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Joshua D. Blank
NYU School of Law, joshua.blank@nyu.edu

Nancy C. Staudt
USC Law School, nstaudt@law.usc.edu

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CORPORATE SHAMS

JOSHUA D. BLANK† & NANCY STAUDT‡

Many people—perhaps most—want to make money and lower their taxes, but few want to unabashedly break the law. These twin desires have led to a range of strategies, such as the use of "paper corporations" and offshore tax havens, that produce sizable profits with minimal costs. The most successful and ingenious plans do not involve shady deals with corrupt third parties, but strictly adhere to the letter of the law. Yet the technically legal nature of the schemes has not deterred government lawyers from challenging them in court as "nothing more than good old-fashioned fraud."

In this Article, we focus on government challenges to corporate financial plans —often labeled "corporate shams"—in an effort to understand how and why courts draw the line between legal and fraudulent behavior. The scholars and commentators who have investigated this question nearly all agree: Judicial decision making in this area of the law is erratic and unpredictable. We build on the extant literature with the help of a new, large dataset, and uncover important and heretofore unobserved trends. We find that courts have not produced a confusing morass of

† Professor of Tax Practice and Faculty Director of the Graduate Tax Program, New York University School of Law.

‡ Edward G. Lewis Chair in Law and Public Policy, University of Southern California Gould School of Law and Price School of Public Policy; Academic Director, Schwarzenegger Institute on State and Global Policy.

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outcomes (as some have argued), but instead have generated more than a century of opinions that collectively highlight the point at which ostensibly legal planning shades into abuse and fraud. We then show how both government and corporate attorneys can exploit our empirical results and explore how these results bolster many of the normative views set forth by the scholarly and policymaking communities.

INTRODUCTION

Imagine your lawyer invites you to consider the following money-making schemes:

(1) Join a tax protest movement and decline to file a tax return on the grounds that the federal government has no authority to impose taxes.
(2) Set up a "paper corporation" in a foreign tax haven to avoid paying taxes on your local but profitable business.
(3) Purchase large assets (such as a fleet of buses, a sewer system, or a bridge) from the City of Chicago and take huge depreciation tax deductions that offset your business's income. The up-front cash outlay will be small, and city officials will retain full control of the assets.

You might respond to these schemes in a manner that goes something like this: (1) "No way!" (2) "Is that legal?" (3) "Interesting . . . tell me more." After all, many (perhaps most) people want to make money and lower their taxes, but few want to unabashedly break the law. Refusing to pay taxes under the guise of being a tax protestor is illegal.[1] Setting up an offshore business to avoid U.S. taxes seems more acceptable but still has the unsavory feel of unlawful behavior.[2] Buying and depreciating assets, however, is not only legal but routine.[3] Indeed, data indicate that while most people and firms likely do not seek to engage in outright fraud,[4] quite a few have taken their

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[1] Willful failure to pay taxes is a violation of the law. *See* I.R.C. § 7201 (2006) (explaining tax evasion); *see also* Cheek v. United States, 498 U.S. 192, 207 (1991) (Scalia, J., concurring) (noting that a tax protestor's "good-faith belief" that he does not owe taxes is a defense to the crime). For a description of the similarly willful "zero wages" position, in which a taxpayer incorrectly claims to have no income, see *IRS Announces "Dirty Dozen" Tax Scams for 2006*, I.R.S. News Release IR-2006-25 (Oct. 7, 2006), *available at* http://www.irs.gov/uac/IRS-Announces-%E2%80%9CDirty-Dozen%E2%80%9D-Tax-Scams-for-2006.

[2] *Cf. Abusive Offshore Tax Avoidance Schemes—Talking Points*, IRS.GOV, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Abusive-Offshore-Tax-Avoidance-Schemes—-Talking-Points (last updated Aug. 1, 2012) (describing the agency's position that evading taxes by shifting liability overseas is illegal). For a brief description of sham operations in offshore tax havens, see RONEN PALAN, RICHARD MURPHY & CHRISTIAN CHAVAGNEUX, TAX HAVENS: HOW GLOBALIZATION REALLY WORKS 87 (2010).

[3] *See A Brief Overview of Depreciation*, IRS.GOV, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/A-Brief-Overview-of-Depreciation (last updated Aug. 2, 2012) (discussing when and how a taxpayer can legally depreciate property).

[4] *See, e.g.*, INTERNAL REVENUE SERV., SOI TAX STATS—CIVIL PENALTIES ASSESSED AND ABATED, BY TYPE OF TAX AND TYPE OF PENALTY—I.R.S. TAX STATS TABLE 17, FISCAL YEAR 2011, *available at* http://www.irs.gov/uac/SOI-Tax-Stats—-Civil-Penalties-Assessed-and-Abated,-by-Type-of-Tax-and-Type-of-Penalty—-IRS-Tax-Stats-Table-17 (follow "2011" hyperlink) (providing data that reveal that civil fraud penalties accounted for .008% of all civil penalties applied by the IRS in 2011).

lawyers' advice to buy city assets—such as buses, light rails, bridges, et cetera—for the sole purpose of obtaining huge depreciation tax deductions.[5]

Notwithstanding a possible distinction between schemes (1) and (2), on the one hand, and scheme (3), on the other, the government has taken the position that all three have a common attribute: They are all shams. More precisely, the schemes are motivated by no reason other than tax avoidance.[6] Policymakers have noted that individuals and businesses have become alarmingly adept at using deception and pretense to extract money from the U.S. Treasury while maintaining the appearance of law-abiding behavior.[7] The problem for the government, however, is that many sham activities *are* entirely consistent with statutory and administrative law. For example, no existing statute prohibits the purchase of city transportation equipment for tax purposes,[8] and the federal tax laws clearly permit owners to depreciate assets used in a trade or business.[9] In fact, many taxpayers have purchased municipal assets for tax reasons, and these transactions are the subject of extensive litigation in federal court, precisely because of their strictly legal nature.[10] While many policymakers view these and other similar transactions as nothing more than fraud,[11] government

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[5] Taxpayers have claimed more than $35 billion in tax deductions associated with this type of depreciation transaction. *See* Mayer Brown LLP v. IRS, 562 F.3d 1190, 1194 (D.C. Cir. 2009) (citing IRS estimates). For a terrific discussion of the technique, see Robert W. Wood & Steven E. Hollingworth, *SILOs and LILOs Demystified*, 129 TAX NOTES 195, 196–98 (2010), *available at* http://woodllp.com/Publications/Articles/pdf/SILOs_and_LILOs_Demystified.pdf.

[6] *See, e.g.*, Rice's Toyota World v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.").

[7] *See* Press Release, Carol Guthrie, U.S. Senate Fin. Comm., Baucus Comments on Auto Bailout Bill Provision Regarding Sale-In-Lease-Out and Lease-In-Lease-Out Transactions (Dec. 10, 2008), *available at* http://www.finance.senate.gov/newsroom/chairman/release/?id=f0fffec0-ef48-4c1e-8bd9-dcfa14dd95ac (quoting former Senate Finance Committee Chairman Max Baucus describing tax shelters run by banks as a "shell game" and "three-card-mont[e] transactions").

[8] *See, e.g.*, INTERNAL REVENUE SERV., PUBLICATION 946, HOW TO DEPRECIATE PROPERTY 4 (2012), *available at* www.irs.gov/pub/irs-pdf/p946.pdf ("You can depreciate most types of tangible property . . . such as buildings . . . .").

[9] I.R.C. § 167(a) (2006).

[10] *See* Robert W. Wood, *What* Wells Fargo *Brings to the SILO/LILO Debate*, 131 TAX NOTES 1389 (2011), *available at* http://woodllp.com/Publications/Articles/pdf/What_Wells_Fargo.pdf (discussing litigation and settlement agreements with respect to the tax plans).

[11] *See, e.g.*, Press Release, U.S. Sen. Comm. on Fin., Grassley Expands Inquiry into Tax Shelters Using Leases, Announces Plans to Move Up Effective Date of Legislative Crackdown (Nov. 18, 2003), *available at* http://www.finance.senate.gov/newsroom/chairman/release/index.cfm?id=70961c0d-d966-475e-866f-ac1b7d2aac0d (quoting Senate

lawyers are tasked with challenging activities that, upon a literal reading, adhere to the letter of the law.[12]

In this Article, we examine judicial responses to technically legal activities that may be perceived as shams. [13] In particular, we focus on government challenges to corporate shams.[14] While corporations have engaged in creative financial planning—or, in the government's view, deceit and manipulation—in a wide range of legal areas, some of the most innovative, complex, and lucrative schemes have emerged with the help of the tax law.[15] Accordingly, we study corporate tax planning in an effort to explain how and why courts draw the line between law-abiding and abusive activities. In doing so, we aim to identify the factors that convince judges that certain behavior crosses the line from legal acceptability to abusive activity in the corporate tax context. Ultimately, we hope to offer transparency and clarity to an area of the law long believed to be erratic, confusing, and indeterminate.[16]

Finance Committee ranking minority member Charles Grassley, R-Iowa, calling these shelters "just good, old-fashioned tax fraud").

[12] *See, e.g.*, Coltec Indus. v. United States, 454 F.3d 1340 (Fed. Cir. 2006) (contingent liability tax shelter); Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006) (contingent liability tax shelter); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001) (foreign tax credit tax shelter); Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992) (straddle transactions); DeMartino v. Comm'r, 862 F.2d 400 (2d Cir. 1988) (straddle transactions); Rice's Toyota World v. Comm'r, 752 F.2d 89 (4th Cir. 1985) (sale and leaseback transactions); Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004) (various cross-border tax avoidance transactions).

[13] For an example of such a response, see *Rice's Toyota World*, 752 F.2d at 91.

[14] Courts have utilized the term "sham" to refer to a variety of transactions. *See, e.g.*, Knetsch v. United States, 364 U.S. 361, 366 (1960) (annuity savings bond transaction); ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 511–12 (D.C. Cir. 2002) (sham partnership); Rice's Toyota World, 752 F.2d at 91 (sale and leaseback transaction). Our study examines Supreme Court cases in which the government alleged that the corporate transactions at issue were abusive of tax laws in any way. For an explanation of how we identified these cases, see *infra* notes 140–50 and accompanying text.

[15] *See* DEP'T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 25–33 (1999), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/ctswhite.pdf (describing the growth of the tax shelter industry in the 1990s); OFFICE OF TAX SHELTER ANALYSIS, IRS, ABUSIVE CORPORATE TAX SHELTERS BACKGROUND PAPER 1 (2001), *available at* http://www.quatloos.com/abbakppr.pdf ("Corporate tax shelters cost the federal government billions of dollars each year.").

[16] *See* Terrence R. Chorvat, *Tax Shelters, Dutch Books, and the Fundamental Theorem of Asset Pricing*, 26 VA. TAX REV. 859, 874–75 (2007) (describing courts' use of the economic substance doctrine to treat similar tax transactions in an inconsistent manner); David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1, 3 (2003) [hereinafter Hariton, *Kafka and the Tax Shelter*] (arguing that formulations of judicial anti-abuse doctrines "apply to everything and nothing"); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 239 (1999) [hereinafter Hariton, *Sorting Out the Tangle*] (arguing that courts' "ability to recharacterize transactions introduces considerable uncertainty and confusion into a system that is based on the application of objective rules"); Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a*

Further, we hope that our study—the first of its kind—will offer insight into other legal contexts in which courts characterize ostensibly legal behavior as abusive and fraudulent.[17]

Our study contributes to the literature on corporate shams by examining both qualitative and quantitative data in an effort to understand and explain the judicial mind. Previous studies focused on a small number of cases, contributing important insights,[18] but their narrow focus may have caused scholars to overlook decisionmaking trends observable only with the help of a large-*n* dataset. Accordingly, we reviewed every Supreme Court case issued since 1909—nearly one thousand cases—and collected information on cases in which the government alleged the presence of a corporate tax sham. With this data in hand, we uncovered surprising trends in the judicial decisionmaking process. Our study shows that certain identifiable factors clearly increase the likelihood that the Court will find that a corporation has overstepped the bounds of acceptable financial planning and moved into the realm of abuse. Signals of questionable behavior, for example,

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Proposal for Codification, 22 AKRON TAX J. 45, 97 (2007) ("[T]here are many uncertainties pertaining to the application of the economic substance's two prong test . . . ."); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J.L. & BUS. 371, 373 (2005) [hereinafter Keinan, *The Many Faces*] ("[C]ircuits and courts have been divided with respect to the application of this two-prong test . . . ."); Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 391 (2010) ("Courts do not apply the [economic substance] doctrine consistently . . . ."); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 195 (2001) (describing differences between judicial anti-abuse doctrines as "fairly gossamer"); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 228–29 (2002) (describing the lack of consistency in the judicial application of anti-abuse standards).

[17] There are numerous other legal contexts to which our study might apply. *See, e.g.*, CHRISTOPHER C. KLEIN, BUREAU OF ECON., FED. TRADE COMM'N, THE ECONOMICS OF SHAM LITIGATION: THEORY, CASES, AND POLICY 27–33 (1989), *available at* http://www.ftc.gov/be/econrpt/232158.pdf (anti-competitive litigation); OFFICE OF INSPECTOR GEN., ENVTL. PROT. AGENCY, WHEN GOOD MONEY GOES BAD: TRUE STORIES OF CONTRACT FRAUD AT EPA 5 (2011), *available at* http://www.epa.gov/oig/reports/ARRA/EPA_OIG_Grant_Fraud_Brochure.pdf (contract fraud); John Copeland Nagle, *CERCLA's Mistakes*, 38 WM. & MARY L. REV. 1405, 1419–20 (1997) (describing Congress's fear of "sham transactions" involving environmental abuses); Douglass G. Smith, *Piercing the Corporate Veil in Regulated Industries*, 2008 BYU L. REV. 1165, 1179 nn.56–69 (liability avoidance); Jacqueline Lang Weaver, *Can Energy Markets Be Trusted? The Effect of the Rise and Fall of Enron on Energy Markets*, 4 HOUS. BUS. & TAX L.J. 21–22 (2004) (financial accounting); Janet Tavakoli, *"Standard" Credit Default Swaps on Greece Are a Sham and It's Not a Surprise*, TAVAKOLI STRUCTURED FIN., (Oct. 27, 2011), http://www.tavakolistructuredfinance.com/Greek%20CDS.pdf (credit default swaps). For theoretical background on the avoidance of regulatory costs through planning techniques that otherwise have little economic substance, see generally Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010).

[18] *See infra* Part I.B.3 for a discussion of other scholars' studies.

include highly complex transactions,[19] inconsistent tax and accounting positions,[20] and requests for large tax refunds.[21] Moreover, notwithstanding the nearly obsessive attention paid by scholars and policymakers to the underlying business purpose of a transaction, our study shows that this factor does not play the key role in the judicial decisionmaking process that might be expected.[22] In short, our findings run counter to the conventional wisdom that courts do not follow predictable patterns when deciding these cases.

Our Article proceeds as follows. Part I provides a brief overview of corporate tax abuse and describes the varied approaches to identifying the problem by the judiciary, regulatory agencies, practitioners, and scholars. Part II.A turns to the empirical component of our project and presents our methodology and findings. Part II.B discusses the successes and limitations of our empirical strategy. Part III investigates a series of normative and practical questions that emerge from our findings. Part III.A explores how lawyers—those representing both corporations and the government—can exploit our empirical results when planning transactions and devising litigation strategies. Part III.B then considers our findings in the context of existing scholarly views. We find that many of our empirical results bolster the normative views set forth in the current literature on how courts should make decisions vis-à-vis corporate shams.

I
Corporate Tax Abuse and Judicial Uncertainty

A. What Is Corporate Tax Abuse?

Taxes are a prime focus of corporate cost-reduction strategies. As discussed in detail below, tax planning offers a lucrative means to preserve corporate profits precisely because the tax law is so complex. Corporate managers, for example, may take advantage of explicit corporate tax preferences in the Internal Revenue Code (IRC) and advise their corporate clients to engage in specific activities. Such recommendations might include purchasing particular types of software or transportation vehicles that are entitled to highly accelerated depreciation for tax purposes.[23] On the other hand, managers may

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[19] *See infra* text accompanying notes 113–21 (explaining highly engineered transactions involving multiple parties and steps).

[20] *See infra* text accompanying notes 103–04 (describing book-tax differences).

[21] *See infra* notes 101–02 and accompanying text (describing the implications of large loss claims).

[22] *See infra* Part II.B.2 (describing the findings of the study).

[23] *See* I.R.C. § 179(d)(1)(A)(ii) (2006 & Supp. IV 2010) (allowing a deduction for off-the-shelf software for the year it is placed in service).

pursue tax strategies that employ hyperliteral readings of the IRC that produce valuable tax benefits (such as tax deductions, tax credits, and tax exemptions) without having any meaningful effect on the economic positions of their corporations. [24] The latter collection of tax strategies is widely perceived to be "abusive" because the plans fail to reflect economic reality and produce tax results that Congress never envisioned.[25]

In the earliest forms of corporate tax abuse, corporations deployed relatively simple strategies to obtain beneficial tax results. For example, business taxpayers would often attempt to characterize themselves as partnerships, which were not subject to entity-level taxation, as opposed to corporations, which were.[26] In another early strategy, corporations would frequently try to eliminate corporate taxation by disguising payments to shareholders as items that generated tax deductions, such as rental or salary payments, even though in reality such payments to shareholders constituted nondeductible dividends.[27] Other corporations attempted to manipulate the characterization of their tax years by exploiting differences between the calendar year and their fiscal year.[28] In each of these cases, corporations aimed to exploit ambiguities in the newly forming statutory law in order to reduce, or eliminate altogether, corporate tax liability.

Over a century after the enactment of the federal corporate income tax,[29] abusive corporate tax strategies have evolved in complexity. The mass marketing of these strategies by major accounting firms and other tax advisors in the late 1990s and early 2000s[30] led to a corporate tax abuse boom that commentators described in terms such

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[24] *See* DEP'T OF TREASURY, *supra* note 15, at 11–24 (describing the characteristics of corporate tax shelter transactions).

[25] *See, e.g.*, Lederman, *supra* note 16, at 396–98 (arguing that "abusive" transactions are those which are inconsistent with congressional intent).

[26] *See, e.g.*, Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 114 (1925) (holding an unincorporated association taxable as a corporation).

[27] *See, e.g.*, John Kelley Co. v. Comm'r, 326 U.S. 521, 530 (1946) (rejecting a corporation's characterization of payments as deductible interest expenses).

[28] *See, e.g.*, Sec. Flour Mills Co. v. Comm'r, 321 U.S. 281, 287 (1944) (rejecting a corporation's attempt to manipulate its taxable year to avoid a tax).

[29] The federal corporate income tax was enacted by the Tariff Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112.

[30] *See* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1781 (1999) (noting the extensive competition between marketed tax shelters); Janet Novack & Laura Saunders, *The Hustling of X-rated Tax Shelters*, FORBES, Dec. 14, 1998, at 198, *available at* http://www.forbes.com/forbes/1998/1214/6213198a.html (describing the promotion of corporate tax shelters).

as an "epidemic,"[31] a "crisis,"[32] and a "beast" that must be "slay[ed]."[33] Modern corporate tax abuse strategies often involve multiple transaction steps, parties, and tax jurisdictions. An abusive corporate tax strategy today, for instance, may feature a transaction in which a corporation purchases millions of dollars of stock, sells that stock back to its original owner several minutes later, and then claims millions of dollars in foreign tax credits.[34] Or it may involve multiple steps in which a corporation participates in a transaction with a Luxembourg bank that enables it to increase its tax basis in stock, which it then sells to a third party, generating a large tax-deductible loss.[35] The government maintains a list of tax strategies that it believes constitute corporate tax abuse.[36] The list contains dozens of colorfully named strategies, such as COBRA (currency options bring reward alternatives),[37] PICO (personal income company),[38] BOSS (bond and options sales strategies), and Son-of-BOSS (option position transfers).[39] While the latest forms of abusive corporate tax strategies are certainly more sophisticated than their predecessors, their basic objective—avoidance of corporate tax liability through an application of tax law that Congress never envisioned—remains the same.

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31 *Frontline: Tax Me if You Can* (PBS television broadcast Feb. 19, 2004) (referring to a tax shelter "epidemic") (transcript available at www.pbs.org/wgbh/pages/frontline/shows/tax/etc/script.html).

32 *See* Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 62 (2004) ("[T]extualism has affected the practice of tax law and has contributed to the recent tax shelter crisis.").

33 Jasper L. Cummings, Jr. & Alan J.J. Swirski, *Gilbert S. Rothenberg: Interview*, ABA SEC. TAX'N NEWS Q., Winter 2010, at 4, 7.

34 *See, e.g.*, Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001) (adjudicating this type of a "dividend-stripping" tax shelter).

35 *See* IRS Notice 2001-45, 2001-2 C.B. 129 (identifying this type of a "basis-shifting" tax shelter).

36 Treas. Reg. § 1.6011-4(b)(2) (as amended in 2010). The IRS maintains the list of abusive tax shelters on its website. *See Abusive Tax Shelters and Transactions*, IRS.GOV, http://www.irs.gov/Businesses/Corporations/Abusive-Tax-Shelters-and-Transactions (last updated Aug. 2, 2012).

37 I.R.S. Notice 2002-35, 2002-1 C.B. 992 (describing contingent payment swaps). This transaction was marketed as "Currency Options Bring Reward Alternatives" by Ernst & Young in the late 1990s. *See* S. REP. NO. 109-54, at 77–78 (2005).

