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A CRITIQUE OF THE BUSINESS-PURPOSE DOCTRINE*

ROBERT S. SUMMERS†

THE AIMS of this article are: (1) to define the nature and significance of the business-purpose doctrine[1] as applied in the field of Federal income taxation;[2] (2) to summarize several considerations that support abandonment of the doctrine; and (3) to consider whether a substitute doctrine is needed. Several recent cases indicate that the influence of the business-purpose doctrine is declining,[3] and in the recent case of *Knetsch v. United States*[4] the Supreme Court appears to have substituted an alternative doctrine. The dual thesis of the present article is that the business-purpose doctrine ought to be abandoned and that there is no need for a substitute.

I

Since the decision of *Gregory v. Helvering*[5] in 1934, the courts have

* This article had its genesis in a paper written for Professor Stanley S. Surrey in the Seminar on Current Issues in Federal Taxation at Harvard Law School in 1959. The author is also indebted to Maurice O. Georges, Esq. of Portland, Oregon, who read an earlier draft of the article and made several valuable suggestions. However, responsibility for error or misjudgment is solely the author's.

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[1] Little has been written on the doctrine recently except in the field of corporate reorganizations. The doctrine has been the subject of several articles of the survey variety. See Robinson, *Determining Income Tax Liability by Taxpayer's Motive*, 12 TAX MAGAZINE 402 (1934); Sutherland, *Taxpayer's Motive as a Basis for Taxability*, N.Y.U. 8TH INST. ON FED. TAX. 990 (1949); Ballentine, *Psychological Bases for Tax Liability*, 27 HARV. BUS. REV. 200 (1949); Fischer, *Intent and Taxes*, 32 TAXES 303 (1954); Holzman, *The Gregory Case*, 100 J. ACCOUNTANCY 54 (1955). See also Paul, *Motive and Intent in Tax Law*, in SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES (1938); HOLZMAN, SOUND BUSINESS PURPOSE (1958). The last is useful only as a catalog of cases.

The most incisive survey discussion of the business-purpose doctrine and allied topics in tax avoidance is Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021 (1953). See also Angell, *Tax Evasion and Tax Avoidance*, 38 COLUM. L. REV. 80 (1938); Cahn, *Taxation, Some Reflections on the Quest of Substance*, 30 GEO. L.J. 587 (1942); Paul, *Restatement of Tax Avoidance*, in SELECTED STUDIES IN FEDERAL TAXATION, first series (1937). Numerous decisions of Judge Learned Hand form the richest quarry of judicial opinions on tax-avoidance law. See Diamond, *Judge Learned Hand and Federal Taxation*, 3 SYRACUSE L. REV. 81 (1951).

[2] The income tax is not the only area of tax law in which taxpayer motivation is significant. See, for example, Estate of May Hicks Sheldon, 27 T.C. 194 (1956).

[3] Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1948); Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1957); Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957); Haas v. Commissioner, 248 F.2d 487 (2d Cir. 1957); Stearns v. Commissioner, 208 F.2d 849 (7th Cir. 1954); Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955).

[4] 364 U.S. 361 (1960).

[5] 293 U.S. 465 (1935). Since the Revenue Act of 1918, there have been statutory

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considered the business-purpose doctrine relevant to the disposition of numerous issues[6] in the field of Federal income taxation.[7] However, the authoritative basis of the doctrine is not solely judicial. Various versions of the business-purpose concept are expressly embodied in provisions of the INTERNAL REVENUE CODE OF 1954.[8]

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provisions that have depended for their operation on findings with respect to taxpayer motivation. The origin of the judicial business-purpose doctrine is usually attributed to *Gregory v. Helvering*. The other basic tenet of the *Gregory* case is that literal compliance with the statute is not alone sufficient, a tenet that is essential to sound tax administration.

