The framework’s purpose is to avoid Type I errors but also avoid the extensive litigation costs associated with a rule of reason analysis.

Generally, this per se/rule of reason framework increases firm certainty by providing a spectrum of legality over specific categories of behavior, as well as a spectrum regarding the level of scrutiny courts will give toward particular transactions. This allows firms to appropriately assess, first, the likelihood of the legality of their conduct and, second, the level of scrutiny a court will likely apply towards their conduct—which allows clients and firms to assess litigation costs. My proposed framework seeks to transfer these certainty-increasing mechanisms to the objective ESD.

221. See id.
222. These certainty-increasing mechanisms are also found in Delaware corporate law through its analysis of conflicted transactions applying a tiered framework of the entire fairness standard, a burden shifted entire fairness standard, and the business judgment rule.
First, a suspect transaction that is pre-tax profitable, including foreign tax expenses in the calculation, is treated as per se valid. However, if the suspect transaction is pre-tax unprofitable, while excluding foreign tax expenses, then it is per se invalid. If the suspect transaction falls outside either of these categories, then a court will engage in a “quick-look” analysis examining whether there is enough market data to conclude that the transaction’s pre-tax profit was attributable to an implicit tax or subsidy. If the market data is insufficient to make a showing either way, then the court may engage in a “rule of reason” style analysis that applies Luke’s comparables analysis. Figure 3 diagrams this proposed analysis.


223. This is subject, of course, to a subjective business purpose analysis. See supra notes 12, 16 and accompanying text.

224. As I was writing this Comment, one colleague suggested a potentially simpler solution: If a transaction falls outside the per se categories, economic substance should be determined by asking whether the challenged portion of the transaction was reasonably necessary to accomplish the transaction as a whole.

For example, in Compaq, the foreign tax expenses were, arguably, reasonably necessary to the transaction as a whole because an essential element of this transaction was the purchase and resale of foreign stock (ADRs). In contrast, the foreign address of the trust in the STARS transaction would likely be argued to not be reasonably necessary to the transaction as a whole. As the Second Circuit pointed out, “the transactions themselves ‘fictionalize’ the concept of international trade” by containing a foreign address. Bank of N.Y. Mellon Corp. v. Comm’r, 801 F.3d 104, 118 (2d Cir. 2015). The funds never left the United States but were still taxed as if in the United Kingdom “because BNY installed a nominal U.K. trustee.” Id. at 118–19. Further, “the SPVs had no real employees or business purpose of their own beyond creating tax benefits for both the lender and borrower.” Id. at 119.

As promising as this suggested solution appears, the “reasonable necessity” inquiry quickly subsumes the question into the second, subjective prong of the ESD-business purpose. That is, by questioning whether a portion of a transaction is reasonably necessary to the transaction as a whole, one is essentially asking whether there is a business purpose to the challenged portion of the transaction. Some may argue that this is an appropriate result—that if the transaction fails to satisfy a per se test, the objective inquiry of the ESD is complete and one should engage in a subjective analysis. However, as argued below, I believe there is still room for a cost-effective, objective analysis that preserves more predictable results for the parties than a subjective test.
Figure 3. Proposed Antitrust Analogy for the Objective Prong of the ESD

Applying this analysis to Compaq, because the transaction is neither profitable when including foreign tax expenses nor unprofitable when excluding foreign tax expenses, Knoll’s implicit taxation analysis would be applicable. Assuming there was evidentiary support that the market actually valued the Royal Dutch ADRs at the market price plus net dividend rather than the market price plus gross dividend, the analysis would be complete, concluding under the “quick look” test that the transaction was pre-tax unprofitable and therefore violates the objective ESD. However, if there was insufficient evidence to make this determination, then Luke’s comparables analysis would apply and would examine factors such as “market comparables,” the tax clientele of the taxpayer, and other factors contributing to the fairness of the transaction.226

I take note that the analysis of tax law is typically contrasted with the analysis of antitrust law, and therefore, my proposed framework may be considered out of place. For example, Judge Easterbrook comments that “tax laws are read particularistically, as rules rather than standards, as specifying required conduct rather than desired end states.”228 He attributes this difference in application to “the nature of delegation,” claiming that “zero power has been delegated to judges in tax cases.”229 Yet, as discussed

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225. See supra note 153 and accompanying text.
226. See supra Section III.C.
228. Id. at 7.
229. Id.
throughout this Comment, the ESD and other related doctrines have developed through the common law with the approval of Congress. Thus, judges have been delegated the authority to apply standard-based reasoning to assess the validity of certain tax benefits. Given this authority, it is reasonable that courts look for guidance in their reasoning to the fields of antitrust and corporate law, areas particularly concerned with promoting client certainty without becoming internally self-defeating.

My proposed framework would appropriately increase taxpayer certainty while limiting litigation costs. That is, similar to the per se/rule of reason framework of antitrust law, the proposed framework allows taxpayers to appropriately assess, first, the likelihood of the court’s finding of objective economic substance within a transaction and, second, the level of scrutiny a court will likely apply toward a transaction. It balances the clarity of the pre-tax profit test with the accuracy of Knoll’s implicit taxation regime by including foreign taxes within the per se analysis and engaging in an implicit taxation analysis, or comparables analysis, only if necessary.

A potential problem with my proposed framework is that it straightforwardly includes foreign taxes within the pre-tax profit calculation. Knoll has criticized this move for two reasons. First, Knoll speculates that a tax shelter that generates huge foreign tax savings, but was actually a tax shelter, could be classified as a legitimate transaction because the savings would be calculated as “‘before-tax’ profit.” Second, Knoll points out that “business transactions with no evident tax motivation or benefit [could turn] into tax shelters.” For example, “borrowing money at 7 percent that generates a U.S. tax deduction in order to invest that money abroad at 10 percent in a country that imposes tax at 35 percent would qualify as a tax shelter.”