38 I.R.S. Notice 2002-65, 2002-2 C.B. 690 (describing a "foreign currency straddle" involving a Subchapter S corporation). This transaction has been described as "Personal Income Company" or "PICO." *See* Lee A. Sheppard, *News Analysis: Two Minutes to Midnight: Settle Your Shelter Case*, TAX NOTES, Feb. 21, 2006 (identifying the transaction described in IRS Notice 2002-65 as PICO).

39 *See IRS Offers Settlement for Son of Boss Tax Shelter*, IRS.GOV, http://www.irs.gov/uac/IRS-Offers-Settlement-for-Son-of-Boss-Tax-Shelter (last updated Aug. 2, 2012).

1. Anti-Abuse Standards

Corporate tax abuse is distinct from other forms of tax noncompliance because its legitimacy is judicially determined ex post. To appreciate this distinction, consider corporate tax behavior that involves the violation of an explicit tax rule, such as claiming a fraudulent tax deduction for a business expense that never actually was incurred, an activity that is illegal ex ante.[40] In other words, a clear tax rule informs corporate managers that a tax position is prohibited *before* they claim it on a corporate tax return. Now consider a tax strategy that corporate managers believe—or at least convince themselves they believe—complies with the literal language of the IRC. Although no explicit rule in tax law prohibits a corporation from claiming the resulting tax benefits, the Internal Revenue Service (IRS) may challenge the strategy and ask a court to declare it abusive ex post on the ground that it enables the corporation to obtain unintended tax benefits that clash with the IRC's revenue-raising policy objectives.[41] The most prominent anti-abuse standards that courts apply when considering whether or not to respect corporate tax strategies ex post are described briefly below.

Sham Transaction Doctrine. Under the "sham transaction" doctrine, a court may disallow a taxpayer's claimed tax treatment if it determines that the substance of the underlying transaction at issue lacked any purpose other than tax avoidance.[42] For example, if a corporation's tax position in a particular year stemmed from the corporation's purchase of treasury notes, but the corporation did not actually purchase the notes, a court could reject the corporation's tax position as a sham.[43]

Economic Substance Doctrine. The precise contours of the "economic substance" doctrine have varied historically from court to court.[44] But under this doctrine, many courts will respect a corporation's claimed tax treatment of a transaction only if (1) the

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[40] I.R.C. § 7206(1) (2006) (describing the felony offense of willfully making false statements in a tax return).

[41] *See* Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 543–44 (2009) (distinguishing ex ante rules from ex post standards).

[42] *See, e.g.*, ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 516 (D.C. Cir. 2000) (holding that a partnership was a sham used to avoid tax); Goodstein v. Comm'r, 267 F.2d 127, 131–32 (1st Cir. 1959) (holding that a borrowing transaction lacked economic substance).

[43] *See* Knetsch v. United States, 364 U.S. 361, 366–67 (1960) (rejecting an annuity savings bond transaction between a taxpayer and an insurance company as a sham when the transaction served no interest besides tax reduction).

[44] *See infra* notes 75–92 and accompanying text (discussing the economic substance doctrine).

corporation possessed a non-tax business purpose in pursuing the transaction and (2) the transaction meaningfully improved the corporation's economic position (apart from reducing its tax liability).[45]

Substance over Form Doctrine. Consistent with the principle that the government should not tax economically similar transactions differently, a court may also apply the "substance over form" doctrine. In doing so, the court ignores the transaction's form and instead taxes the transaction based on its underlying economic substance.[46] The government may invoke this doctrine, but courts historically have barred corporate attorneys from using it strategically in court to abandon the chosen legal form of a transaction.[47]

Step Transaction Doctrine. Lastly, the "step transaction" doctrine enables a court to reject a corporation's tax position by integrating a "series of formally separate 'steps' as a single transaction" and then by applying the appropriate tax treatment to the integrated transaction.[48] The effect of this integration is often to treat portions of the transaction—individual steps—as if they never occurred, thereby eliminating the sought-after tax benefits. This judicial anti-abuse standard appears in several forms.[49]

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[45] *See* ACM P'ship v. Comm'r, 157 F.3d 231, 247–48 (3d Cir. 1998) (holding that an "objective analysis of the actual economic consequences" and "subjective analysis of their intended purposes" indicate that the appellant failed to satisfy the economic substance doctrine). For a discussion of the development of the economic substance doctrine, see generally Lederman, *supra* note 16, at 402–16. This judicial anti-abuse standard originated in *Gregory v. Helvering*, in which the Supreme Court held that the transaction at issue (a corporation's distribution of a subsidiary's stock to its controlling shareholder followed by the sale of that stock, resulting in capital gains instead of dividend treatment) lacked a non-tax business purpose and was inconsistent with Congress's intent underlying the relevant statutes. 293 U.S. 465, 469–70 (1935); *see also Knetsch*, 364 U.S. at 366 (applying the economic substance doctrine to reject an annuity savings bond transaction between a taxpayer and an insurance company as a sham, when the transaction served no interest besides tax reduction).

[46] *See, e.g.*, Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) (finding the distribution to shareholders to be "meaningless and unnecessary" and "transparently artificial").

[47] *See* Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967) ("[A] party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction . . . .").

[48] Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

[49] For example, under the "binding commitment" test, a court may integrate one transaction with a second transaction if there was a binding commitment to undertake the second transaction at the time of the first transaction. *See, e.g.*, J.E. Seagram Corp. v. Comm'r, 104 T.C. 75, 98 (1995). The "interdependence" test provides that two transactions should be integrated if the legal relationships created by the first transaction would be meaningless without the completion of the second transaction. *See* Redding v. Comm'r, 630 F.2d 1169, 1177 (7th Cir. 1980). The "end result" test enables a court to integrate a transaction's steps if the court determines that the corporation intended to undertake the separate steps simply to achieve a specific end result. *See, e.g.*, King Enters. v. United

2. Judicial Uncertainty

Tax lawyers and scholars have commented for generations that the courts often apply anti-abuse standards in unpredictable ways.[50] Some commentators focus on the vague elements incorporated into particular standards (such as the business purpose requirement), arguing that as a result of their breadth, these standards "apply to everything and nothing."[51] Others focus more closely on the difficulty of distinguishing among the various standards—for example, they claim that different versions of the step transaction doctrine are not very different from one another.[52] Many highlight cases that involve similar facts but that nonetheless result in different judicial outcomes.[53] Regardless of their specific criticisms, many commentators argue that the possible application of one or more judicial anti-abuse standards introduces uncertainty into the practice of corporate tax planning.[54]

To better comprehend the difficulty in differentiating between transactions that represent corporate tax abuse from those that represent legal corporate tax avoidance, consider two well known Supreme Court decisions involving corporate tax planning: *Commissioner v. Court Holding Co.*[55] and *Cottage Savings Ass'n v. Commissioner*.[56]

States, 418 F.2d 511, 519 (Ct. Cl. 1969) (finding an initial exchange of stock and subsequent merger to be a unified transaction when the merger was intended from the outset).

[50] *See, e.g.*, Sheldon I. Banoff, *Mr. Popeil Gets 'Reel' About Conversions of Legal Entities: The Pocket Fisherman Flycasts for "Form" but Snags on "Substance*," 75 TAXES 887, 888 (1997) ("Substance controls over form, except where form controls over substance."); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 346 (describing judicial uncertainty but refuting contention that judicial decisions are no more consistent than "coin tossing"); Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457, 499 (1999) ("[D]ifferent transactional forms having identical (or near identical) substances often have differing tax consequences . . . ."); *see also supra* note 16 (describing a variety of inconsistencies in tax abuse doctrine).

[51] Hariton, *Kafka and the Tax Shelter*, *supra* note 16, at 3. For a discussion of the business purpose requirement, see *infra* notes 110–12 and accompanying text.

[52] For discussion of the different versions of the step transaction doctrine, see *supra* note 49. Professor Martin McMahon argues that "any fair minded person would have to admit that those differences are often fairly gossamer." McMahon, *supra* note 16, at 195.

[53] *See infra* notes 74–75 and accompanying text.

[54] *See, e.g.*, Hariton, *Sorting Out the Tangle*, *supra* note 16, at 239 (describing "uncertainty" in corporate tax planning); Weisbach, *supra* note 16, at 228 (commenting that government victories in corporate tax abuse cases were "mere coincidence, much like baseball teams on a streak").

[55] 324 U.S. 331 (1945).

[56] 499 U.S. 554 (1991).

In the former, the Court Holding Company held appreciated real property, which its managers wanted to sell.[57] If the Court Holding Company had sold the property itself, it would have incurred tax on the sale of the property and its shareholders would have incurred a second tax liability on the distribution of any proceeds from the sale.[58] The management of the Court Holding Company, however, devised an alternative tax strategy. [59] They advised the Court Holding Company to distribute the real property first to its shareholders as a dividend distribution, which at the time (1940)[60] did not cause the Court Holding Company to recognize gain. The shareholders then sold the property to the ultimate purchaser.[61] By preventing the corporation from playing the part of seller, the Court Holding Company eliminated the corporate-level tax on the transaction and thus saved the shareholders substantial money. In response, the government argued that the shareholders had merely acted as agents or conduits of the corporation. The Supreme Court agreed, holding that it would not allow the "true nature of [the] transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities."[62]

Almost fifty years later, in 1991, the Court decided *Cottage Savings Ass'n v. Commissioner*.[63] In that case, the taxpayer, a savings and loan association, owned single-family home mortgages that had declined in value as a result of a rise in interest rates.[64] If the savings and loan association had attempted to sell the mortgages, it would have suffered a real economic loss.[65] To avoid that loss, the managers designed a transaction that would allow it to incur only a tax loss. The transaction involved a swap with a group of other lenders: The association traded its depreciated single-family home mortgages for nearly identical mortgages held by the other lenders.[66] As a result of the economic similarity between the two groups of mortgages, the savings and loan association did not incur a real economic loss and reported

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[57] *Court Holding*, 324 U.S. at 332–33.

[58] *Id.* at 333.

[59] *Id.*

[60] Prior to 1986, corporations could distribute appreciated property to shareholders without recognizing corporate-level gain. *See* Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). In 1986, Congress overruled the *General Utilities* doctrine by enacting a statute that required corporations to recognize gain on the distribution of appreciated property. I.R.C. § 311(b) (2006).

[61] *Court Holding*, 324 U.S. at 333.

[62] *Id*. at 334.

[63] 499 U.S. 554 (1991).

[64] *Id.* at 556.

[65] *Id.*

[66] *Id.* at 557.

no loss for regulatory or accounting purposes.[67] The key to the strategy was that, even though the association's economic position did not change, the swap transaction allowed it to claim a $2.4 million tax loss.[68] The government asserted that the tax loss should be disallowed on the grounds that the underlying transaction failed to satisfy the economic substance doctrine.[69] Unlike the result in *Court Holding*,[70] however, the Supreme Court sided with the taxpayer, allowing the tax loss even though the exchange of mortgages was economically meaningless.[71]

While these cases resulted in different judicial outcomes, it is not at all clear why the Supreme Court applied a judicial anti-abuse standard in *Court Holding* but refused to apply one in *Cottage Savings*. The taxpayer in each case pursued transactions for the sole purpose of avoiding corporate tax liability in both cases, and the transactions that they entered into had no real economic effect. Moreover, the government set forth similar arguments in its briefs seeking to bar the taxpayer from obtaining the desired tax benefits.[72] The record in both cases shows that the taxpayers clearly intended to avoid federal corporate tax liability rather than to serve a non-tax-related business purpose.[73] Consequently, when comparing cases involving judicial anti-abuse standards, commentators often find the possible reasons for the disparate outcomes to be "inscrutable."[74]

Commentators also attribute unpredictable corporate tax abuse decisions to courts' inconsistent application of particular anti-abuse

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[67] *Id.* at 558.

[68] *Id.*

[69] *Id.* at 562.

[70] *Id.* at 334.

[71] Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 566 (1991) (allowing the taxpayer's claimed tax loss on the exchange of participation interests in mortgages).

[72] *Compare* Brief for the Respondent at 34, Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991) (No. 89-1965) *with* Brief for the Petitioner at 29–30, Comm'r v. Court Holding, 324 U.S. 331 (1945) (No. 581). Commentators have attempted to offer distinctions between cases like these—for instance, the taxpayer's transaction in *Court Holding* was unrelated to any ongoing ordinary business, while the taxpayer's transaction in *Cottage Savings* was part of an ongoing mortgage business. *See, e.g.*, Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 17 (2000) ("[T]he swap in *Cottage Savings*, while economically insignificant in itself, was tied to ordinary business operations, and what was measured for substantial economic effect was not just the swap, but the business operations to which it was tied."). Yet the presence of an ongoing business is not a requirement of any of the judicial anti-abuse standards.

[73] *See Court Holding*, 324 U.S. at 333; Brief for the Respondent at 29, *Cottage Savings*, 499 U.S. 554 (No. 89-1965) (describing the petitioner as entering into "these transactions 'solely' for the purpose of tax avoidance").

[74] *See, e.g.*, Hariton, *Sorting Out the Tangle*, *supra* note 16, at 240 ("The efforts to tease out what the taxpayers did wrong in these cases and distinguish them from what taxpayers did right in other cases have been wholly inscrutable.").

standards, especially the economic substance doctrine.[75] While some courts have required satisfaction of both prongs of the economic substance doctrine,[76] other courts have required that the taxpayer show that a particular transaction achieved either a non-tax-related business purpose *or* had the potential to generate an economic profit.[77] Some courts have refused to apply the economic substance doctrine completely.[78] As one commentator has written, "The result is a test that does little to distinguish tax shelters and other abusive transactions from legitimate ones."[79]

Judicial outcomes over the past decade support the view that corporate tax abuse is an uncertain area of the law. In the late 1990s and early 2000s, corporate taxpayers lost their cases at the trial level in *United Parcel Service of America v. Commissioner*,[80] *Compaq Computer Corp. v. Commissioner*,[81] and *IES Industries, Inc. v. United States*.[82] In each of these cases, the trial court applied one of the

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[75] *See, e.g.*, *id.* at 239 (noting that courts' "ability to recharacterize transactions" leads to uncertainty); Keinan, *The Many Faces*, *supra* note 16, at 373 (noting variation in the application of the two-prong test); Martin J. McMahon, Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017, 1017 (2002) (referring to the economic substance doctrine, among other judicial anti-abuse standards, as "a useless mechanistic test"); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 94 TAX NOTES 511, 518 (2002) (criticizing an application of the economic substance doctrine).

[76] *See, e.g.*, Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 171–74, 186–87 (D. Conn. 2004) (holding that the litigated transaction lacked both the expectation of economic profit and a non-tax-related business purpose); *see also* Yoram Keinan, *It Is Time for the Supreme Court to Voice Its Opinion on Economic Substance*, 7 HOUS. BUS. & TAX L.J. 93, 95 (2006) (describing *Long Term Capital Holdings* as applying this test).

[77] *See, e.g.*, Rice's Toyota World v. Comm'r, 752 F.2d 89, 91–92 (4th Cir. 1985) (holding that a taxpayer's characterization of a sale and leaseback transaction will be rejected if the transaction "was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists"). In other words, under the version of the economic substance doctrine articulated by the *Rice's Toyota* court, if the taxpayer had demonstrated satisfaction of *one* of the prongs, the taxpayer's transaction would have been respected as having economic substance. *See also* Black & Decker Corp. v. United States, 340 F. Supp. 2d 621, 623–24 (D. Md. 2004) (holding a similar outcome in a contingent liability transaction), *aff'd in part, rev'd in part*, 436 F.3d 431 (4th Cir. 2006); Monte A. Jackel, *Summary of Economic Substance Case Law*, PLI ORDER NO. 27151, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2011, at 431–83 (Practising Law Inst. ed., 2011), *available at* 954 PLI/Tax 431-1 (West) (describing *Rice's Toyota* as applying the "disjunctive test").

[78] *See, e.g.*, Coltec Indus. v. United States, 62 Fed. Cl. 716, 756 (2004), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006) (holding the application of the economic substance doctrine to be an unconstitutional violation of separation of powers).

[79] Lederman, *supra* note 16, at 391.

[80] 78 T.C.M. (CCH) 262 (1999), *rev'd*, 254 F.3d 1014 (11th Cir. 2001).

[81] 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

[82] 84 A.F.T.R.2d 99-6445 (N.D. Iowa 1999), *rev'd*, 253 F.3d 350 (8th Cir. 2001).

judicial anti-abuse standards to reject the taxpayer's claimed tax treatment. On appeal, however, the court of appeals reversed the trial court's decision in each case and held in favor of the corporate taxpayer.[83] Several years later, however, the opposite string of events occurred. In 2004, the government lost a trio of high-profile corporate tax abuse cases at the trial level: *Black & Decker Corp. v. United States*,[84] *Coltec Industries, Inc. v. United States*,[85] and *TIFD III-E, Inc. v. United States*.[86] Again the courts of appeals reversed the trial court decisions, this time holding in favor of the government in each case.[87] The split between trial courts and appellate courts provides further evidence that judges may unevenly apply the judicial anti-abuse standards when determining whether or not a tax strategy represents corporate tax abuse.

3. Economic Substance Codification

Congress enacted legislation in 2010 in response to the courts' inconsistent application of the economic substance doctrine.[88] The legislation created a standard that courts must apply in cases where they determine the economic substance doctrine to be relevant: They must treat a transaction as possessing economic substance if it changes the taxpayer's economic position in a meaningful way (apart from tax effects) and if the taxpayer has a substantial purpose (apart from tax reasons) for entering into the transaction. [89]

While the new legislation creates a uniform economic substance doctrine, many commentators believe that it has little chance of

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[83] United Parcel Serv. of America v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001); Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 788 (5th Cir. 2001); IES Indus., Inc. v. United States, 253 F.3d 350, 359 (8th Cir. 2001).

[84] 340 F. Supp. 2d 621, 624 (D. Md. 2004), *aff'd in part, rev'd in part*, 436 F.3d 431 (4th Cir. 2006).

[85] 62 Fed. Cl. 716, 756 (2004), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006).

[86] 342 F. Supp. 2d 94, 121–22 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006).

[87] Black & Decker Corp. v. United States, 436 F.3d 431, 493 (4th Cir. 2006); Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1360 (Fed. Cir. 2006); TIFD III-E, Inc. v. United States, 459 F.3d 220, 241 (2d Cir. 2006).

[88] *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–68 (codified at I.R.C. § 7701(o) (Supp. IV 2010)).

[89] *Id.* In addition, to deter taxpayers from entering into abusive corporate tax strategies, Congress also enacted a 20% tax penalty that applies whenever a taxpayer loses a tax benefit as a result of the application of the economic substance doctrine or "any similar rule of law." I.R.C. § 6662(b)(6) (Supp. IV 2010). The tax penalty increases to 40% in the case of nondisclosed transactions. I.R.C. § 6662(i) (Supp. IV 2010). Taxpayers are not entitled to raise reasonable cause as a defense to these new tax penalties, effectively making them strict liability tax penalties. *See* I.R.C. § 6664(c)(2) (Supp. IV 2010).

reducing inconsistent judicial outcomes.[90] First, courts must still reach subjective determinations, such as whether a particular business purpose is "substantial" and whether a change in a taxpayer's economic position is "meaningful."[91] Second, the new statute provides that "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."[92] In other words, if a judge decides not to apply the pre-statute economic substance doctrine, she does not have an obligation to apply this particular judicial anti-abuse standard now.

B. Red Flags and Smell Tests

Predicting whether a court will apply a particular judicial anti-abuse standard, or any standard at all, is challenging. While one court may respect the separate, independent steps of a taxpayer's transaction, a different court may review the same transaction and determine that the steps should instead be viewed, and taxed, as one.[93] Figure 1 draws on the insights of Professor Kyle Logue[94] and illustrates the challenge of identifying transactions that may be characterized as "abusive" by describing the judicial characterizations that may apply to corporations' tax reduction strategies:

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[90] *See* David Hariton, *Has Codification Changed the Economic Substance Doctrine?*, 2 COLUM. J. TAX L. TAX MATTERS 5 (2011) ("[C]odification has almost no substantive effect."); Richard M. Lipton, *'Codification' of the Economic Substance Doctrine—Much Ado About Nothing?*, 112 J. TAX'N 325, 333 (2010) (speculating that the codified economic substance doctrine will be viewed as "a continuation of the status quo").

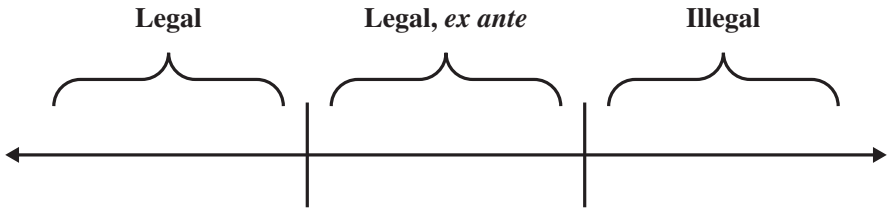
[91] I.R.C. §§ 7701(o)(1)(A), (B) (Supp. IV 2010).

[92] I.R.C. § 7701(o)(5)(C) (Supp. IV 2010).

[93] *See supra* Part I.A.2 (discussing inconsistent judicial approaches). As Judge Learned Hand famously wrote in *Helvering v. Gregory*, "Any one may so arrange his affairs that his taxes shall be as low as possible." 69 F.2d 809, 810 (2d Cir. 1934). Yet, in the same opinion, before rejecting the taxpayer's claimed treatment, Judge Hand offered the contradictory statement that "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes." *Id.* at 810–11.