The question whether in tax cases literal compliance with the statute should alone be sufficient is another facet of the more general dispute over how a statute should be interpreted. The issue was clearly drawn as early as Heydon's Case, 76 Eng. Rep. 637 (1584). There is an enormous literature on the subject. See, in the tax field, Surrey, *The Supreme Court and the Federal Income Tax*, 35 ILL. L. REV. 779, 803 (1941); Griswold, *The Function of Courts in Interpreting Tax Statutes*, 58 CAN. CHARTERED ACCOUNTANT 227 (1951); and the rejoinder by Thom, *Taxation Statutes: Strict or Functional Interpretation*, 58 CAN. CHARTERED ACCOUNTANT 235 (1951).

For a brief and accurate, but unsympathetic, historical treatment of the rise and fall of interpretational literalism in the tax field, see Magill, *Four Urgently Needed Changes in Federal Income Taxation*, 88 J. ACCOUNTANCY 488, 493 (1949).

[6] Corporate reorganizations and distributions: Gregory v. Helvering, 293 U.S. 465 (1935); disregard of the corporate entity: Moline Properties v. Commissioner, 319 U.S. 436 (1943); disregard of the partnership entity: Culbertson v. Commissioner, 337 U.S. 733 (1949); "thin" incorporation: Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956); "step transaction" issues: Commissioner v. Transport Trading and Terminal Corp., 176 F.2d 570 (2d Cir. 1949); Weyl-Zuckerman v. Commissioner, 232 F.2d 214 (9th Cir. 1956); sale and leaseback: Armston v. Commissioner, 188 F.2d 531 (5th Cir. 1951); anticipatory assignment of income: Home Furniture Co. v. Commissioner, 168 F.2d 312 (4th Cir. 1948); numerous other issues: see, for example, Deal v. Morrow, 197 F.2d 821 (5th Cir. 1957); Jacobs v. Commissioner, 224 F.2d 412 (9th Cir. 1955); T. V. D. Co., 27 T.C. 879 (1957); Main Hammond Trust v. Commissioner, 200 F.2d 308 (6th Cir. 1952); Emmons v. Commissioner, 270 F.2d 294 (3d Cir. 1959). The doctrine will probably be applied in the new "subchapter S" area. Hoffman *Let's Go Slow with Tax Option Corporations*, 37 TAXES 21, 27 (1959); Note, *Subchapter S of the 1954 Code*, 33 ST. JOHN'S L. REV. 187, 207 (1958).

[7] One writer has said: "The existence of a calculated plan to avoid taxes is the basic explanation for all of the cases concerning the effect of transactions which are commercially unfamiliar and comply with formal requirements for minimizing taxes under the statutes." Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021, 1038 (1953).

Compare these remarks by the late Randolph Paul: *Minimizing motive:* "But in the absence of a statutory provision making purpose the criterion of taxability the courts should, and usually do, disregard the purposes of taxpayers, except as motive may throw light upon equivocal conduct. What is done rather than the design and purpose of the participants in a transaction, is the critical fact; design and purpose are irrelevant." PAUL, TAXATION IN THE UNITED STATES 661 (1st ed. 1954). *Emphasizing motive*: "Advice to a particular client in a specific case too often turns upon answers to riddles such as: What is the scope of the 'business purpose' doctrine?" Paul, *The Responsibilities of the Tax Adviser*, 63 HARV. L. REV. 377, 381 n. 28 (1950). "Proof of the absence of tax avoidance motives, so crucial to many tax cases, often requires inquiry into remote corners of motive and intent..." *Id.* at 382 n. 33.

[8] INT. REV. CODE OF 1954, secs. 269(a), 302(c)(2)(B), 306(b)(4), 341(b)(1), 355(a)(1)(D), 357(b), 367, 532(a), 704(b)(2), 706(b)(1), 1492(2), 1551.