230. See supra Part II.
231. See Knoll, supra note 22, at 848.
232. Id. at 848–49.
233. Id. at 849. This criticism is similar to the Fifth and Eighth Circuits’ concern of treating foreign tax expenses differently than other forms of taxes and subsidies.
234. Id.
235. Id.
Yet, with respect to Knoll’s latter criticism, such a transaction would be validated under my proposed rule because it would fall outside the per se boundaries and, thus, be subject to a quick-look analysis examining the presence of any implicit taxation. Further, with respect to Knoll’s former criticism, Knoll acknowledges that foreign tax savings may not be counted as pre-tax profit; however, “[i]t is unclear how such a rule would operate in practice.”\footnote{Id. at 849 n.91.} I envision my proposed analysis would narrowly include foreign tax savings, thus making the situation described by Knoll unlikely. Specifically, my proposed analysis would only consider foreign tax savings that occurred through subsidies by the foreign countries specifically related to the taxpayer’s foreign tax expenses in that country. Such a limitation would avoid the situation feared by Knoll; namely, because I performed the transaction in country $A$ instead of country $B$, the amount I saved by doing so should be included as revenue in my calculation of pre-tax profit.

In the end, this proposed analysis would increase taxpayer certainty because it provides them with “safe zones” as well as constrained tests. In particular, if a party can prove either of the outer bounds of the per se analysis, then they may reliably predict whether their transaction will violate the objective ESD. The party increases their risk when they do not fall within one of the per se categories; however, they may predict for such circumstances by collecting evidence related to the market surrounding their transaction to support the existence, or non-existence, of some implicit tax or subsidy. Finally, should there be weak or insufficient market evidence, a party may attempt to ensure that the transaction satisfies the objective ESD by finding a “market comparable” that has a “substantially similar” after-tax rate of return.

This proposed analysis, designed for debates regarding the inclusion of foreign tax expenses, may be generalized by replacing foreign taxes with the expense that the taxpayer would not have to pay should they receive the tax benefit in question. That is, one would examine whether the transaction was profitable by including the expenses that the taxpayer would supposedly be able to avoid given the tax benefit they claim. If so, then the transaction would be considered per se valid. If not, and the transaction would not
even have been profitable with the tax benefit applied, then the transaction would be considered per se invalid. If neither of these conditions is satisfied, then it makes sense for the court to engage in a deeper investigation of the transaction under the implicit taxation and, if necessary, comparables analyses.

*Figure 4. Generalized Proposed Antitrust Analogy Analysis*

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<th>Pre-tax profit without tax benefit</th>
<th>Per Se Valid</th>
<th>Quick Look</th>
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<tr>
<td>Comparables analysis</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
<td>Rule of Reason</td>
</tr>
</tbody>
</table>

In conclusion, while the pre-tax profit test rests on the assumption that the pre-tax profits of a transaction may easily be separated from the rest of the transaction, it remains a useful per se rule for determining whether a transaction should be further scrutinized for economic substance. Likewise, while Knoll’s examination of implicit taxation and Luke’s comparables analysis require extensively more litigation costs, these analyses are worth engaging in by courts when a transaction remains unresolved by the per se pre-tax profit test.

My proposed framework of the objective economic substance analysis borrows from antitrust law. While antitrust analysis is typically considered antithetical to tax analysis, its utilization within the narrow realm of the ESD appropriately balances Judge Hand’s concerns regarding taxpayer certainty and the potentially self-defeating nature of the tax code. It provides a spectrum of defenses the taxpayer may rely on in planning a transaction and may accordingly be used to evaluate the risk that the claimed tax benefit will be heavily scrutinized. In the end, this analysis is useful not only for resolving the current circuit split regarding the inclusion of foreign tax expenses but also generally for resolving
the problem of accurately assessing objective economic substance while preserving taxpayer certainty.

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APPENDIX

Diagram A. In Bank of New York Mellon, the Tax Court used the following diagram to describe the structure of the STARS transaction.†

† Bank of N.Y. Mellon Corp. v. Comm’r, 140 T.C. 15, 20 (2013), aff’d, 801 F.3d 104 (2d Cir. 2015).
Diagram B. Knoll provides the following table, summarizing his result. The “Shell Stock” is the Royal Dutch ADRs.‡

<table>
<thead>
<tr>
<th>Proceeds from Sale and Dividend</th>
<th>Before All Taxes (Both Explicit and Implicit) (in millions)</th>
<th>After All Taxes (Both Explicit and Implicit) (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale</td>
<td>$868.4</td>
<td>$868.4</td>
</tr>
<tr>
<td>Dividend</td>
<td>22.5</td>
<td>22.5</td>
</tr>
<tr>
<td>FTC</td>
<td>—</td>
<td>3.4</td>
</tr>
<tr>
<td>W/h Tax</td>
<td>—</td>
<td>(3.4)</td>
</tr>
<tr>
<td>US Tax</td>
<td>—</td>
<td>(0.7)</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$890.9</strong></td>
<td><strong>$890.2</strong></td>
</tr>
</tbody>
</table>

| Cost of Purchase                |                                                           |                                                         |
| Purchase                        | $890.9                                                   | $890.9                                                  |
| Fees                            | 1.0                                                      | 1.0                                                     |
| Expenses                        | 0.4                                                      | 0.4                                                     |
| Implicit Subsidy                | —                                                        | (3.4)                                                   |
| **Subtotal**                    | **$892.3**                                                | **$888.9**                                              |
| **Net Profit**                  | **($1.4)**                                                | **$1.3**                                                 |

‡ Knoll supra note 22, at 840.