[94] Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 251–52 & 252 fig.1 (2007) (presenting a useful continuum of uncertainty in tax abuse cases similar to our Figure 1); Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance,* 25 VA. TAX REV. 339, 360 fig.1 (2005) (same).

FIGURE 1
CONTINUUM OF CORPORATE TAX PLANNING CONTROVERSIES



At the left end of the continuum are legal activities. This category includes clearly permissible tax positions, such as a corporation's decision to apply the correct tax rate to its established tax liability.[95] This category may also include more aggressive, yet permissible, strategies. For example, a corporate parent may deliberately commence a complete liquidation of its corporate subsidiary at a time when it owns less than 80% of its vote and value, even though the corporate parent will eventually acquire 100% ownership, solely to enable the subsidiary to recognize a tax loss on the distribution of depreciated property.[96] At the right end of the continuum are clearly illegal activities, such as a corporation's decision to claim a business expense for high salary expenses that it never actually incurred. The middle section of the continuum represents corporate tax abuse: tax positions that are consistent with the letter of the tax law and are legal ex ante, but do produce tax benefits for the corporation that Congress did not intend and thus may be viewed as abusive ex post. Individuals involved in corporate tax planning expend significant effort endeavoring to determine ex ante whether a court would view a particular tax strategy as crossing the aggressive but legal line—that is, the line between legal corporate tax minimization (on the left side of the continuum) and abusive corporate tax evasion (in the middle of the continuum).

Given the uncertain nature of the judicial anti-abuse standards, individuals disagree on the factors that are most critical to a court's decision to reject a corporation's claimed tax treatment. In this Subpart, we examine the respective methodologies that three different groups of individuals—government officials, practitioners

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[95] *See* I.R.C. § 11(a) (1994) (stating that, under the I.R.C., a tax is imposed "for each taxable year on the taxable income of every corporation").

[96] *See, e.g.*, George L. Riggs, Inc. v. Comm'r, 64 T.C. 474, 489 (1975) ("[S]ection 332 is elective in the sense that with advance planning and properly structured transactions, a corporation should be able to render section 332 applicable or inapplicable."); *see also* I.R.C. § 332(a) (2006).

representing taxpayers, and scholars—have applied when engaging in this inquiry.

1. Government Officials

Government officials have identified several factors that they believe are relevant to determining whether or not a court will respect a corporation's tax position. One source of these factors is the broad set of disclosure requirements with which corporations (and other types of taxpayers) must comply.[97] Under these rules, corporations must file special disclosure forms with the IRS whenever they engage in transactions that bear certain "red flag" traits.[98] The purpose of these disclosure forms is to enhance the detection efforts of the IRS.[99] In addition, these disclosure requirements indirectly reveal the types of factors that government officials believe would influence a court in a tax controversy. Another source of government officials' beliefs is the IRS's internal administrative guidelines. The guidelines explain how IRS agents should address the newly codified economic substance doctrine and related tax penalties.[100] The following are some of the most significant factors that appear in the IRS's administrative guidance:

Loss Transactions. The government requires corporations to file a special disclosure form whenever they claim a $10 million or greater loss in any single taxable year.[101] Not every tax loss claimed by a corporation is the result of corporate tax abuse, but government officials believe large tax losses signal the possibility of corporate tax abuse. In addition, government officials believe that courts are likely to view a

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97 Treas. Reg. § 1.6011-4(e) (as amended in 2007).

98 *Id.* The law requires a taxpayer to file a disclosure statement with the IRS Office of Tax Shelter Analysis if the taxpayer has participated in any reportable transaction during the taxable year. *See* Sheryl Stratton, *Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS*, 100 TAX NOTES 1246, 1246–47 (2003). Taxpayers are also required to attach the disclosure statement to their annual tax returns. Treas. Reg. § 1.6011-4(e)(1) (as amended in 2007).

99 *See* Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1637–42 (2009) (describing "red flag" tax shelter detection strategy).

100 *See Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*, IRS.GOV, http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties (last updated Aug. 4, 2012) [hereinafter *Guidance for Examiners and Managers*]. For a discussion of the guidance issued by the IRS to its agents regarding how economic substance penalties should be applied, see *Economic Substance Guidance Issued to IRS Examiners*, J. ACCT., Oct. 2011, at 70.

101 Treas. Reg. § 1.6011-4(b)(5)(A) (as amended in 2007). A corporation must file the same disclosure form whenever it claims a loss of $20 million or more in "any combination of taxable years." *Id.*

tax strategy as abusive if the underlying transaction enables the corporation to "accelerate[ ] a loss or duplicate[ ] a tax deduction."[102]

Book-Tax Differences. Corporations have two distinct income reporting mechanisms. They report income for tax purposes on their federal tax returns (taxable income), but they also report income in corporate financial documents for purposes of informing shareholders and potential investors (book income).[103] Large corporations are required to reveal and explain differences between these two types of income by filing a special disclosure form with the IRS.[104] This requirement indicates that policymakers believe that a court should consider book-tax differences in a corporation's treatment of a particular item when determining whether the corporation engaged in an abusive tax strategy.

Third Parties. IRS administrative guidance documents also indicate that a court may find the application of the economic substance doctrine appropriate in cases when a corporation's transaction did not feature arm's length dealings with third parties.[105]

Economic Change. Finally, the IRS states that the application of the economic substance doctrine may be appropriate for transactions that create "no meaningful economic change on a present value basis" before considering tax consequences.[106] This statement confirms that government officials believe that courts may reject tax positions that lack corresponding real-world economic effects.

2. Tax Practitioners

Corporate tax lawyers devote significant time and energy to advising clients on the likelihood that courts will either (1) respect their transactions as consistent with the tax law or (2) label them as abusive. The most preeminent corporate tax lawyers are often the most confident in their ability to predict whether a particular corporate tax reduction strategy will pass the judicial smell test. For example, when commenting on a series of cases in the late 1990s in which courts rejected corporations' tax positions as abusive, M. Carr Ferguson, an experienced practitioner, queried: "Was it really so

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[102] *See Guidance for Examiners and Managers*, *supra* note 100.

[103] For a general discussion, see Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, *in* 17 TAX POLICY AND THE ECONOMY 169 (James M. Poterba ed., 2003), *available at* http://www.nber.org/chapters/c11538.pdf.

[104] Large corporate taxpayers, those with total assets of $10 million or more, file a Schedule M-3 form with the IRS. This form requires them to reconcile inconsistencies between income they report for income tax and financial accounting purposes. *See* I.R.S. Form 1120, Schedule M-3 (2010), *available at* http://www.irs.gov/pub/irs-pdf/f1120sm3.pdf.

[105] *See Guidance for Examiners and Managers*, *supra* note 100.

[106] *Id*.

difficult for counsel planning the taxpayers' transaction in those recent cases to make this prediction?"[107] Peter Canellos, another seasoned practitioner, described the prognostic ability of experienced tax lawyers even more directly: "Although in theory the line between a tax shelter and an aggressively structured real transaction may appear difficult to draw, in actuality the distinction is generally rather easy."[108] Some of the factors that many "experienced tax professionals"[109] believe will cause a court to designate a corporation's tax strategy as abusive are described as follows:

Business Purpose. When practitioners analyze the probability that a court will apply a judicial anti-abuse standard to unwind a corporation's transaction, they often focus on the strength of the business purpose underlying the transaction.[110] As Ferguson argued, courts are likely to respect transactions that "are grounded on long-understood principles of business purpose and economic substance."[111] Regarding the specifics of the type of purpose that a transaction should serve, Canellos advised: "Real transactions, most obviously, have as their origins and purpose making money in the short-run or the long-run by increasing revenues or reducing (non-tax) expenses."[112] For tax practitioners, business purpose (apart from tax avoidance) is often one of the most important factors considered when analyzing the potential judicial merits of the tax treatment of the transaction.

Multiple Parties and Convoluted Steps. Another factor that tax practitioners tend to consider is whether a transaction involves more than one party and thus has the resulting potential to lead to complex, or as some might say, "convoluted,"[113] transaction steps. Gary Wilcox, a practitioner at a large firm, explained: "Multi-step transactions designed to achieve a favorable tax result are often subject to more

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[107] M. Carr Ferguson, Senior Counsel, Davis Polk & Wardwell LLP, 2000 Erwin N. Griswold Lecture Before the American College of Tax Counsel: How Will a Court Rule?, *in* 53 TAX LAW. 721, 730 (2000).

[108] Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 53–54 (2001).

[109] *See id.* at 51 (describing the ease with which "experienced tax professionals can usually readily distinguish tax shelters from real transactions").

[110] *See, e.g.*, Jeffrey C. Glickman & Clark R. Calhoun, *The "States" of the Federal Common Law Tax Doctrines*, 61 TAX LAW. 1181, 1189 (2008) (defining the business purpose doctrine and explaining the importance of the question, "How much business purpose is enough?" to the business purpose analysis (internal quotation marks omitted)); Kevin M. Keyes, *Evolving Business Purpose Doctrine*, *in* 26 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2007, at 643 (Practising Law Inst. ed., 2007).

[111] Ferguson, *supra* note 107, at 730.

[112] Canellos, *supra* note 108, at 52.

[113] *See* Weisbach, *supra* note 16, at 232.

rigorous scrutiny when the results are significantly different depending on whether the steps are respected or collapsed."[114] Tax practitioners are especially wary of constructing tax strategies that contain "unusual contrived steps"[115] or that involve "accommodation parties,"[116] such as tax-exempt or foreign entities, which corporations often use to absorb taxable income resulting from their overall transactions.[117]

Timing of Steps. When predicting whether a court will respect the steps separately or characterize them as a single transaction, tax practitioners often analyze not only the presence of multiple steps, but also the timing of these steps.[118] One critical question that tax practitioners often consider is the amount of time that occurs *between* steps.[119] As one practitioner explained: "The amount of time elapsed between transactions . . . will also be important with respect to whether transactions are stepped together. The shorter the period the more likely transactions will be stepped together."[120] Lewis Steinberg, another established practitioner, commented that if the steps of a transaction occur too close in time to one another, a court may view certain entities or steps as having "transitory existence"[121] and disregard them completely.

Choice of Forum. In addition to the factors described above, tax practitioners make predictions regarding the likelihood that a court would respect a corporation's tax position by considering the *type* of court that would review the transaction.[122] Some tax practitioners believe that a corporation might fare better with a generalist judge in

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114 Gary B. Wilcox, *How and When To Apply Step Transaction Doctrine in Corporate and Partnership Restructuring Transactions*, 24 REAL ESTATE J. 266, 266 (2008).

115 Canellos, *supra* note 108, at 52.

116 *Id*. at 54.

117 *See, e.g.*, I.R.S. Notice 2001-16, 2001-9 I.R.B. 730 (describing an intermediary corporation tax shelter).

118 *See, e.g.*, AARON D. RACHELSON, *Step-Transaction Doctrine—Planning To Avoid the Step-Transaction Doctrine*, *in* CORPORATE ACQUISITIONS, MERGERS AND DIVESTITURES § 5:22 (2012), *available at* Westlaw CAMD; Mark J. Silverman, *Recent Developments in the Step Transaction Doctrine*, *in* PLI ORDER NO. 35322, TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES, NEW YORK CITY FEB. 27–28, 2012 (Practising Law Inst ed., 2012), *available at* 975 PLI/Tax 89 (West); Richard W. Bailine, *The Step Transaction Doctrine: Not Just a Matter of Time*, 30 CORP. TAX'N 50, 52 (2003).

119 *See* Bailine, *supra* note 118, at 52–54 (discussing the ramifications of timing classifications); Steinberg, *supra* note 50, at 496 n.181 (incorporating timing into the consideration of a multistep approach); Wilcox, *supra* note 114, at 270–71 (explaining the minimum time period).

120 RACHELSON, *supra* note 118, at § 5:22.

121 Steinberg, *supra* note 50, at 479.

122 *See, e.g.*, Joel V. Williamson et al., *Modern Tax Controversies*, *in* PLI ORDER NO. 27151, THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS &

a district court rather than a judge with tax expertise at the Court of Federal Claims, whereas others believe that litigating in Tax Court may produce the most favorable result for the corporation. Practitioners of the former category focus on whether the corporation's transaction was motivated by a strong non-tax business purpose, while practitioners of the latter category focus on whether a client's case hinges on winning a highly technical argument.[123]

3. Tax Scholars

Finally, we consider the expectations of the academic community. Tax law scholars generally do not advise clients on transaction structures or issue legal opinions. Instead, scholars tend to make normative claims with respect to how judges *should* decide corporate tax abuse cases and then provide prescriptive suggestions, such as concrete tests that judges should apply or legislation that Congress should enact. Implicit in these normative and prescriptive arguments, however, are positive claims regarding judicial behavior in corporate tax abuse cases. Several of these implicit positive claims are described below.

Intent. Scholars have implicitly argued that judges in corporate tax abuse controversies focus excessively, even incorrectly, on arguments regarding the intent of the taxpayer.[124] Professor Leandra Lederman, for example, has criticized the current economic substance decisions for "shift[ing] from a focus on congressional intent to a focus on the taxpayer's intent,"[125] and others, including Professor Martin McMahon, have echoed this view.[126] In addition, Professor Shannon

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RESTRUCTURINGS, at 478-9 (Practising Law Inst. ed., 2011), *available at* 957 PLI/Tax 478-1 (West) (discussing forum selection strategies in corporate tax shelter litigation).

123 *Compare* Marshall W. Taylor et al., *How to Choose the Right Forum in Tax Litigation*, PRAC. LAW., June 1991, at 39, 46–47 (discussing comparative judicial expertise), *with* Robert M. Howard, *Comparing the Decision Making of Specialized Courts and General Courts: An Exploration of Tax Decisions*, 26 JUST. SYS. J. 135, 138 (2005) ("[T]ax court judges should be able to use their expertise to premise their decisions less on ideological grounds and more on the facts and the law. In contrast, the district court is likely to show a greater reliance on IRS expertise, and . . . on relevant court-of-appeals decisions."). The underlying theory with respect to a generalist judge versus a judge with tax expertise is not investigated in this project, which focuses exclusively on the Supreme Court. We hope to investigate this theory about trial court judges in future work focusing on corporate abuse cases in lower federal courts.

124 *See* Lederman, *supra* note 16, at 389 (criticizing courts' focus on taxpayer intent); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 715 (arguing that intent-based standards, such as the business purpose doctrine, have "proved troublesome and the courts' application of the doctrine is remarkably inconsistent").

125 Lederman, *supra* note 16, at 389.

126 *See* McMahon, *supra* note 75, at 1017 ("The classic Supreme Court jurisprudence supports the application of a 'purposive activity' test that is closer to the analysis employed by the Tax Court in corporate tax shelter cases.").

Weeks McCormack has offered a detailed policy proposal, which would focus the attention of judges who hear corporate tax abuse controversies on the purpose of the tax laws.[127] Regardless of the specific policy prescription offered, each of these scholars implicitly has argued that judges in corporate tax abuse cases do not examine adequately the intent of the legislators who drafted the applicable tax statutes, as judges instead excessively scrutinize the intent of the taxpayers in structuring and implementing their transactions.

Textualism and Justice Scalia. Another implicit positive claim that some scholars have offered relates to textualism[128] and its increasing importance for judges. As the text of the statute begins to take precedence over all other interpretive methodologies, the number of corporate tax abuse cases in court has risen. For example, when describing corporate tax abuse cases, Professors Noël Cunningham and James Repetti argued: "The recent proliferation of tax shelters has, at least in part, been facilitated by the ascendancy of textualism," and that textualism "has dramatically affected the practice of tax law."[129] Further, scholars point to the judicial appointment of Justice Antonin Scalia as having an effect on corporate tax abuse controversies.[130] As Professors Dean and Solan have commented in the context of corporate tax abuse: "Since his appointment to the Supreme Court in 1986, Justice Scalia's 'new textualism' has been seen as a challenge to an intent-oriented approach to statutory interpretation."[131]

Alternative Proposals. Finally, tax scholars have offered a plethora of judicial, administrative, and legislative proposals for controlling corporate tax abuse.[132] They believe that their proposals

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127 *See* McCormack, *supra* note 124, at 720–31.

128 For an introduction to textualism, see generally Antonin Scalia, *Common Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, *in* A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 3 (1997).

129 Cunningham & Repetti, *supra* note 32, at 2–3.

130 *See, e.g.*, *id.* (describing the general effect of textualism on tax jurisprudence).

131 Steve A. Dean & Lawrence M. Solan, *Tax Shelters and the Code: Navigating Between Text and Intent*, 26 VA. TAX REV. 879, 885 (2007).

132 *See, e.g.*, Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. CORP. L. 219 (2004) (shaming); Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005) (loss disallowance rule); Michael S. Knoll, Compaq *Redux: Implicit Taxes and the Question of Pre-tax Profit*, 26 VA. TAX REV. 821 (2007) (consideration of implicit taxes in economic substance analysis); Lederman, *supra* note 16 (congressional intent-based inquiry); McCormack, *supra* note 124 (purposive approach); Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289 (2002) (enhanced tax shelter disclosure); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569 (2006) (self-adjusting penalty); Jay A. Soled & Dennis J. Ventry, Jr., *A Little*

would be more successful than judicial anti-abuse standards, which are unable to "protect the collection of income tax from assault by abusive shelter planners."[133] By offering these alternatives, scholars implicitly argue that judges in corporate tax abuse controversies fail to apply the current anti-abuse standards in a reliable and effective manner.

C. The Stakes of Judicial Uncertainty

As the discussion thus far reveals, judicial decisionmaking in corporate tax abuse controversies is grounded in a range of interrelated anti-abuse standards. These standards appear to govern in a highly uncertain fashion. Government regulators, practitioners, and scholars have proffered a wide range of views with respect to judicial decisionmaking in the corporate tax abuse context, but there is no consensus as to what courts *actually* do. Our study adds to the positive literature but adopts a different approach. Whereas the previous studies have focused on a small collection of cases and provided qualitative insights, we have collected the entire population of corporate tax abuse cases litigated in the U.S. Supreme Court and used quantitative methods in an effort to understand how the Justices view corporate tax abuse. Before proceeding to our own study, we briefly consider what is at stake in this area of the law and the potential benefits of adding an empirical study to the already vast extant literature on the topic.

First, judicial decisionmaking directly affects the negotiation of tax controversy settlements between the IRS and taxpayers. When IRS agents audit and then challenge a corporation's tax position, the parties negotiate in the shadow of litigation. Moreover, both corporate tax lawyers and IRS Appeals Division officers must make predictions regarding how a judge will respond to various factors present in the taxpayer's case while negotiating a settlement. The IRS explicitly

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Shame Might Just Deter Tax Cheaters, USA TODAY, Apr. 10, 2008, at A11 (shaming); *see also* Bankman, *supra* note 72, at 29 (substantive law reform if nature of corporate tax shelters changes); Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 CAN. J.L. & JUR. 95, 111–13 (2005) (shaming); Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 472–83 (2009) (50% adjustment of taxable income towards financial accounting income for public corporations); David A. Weisbach, *Disrupting the Market for Tax Planning*, 26 VA. TAX REV. 971, 974 (2007) (broad-based anti-abuse standards); *cf.* Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Norm*, 75 FORDHAM L. REV. 961 (2006) (transparency within corporate decisionmaking groups); George Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 406 (2002) (reform of judicial anti-abuse standards).

[133] Chirelstein & Zelenak, *supra* note 132, at 1962.

considers the "hazards of litigation" when deciding issues such as the floor settlement offer that they are willing to accept[134] and whether to seek the imposition of tax penalties.[135] A better and more informed understanding of how judges actually decide corporate tax cases could encourage settlement and simultaneously prevent parties from accepting inappropriate settlement offers. A large-*n* quantitative study will add to the qualitative research discussed above by uncovering judicial decisionmaking trends that explain outcomes but that are hidden in a qualitative case-based approach.

Second, the behavior of judges in corporate tax abuse cases, as perceived by tax practitioners and corporate managers, has a major impact on corporate planning of a wide array of transactions, including ordinary business transactions.[136] If courts do not privilege the features that tax practitioners tend to view as supremely important, such as the presence of a business purpose, corporations may pursue unnecessary actions and incur unnecessary costs in order to avoid the application of judicial anti-abuse standards.[137]

Third, academic proposals addressing corporate tax abuse are often reactions to judicial behavior.[138] For example, in order to fix perceived problems with the intent-based business purpose standard, several scholars have proposed alternative methods of statutory interpretation.[139] Without more information regarding how judges actually act in these cases, it is difficult to determine which of these proposals should be explored further.

In this Article, we do not express a normative view on whether judicial uncertainty in corporate tax abuse cases is beneficial or harmful; other scholars have considered this question in great depth. Rather, we investigate the extent to which judicial decisionmaking is characterized by identifiable trends or is, in fact, uncertain and erratic, as many scholars and commentators have argued.

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134 *See* David M. Fogel, *The Inside Scoop About the IRS's Appeals Division*, 99 TAX NOTES 1503, 1503–04 (2003) (discussing the "hazards of litigation" analysis).

135 *See* Taylor et al., *supra* note 123, at 42–43 (noting some considerations that shape the decision to seek an increased deficiency or penalty).

136 *See supra* Part I.B.2 (discussing judges' effects on corporate planning).

137 For discussion of the social cost of unecessary actions, see Weisbach, *supra* note 16, at 222–23.

138 *See, e.g.*, McCormack, *supra* note 124, at 720–31 (presenting a policy proposal following a criticism of intent-based judicial standards).

139 *See supra* notes 132–33 and accompanying text (describing scholars' proposals).

II
An Empirical Study of Corporate Tax Abuse in the Supreme Court

A. The Data and the Models

In this Part, we seek to fill a void in the extant literature with a new study that explores the factors that influence judicial decisions in corporate tax abuse controversies. More specifically, we investigate U.S. Supreme Court cases decided between the years 1909 and 2011 involving allegations of corporate tax abuse.

1. Data Collection Strategy

To identify and analyze corporate tax abuse we designed a data collection process with the following three steps:

(1) Collect the superset of Supreme Court cases involving any type of federal taxation issue (that is, issues relating to individuals, corporations, nonprofit entities, and so forth) decided by the Court between the years 1909 and 2011.[140]
(2) Identify the subset of federal taxation cases involving corporate tax issues.
(3) Identify the sub-subset of cases involving alleged corporate tax abuse.

In the first step of our strategy, we found 919 federal tax cases decided during our period of interest. For purposes of the second step, we read each of the 919 opinions and determined that 40% (n = 364) involved a corporate tax controversy—that is, one that involved corporate rather than individual tax liability. Our third and final step required us to identify yet another subset—cases that alleged corporate tax abuse. Because the third prong of our data collection process entailed a more complex procedure than the first two prongs and also goes to the very heart of our project, we elaborate on our methodology below.

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[140] We identified these cases in a Lexis search. The search that we conducted read as follows: (federal w/s tax!) or (excise w/s tax!) or (estate w/s tax!) or (user w/5 fee) or (user w/s tax!) or (tax! w/s fraud) or (irc) or (i.r.c.) or (stamp w/s tax!) or (income w/s tax!) or (internal w/s revenue) or (tax! w/s lien) or (tax! w/s code) or (tax! w/s evad!) or (tax! w/s evasion) or (corporate w/s tax!) or (payroll w/s tax!) or (employment w/s tax!) or (social w/s security) or (26 usc) or (26 u.s.c.) or (tax! w/s refund) or (tax! w/s deficiency) or (unemployment w/s tax!) or (gift w/s tax!) or (fica w/s tax!) or (f.i.c.a. w/s tax!). We then read each case and identified those that involved a federal tax controversy; we excluded the cases that did not interpret the federal tax code, such as those that merely referred to the code or involved state and local taxation issues.

2. *Allegations of Corporate Tax Abuse: Why They Are Important and Where To Find Them*

Our discussion in Part I suggested that while scholars and commentators widely agree that corporate tax abuse exists, there is no universally accepted definition of the phenomenon—which creates high levels of uncertainty in the federal courts. Paradoxically, this fact does not pose a problem for our empirical study. Because we only seek to understand the factors that explain Supreme Court decisions, we need not settle on a single definition of corporate tax abuse. Rather, we need identify only the cases in which the government *alleged* abuse and then determine how the Justices reached a decision in the controversy. Put more directly, our project investigates how and why the Justices reach particular legal conclusions when the government argues that a corporation claimed an inappropriate tax position through an abusive tax strategy.

Accordingly, in the third and final step of our data collection process we focus on the group of corporate tax cases in which the government *alleged* abuse—not only on the cases in which the Court actually *found* abuse. By adopting this strategy, we are able to examine all of the factors alleged by the government vis-à-vis abuse and determine which factors were (and were not) convincing to the Justices when they granted or denied the tax benefits sought by a corporate taxpayer. It is important to examine the entire collection of cases in which the Court *could have found* abuse in order to fully understand the outcomes.[141] We seek to explain why the government wins and loses the cases it litigates in the Supreme Court.

To see why this approach to data collection is essential to our project, consider a hypothetical study in which a research team seeks to identify the factors that explain the Law School Admission Test (LSAT) results. The hypothetical research team does not seek to describe the successful students, but rather to identify the factors that differentiate the successful group from all other test-takers. If the investigators conduct their study by focusing only on the group of high-scoring students and ignore those who failed the exam, their empirical findings would likely be seriously flawed. Spurious results would emerge because the researchers would not possess the appropriate sample of students; in order to differentiate high-scoring

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[141] *See* Barbara Geddes, *How the Cases You Choose Affect the Answers You Get: Selection Bias in Comparative Politics*, 2 POL. ANALYSIS 131 (1990) (providing useful examples for a selection bias problem that emerges when portions of data are purposefully excluded from studies); *see also* PETER KENNEDY, A GUIDE TO ECONOMETRICS 286–87 (2003) (discussing various selection problems that can produce biased results).

from low-scoring students, both groups must be represented in the study.

Similarly, in our project, we do not examine only the cases in which the government succeeded in convincing the Court to find tax abuse. Rather, we examine *all* the cases which included allegations of corporate tax abuse and seek to discern the factors that led the Court to find corporate tax abuse in only some. With this strategy, we will be able to understand and explain how the Court conceptualizes the problem of corporate tax abuse and better understand the types of transactions perceived to be problematic and against public policy. More importantly, our strategy will enable us to predict how the Court will respond to future transactions challenged by the government as abusive. Again, if we examined only the cases in which the Court found abuse, we would be unable to accomplish these goals because the data would not permit comparative analytics.[142]

From an empirical standpoint, it is quite obvious that we must investigate all of the cases in which the government alleged abuse in order to understand the Supreme Court's decisions. But identifying this large collection of cases poses a difficult data collection problem. Recall from above that the first step of our data collection process identified 919 federal taxation cases in the Supreme Court, and in the second step, we read the 919 opinions and identified 364 as corporate tax cases. Now, in the third step, we must identify the subset of corporate tax cases that involved alleged corporate tax abuse. To do this, it was not possible to rely on the judicial opinions, because the Court often passes on legal issues without expressly addressing all the claims set forth in the brief, including allegations of abuse. Accordingly, for purposes of our third step of the data collection process—and to identify the cases in which corporate tax abuse was alleged (but not necessarily found by the Court)—we turned to the government's briefs filed with the Court.[143]

We read the government's legal arguments presented in Court filings in each of the 364 corporate tax cases, and found that few of the documents explicitly referred to corporate tax abuse. Indeed, only two briefs filed over the course of the last century referred to a corporate tax "shelter."[144] More often, when describing perceived inappropriate

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[142] *See supra* note 141.

[143] We accessed these briefs through the Thompson/Gale Corporation's database, "U.S. Supreme Court Records and Briefs, 1832–1978," and through the Lexis-Nexis collection of "Court Records, Briefs and Filing Sources" for the briefs filed after 1978.

[144] Brief for the United States at 9, Fulman v. United States, 434 U.S. 528 (1978) (No. 76-1137). The government's brief in the 2012 case, *United States v. Home Concrete & Supply, LLC*, also references tax shelters—but this case is not in our dataset because the

corporate behavior, the government used terms such as "distortion,"[145] "avoidance,"[146] "manipulation,"[147] "evasion,"[148] "tax-motivated,"[149] and so forth. In our review of the legal arguments, we focused on the cases in which the government argued that these types of transactions and tax positions should be viewed as abusive, even though one could argue that they were legal under a hyper-literal reading of the tax law. Through this process, we found that 38% (n = 137) of the corporate tax controversies involved government allegations of abuse.[150] As we discuss in detail below, the government did not prevail in all 137 cases. The empirical question that we seek to answer, therefore, is this: What are the factors that lead the Court to agree with the government in some of these cases but to reject the claims of abuse in others?

Before moving to the statistical models that we use to answer this question, it is useful to describe the cases that we plan to analyze. Figure 2 depicts the three groups of cases uncovered in our data collection efforts. The light grey area denotes the superset of 919 tax cases decided over the course of the last century, the dark grey area denotes the set of 364 corporate tax cases, and the black area indicates the subset of 137 corporate tax abuse cases as defined above.

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specific issue to be addressed by the Supreme Court involves a procedural issue, the statute of limitations, and not the abusive nature of the tax shelter. Brief for the United States at 5, 6, United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012) (No. 11-139).

145 Brief for the Respondent at 19, Murphy Oil Co. v. Burnet, 287 U.S. 299 (1932) (No. 80).

146 Brief for the Petitioner at 25, Helvering v. Nat'l Grocery Co., 304 U.S. 282 (1938) (No. 723); Brief for the Petitioner at 17, McLaughlin v. Pac. Lumber Co., 293 U.S. 351 (1934) (No. 125).

147 Brief for the Petitioner at 33, Helvering v. Minn. Tea Co., 296 U.S. 378 (1935) (No. 174); *see also* Brief for the Respondent at 42, Colonial Am. Life Ins. Co. v. Comm'r, 491 U.S. 244 (1989) (No. 88-396) ("manufacture . . . tax losses").

148 Brief for the Respondent at 8, First Chrold Corp. v. Helvering, 306 U.S. 117 (1939) (No. 385).

149 Brief for the Respondent at 26, Atl. Mut. Ins. Co. v. Comm'r, 523 U.S. 382 (1998) (No. 97-147).

150 Both authors read the 364 corporate tax cases to identify the subset of corporate tax abuse cases. Our inter-coder reliability was high: We reached initial conflicting decisions in a small number of cases but upon review easily reached a consensus on these cases. We then re-read the briefs to confirm our initial coding decisions.

FIGURE 2
THREE GROUPS OF TAX CASES ON THE SUPREME COURT DOCKET FROM 1909 TO 2011

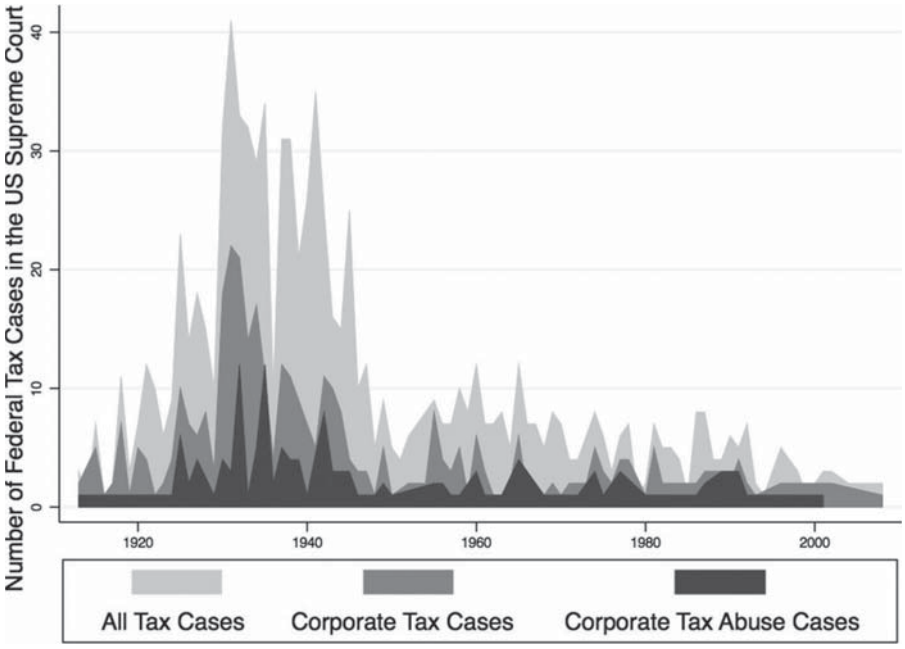

Figure 2 indicates that controversies in each set and subset—tax cases, corporate tax cases, and corporate tax abuse cases—have appeared on the Supreme Court's docket in every era. While the number of cases in each category spiked in the early- to mid-1900s, the decreasing frequency of tax cases reflects a decrease in the size of the overall docket—not the relative importance of taxation. In fact, federal tax issues have comprised roughly 5% of the Supreme Court's docket nearly every year over the course of the last century.[151] That the Justices believe tax cases raise important legal questions is evident by the justifications set forth for granting review. In more than a few opinions, the majority has noted that tax cases raise important issues for both taxpayers and for the administration of the nation's revenue laws;[152] the Court has also noted that abuse cases are particularly

[151] *See* Nancy Staudt, Lee Epstein, Peter Weidenbeck, René Lindstädt & Ryan J. Vander Wielen, *Judging Statutes: Interpretive Regimes*, 38 LOY. L.A. L. REV. 1909, 1926–29 (2005) (presenting data and graphs on the size of the Supreme Court's docket).

[152] *See, e.g.*, United States v. Hill, 506 U.S. 546, 549 (1993) ("Because of the importance of the issue to the federal fisc, we granted certiorari."); United States v. Atlas Life Ins., 381 U.S. 233, 239 (1965) ("We granted certiorari to consider this important question relating to the taxation of life insurance companies."); Magruder v. Wash., Balt. & Annapolis Realty,

important to review because they generate heavy litigation in the lower courts. [153]

In analyzing the various cases in our data set, we observed that corporations have sought to avoid paying taxes with the help of clever strategies since the adoption of the modern corporate tax laws in 1909 (if not earlier), although the tactics have evolved over time. For example, the 1913 case *McCoach v. Minehill & Schuylkill Haven Railroad* involved an incorporated railroad company that sought to avoid paying corporate taxes by leasing its assets to a secondary company and then distributing the rental income directly to its shareholders. [154] Minehill argued that because its financial activities did not reflect typical corporate behavior, it should not be viewed as a corporation for tax purposes.[155] In *Hellmich v. Missouri Pacific Railroad*, decided in 1927, the Missouri Pacific Railroad used inter-corporate barters and trades in an effort to avoid the receipt of income and thus the burden of the corporate income tax.[156] Forty years later, the Court decided *Fribourg Navigation Co. v. Commissioner*, in which a corporation claimed substantial and questionable depreciation deductions on its property and then proceeded to sell the property (which had appreciated) in a complete liquidation, thereby enabling the corporation to decrease its ordinary income in the short term and avoid capital gains altogether in the long term.[157] The most recently decided abuse case in our collection, *United Dominion Industries, Inc. v. United States*,[158] involved a group of related companies filing a consolidated return. The companies adopted a single entity approach to calculate product liability losses rather than a method that calculated each affiliate's losses separately, which would have worked to their tax disadvantage.[159] The government argued in its brief that the position advocated by companies "would permit significant tax avoidance abuses"[160] and further observed that as the "Court emphasized in a

316 U.S. 69, 72 (1942) ("We granted certiorari because of the importance of the question in the administration of the revenue acts.").

153 *See, e.g.*, Thor Power Tool v. Comm'r, 439 U.S. 522, 525 (1970) ("We granted certiorari to consider these important and recurring income tax accounting issues.").

154 228 U.S. 295, 297–300 (1913).

155 *Id*. at 304–05 (holding that because Minehill was not actively engaged in the railroad business, it should be exempt from the corporate tax).

156 273 U.S. 242, 247–49 (1927).

157 Fribourg Navigation Co. v. Comm'r, 383 U.S. 272, 274–79 (1966) (explaining, though ultimately rejecting, the government's account of the corporation's questionable tax practices).

158 532 U.S. 822 (2001).

159 *Id.* at 827–28.

160 Brief for the United States at 12, United Dominion Indus., Inc. v. United States, 532 U.S. 822 (2001) (No. 00-157).

case that involved a similar abuse, 'the mind rebels against the notion that Congress in permitting a consolidated return was willing to offer an opportunity for juggling so facile and so obvious.'"[161] These are just a few examples of the types of transactions that the government has challenged in Court, arguing that the statute may not be used to "defeat the manifest purpose of Congress" in raising revenue.[162] In short, while the form of a transaction or a position taken on a tax return may be perfectly legal ex ante, the government may nonetheless believe the corporation adopted an abusive position and thus should be denied the tax benefits it seeks ex post.

3. Three Statistical Models

In an effort to understand and explain Supreme Court decision-making in the corporate abuse context, we created three separate statistical models. In the first model, we investigate how the government fares in the Supreme Court in abuse cases versus all other types of tax controversies. More specifically, we seek to determine whether the government is more (or less) likely to prevail in the Supreme Court in cases where it alleges corporate tax abuse compared to cases that do not involve such allegations.

The abuse cases, obviously, are a subset of the tax cases generally and the corporate tax cases particularly. Thus, our second model compares the outcomes in cases where the government alleged abuse to cases in which the government set forth non-abuse grounds for denying the taxpayer its preferred tax position. Put most directly, our first two models seek to determine whether or not, on average, the Justices favor—or disfavor—the government in controversies that involve transactions that conform to the letter of the tax law but that are inconsistent with legislative intent and the general revenue-raising goals imbedded in the tax law. We conceptualize our empirical questions more formally with the help of two statistical models:

$$\Pr(\text{AllTaxOutcome}_i=1) = b_0 + b_1\text{CorporateAbuse}_i + \Sigma b_j C_{ij} + e \quad (1)$$

$$\Pr(\text{CorporateTaxOutcome}_i=1) = b_0 + b_1\text{CorporateAbuse}_i + \Sigma b_j C_{ij} + e \quad (2)$$

AllTaxOutcome$_i$ in equation (1) is the Court's decision in a given federal tax case (raising any type of issue, corporate or not) and is coded to be 1 if the government prevails and 0 otherwise. *CorporateTax Outcome*$_i$ in equation (2) is the Court's decision in a given corporate

[161] *Id.* at 13 (citing Woolford Realty Co. v. Rose, 286 U.S. 319, 330 (1932)).

[162] Brief for the Petitioner at 34, Helvering v. Minn. Tea Co., 296 U.S. 378 (1935) (No. 174).

tax case and is coded to be 1 if the government prevails and 0 otherwise.

In both equations, $CorporateAbuse_i$ is a variable indicating whether the government contended in its Supreme Court brief that a corporation engaged in an abusive transaction or took an abusive accounting position and is coded to be 1 if such an allegation was made and 0 otherwise. C_{ij} in both equations represents a collection of five control variables that scholars have already found to affect judicial outcomes in the taxation context. The first is *Defense Spending*: One of the authors of this study has previously found that spikes in the nation's defense spending leads the Court to issue a greater number of pro-government decisions in tax cases.[163] The second is *Government Is Petitioner*: Various other scholars have found that when the government is the petitioner (and not the respondent) in the Supreme Court, the Justices are more likely to reach outcomes in favor of the government and against the taxpayer.[164] The third is *Judicial Political Preferences*: Republican-appointed Justices appear to favor the corporation over the government in the tax cases.[165] Fourth and fifth are *State of the Economy* and *Year*: We control for these in

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163 *See generally* NANCY STAUDT, THE JUDICIAL POWER OF THE PURSE (2011). For purposes of our study, the variable *Defense Spending* is coded equal to the nation's defense spending in 2009 dollars, in ten billion dollar increments.

164 *See* Linda R. Cohen & Matthew L. Spitzer, *The Government Litigant Advantage: Implications for the Law*, 28 FLA. ST. U. L. REV. 391, 408–11 (2000); Stephanie A. Lindquist & David E. Klein, *The Influence of Jurisprudential Considerations on Supreme Court Decisionmaking: A Study of Conflict Cases*, 40 LAW & SOC'Y REV. 135, 144–57 (2006) (investigating the effects of the Solicitor General's participation on case outcomes). The variable *Government Is Petitioner* is coded 1 if the government is the petitioner in the U.S. Supreme Court and 0 otherwise.

165 *See* Nancy Staudt, Lee Epstein & Peter Wiedenbeck, *The Ideological Component of Judging in the Taxation Context*, 84 WASH. U. L. REV. 1797, 1815–21 (2006). The variable *Judicial Preferences* is coded to be 1 if a Republican president appointed the majority of the Justices and 0 otherwise. We used this admittedly very rough measure because it was the only available measure for early Justices in our database. Other more sophisticated measures of judicial preferences exist, but are not available for the Justices on the Court as early as 1909. *See, e.g.*, Andrew D. Martin & Kevin M. Quinn, *Dynamic Ideal Point Estimation via Markov Chain Monte Carlo for the U.S. Supreme Court, 1953–1999*, 10 POL. ANALYSIS 134 (2002) (discussing Martin-Quinn scores for measuring judicial preferences); Andrew D. Martin et al., *The Median Justice on the United States Supreme Court*, 83 N.C. L. REV. 1275 (2005) (same). Others have examined judicial measurement issues with great insight. *See* Daniel E. Ho & Kevin M. Quinn, *How Not To Lie with Judicial Votes: Misconceptions, Measurement, and Models*, 98 CALIF. L. REV. 813 (2010) (discussing the uses and abuses of judicial measures); *see also* BARRY FRIEDMAN, THE WILL OF THE PEOPLE: HOW PUBLIC OPINION HAS INFLUENCED THE SUPREME COURT AND SHAPED THE MEANING OF THE CONSTITUTION (2009) (moving beyond judicial politics to the role of public opinion on judicial outcomes); Barry Friedman, *The Politics of Judicial Review*, 84 TEX. L. REV. 257 (2005) (discussing the value of accounting for judicial preferences in normative scholarship).

the year that the decision was rendered in order to capture any influences that may affect the Court's outcome but are not directly included in our model.[166]

The variable of interest in our two preliminary models is *CorporateAbuse*. The coefficients on *CorporateAbuse* will indicate whether corporate tax abuse cases are easier or harder to win for the government compared to the other types of tax cases that the Supreme Court decides. In the abuse controversies, as discussed above, both the government and the corporate taxpayer have viable legal arguments. The government argues that the corporation should not obtain the tax consequences it desires because tax laws should not be used in a manner that undermines their legislative intent and revenue-raising potential. The taxpayer, by contrast, argues that it followed the letter of the law and thus is entitled to its preferred tax outcome. We expect that the government will encounter more difficulty prevailing in cases that rest primarily (or solely) on public policy considerations related to abuse, compared to other types of cases that implicate, for instance, disputes associated with statutory or regulatory interpretation. Accordingly, we predict that the coefficients on *CorporateAbuse* will be negative: $b_1 < 0$. When the government alleges abuse, the probability that the government will prevail will decrease.

Models (1) and (2) investigate a very simple question: Does the government have an easier or more difficult time winning corporate tax abuse cases than other types of tax cases that it litigates in the Supreme Court? The more interesting inquiry—and the point of this study—attempts to identify the factors that are most likely to convince the Court to decide in favor of the government when abuse is alleged. After all, we expect the government to have a more difficult time winning abuse cases, but we know it does win sometimes. To answer our question, we must focus exclusively on the 137 abuse cases that we identified in the data collection process and use a statistical model that

166 The variable *State of the Economy* is coded to be 1 if the economy is growing and 0 if the economy is in a state of recession, as measured by the NBER Dating Committee. For a discussion of this variable, see Thomas Brennan, Lee Epstein & Nancy Staudt, *Economic Trends and Judicial Outcomes: A Macro-theory of the Court*, 58 DUKE L.J. 1191 (2009). The variable *Year* is the year in which the decision was argued.

In earlier versions of this study, we included a control for the court in which the controversy originated on the theory that the Justices may give more deference to the experts on the Tax Court (than to the generalist district court judges). The variable, however, did not produce statistically significant or robust results. Our dataset as currently constructed does not identify how the trial court ruled (or whichever venue made this ruling) but only how the appellate court decided the tax issue—thus the Justices' views of the appellate court cannot offer insight to their views of the substantive trial court outcomes. We plan to investigate this issue in future empirical studies.

will predict and explain when and why the government wins in this subset of controversies.

For purposes of answering our empirical question, we again investigated the legal briefs filed in the Supreme Court.[167] We found that when government lawyers seek to convince the Court to invoke an anti-abuse doctrine, they routinely point to a small collection of very specific facts and circumstances.[168] Three of the factors are tied to the nature of the transaction itself and two are linked to the position taken by the corporation on its tax return filed with the IRS. These five factors are: (1) the presence of third parties in the transaction; (2) multistep transactions; (3) the lack of a business purpose other than tax avoidance; (4) accounting irregularities, such as book-tax differences; and (5) a claim for a tax refund on the initial return. We found, as indicated in Table 1 below, that the government cited to at least one of these factors in 81% of all the corporate tax abuse controversies litigated in Court. The briefs also indicate, as expected, that the government will point to these factors both alone and in tandem in an effort to win its case.

TABLE 1
INDICIA OF CORPORATE TAX ABUSE AND FREQUENCY OF ALLEGATION IN THE GOVERNMENT'S BRIEFS

Indicia of Corporate Tax Abuse	*Number of Government's Briefs Which Raised Allegation*
(1) Third Party	65 (47%)
(2) Multistep Transaction	50 (36%)
(3) Lack of Business Purpose	34 (24%)
(4) Accounting Irregularity	39 (28%)
(5) Request for Tax Refund	19 (14%)
Any Indicia[169]	111 (81%)
No Indicia	26 (19%)
Total Observations	137 (100%)

[167] *See supra* note 143 (explaining the database we used).

[168] *See supra* Part I.B.1. A recent government publication also lists the characteristics of abusive corporate tax strategies. We relied on this to identify the factual claims set forth by the government with respect to its abuse arguments. *See* DEP'T OF TREASURY, THE PROBLEM OF TAX SHELTERS: DISCUSSION, ANALYSIS, AND LEGISLATIVE PROPOSALS (1999).

[169] We can parse the data even further. Roughly 37% of the cases had at least one indicium, 20% of the cases had two indicia, 20% had three indicia, and 3% had four indicia of tax abuse. None of the cases had all five factors alleged.

In addition to the facts and circumstances alleged in the briefs, scholars have argued that the government is less likely to prevail after 1986. As we discussed earlier, Professors Noël Cunningham and James Repetti, among others, imply that Justice Scalia's ascension to the Supreme Court in 1986 and the attendant rise in the plain meaning approach to statutory interpretation have had an effect on judicial outcomes and votes.[170] Allegedly, Justice Scalia increases the probability that a corporate taxpayer will prevail (and the government will lose) because abusive tax strategies tend to adhere literally to the tax law. Thus, the plain meaning approach works to the corporation's advantage in front of the post-1986 Supreme Court.

Because the primary goal of this study is to determine what role the facts and circumstances listed in Table 1 (along with the appointment of Justice Scalia) had on the Supreme Court's decisionmaking process in the 137 corporate tax abuse cases, we must set up a model that incorporates all these variables. To identify the effects of interest, we have derived the following:

$$\begin{aligned}\Pr(\text{CorpAbuseOutcome}_i=1) = b_0 &+ b_1\text{ThirdParty} + b_2\text{MultiStep} + \\ &b_3\text{NoBusPurpose} + b_4\text{AccountingIrreg} \\ &+ b_5\text{RefundClaim} + b_6\text{JusticeScalia} \\ &+ \Sigma b_j C_{ij} + e \qquad (3)\end{aligned}$$

CorpAbuseOutcome$_i$ is the Court's decision in a case involving alleged corporate tax abuse. It is coded to be 1 if the government prevails and 0 otherwise.[171] Note that we are now focused solely on the corporate tax abuse cases. No other cases are included in this part of our investigation, because it is only the corporate tax abuse cases that raise the first four allegations found on the right side of equation (3). We will, of course, investigate all of the variables on the right side of the equation in an effort to determine what effect, if any, they have on Supreme Court decisionmaking.

The primary variables of interest in this study are *ThirdParty*, *MultiStep*, *NoBusPurpose*, *AccountingIrregularity*, and *RefundClaim*,

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170 *See* Cunningham & Repetti, *supra* note 32.

171 Investigating court outcomes is useful because it indicates the ultimate winner of the dispute. Thus, if we can identify factors that explain when and why one party prevails over the other, we will advance the extant understanding of how courts decided tax abuse cases. This approach, however, obscures the views of the individual Justice and the factors that help to explain individual, rather than institutional, behavior. In the future, we will investigate the *individual Justice's vote* in each case. For now, however, it is useful to note that our work in other venues suggests that the empirical findings with respect to individual Justices' voting strongly confirms the findings with respect to outcomes. *See generally* STAUDT, *supra* note 163 (exploring both case outcomes and individual Justices' votes in a study of taxation cases generally and finding a similar empirical result).

and are all coded to be 1 if the government alleged the factor and 0 otherwise. The variable *JusticeScalia* is also a binary variable equal to 1 if the year the Court heard oral arguments was post-1986 and 0 otherwise. Finally, C_{ij} is the same collection of control variables discussed above with respect to models (1) and (2).[172] As to our modeling expectations, we have developed the following hypotheses. The presence of third parties, multi-step transactions, the lack of a business purpose, accounting irregularities, and refund claims are all indicia of corporate tax abuse, and consequently we expect that the presence of these variables will increase the likelihood that the Justices will side with the government. They will *positively* correlate with judicial outcomes—thus, when they are present the likelihood that the government will prevail will increase. We expect the presence of Justice Scalia to *negatively* correlate with judicial outcomes, because his approach prioritizes the plain meaning of the tax statute over public policy concerns. Thus, when Justice Scalia is on the Court, the government will be less likely to win. Formally, we expect to find b_1, b_2, b_3, b_4, and $b_5 > 0$, and $b_6 < 0$. It is useful to note here that if we are unable to uncover the factors that correlate with judicial outcomes (or if they correlate in unexpected ways) then the scholarly argument that corporate tax abuse controversies generate unpredictable results will be all the more convincing.

B. Empirical Findings

In this Subpart, we turn to our empirical findings. We seek to determine whether our models explain Supreme Court decision-making, or whether we should reconceptualize the process that leads to a pro-government or pro-taxpayer outcome in the cases of interest. At the outset, we wish to note a few nuances with respect to the interpretion of our results. We use probit models[173] and the tables below depict our statistical findings using this type of model. Because probit coefficients are difficult to interpret,[174] we present our results in a

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[172] *See supra* notes 163–66 and accompanying text.

[173] Probit models are necessary because the dependent variable is binary. A large literature discusses the advantages of using a probit (or a logit) model over a linear probability model with a binary dependent variable. *See, e.g.*, KENNEDY, *supra* note 141, at 259–61 (using a linear probability model and producing estimated probabilities outside the 0–1 range); J. SCOTT LONG, REGRESSION MODELS FOR CATEGORICAL AND LIMITED DEPENDENT VARIABLES 34–84 (1997) (using a linear probability model with a binary dependent variable necessarily violates many of the underlying assumptions of the former, including those associated with heteroskedasticity, normality, and functional form).

[174] *See* JEFFREY M. WOOLDRIDGE, INTRODUCTORY ECONOMETRICS: A MODERN APPROACH 588 (2006) ("[F]rom a practical perspective the most difficult aspect of logit or probit models is presenting and interpreting the results."); *see also* JACK JOHNSTON &

different format: The findings reflect the marginal change in the probability that the government will win a case given a unit increase in the independent variable.[175] Recall that we explained above how we coded each variable of interest—this is important information if our results are to be interpreted correctly. For example, a positive sign on a coefficient presented in a table below indicates that as the independent variable increases (or moves from 0 to 1 if it is binary), the government is more likely to win; a negative sign indicates that the government is less likely to win as the independent variable increases.[176]

1. Corporate Tax Abuse Cases Versus Other Types of Tax Cases in the Supreme Court

To begin our investigation, we focus on models (1) and (2) set out above, which enable us to compare how the government fares in the corporate tax abuse cases vis-à-vis all other types of tax cases that are litigated in the Supreme Court. We theorized that allegations of abuse are not winning arguments in the High Court.[177] Our results appear to confirm this hypothesis, albeit not always at a statistically significant level. Column (1) of Table 2 indicates that the government is 7% less likely to win a corporate tax abuse case than other tax cases generally. Column (2) indicates the government is 8% less likely to win a corporate tax abuse case compared to corporate tax cases raising alternative legal issues. Neither of these results is statistically significant, even at the 0.10 level. But, our dataset includes Supreme Court controversies decided over the course of the last century, which raises the question of whether our results would be the same if we examined a subset of cases decided in the more recent era. We discuss this issue in greater

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JOHN DINARDO, ECONOMETRIC METHODS 422 (1997) (noting that probit coefficients are difficult to interpret and arguing that "it is not generally useful merely to report the coefficients from a probit (as it is for a linear probability model) unless only the sign and significance are of interest"); LONG, *supra* note 173, at 61–83 (discussing four interpretive approaches).

175 We generated these probability estimates by transforming the probit coefficients with the "dprobit" command in STATA. *See* 2 STATA CORP., STATA BASE REFERENCE MANUAL: RELEASE 9, K-Q, at 475–77 (2005) (discussing dprobit as a useful means for transforming probit coefficients into easily interpreted probabilities). The marginal effects are calculated for each variable, holding all other variables at their mean. The original probit models have an intercept, but we use "dprobit" and thus do not report marginal effects for the intercept on the theory that this would make no sense given all the variables are held at the mean with the "dprobit" command.

176 For example, we coded the variable *CorpTaxAbuse* to be 0 if the government did not allege abuse in the case and equal to 1 if the government did make such an allegation. Thus, if the sign on the *CorpTaxAbuse* variable is positive (negative) then the presence of such an allegation makes it more (less) likely that the government will win.

177 *See supra* Part II.A.3.

depth below.[178] For preliminary purposes, we reexamined the cases decided after World War II and presented our findings in columns (3) and (4) of Table 2 below. Our results show an even stronger, and significant, negative correlation: The government is 18% less likely to prevail in the post–World War II period when it alleges corporate abuse. This finding is statistically significant in both models at the 0.05 level, indicating strong empirical evidence that the type of argument set forth in the government's briefs has an effect on outcomes.[179]

Our findings suggest that, as expected, the Supreme Court is sympathetic to corporations that adhere to the letter of the tax law, even if the transactions and tax positions undermine the revenue-raising potential of the tax law. It is, in short, more difficult for the government to prevail when all parties agree that the corporate taxpayer complied with the formal tax rules, yet the government alleges that the taxpayer nevertheless engaged in abuse.

TABLE 2
CORPORATE TAX ABUSE CASES ARE MORE DIFFICULT FOR THE GOVERNMENT TO WIN

U.S. Supreme Court Outcomes Results depict change in the probability of a pro-government outcome, given a unit increase in the independent variable				
Explanatory Variable	*All Tax Cases* (1)	*Corporate Tax Cases* (2)	*All Tax Cases Post-WWII* (3)	*Corporate Tax Cases Post-WWII* (4)
Corporate Tax Abuse Case	-.07 (.05)	-.08 (.05)	-.18 (.08)**	-.18 (.09)**
Probability of Pro-Government Outcome at X-Bar	.68	.68	.71	.68
Total Observations	850	341	304	106

Note: Results marked *** are statistically significant at the 0.01 level, ** are statistically significant at the 0.05 level, and * are statistically significant at the 0.10 level. Errors are clustered by Chief Justice. All models include controls for judicial political preferences, the economy, defense spending, the identity of the petitioning party, and a time trend.[180]

178 *See infra* notes 232–42 and accompanying text.

179 For a useful discussion of statistical significance and its interpretation for empirical results, see WOOLDRIDGE, *supra* note 174, at 133–38.

180 For purposes of fitting the models, we included cases that involved only one legal issue in order to avoid any possible confounding. For readers interested in the pseudo *R*-squared, these findings are as follows for models 1, 2, 3, and 4 respectively: .03, .04, .03, .13.

Our statistical methods enable us to predict whether an allegation of corporate tax abuse will improve or detract from the government's case on average, but we can also use the models to predict the likelihood that the government will prevail in *specific* cases.[181] For example, conditional on the factors for which we have controlled in the model presented in column (4) of Table 2, we predict that the government had a 75% chance of winning in *Corn Products v. Commissioner* (the government won),[182] a 48% chance of winning in *Cottage Savings Ass'n v. Commissioner* (the government lost),[183] and a 45% chance of winning in *United Dominion Industries, Inc. v. United States* (the government lost).[184] This small sampling of results suggests that our initial models perform very well. Given that we know the outcome of every case in our database, we can investigate our model's performance in detail and we do so below.[185] For now we simply note that our models predict that the government has a substantially lower likelihood of prevailing in corporate tax abuse cases than in any other type of tax case litigated in the Supreme Court.

The results presented in Table 2 indicate that the government is, on average, 7% to 8% less likely to prevail in corporate tax abuse cases. This estimate increases to 18% in the post–World War II period. Figure 3 below presents the results with respect to the distribution of probabilities over the course of the last century. The graph on the left in Figure 3 presents *all* taxation cases versus corporate tax abuse cases, and the graph on the right presents *only* corporate tax cases versus corporate tax abuse cases. The *y*-axis in both figures is the average predicted probability of a pro-government outcome in the cases decided each year. The *x*-axis is the year in which the case was decided. The solid line in both graphs depicts cases without an allegation of corporate tax abuse and the dashed line indicates that the government alleged corporate tax abuse. Note that in both graphs the solid line is above the dashed line, indicating a higher predicted probability of government success in the cases in which abuse was not a litigated issue.[186]

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[181] To generate the model's predictions with respect to individual cases, we used the "predict" syntax in STATA. *See* STATA CORP., *supra* note 175 at 445–48.

[182] 350 U.S. 46 (1955).

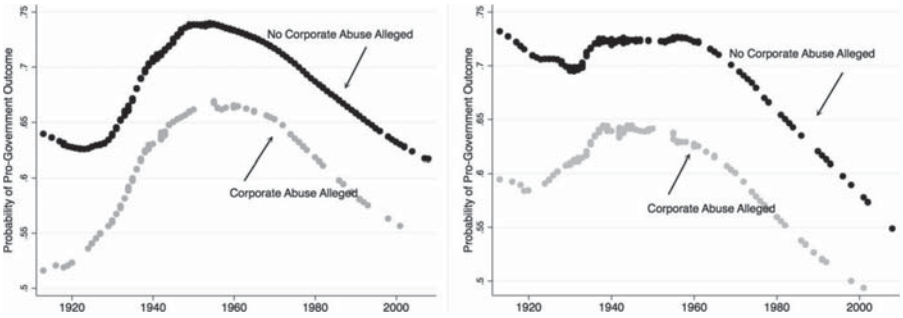
[183] 499 U.S. 554 (1991).

[184] 532 U.S. 822 (2001).

[185] *See infra* Part II.C (examining the model's performance and success).

[186] We generated these graphs with the help of the "graph twoway lowess" syntax in STATA. *See* STATA, GRAPHICS 217–19 (2005).

FIGURE 3
PROBABILITY OF A PRO-GOVERNMENT OUTCOME IN CORPORATE TAX ABUSE AND NON-CORPORATE TAX ABUSE CASES



Note: The graph on the left depicts the probability of a pro-government outcome in the superset of all federal taxation cases. The graph on the right depicts the subset of corporate tax cases. Both graphs disaggregate the cases based on whether the government alleged corporate tax abuse. The graphs present the predicted probability of a pro-government outcome using a Locally Weighted Scatterplot Smoothing (Lowess) curve. Note that in both graphs, our models predict a lower probability of a pro-government outcome if abuse is alleged.

Although corporate tax abuse cases are more difficult for the government to win than other types of cases, it is useful to note that, aside from a few exceptional years, the government has had a greater than 50% chance of winning. In fact, on average, the government prevailed in 61% of all the corporate tax abuse cases it litigated since 1909. This suggests that while the government may have a weaker case in corporate abuse controversies compared to other types of tax controversies, nevertheless it is likely to prevail if the dispute reaches the Supreme Court. Thus, while a corporate taxpayer's chance of prevailing increases in the abuse cases, corporations always seem to be at a disadvantage.[187]

Our data, however, indicate that the government's win rate in tax cases was at an all-time high in the 1950s and began to decline after that time. Note that in Figure 3, the drop-off occurred simultaneously in all the tax cases litigated, cases in which abuse was alleged and also when it was not alleged. This is an important development because

[187] Numerous studies have investigated the government's chances of success and argue that, as a repeat player, it enjoys advantages that other litigants lack. *See, e.g.*, Cohen & Spitzer, *supra* note 164, at 395 (arguing that government litigators influence the set of cases from which the Supreme Court can choose, tilting administrative common law in a pro-government direction); Kevin T. McGuire, *Repeat Players in the Supreme Court: The Role of Experienced Lawyers in Litigation Success*, 57 J. POL. 187, 189–93 (1995) (pointing to the government's well-established advantage based on both status and the tendency of its lawyers to be repeat players).

scholars have argued that the makeup of the Court, in particular the appointment of Justice Scalia, may have caused the observed pro-taxpayer turn in judicial outcomes.[188] This claim may have merit, but the data unambiguously indicate that other factors were also at work.

2. *What Explains Supreme Court Decisions in the Corporate Tax Abuse Cases?*

We now move from comparisons between abuse and non-abuse controversies and focus solely on the abuse cases, hoping to illuminate the judicial decisionmaking process in this specific context. We use model (3) described above[189] to determine which factors enhance and which factors undermine the government's chances of winning the abuse cases. Table 3, below, presents our empirical findings. For discussion purposes, we begin by focusing on the transaction-related variables associated with corporate tax abuse. We then turn to the cases involving accounting irregularities and refund claims. Next we examine Justice Scalia's role in the decisionmaking process. Finally, we discuss the five control variables and their effects on Supreme Court outcomes. We conclude with a summary of our findings and an analysis of how well our models performed compared with the actual outcomes in the cases that we analyzed.

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188 *See supra* notes 128–31 and accompanying text.

189 *See supra* Part II.A.3.

TABLE 3
FACTORS THAT EXPLAIN OUTCOMES IN CORPORATE TAX ABUSE CASES

U.S. Supreme Court Outcomes Results depict change in the probability of a pro-government outcome given a unit increase in the independent variable			
Explanatory Variable	*Corporate Tax Abuse Cases*		
	(1)	(2)	(3)
Third Party Involved	-.21 (.05)***		-.36 (.13)***
Multistep Transaction	-.03 (.08)		-.35 (.09)***
Lack of Business Purpose	.07 (.07)		.29 (.15)
Count (Total Number of Allegations)		-.06 (.04)	
Third Party & Multistep			.50 (.07)***
Third Party & Lack of Business Purpose			-.22 (.19)
Multistep & Lack of Business Purpose			-.26 (.26)
Accounting Irregularity	.18 (.09)*	.22 (.08)**	.15 (.10)
Taxpayer Claimed Refund	.28 (.09)***	.24 (.09)**	.22 (.06)***
Justice Scalia on Court	-.05 (.15)	-.09 (.18)	-.01 (.13)
Defense Spending *(in $10 billions)*	.004 (.001)***	.003 (.001)**	.003 (.001)**
Government Is Petitioner	.11 (.08)	.13 (.07)*	.14 (.08)
Supreme Court Controlled by Republicans	.05 (.13)	.02 (.13)	.06 (.12)
Business Cycle *(growing economy)*	-.13 (.10)	-.13 (.08)	-.11 (.10)
Time Trend	-.004 (.002)**	-.002 (.002)	-.006 (.002)
Probability of Pro-Government Outcome at X-Bar	.63	.63	.64
Total Observations	123	123	123

Note: Results marked *** are statistically significant at the 0.01 level, ** are statistically significant at the 0.05 level, and * are statistically significant at the 0.10 level. Errors are clustered by Chief Justice. To avoid any possible confounding, we included cases with only one legal issue in our modeling process.[190]

[190] For readers interested in the pseudo *R*-squared, these findings are as follows for model 1, 2, and 3, respectively: 0.13, 0.11, and 0.18.

a. Transaction-Related Factors

Recall from the discussion above that the legal briefs filed with the Supreme Court indicate that the government continually points to three transaction-related indicia of abuse when litigating cases involving alleged abusive transactions: (1) the presence of a third party; (2) multistep transactions; and (3) the lack of a non-tax business purpose.[191] Column (1) in Table 3 presents somewhat surprising results vis-à-vis these variables. We found that the presence of third parties and multistep transactions decrease the probability that the government will win in the Supreme Court by 21% and 3%, respectively, although only the finding on third parties is statistically significant—thus it is the only finding in which we can have confidence. With respect to the lack of a business purpose, the government is 7% more likely to prevail when it alleges this factor. But, this finding is not statistically significant and provides weak evidence against the null hypothesis that this variable is playing no role in the decisionmaking process.[192] *These findings suggest that the facts and circumstances widely believed to strongly and positively correlate with corporate tax abuse are simply not very convincing to the Court.* Only one finding achieves significance—the presence of third parties. While this fact may look suspicious to government litigators, it appears that the Justices disagree. Perhaps the Justices believe that the presence of an outside party indicates an arm's-length transaction that should be respected and not disregarded, as advocated by the government. These results are not what we expected, yet they may suggest what many tax scholars and commentators have argued for years: Courts are unpredictable when it comes to corporate tax abuse controversies.[193]

The results presented in column (1) of Table 3 depict the effects of each of these three case-related factors separately, but what if the government alleges two or more factors simultaneously? Perhaps the Court is more likely to unwind an otherwise legal corporate tax strategy when the government musters a strong case with numerous indicia of abuse. To test this hypothesis, we created a *count* variable that represents the number of factors alleged. It is coded as equal to 0, 1, 2, or 3, indicating the number of these factors alleged concurrently in each case. Column (2) of Table 3 presents our findings with respect to the *count* variable and indicates that the presence of more than one

191 *See supra* Part I.B.1 (discussing factors to which the government points in its briefs).

192 For a useful discussion of statistical significance and its interpretation for empirical results, see WOOLDRIDGE, *supra* note 174, at 133–38.

193 *See supra* Part I.A.2 (explaining the Court's variation).

abuse factor actually decreases the probability that the Court will side with the government, although this finding is not statistically significant. The results associated with the *count* variable indicate that, as the number of transaction-related allegations increase, the probability of a pro-government outcome decreases by 6%. This finding suggests that even if the government believes certain factors indicate abuse, pointing to an increasing number of the factors is not a winning strategy. Again the model implies support for critics of judicial decisionmaking in the abuse context: The outcomes are unpredictable and perhaps counterintuitive.[194] Stated most directly: Why does the taxpayer's case get stronger as the government points to more indicia of abuse? We expected that the taxpayer's case would weaken in these circumstances, but we were wrong.[195]

To further probe the effects of the transaction-related variables, we examined specific combinations of the factors on the theory that while the Court is not convinced by an increasing number (or count) of allegations, the Justices may be persuaded by specific combinations or groupings. Perhaps specific combinations of factors may serve as convincing evidence of abuse, whereas factors cited alone or factors randomly grouped together may not have the same probative value. Accordingly, we investigated cases in which the government alleged the following combinations: (1) third parties and multistep transactions; (2) third parties and the lack of business purpose; and (3) multistep transactions and the lack of business purpose.[196] Column (3) of Table 3 presents our findings and suggests that the precise blend of factors is important to the decisionmaking process.

To understand the results presented in column (3) of Table 3, first note that the column reports empirical findings for each variable separately and then in the three unique combinations. The three variables listed separately indicate the effects of the variable when it is alleged and when the others are *not* alleged. Thus, we see that when the government *only* alleges the presence of a third party, it is 36% less likely to win; when it alleges *only* a multistep transaction it is 35% less likely to win; when it alleges *only* the lack of a business purpose it is 29% more likely to win. The first two factors, standing alone, hurt the government at statistically significant levels, but when the government

194 *See id.*

195 *See supra* Part II.A.3 (explaining our models and hypotheses).

196 We were unable to examine all three variables simultaneously due to the small number of cases in our dataset.

alleges only the lack of a business purpose the finding is not statistically significant and thus we cannot have confidence in the finding.[197]

Now consider the three unique combinations of the variables (known as "interaction effects"),[198] presented in column (3) of Table 3. While the interpretation of these terms is somewhat more complex than the other terms in the model,[199] we begin by noting that the results presented indicate the following: When third parties *and* multistep transactions are alleged together, the government is 50% more likely to win. This combination convinces the Court, at the highest, 0.01 statistically significant level, that the corporation engaged in a transaction that the judiciary should not support.[200] The other two combinations, by contrast, do not exert the same positive effect on the Court. When third parties and a lack of business purpose are combined in the government's argument, the government is 22% less likely to prevail. When the government alleges multistep transactions and a lack of business purpose it is 26% less likely to prevail—though neither of these two findings is statistically significant. The government's actual win rate confirms these findings: The government prevailed in 60% of the cases that involved third parties and multistep transactions; it prevailed in 50% of the cases involving third parties and an alleged lack of a business purpose; and it prevailed in just 45% of the cases that involved multistep transactions and the alleged lack of a business purpose.

The results, however, are somewhat more nuanced than we have just suggested. Interaction terms in this type of statistical model may have different effects for different cases, so the "average effects" associated with the interaction terms may not be an accurate predictor of results.[201] To understand fully the effects of a government litigation strategy that combines two transaction-related factors, we should

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197 *See* WOOLDRIDGE, *supra* note 174, at 133–38 (discussing statistical significance and its interpretation for empirical results).

198 *See id.* at 197–99.

199 *See* Edward C. Norton, Hua Wang & Chunrong Ai, *Computing Interaction Effects and Standard Errors in Logit and Probit Models*, 4 STATA J. 154, 154–67 (2004) (arguing that most applied researchers misinterpret the coefficients on interaction terms and proposing useful interpretive procedures); *see also* William Greene, *Testing Hypotheses About Interaction Terms in Nonlinear Models*, 107 ECON. LETTERS 291, 291 (2010) (arguing that graphical presentations are the most effective means for presenting the results).

200 Familiar cases such as *Commissioner v. P.G. Lake*, 356 U.S. 260 (1958), and other less known cases such as *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946), and *Handy & Harmon v. Burnet*, 284 U.S. 136 (1931), confirm our statistical finding: These factors work to the distinct advantage of the government.

201 *See* Norton et al., *supra* note 199, at 154.

consider the effect on various cases by taking into consideration the overall probability that the government will prevail.[202]

Consider Figure 4.[203] The *y*-axis indicates whether the two-pronged argument helps or hurts the government's case. The *x*-axis depicts these results based on the overall probability of a government win, conditional on all the variables in the model. Note that when the government alleges both third parties and multistep transactions, its likelihood of winning is always well above zero, though the effect begins to decline as the probability of winning approaches 80%. This suggests that when the government has a strong case, based on other factors discussed above, these transaction-related variables have a positive effect, but the effect is decreasing in overall strength. Stated most directly, the model indicates that when the government's case is otherwise weak, alleging these transaction-related variables will increase the probability of a pro-government decision by more than 40%. But when the government's case is strong based on other factors, the probability of a pro-government outcome is increased by less than 20% with these allegations.

Note that the other two combinations, a lack of business purpose combined with third parties and a lack of business purpose combined with multistep transactions, exert a negative effect on the government's case. The effect is always negative but approaches zero, suggesting no effect as the probability of a government win moves closer and closer to 100%. These findings indicate that when the government has a weak case, the transaction-related variables play a stronger role in the decisionmaking process. But, as the government's case improves (due to the factors we discussed above), the transaction-related variables have a minor effect on the Justice's decisions.

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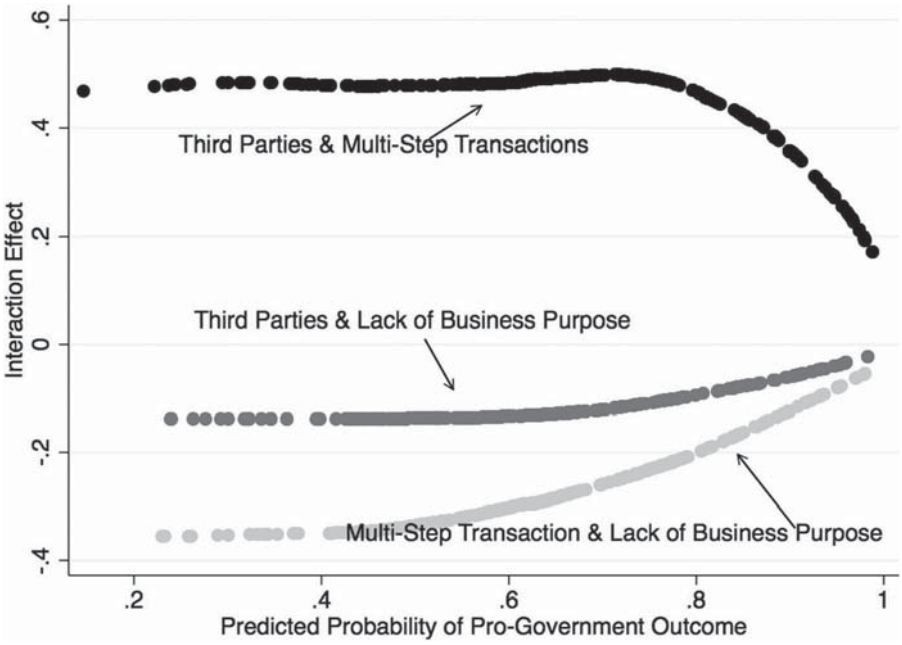
202 *See id.*

203 We generated these graphs with the help of the "graph twoway lowess" syntax in STATA. *See* STATA, GRAPHICS 217–19 (2005) (discussing graphics technology).

FIGURE 4
GOVERNMENT STRATEGY OF COMBINING MULTIPLE FACTORS CAN HELP *and* HURT ITS CASE



Note: The y-axis indicates whether government arguments that combine transaction-related variables help or hurt the case. The x-axis indicates the probability of a pro-government outcome conditional on all the variables in the model presented in Table 3, column (3).

We believe that the best model of judicial decisionmaking is presented in column (3) of Table 3 because it accounts for a range of realistic government litigation strategies.[204] As we will discuss in greater depth in Part III, corporate lawyers who advise clients on the tax consequences of their deals and government litigators who subsequently challenge a deal in court can use these findings strategically. First, we can see that a single indicator of abuse does not convince the Court that the Justices should deny the corporation its preferred tax outcome. The government appears to be more effective when it alleges multiple indicia of abuse—but only if certain combinations are present, not simply an increasing number of allegations as indicated

[204] We believe the model avoids any possible omitted variable bias. *See* WOOLDRIDGE, *supra* note 174, at 84–94, 133–40 (discussing the omitted variable bias in general terms). It also has the highest pseudo *R*-squared, although we do not put too much weight on this measure. *Id*. at 199–200, 580–84 (noting that *R*-squared is an estimate of how much variation in the dependent variable is explained by the independent variables, and the pseudo *R*-squared is used for the probit models).

by the results associated with the *count* variable.[205] Specifically, the government should point to third parties and multistep transactions —two objective fact-based allegations—in order to increase its chances of winning. But third parties combined with a lack of business purpose, or a multistep transaction combined with a lack of business purpose—one fact-based allegation and the other a matter of opinion —is not a winning combination and together operate to decrease the likelihood that the Court will find in favor of the government. These findings, all taken together, suggest that the presence of the third-parties and multistep transactions in general make the government's case substantially weaker with one exception: when they are present together in a transaction that the government believes to be abusive. Finally, the results presented in Table 3 above indicate that the business purpose test is not playing a strong role in the Court's decision-making process. Indeed, it appears to play little or no role when standing alone and a negative role when combined with other factors.[206]

b. Tax Return Factors: Accounting Irregularities and Refund Claims

We now turn to the items on the corporate tax return that raise a red flag of abuse in the government's view. We begin with accounting irregularities, such as an asymmetry in the amount of income reported on corporate financial accounting documents and on the corporate tax return filed with the IRS.[207] Columns (1), (2), and (3) of Table 3 indicate that when the government points to an accounting irregularity in its legal brief filed in Court, it is 15% to 22% more likely to prevail. This finding is statistically significant in two of the three models, suggesting that accounting irregularities increase the chances that the Justices will find that the corporation sought an inappropriate tax advantage. The raw numbers in our database confirm this finding: The government prevailed in 80% of the cases in which it pointed to accounting irregularities. [208]

We now turn to the loss transactions that a corporation might use to claim a refund on its tax return filed with the IRS, where the IRS

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[205] *See supra* notes 198–202 and accompanying text.

[206] Many scholars have examined and critiqued the business purpose test as being difficult to apply objectively and thus not particularly useful for judicial decisionmaking. *See supra* notes 124–27 and accompanying text.

[207] For discussion of this variable, see *supra* notes 103–04 and accompanying text.

[208] Cases such as *Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960), *Hertz Corp. v. United States*, 364 U.S. 122 (1960), and *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986), all suggest that when the government attacks inventive tax reporting strategies it is likely to win in the Supreme Court.

subsequently denied the corporation's claim. As noted above, corporate refund claims signal to the government that the taxpayer *may* have participated in an abusive transaction in order to generate a tax loss.[209] All three models presented in Table 3, above, indicate that when the corporate taxpayer seeks a refund and when the IRS denies the refund claim, the government's chances of winning increase by 34% to 42% at highly statistically significant levels.[210] When numerous models produce consistent and significant findings, the results can be interpreted as robust and strongly probative of the variable's effects on the outcome of interest. Our findings suggest that when corporate taxpayers seek the Court's assistance in extracting money from the Treasury in a refund claim, the Justices are much more likely to find the transaction abusive than in cases in which the corporation simply seeks to pay less tax than the government deems owed. In terms of raw numbers, the government prevailed in 77% of the cases that involved such a refund denial. This win rate increases to 84% when the refund denial includes allegations of abuse.

Figure 5 below presents two graphs that visually display the findings in Table 3 with respect to accounting irregularities and refund claims. The *y*-axis in both graphs indicates the predicted probability of a pro-government outcome based on the model presented in column (3) in Table 3, and the *x*-axis is the year in which the case was decided. The graph on the left indicates that, while alleged accounting irregularities were not a winning argument early on, by the mid-1930s this argument increased the probability that the government would prevail. The graph on the right indicates that when a corporate taxpayer seeks a refund, which the IRS subsequently denies, its chances of winning substantially decrease.

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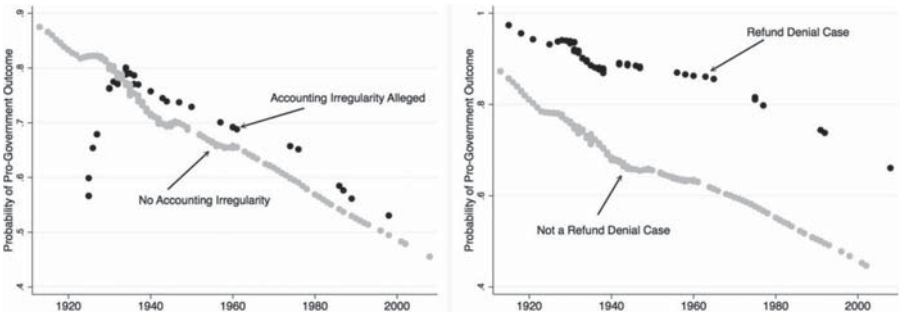
[209] *See supra* text accompanying notes 101–02 (describing large tax losses as a possible signal of abuse).

[210] To be clear, this factor refers to instances when the taxpayer requested a refund on its initial return or in a separate return. It does not refer to situations when the taxpayer sought to recover an amount that it paid following the finding of a deficiency by the IRS during an audit of the taxpayer's return.

FIGURE 5
ACCOUNTING DISCREPANCIES AND CORPORATE REFUND CLAIMS INCREASE THE GOVERNMENT'S CHANCES OF WINNING IN COURT



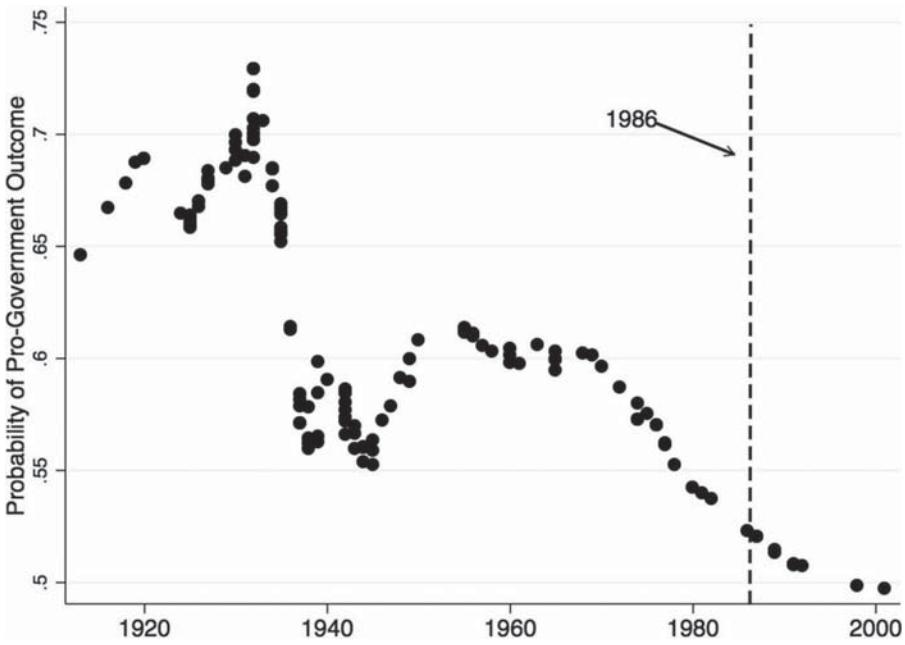
Note: The *y*-axis indicates predicted probability of a pro-government outcome and the *x*-axis is the term in which the cases are argued.

c. Personnel Factor: Justice Scalia

As we have discussed, several scholars have suggested that Justice Scalia's appointment led to an increase in judicial deference to the text of the tax statute, a literalist approach that often underlies taxpayers' arguments in corporate tax abuse cases.[211] Our models indicate that a corporation's chance of winning increased between 1% and 9% in the post-1986 era. The negative sign on Justice Scalia's coefficient in all three models presented in Table 3 indicates that Justice Scalia may have had an effect on the government's win rate, but the results never achieve statistical significance. The empirical findings presented in Table 3 are presented graphically in Figure 6, below.

[211] *See supra* notes 128–31 and accompanying text (explaining a potential Justice Scalia effect).

FIGURE 6
JUSTICE SCALIA'S APPOINTMENT AND CORPORATE TAX ABUSE CASE OUTCOMES



Note: The *y*-axis indicates predicted probability of a pro-government outcome and the *x*-axis is the term in which the cases are argued.

We cannot confidently conclude that Justice Scalia and the plain meaning approach to statutory interpretation has had the predicted impact for a few important reasons. First, the results are not statistically significant. Second, our dataset includes only a small number of judicial opinions—nine—in the time period under investigation. Third, and perhaps most problematic to the theory highlighting Justice Scalia's role in tax abuse cases, Figure 6 indicates that the government's probability of winning began to decline well before Scalia's appointment, casting further doubt on the Scalia theory. Finally, the appointment of Justice Scalia in 1986 occurred during the same period as other significant developments in the federal tax law, namely the enactment of the Tax Reform Act of 1986,[212] which may have had an effect on the Justices' interpretation of tax avoidance strategies. It bears noting, however, that although the Supreme Court appears to have taken a pro-taxpayer turn in the late 1950s, the government's

[212] Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

probability of winning consistently exceeds the taxpayer's probability of winning.

d. The Control Variables

We have focused thus far on the variables in our model that directly relate to the corporate transaction, the tax return, and a specific Supreme Court Justice—all discussed and debated by tax scholars and tax commentators in the existing literature.[213] We now turn to the set of control variables that commentators, with just a few exceptions, have largely ignored[214]—but that we believe exert influence on the Court's decisionmaking process. For this discussion, we focus on Table 3. We note, as a preliminary matter, that the three models presented in the table produce consistent results across all the control variables, indicating that our findings are robust to different model specifications and giving us confidence in our results.

We begin by reviewing defense spending effects. We find that every $10 billion increase (measured in 2009 dollars) in national defense spending leads to a 0.3% to 0.4% increase in the likelihood of a pro-government outcome at highly statistically significant levels.[215] At first cut, this finding may not appear substantively interesting given the small size of the coefficient, but consider the magnitude of the defense spending spikes that have occurred over time. During World War I, World War II, the Vietnam War, and President Reagan's defense build-up in the 1980s, for example, defense spending increased by $70 billion, $97 billion, $10 billion, and $17 billion, respectively.[216] These increases, in turn, correspond to an expected increase in the government win rate by *at least* 21%, 29%, 3%, and 5% respectively, and possibly substantially more. The government's chance of winning increases at notable levels during times of war and foreign policy crises.

With respect to our second control, whether the government is the petitioner or the respondent in the Supreme Court, we find that when the government is the petitioner, the likelihood of a pro-government outcome increases by 11% to 14%. However, this finding is statistically significant in only one of our three models. This

213 *See supra* Part I.B.3 (reviewing scholarly literature on corporate tax abuse).

214 *See id*.

215 *See* STAUDT, *supra* note 163, at 2 (also finding strong evidence against the null hypothesis that defense spending has *no* effect on Supreme Court outcomes).

216 For a detailed discussion of historical defense spending trends, see OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2013 HISTORICAL TABLES, BUDGET OF THE U.S. GOVERNMENT 7–10 (2012), *available at* http://www.gpo.gov/fdsys/pkg/BUDGET-2013-TAB/pdf/BUDGET-2013-TAB.pdf.

substantive result is consistent with a large body of literature that has theorized and found empirically that the Court is more likely to reverse a lower court decision than uphold it, thus boosting the petitioning party's chances after the Justices grant the petition for certiorari.[217]

Our last three controls do not produce statistically significant results in any of the three models, and thus we cannot have confidence that they reflect the true effects. Nonetheless, we have "best guesses" based on our modeling efforts: When a majority of the Justices on the Court are appointed by Republicans, the Court is 2% to 5% more likely to rule in favor the government; when the economy is booming, the government is 11% to 13% less likely to win; and our time trend indicates that the government's win rate has decreased in the more recent era.

C. Model Evaluation: Its Successes and Its Limitations

We now examine how well our model predicts the Supreme Court's decisions that we actually observe over the course of the last century. We are able to assess our model's performance because it generates the probability that the government will win in each case, conditional on our set of independent variables (that is, the variables listed on the right side of equations (1), (2), and (3) above). [218] Consider, for example, two well-known cases involving corporate taxpayer attempts to avoid tax costs associated with selling property directly to a third party, *United States v. Cumberland Public Service Co.*[219] and *Commissioner v. Court Holding Co.*,[220] which we discussed earlier.[221] In both cases, the corporation sought to avoid corporate-level taxation by distributing the designated property to shareholders, who then sold the property to an outside third party.[222] In both cases, the government took the position that the corporations used the tax law in a manner that would undermine its revenue-raising purpose.[223] Using the model presented in column (3) of Table 3, we find that the government had a 28% chance of prevailing in *Cumberland* (the government

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217 *See, e.g.*, Cohen & Spitzer, *supra* note 164, at 409 (pointing to the overall tendency of the Supreme Court to reverse the circuit courts).

218 *See supra* Part II.A.3.

219 338 U.S. 451 (1950).

220 324 U.S. 331 (1945).

221 *See supra* notes 55–62.

222 *Cumberland*, 338 U.S. at 452; *Court Holding*, 324 U.S. at 332.

223 Brief for the United States at 17–18, United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950) (No. 214) (arguing that transaction was set up simply to avoid taxes); Brief for Petitioner at 10, Comm'r v. Court Holding Co., 324 U.S. 331 (1945) (No. 581) (same).

lost) and a 62% chance of winning in *Court Holding* (the government won). We are able to examine the probability of a government win in every case and compare this prediction to the true outcome generated by the Court. Readers interested in the list of abuse cases included in our study should consult the Appendix.

In addition to examining individual cases, we can examine the model's performance in more general terms. With respect to our 137 corporate abuse cases, our model predicted that the government had a greater than 50% chance of winning 92 of these cases, and a less than a 50% chance of prevailing in the remaining 45 cases. In short, the model predicted that the government was more likely than not to prevail in 67% of the cases, or 92 out of 137—in reality, the government won 65%, or 89 of 137. These preliminary numbers suggest the model performed well, though far from perfectly. For example, the lowest probability of a government win was 11%, for the case *United States v. Goodyear Tire & Rubber Co.*, a case the government actually won.[224] The highest probability was 99%, generated for *Hertz Corp. v. United States,* which the government also won.[225] Table 4 disaggregates the data and presents the predictions and observed outcomes along an inter-quartile continuum. The first column indicates the predicted probabilities from our statistical model for each quartile, the second column indicates the number of cases that fell within that quartile, and the third column indicates the percentage of cases that were decided in favor of the government. Of course, as the predicted probability increases in the first column, the percentage of actual wins should also increase in the third column. A brief look at the two columns indicates that our model performed well: As the model predicted an increased likelihood that the government would prevail in the Supreme Court, the government in fact won more cases.

TABLE 4
PREDICTED VERSUS OBSERVED OUTCOMES IN CASES INVOLVING ALLEGED ABUSE

Model Prediction as to the Likelihood That the Government Will Win	*Number of Corporate Tax Abuse Cases*	*Observed Percentage of Cases in Which the Government Won*
Predicted Probability < 25%	6	16%
25% < Predicted Probability < 50%	39	33%
50% < Predicted Probability < 75%	45	76%
Predicted Probability > 75%	47	87%
Total Observations	137	100%

[224] 493 U.S. 132, 138 (1989).
[225] 364 U.S. 122, 125–26 (1960).

Our analysis indicates that our model offers useful predictions with respect to Supreme Court decisionmaking in corporate tax abuse cases. But the model also suffers from various limitations that are important to note.[226]

First and most importantly, our dataset may suffer from a selection problem. That is, litigants (either the government or the taxpayer) may choose to appeal a distinctive set of cases to the Supreme Court, thereby biasing our dataset and potentially leading to spurious empirical results.[227] To understand this problem, consider the possibility that the government does not appeal cases that involve allegedly abusive transactions when they have a strong business purpose on the theory that it will lose in the Supreme Court. If the government in fact selects cases to appeal on the strength of the business purpose, then our finding that the business purpose factor is not playing the expected role in the Supreme Court's decisionmaking process should not be surprising—after all, the cases with strong arguments have been selected out of the process.[228] Of course, this potential problem is offset by the counter-strategy that taxpayers will adopt: They will appeal cases that have factors that work in their favor. In fact, we expect cases that have strong arguments in one direction or another likely are settled before they reach the Supreme Court, leaving only the collection of cases that have strong arguments in *both* directions.[229] Moreover, we have conducted preliminary studies of the selection issue and have found that if the problem exists, it operates to confirm and not undermine our findings.[230] Although we plan to further investigate judicial decisionmaking in the context of corporate tax

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226 Advantages and disadvantages exist in all empirical research. *See, e.g.*, Roger J. Gagnon, *Empirical Research: The Burdens and the Benefits*, 12 INTERFACES 98 (1982) (explaining the advantages and disadvantages of empirical research in a business context); *The Promise and Limitations of an Empirical Approach to Law*, VA. J., no. 11, 2008, at 29, 29–35 (explaining the advantages and disadvantages of empirical research in the legal context).

227 For a useful discussion of sample selection problems, see WOOLDRIDGE, *supra* note 174, at 174.

228 We thank Professor Ted P. Seto for pointing out this particular example of a selection bias problem.

229 A large existing literature explores the selection problem both inside and outside of the taxation context. *See, e.g.*, Theodore Eisenberg, *Litigation Models and Trial Outcomes in Civil Rights and Prisoner Cases*, 77 GEO. L.J. 1567 (1989) (discussing selection problems from Title VII, 42 U.S.C. § 1983, and prisoner cases); Leandra Lederman, *Which Cases Go to Trial?: An Empirical Study of Predictors of Failure to Settle*, 49 CASE W. RES. L. REV. 315 (1999) (discussing selection problems among Tax Court cases); George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984) (exploring selection problems generally).

230 *See* STAUDT, *supra* note 163, at 89, 96 (using the Heckman selection model to empirically investigate the selection effects operating in tax cases in the Supreme Court).

abuse in the future, we believe that our study is useful for understanding and explaining the outcomes in the cases that actually reach the Supreme Court, irrespective of the strategies that underlie litigants' decisions to appeal.[231]

Second, even if our study is free of selection bias, we have focused on Supreme Court decisionmaking over the course of the last century. Our findings therefore reflect statistical effects averaged over the course of many years. This raises the question: Are the decisions and outcomes rendered in the mid-1900s and earlier relevant for understanding the contemporary Supreme Court? To begin, we note that we examined abuse cases over such a long period in order to obtain a sufficient number of observations to fit the data to the models.[232] This technical explanation, of course, leaves the substantive question unanswered. Thus, we conducted a qualitative investigation of the early Court opinions to understand and explain how the docket, arguments, and legal analyses have changed over time. As we discuss below, to our surprise, we found high levels of consistency over the different eras.

We found that while the specific details of the transactions and tax positions have changed over the years, the government has consistently looked to the same five factors when identifying abuse. It has pointed to the presence of third parties in cases decided as early as 1913 and as late as 1991; to multistep transactions in cases decided as early as 1925 and as late as 1991; to the lack of a business purpose from 1920 through 1991; to accounting irregularities from 1925 through 2011; and to inappropriate refund requests from 1927 through 1991. These findings indicate that the taxpayers have altered the details of their avoidance strategies over the course of the last century, but they have also continually incorporated the same general attributes that have served as signals of abuse since 1913.[233]

We also examined the Supreme Court's opinions for purposes of understanding the transformations in precedent and legal analyses. This was necessary because even if the signals of abuse have remained constant, if the Court has updated and transformed its view of the five factors, then the early opinions may have very little relevance for understanding today's decisionmaking process. Our qualitative

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231 We thank Professor Leandra Lederman for emphasizing this point.

232 We identified 137 tax abuse cases using the methodology described above. *See supra* Parts II.A.1–2. The Supreme Court decided ninety-three of these cases prior to 1950, leaving only forty-four to analyze with our models in the post-1950 era. When we attempted to do this with STATA, we found the model dropped numerous variables and produced unintelligible results.

233 *See, e.g.*, *supra* notes 154–62 and accompanying text.

investigation, however, indicates that early judicial opinions continue to affect later Courts. Consider *United States v. Hughes Properties, Inc.*, a 1986 case that involved accounting irregularities.[234] The majority opinion cited to abuse cases decided in 1926, 1930, and 1961 in order to identify the fundamental principles of tax accounting.[235] In *United Dominion Industries, Inc. v. United States*, a 2001 case in which the government argued that the taxpayer took a tax position that rose to the level of abuse,[236] the Court also considered early cases such as *Woolford Realty Co. v. Rose* (decided in 1932)[237] and *Libson Shops, Inc. v. Koehler* (decided in 1957).[238] Indeed, one of the cases included in our study, *North American Oil Consolidated v. Burnet*,[239] decided in 1932, has been cited over one hundred times in the post–World War II era, including in numerous Supreme Court corporate tax abuse cases.[240] The seventy-six judicial opinions addressing corporate tax abuse and issued between the years 1909 and 1945 have generated 9863 citations—and more than half of these citations occur in the post–World War II era. Our qualitative analysis, in short, leads us to conclude that the corporate tax abuse opinions do not become antiquated, but rather serve as useful precedent for generations. Professor James Eustice noted that modern corporate tax abuse is "packaged in new and exotic wrappers,"[241] but its basic elements are "still the same old, same old thing."[242] We would add that the cases also require the same old jurisprudential considerations.

The third and final limitation is whether our empirical findings with respect to the Supreme Court are generalizable to lower courts. This question is particularly important because most corporate tax abuse litigation ends with a lower federal court opinion. On the one hand, the Supreme Court's decisions govern in all lower courts, and for this reason we believe that the factors that persuade the Supreme

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234 476 U.S. 593, 595 (1986).

235 The Court, for example, cited to *United States v. Anderson*, 269 U.S. 422, 441 (1926); *Lucas v. Kansas City Structural Steel*, 281 U.S. 264, 269 (1930), and also noted *United States v. Consolidated Edison Co. of New York*, 366 U.S. 380, 385 (1961). *Hughes Properties*, 476 U.S. at 600, 603 (1986).

236 532 U.S. 822, 837 (2001).

237 *Id.* at 840, 842 (Stevens, J., dissenting) (citing Woolford Realty Co. v. Rose, 286 U.S. 319, 328, 330 (1932)).

238 *United Dominion*, 532 U.S. at 825 (citing Lisbon Shops, Inc. v. Koehler, 353 U.S. 382, 386 (1957)).

239 286 U.S. 417 (1932).

240 *See, e.g.*, Comm'r v. Indianapolis Power & Light Co., 493 U.S. 203, 209 (1990); Am. Auto. Ass'n v. United States, 367 U.S. 687, 700 (1961) (Stewart, J., dissenting).

241 James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 172 (2002).

242 *Id.*

Court likely have an effect on lower federal court judges.[243] On the other hand, we are mindful of the fact that lower federal courts may face an entirely different collection of cases and thus weigh factors very differently.[244] As a result, we believe it is important to extend our study to the lower federal courts in order to determine several questions left unanswered, including the following three: (1) How do the lower courts (both appellate and trial) weigh the collection of factors that we found to affect the Supreme Court? (2) Do lower courts consider different factors in the judicial decisionmaking process? (3) Do the Tax Court and federal district court judges weight factors differently in the judicial decisionmaking process?[245]

III
Implications and Future Research

This study explores patterns of the Supreme Court's approach to corporate tax abuse over a time period spanning more than a century. The findings may have implications for a variety of different parties, including private practitioners who design corporate tax strategies, IRS agents who audit corporations, government and private lawyers who litigate corporate tax abuse cases, and policymakers and scholars who study the judiciary's role in controlling corporate tax abuse.[246]

In this Part, we present the questions raised by our study and the potential implications of our findings. But before we do so, we would like to comment briefly on the role of statistics in the everyday practice of law. Many lawyers believe their own expertise and knowledge is sufficient when advising clients and litigating cases. Some believe that empirical studies are interesting, but not altogether relevant to

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243 *See, e.g.*, Frank B. Cross & James F. Spriggs II, *The Most Important (and Best) Supreme Court Opinions and Justices*, 60 Emory L.J. 407, 501 (2010) (discussing the influence of the Supreme Court opinions, and Justice Scalia opinions in particular, on other courts).

244 Scholars have discussed different influences on lower courts as compared to the Supreme Court. *See* Frank B. Cross & Emerson H. Tiller, *Judicial Partisanship and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals*, 107 Yale L.J. 2155, 2158–59 (1998) (discussing five reasons for lower courts to comply with or disobey the Supreme Court); Nancy C. Staudt, *Modeling Standing*, 79 N.Y.U. L. Rev. 612 (2004) (exploring factors that affect district and circuit court decisions in taxpayer standing cases).

245 These are just three of the questions that we plan to address in future analyses of the decisions of the federal appellate and trial courts, as we develop a more comprehensive theory that explains the judicial decisionmaking process in corporate tax abuse cases. In our next studies, we first plan to analyze a sample of the corporate tax abuse decisions of the federal appellate courts and then plan to analyze decisions of the U.S. District Courts, the U.S. Tax Court, and the U.S. Court of Federal Claims.

246 These are the interested parties we discussed above. *See supra* Part I.B.

the actual practice of law.[247] We agree that knowledge and expertise are *necessary* to achieve legal success, but we are not convinced that they are always *sufficient*. That is to say, general trends identified with the help of data and statistics, such as those presented in our study, can provide useful information that should supplement and refine the insights provided by individual lawyers.[248] Put differently, we believe lawyers are not so different from other professionals, such as those in the health care industry. Most individuals, for example, prefer a doctor who is up-to-date on the latest studies and uses of drugs, yet also desire to be treated by a doctor who understands the unique attributes and concerns of an individual patient. We believe that the qualitative information and knowledge acquired through hard work and experience is essential to success in most professions, but systematically and completely ignoring scientific findings is not a strategy that best serves clients' interests.

A. Can Parties Exploit Our Findings?

Our study identifies a range of factors that both hurt and help the government's case in the Supreme Court, and for this reason it may be helpful to lawyers engaging in corporate transactional work and to litigators defending corporations following an audit. We first note that the variables that we analyzed, such as the allegation of a lack of non-tax business purpose, the use of multiple transaction steps, or accounting irregularities, have played a significant role in corporate tax abuse controversies for generations.[249] These factors will likely

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[247] We thank Michael J. Desmond for making this point. Mr. Desmond presented excellent comments on an earlier draft of this Article.

[248] *See* Theodore Ruger et al., *The Supreme Court Forecasting Project: Legal and Political Science Approaches to Predicting Supreme Court Decisionmaking*, 104 COLUM. L. REV. 1150, 1183, 1188–89 (2004) (demonstrating that in some circumstances, scientific models can and do outperform individual experts when it comes to predicting Supreme Court behavior). For an example of practicing lawyers' use of data and statistics, see John S. Summers & Michael J. Newman, *Towards a Better Measure of Understanding of U.S. Supreme Court Review of Courts of Appeals Decisions*, 80 U.S.L.W. 393, 394 (2011). *See also* John S. Summers & Michael J. Newman, *'Matrixx,' Materiality and Statistical Significance*, LEGAL INTELLIGENCER, Apr. 28, 2011 (discussing the role of the "statistical significance" test in judicial decisionmaking). John Summers and Michael Newman are conducting a large empirical study of Supreme Court decisionmaking and its review of the thirteen courts of appeals. *See Supreme Court Project*, HANGLEY ARONCHICK SEGAL PUDLIN & SCHILLER, http://www.hangley.com/Supreme_Court_Project/ (last visited Aug. 19, 2012). For a fun investigation into the role of statistics in a profession long perceived to rely on individual expertise and knowledge, see MICHAEL LEWIS, MONEYBALL: THE ART OF WINNING AN UNFAIR GAME (2004), profiling a sabermetric approach to recruiting baseball players.

[249] *See* Eustice, *supra* note 241, at 136 (describing the tax shelter boom of the late 1990s as "not a new" problem).

continue to influence the government's decision to challenge corporate tax strategies as abusive.[250] Consequently, our results may enable tax lawyers to develop strategies that account for how judges identify corporate tax abuse, a concept historically considered nebulous at best and unknowable at worst.[251] In short, notwithstanding the fact that our study is limited to cases that appeared before the Supreme Court, this new understanding of how the Justices respond to corporate tax abuse allegations can serve important practical purposes.

Before proceeding, it is necessary to acknowledge the limitations on the potential application of our findings for corporate tax transactional work. Specifically, we concede that most tax lawyers will not incorporate certain findings regarding external factors into their planning analysis. For example, our study indicates that an increase in defense spending has a statistically significant effect on the government's likelihood of winning a corporate tax abuse case.[252] Not only are most lawyers likely unaware of the relative levels of government spending on national defense (though this data is widely available), but a significant time lag usually occurs between a corporation's pursuit of a tax strategy and litigation before any court, let alone the Supreme Court.[253] These findings may have important implications for scholars, policymakers, and litigators, but they are admittedly of little use to practitioners during the planning stages of corporate transactions. We expect that many of our findings will have important and interesting applications for private practitioners and government lawyers in various contexts.

1. Private Practitioners

Our study has implications for private practitioners who seek to reduce the risk of a judicial decision that unwinds a corporate tax planning strategy and for those who simply desire a better understanding of these risks.

First, our study suggests that private practitioners can increase the likelihood that the Supreme Court will respect their planning choices if they structure transactions that do not feature both the

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[250] *See* DEPT. OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 25–31 (July 1999).

[251] *See supra* Part I.A.2 (describing the uncertain nature of judicial anti-abuse standards).

[252] *See supra* notes 215–16 and accompanying text.

[253] *See* Blank, *supra* note 41, at 573–74 (discussing the "tax shelter time lag"); Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 87 (2006) (describing the "lengthy time lag" between the execution of a tax shelter and its eventual detection by the IRS).

participation of third parties *and* multiple transaction steps.[254] Put differently, practitioners should be aware that the use of simpler transaction structures that involve only a third party *or* only multiple transaction steps appear to best protect corporations from judicial anti-abuse standards. Again, in our future research, we will investigate whether this specific effect occurs in federal appellate and trial courts.

Our study also reveals that the procedural posture of a tax controversy has a significant effect on its outcome.[255] As noted above, when a tax controversy arises from the IRS's denial of a corporation's claim for a refund, instead of from an IRS agent's own discovery of a deficiency item during an audit, the government's chances of success in litigation increase significantly.[256] One explanation for this outcome is that the framing of the controversy as a dispute over the corporation's request for a *refund* of taxes from the government, as opposed to one that involves an *underpayment* of taxes to the government, may influence the Justices' views of abuse.[257] A possible implication of our study is that private practitioners may protect against the application of judicial anti-abuse standards by designing tax strategies that do not require the corporation to file a refund claim with the IRS on its original or amended return. For example, rather than structuring a transaction where a corporation files a refund claim as a result of using a net operating loss carry back (which would necessitate the filing of a separate refund claim),[258] practitioners could design tax strategies that involve a decrease in the corporation's reported taxable income on its return. Our findings show that, at least in the Supreme Court, a corporation will fare much better if the controversy centers on an underreporting controversy than on the amount of money a corporation can extract from the federal fisc.[259]

Finally, the Court has not looked favorably on corporate tax strategies that result in divergent positions on financial accounting documents and filed tax returns. While such book-tax differences[260] do not necessarily mean that the corporation will be denied its

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254 *See supra* Part II.B.2.a.

255 *See supra* note 217 and accompanying text.

256 *See id*.

257 For a discussion of the framing of refunds and tax payments, see John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, *in* WHY PEOPLE PAY TAXES 43, 60 (Joel Slemrod ed., 1992). *See also* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 731 n.205 (2007) (describing how tax law favors transactions involving third parties).

258 *See* IRS Form 1120X (Jan. 2011), *available at* www.irs.gov/pub/irs-pdf/f1120x.pdf; *see also* I.R.C. § 172(a) (2006) (defining a net operating loss carryback).

259 *See supra* Part II.B.2.b.

260 For a description of book-tax differences, see *supra* notes 103–04 and accompanying text.

preferred tax position, they raise a red flag to IRS auditors and judges alike that tax avoidance might be at hand. Our findings are yet another indication that corporate transactional lawyers should be wary of transactions that result in book-tax differences, or should at least inform clients of the potential risks of judicial recharacterization.

2. Government Lawyers

Although government lawyers will not utilize our findings to plan tax strategies and transactions (this function is carried out by private practitioners), they may nonetheless be able to make use of several of our empirical results when planning litigation strategies.

Our findings suggest that government lawyers should be hesitant to litigate against corporate taxpayers in the Supreme Court if the basis of their case rests on the assertion that the taxpayer lacked a non-tax business purpose for pursuing a transaction. Our results indicate that Supreme Court Justices generally rely on the corporation's view of business purpose and generally are not convinced to unwind a deal simply because the government alleges a business purpose is lacking.[261] Our study also indicates that government lawyers make a strategic litigation error when they focus excessively on a single factor of abuse—or build their case by pointing to as many indicia of abuse as possible.[262] Instead, government lawyers should focus on the two most objective factors, multiple steps and third parties, and use these factors not alone but in combination when challenging a transaction.

Further, our models consistently suggest that when the nation's defense spending spikes, the likelihood that the government will prevail also increases. The underlying judicial motivation for this pro-government position has been extensively explored elsewhere;[263] for our purposes we simply note that just as private practitioners should consider the external environment, government lawyers should consider factors beyond the parameters of the case in order to succeed.

3. Settlement Negotiations

Our study could shape corporate tax planning strategies in the short term and litigation strategies over the long term, but it may also affect settlement discussions.[264] For instance, if a corporation filed a

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[261] *See supra* text accompanying notes 191–92.

[262] For example, the government provides a lengthy list of possible indicia of abuse in its guidance to its agents regarding the newly codified economic substance doctrine. *See Guidance for Examiners and Managers*, *supra* note 100.

[263] *See generally* STAUDT, *supra* note 163.

[264] *See* CLIFF JERNIGAN, CORPORATE TAX AUDIT SURVIVAL 81–84 (2005) (describing the audit and settlement process for large corporations).

tax refund claim with the IRS, engaged in a multistep transaction with outside parties, and is defending its plan in the Supreme Court after winning in the lower appellate court, then that corporation should expect to lose in the Supreme Court.[265] If the case reaches the docket during a wartime emergency, the taxpayer's chances of success fall further and, thus, settlement should be viewed as an acceptable option given the high risk of losing.[266] Indeed, even if the transaction avoids those factors that our study suggests cause the Court to decide in the government's favor, but the Justices decide to hear the case on appeal by the government while the nation is at war, the corporation should again seriously consider settlement. Our empirical findings, of course, must be refined and modified by case-specific factors, factors known by lawyers due to their own background knowledge and expertise in a particular case.

The same type of analyses can be conducted with respect to the government. If the government relies on the lack of a business purpose to convince the Court to unwind a transaction, and the Court agrees to hear the case on the taxpayer's certiorari petition in a period of peace, the government is unlikely to prevail.[267] Government lawyers, consequently, should focus on other factors discussed above in designing their litigation strategies or, alternatively, consider settlement. Again, this presumes an absence of competing concerns known by the lawyers due to their own professional experience.

Not only do we believe that our modeling efforts can advance the interests of lawyers and litigators when it comes to strategizing and settling, but we also believe the judiciary itself will benefit. Our study illuminates judicial decisionmaking in corporate tax abuse cases, a process that has long been viewed as elusive. This study provides a greater level of predictability to the decisionmaking process, a feature widely believed to be associated with fair and just decisionmaking.[268] We do not express a normative view regarding whether judicial uncertainty increases tax compliance or serves any other purpose. However, we are confident that the judiciary itself would benefit from a statistical analysis of judicial decisionmaking in the corporate tax abuse context given that this transparency would encourage parties in federal appellate disputes to reach settlements and, consequently, avoid the use of judicial resources.

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265 *See supra* Parts II.B.2, II.C.

266 *See supra* notes 215–16 and accompanying text.

267 *See supra* Parts II.B.2.a, II.B.2.d.

268 For a discussion of these issues and a review of the literature, see Nancy C. Staudt, *Taxpayers in Court: A Systematic Study of a (Misunderstood) Standing Doctrine*, 52 EMORY L.J. 771, 836–46 (2003).

B. Should Business Purpose Matter?

In addition to offering possible guidance to private practitioners, IRS agents, and government lawyers, our study also elicits normative questions regarding the utility of the business purpose doctrine as an anti-abuse mechanism. The Supreme Court has described the business purpose doctrine as necessary to ensure that a taxpayer's transaction is "imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ."[269] The presence of a business purpose is often of paramount importance to tax practitioners when structuring transactions,[270] and the standard now appears in the text of the IRC itself.[271] Yet, as the discussion above reveals, commentators have criticized the business purpose standard as a weak barrier against abuse.[272] While the scope of this study is limited to Supreme Court decisions, it suggests, for the first time using empirical evidence, that the criticism voiced by these commentators may deserve further consideration.[273]

Our findings show that when the government alleges that the taxpayer lacked a non-tax business purpose, which almost always results in a counterargument from the corporate taxpayer,[274] the issue has no statistically significant effect on the judicial outcome.[275] A possible explanation for this finding is that when the issue of a non-tax-related business purpose arises in a corporate tax abuse controversy, the government and the corporate taxpayer may offer equally convincing arguments. The potential positive effect of a business purpose allegation on the government's chance of success is thus negated by the taxpayer's effective counterargument. Another possibility is that in corporate tax abuse controversies that reach the Supreme Court, the issue of whether the transaction possesses a non-tax business purpose is not as central to the dispute as other issues.[276] A final intriguing possibility is that the Justices may not believe that a

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269 Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978).

270 *See, e.g.*, Canellos, *supra* note 108, at 52 (characterizing transactions motivated by non-tax business purpose as "real transactions"); Ferguson, *supra* note 107, at 727–28 (describing the importance of "business purpose" to courts' analyses of transactions).

271 I.R.C. § 7701(o)(1)(B) (Supp. IV 2010) (stating that a transaction has economic substance if "the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction").

272 Chirelstein & Zelenak, *supra* note 132, at 1962.

273 *See supra* notes 124–27 and accompanying text.

274 *See* David P. Hariton, *The Frame Game: How Defining the "Transaction" Decides the Case*, 63 TAX LAW. 1, 1 (2009) ("[T]he battle in the courts is primarily about 'framing' the transaction as consisting of either the narrower tax-motivated structures or steps . . . or of the broader business objectives . . . .").

275 *See supra* notes 191–92 and accompanying text.

276 *See* WOOLDRIDGE, *supra* note 174, at 174 (discussing possible selection effects).

non-tax-motivated purpose for a transaction can be separated from a tax-motivated purpose as neatly as some commentators suggest.[277] In any case, this finding appears to confirm the criticism of many commentators that the Justices may view the business purpose requirement as a standard that can be manipulated by both the taxpayer and the government and thus is neither probative nor decisive for legal analytic purposes.

Further, in some cases, the Court may be more inclined to accept the corporation's business purpose argument than the government's tax abuse accusation. As our study shows, in corporate tax abuse cases when the government alleges a lack of business purpose *and* that a third party was involved in the transaction at issue, the government's probability of success decreases.[278] This reaction may occur because the Court may perceive the presence of a third party in a transaction as signaling that, as the corporation argues, the transaction at issue satisfied some genuine non-tax business purpose. This finding supports the view of many commentators that the business purpose standard does not enable the government to attack corporate tax abuse effectively.[279]

Our discussion suggests that policymakers should consider adopting an alternative to the business purpose standard in order to prevent corporate tax abuse.[280] Potential policy candidates include proposals that attempt to identify corporate tax abuse without requiring a subjective, intent-based analysis. For example, the objective loss disallowance rule that Professors Marvin Chirelstein and Lawrence Zelenak have proposed would prohibit tax losses that do not mirror economic losses and would not require a court to analyze the corporation's business purpose for pursuing particular transactions.[281] Professor Daniel Shaviro has also offered a proposal that highlights objective differences between a corporation's reported taxable income and its financial income, along with tax penalties based on the difference as a means to deter abuse.[282] Several other proposals employ similar objective approaches in an effort to detect and deter

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277 *See, e.g.*, *supra* note 270.

278 See *supra* Part II.B.2.a for an explanation of these findings.

279 *See supra* notes 124–27 and accompanying text (describing commentators' criticism of application of judicial anti-abuse standards).

280 While our study provides empirical evidence that the business purpose standard may not serve the government's interests, we do not endorse any particular alternative proposal that has been offered.

281 Chirelstein & Zelenak, *supra* note 132, at 1953–55.

282 Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 472–83 (2009).

corporate tax abuse.[283] Our study bolsters the arguments set forth by critics of the business purpose standard. We thus provide further justification for the argument in favor of anti-abuse proposals that eliminate subjective analysis of the taxpayer's intent.

Conclusion

Many corporations seek to lower their tax bills with the help of creative tax planning. While the best and most ingenious strategies adhere to the letter of the law, government lawyers routinely challenge these strategies as mere deception and manipulation. This Article examines government challenges to these alleged corporate shams in an effort to determine how and why the Supreme Court determines when ostensibly legal behavior has shaded into abuse and fraud.[284] In an effort to provide insight into this decisionmaking process, previous researchers conducted qualitative case studies and proposed standards and rules that would lead to better and more predictable judicial outcomes. This Article adopts a new approach by undertaking the first large-*n* quantitative study of Supreme Court tax-abuse decisions in an effort to identify the trends that could not be observed in the prior studies.

Our empirical results run counter to the conventional wisdom that judges do not follow predictable patterns when deciding corporate abuse cases. We uncover a collection of factors that systematically lead Supreme Court Justices to favor (or disfavor) the government in the controversies that appear on the Court's docket. By explaining the judicial decisionmaking process and the factors linked to specific judicial outcomes, we believe that our study will increase knowledge and understanding of the law that governs and defines corporate abuse. This more nuanced understanding of corporate tax law, in turn, should have important practical implications for private practitioners, government lawyers, and policymakers.

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[283] See *supra* notes 124–27 and accompanying text for a discussion of the proposals.

[284] The use of standards to combat the unintended results that stem from a literalist use of rules occurs in other areas of the law as well. *See* Kristin E. Hickman & Claire A. Hill, *Concepts, Categories, and Compliance in the Regulatory State*, 94 Minn. L. Rev. 1151, 1156 (2010) ("Law typically seeks to avoid the potentially absurd extremes of rules or formalistic interpretations of statutory text through the use of ex post standards . . . .").

Appendix: Corporate Tax Abuse Cases in the U.S. Supreme Court 1909–2011

This Appendix contains the 137 cases that we designated as "corporate tax abuse cases" in our study. These cases involve a corporate tax controversy in which the government alleged in its brief that the corporation's tax strategy was abusive.[285]

Case	Citation	Year
McCoach v. Minehill & Schuylkill Haven R.R.	228 U.S. 295	1913
Von Baumbach v. Sargent Land Co.	242 U.S. 503	1917
United States v. Biwabik Mining Co.	247 U.S. 116	1918
United States v. Supplee-Biddle Hardware Co.	265 U.S. 189	1924
Lederer v. Fidelity Trust Co.	267 U.S. 17	1925
Duffy v. Cent. R.R. of N.J.	268 U.S. 55	1925
Edwards v. Cuba R.R.	268 U.S. 628	1925
Burk-Waggoner Oil Ass'n v. Hopkins	269 U.S. 110	1925
United States v. Bos. Ins. Co.	269 U.S. 197	1925
United States v. Anderson	269 U.S. 422	1926
Edwards v. Chile Copper Co.	270 U.S. 452	1926
Bowers v. Kerbaugh-Empire Co.	271 U.S. 170	1926
Hellmich v. Mo. Pac. R.R.	273 U.S. 242	1927
Am. Nat'l Co. v. United States	274 U.S. 99	1927
Willcuts v. Milton Dairy Co.	275 U.S. 215	1927
Lewellyn v. Elec. Reduction Co.	275 U.S. 243	1927
United States v. Bos. & Me. R.R.	279 U.S. 732	1929
United States v. Am. Can Co.	280 U.S. 412	1930
Lucas v. Ox Fibre Brush Co.	281 U.S. 115	1930
Lucas v. Kan. City Structural Steel Co.	281 U.S. 264	1930
Niles Bement Pond Co. v. United States	281 U.S. 357	1930
Handy & Harman v. Burnet	284 U.S. 136	1931
Am. Hide & Leather Co. v. United States	284 U.S. 343	1932

[285] As we have stated, these cases involve *corporate* rather than individual tax liability. Consequently, the list does not contain certain "classic" Supreme Court cases involving abusive tax strategies, such as *Gregory v. Helvering*, 293 U.S. 465 (1935). In that famous case, the principal issue was the tax treatment of Mrs. Gregory, an individual shareholder, on her receipt and sale of Monitor Corporation stock. *Id*. at 467. The issue was not the tax treatment of the corporations that Mrs. Gregory owned. *Id*. As a result, we did not designate this tax case, or several others like it, as "corporate tax cases" or "corporate tax abuse cases."

Case	Citation	Year
U.S. Cartridge Co. v. United States	284 U.S. 511	1932
Bowers v. Lawyers Mortg. Co.	285 U.S. 182	1932
Tex. & Pac. Ry. Co. v. United States	286 U.S. 285	1932
Cont'l Tie & Lumber Co. v. United States	286 U.S. 290	1932
Woolford Realty Co. v. Rose	286 U.S. 319	1932
N. Am. Oil Consol. v. Burnet	286 U.S. 417	1932
Murphy Oil Co. v. Burnet	287 U.S. 299	1932
Bankers Pocahontas Coal Co. v. Burnet	287 U.S. 308	1932
Pinellas Ice & Cold Storage Co. v. Comm'r	287 U.S. 462	1933
Burnet v. Aluminum Goods Mfg. Co.	287 U.S. 544	1933
Atl. City Electric Co. v. Comm'r	288 U.S. 152	1933
Charles Ilfeld Co. v. Hernandez	292 U.S. 62	1934
Rockford Life Ins. Co. v. Comm'r	292 U.S. 382	1934
McLaughlin v. Pac. Lumber Co.	293 U.S. 351	1934
Helvering v. Inter-Mountain Life Ins. Co.	294 U.S. 686	1935
Raybestos-Manhattan, Inc. v. United States	296 U.S. 60	1935
Gen. Utils. & Operating Co. v. Helvering	296 U.S. 200	1935
Morrissey v. Comm'r	296 U.S. 344	1935
Swanson v. Comm'r	296 U.S. 362	1935
Helvering v. Combs	296 U.S. 365	1935
Helvering v. Coleman-Gilbert Assocs.	296 U.S. 369	1935
John A. Nelson Co. v. Helvering	296 U.S. 374	1935
Helvering v. Minn. Tea Co.	296 U.S. 378	1935
G. & K. Mfg. Co. v. Helvering	296 U.S. 389	1935
Bus & Transp. Sec. Corp. v. Helvering	296 U.S. 391	1935
Great W. Power Co. v. Comm'r	297 U.S. 543	1936
Helvering v. Ill. Life Ins. Co.	299 U.S. 88	1936
Helvering v. Midland Mut. Life Ins. Co.	300 U.S. 216	1937
Founders Gen. Corp. v. Hoey	300 U.S. 268	1937
Helvering v. Tex-Penn Oil Co.	300 U.S. 481	1937
A.A. Lewis & Co. v. Comm'r	301 U.S. 385	1937
Minn. Tea Co. v. Helvering	302 U.S. 609	1938
Helvering v. Mountain Producers Corp.	303 U.S. 376	1938
United States v. Hendler	303 U.S. 564	1938
Helvering v. Nat'l Grocery Co.	304 U.S. 282	1938
M.E. Blatt Co. v. United States	305 U.S. 267	1938
Helvering v. R.J. Reynolds Tobacco Co.	306 U.S. 110	1939

Case	Citation	Year
First Chrold Corp. v. Comm'r	306 U.S. 117	1939
Helvering v. Metro. Edison Co.	306 U.S. 522	1939
Helvering v. F. & R. Lazarus & Co.	308 U.S. 252	1939
Real Estate–Land Title & Trust Co. v. United States	309 U.S. 13	1940
United States v. A.S. Kreider Co.	313 U.S. 443	1941
United States v. Joliet & Chi. R.R. Co.	315 U.S. 44	1942
Helvering v. Ala. Asphaltic Limestone Co.	315 U.S. 179	1942
Palm Springs Holding Corp. v. Comm'r	315 U.S. 185	1942
Bondholders Comm. v. Comm'r	315 U.S. 189	1942
Helvering v. Sw. Consol. Corp.	315 U.S. 194	1942
Magruder v. Wash., Balt. & Annapolis Realty Corp.	316 U.S. 69	1942
Helvering v. Credit Alliance Corp.	316 U.S. 107	1942
Helvering v. Cement Investors, Inc.	316 U.S. 527	1942
Helvering v. Sabine Transp. Co.	318 U.S. 306	1943
Helvering v. Chi. Stock Yards Co.	318 U.S. 693	1943
Detroit Edison Co. v. Comm'r	319 U.S. 98	1943
Virginian Hotel Corp. v. Helvering	319 U.S. 523	1943
Sec. Flour Mills Co. v. Comm'r	321 U.S. 281	1944
Equitable Life Assurance Soc'y v. Comm'r	321 U.S. 560	1944
United States v. Seattle–First Nat'l Bank	321 U.S. 583	1944
Wis. Gas & Electric Co. v. United States	322 U.S. 526	1944
Comm'r v. Court Holding Co.	324 U.S. 331	1945
John Kelley Co. v. Comm'r	326 U.S. 521	1946
Kirby Petroleum Co. v. Comm'r	326 U.S. 599	1946
Burton-Sutton Oil Co. v. Comm'r	328 U.S. 25	1946
United States v. Ogilvie Hardware Co.	330 U.S. 709	1947
Comm'r v. S. Tex. Lumber Co.	333 U.S. 496	1948
Nat'l Carbide Corp. v. Comm'r	336 U.S. 422	1949
United States v. Cumberland Pub. Serv. Co.	338 U.S. 451	1950
Brown Shoe Co. v. Comm'r	339 U.S. 583	1950
United States v. Anderson, Clayton & Co.	350 U.S. 55	1955
Comm'r v. Sw. Exploration Co.	350 U.S. 308	1956
United States v. Leslie Salt Co.	350 U.S. 383	1956
Millinery Ctr. Bldg. Corp. v. Comm'r	350 U.S. 456	1956
Libson Shops, Inc. v. Koehler	353 U.S. 382	1957
Comm'r v. P.G. Lake, Inc.	356 U.S. 260	1958
United States v. Cannelton Sewer Pipe Co.	364 U.S. 76	1960

Case	Citation	Year
Massey Motors, Inc. v. United States	364 U.S. 92	1960
Hertz Corp. v. United States	364 U.S. 122	1960
Am. Auto. Ass'n v. United States	367 U.S. 687	1961
Riddell v. Monolith Portland Cement Co.	371 U.S. 537	1963
Paragon Jewel Coal Co. v. Comm'r	380 U.S. 624	1965
United States v. Midland-Ross Corp.	381 U.S. 54	1965
Fribourg Navigation Co. v. Comm'r	383 U.S. 272	1966
United States v. Donruss Co.	393 U.S. 297	1969
United States v. Hilton Hotels Corp.	397 U.S. 580	1970
Comm'r v. First Sec. Bank of Utah	405 U.S. 394	1972
Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co.	417 U.S. 134	1974
Cent. Tablet Mfg. Co. v. United States	417 U.S. 673	1974
Comm'r v. Idaho Power Co.	418 U.S. 1	1974
Ivan Allen Co. v. United States	422 U.S. 617	1975
Don E. Williams Co. v. Comm'r	429 U.S. 569	1977
United States v. Consumer Life Ins. Co.	430 U.S. 725	1977
Fulman v. United States	434 U.S. 528	1978
Frank Lyon Co. v. United States	435 U.S. 561	1978
HCSC-Laundry v. United States	450 U.S. 1	1981
United States v. Swank	451 U.S. 571	1981
United States v. Vogel Fertilizer Co.	455 U.S. 16	1982
Hollsboro Nat'l Bank v. Comm'r	460 U.S. 370	1983
United States v. Hughes Props., Inc.	476 U.S. 593	1986
Comm'r v. Asphalt Prods. Co.	482 U.S. 117	1987
United States v. Gen. Dynamics Corp.	481 U.S. 239	1987
Ark. Best Corp. v. Comm'r	485 U.S. 212	1988
Colonial Am. Life Ins. Co. v. Comm'r	491 U.S. 244	1989
United States v. Goodyear Tire & Rubber Co.	493 U.S. 132	1989
Cottage Sav. Ass'n v. Comm'r	499 U.S. 554	1991
United States v. Centennial Sav. Bank FSB	499 U.S. 573	1991
Holywell Corp. v. Smith	503 U.S. 47	1992
United States v. Thompson/Ctr. Arms Co.	504 U.S. 505	1992
Comm'r v. Keystone Consol. Indus.	508 U.S. 152	1993
Atl. Mut. Ins. Co. v. Comm'r	523 U.S. 382	1998
United Dominion Indus., Inc. v. United States	532 U.S. 822	2001