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The judicial (i.e., nonstatutory) formulation of the business-purpose doctrine may be expressed in various ways. Perhaps the least inaccurate formulation would be as follows: determinations of Federal income-tax liability may depend partially on the purpose a taxpayer has in mind when he enters upon transactions that allegedly reduce his taxes; in some situations, the courts will be less inclined to impose liability if the taxpayer can prove that he intended his transaction to serve a sound[9] business purpose instead of, or in addition to, a purpose to reduce taxes.[10]

One of the least accurate formulations of the doctrine would be the statement that, to reduce taxes, a taxpayer must always show that he intended his transactions to serve a nontax purpose. There are many modes of tax saving that neither the courts nor Congress have sought to thwart by requiring a "business" (i.e., a nontax) motivation.[11] "For instance, if a very rich man sells shares of stock and invests the proceeds in municipal bonds, he will not be taxed on the dividends of the shares, although his only motive was to avoid the tax upon his dividends."[12] No business purpose is required for an ordinary sale, a very common transaction that often entails desirable tax consequences.[13]

The judicial business-purpose doctrine has been applied in corporate-reorganization cases, in corporate-distribution cases, in the so-called "entity" cases in which the Commissioner of Internal Revenue has sought to disregard the existence of a corporation or a partnership, in the so-called "thin incorporation" cases, in "step transaction" cases, in cases involving use of the sale and leaseback device, in cases involving anticipatory assignments of income, and in several other types of cases.[14] Among the provisions of the INTERNAL REVENUE CODE that expressly invite proof of business purpose are such important provisions

[9] On the meaning of "sound," see David's Specialty Shops, 131 F. Supp. 458 (S.D.N.Y. 1955).

[10] It is occasionally advantageous for the taxpayer to contend that he did not act for a business purpose. See, for example, Skarda v. Commissioner, 250 F.2d 429 (10th Cir. 1957); Survant v. Commissioner, 162 F.2d 753 (8th Cir. 1947).

[11] And "it is frequently stated ... that a tax saving motive behind a transaction is immaterial for tax purposes. This is unquestionably the most confusing doctrine of all, for it is almost never asserted unless accompanied by a caveat. Thus, decisions asserting this rule have stated it to be applicable in reorganization cases only if reorganization was in fact effected or adopted. In other cases the rule is to be applied only if there is conformance to the terms or the purpose of the statute, or if the transaction is not a sham and has substance, or is in fact what it appears to be in form, or is genuine, or has the 'essential elements' necessary to establish its validity as an actual sale and purchase or is in reality what it appears to be or is not illegal or fraudulent." (Numerous citations omitted.) Rice, *supra* note 7, at 1037.

[12] Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957).

[13] Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955); Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1957).

[14] See cases cited in note 6 *supra* and in notes 32, 33, 34, and 35 *infra*.

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as section 355, relating to corporate separations, and section 1551, relating to disallowance of surtax and accumulated-earnings credits.

The relative significance of the business-purpose doctrine as a decisional factor is difficult to measure. Where the doctrine is embodied in the INTERNAL REVENUE CODE, the pertinent provision specifies its effect.[15] Where its authoritative basis is solely judicial, its relative significance as a decisional factor appears to vary, depending on the nature of the issue and the attitude of the court toward subjective tests.[16] Usually, the factor of motive is only one of several factors that influence the court.[17] Often, this factor serves only as a makeweight.[18]

II

Several considerations support abandonment of the business-purpose doctrine.

The late Randolph Paul and others have argued that findings of fact with respect to taxpayer motivation are not sufficiently reliable inasmuch as the evidence on which such findings are based can be easily "manufactured."[19] Accordingly, the doctrine is largely ineffective as a device for combating tax avoidance.

Judge Calvert Magruder, formerly chief judge of the Court of Appeals for the First Circuit, has stated two additional objections to

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[15] The phraseology of some of these provisions differs significantly. Operation of a provision may depend on whether the taxpayer's purpose to reduce taxes was: "the principal purpose," sec. 269(a); "one of its principal purposes," sec. 355(a)(1); or "a major purpose," sec. 1551.

[16] For example, the courts of appeal for the first and second circuits appear to be disinclined to rely on the subjective factor of motive. See cases cited note 3 *supra*. *But see* Diggs v. Commissioner, 281 F.2d 326 (2d Cir. 1960). Generally speaking, the doctrine appears to be more significant in corporate-reorganization cases than in other types.

[17] See any business-purpose case cited in this article.

[18] Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957), and see comment in Northup v. United States, 240 F.2d 304, 307 (2d Cir. 1957).

[19] "... such tests actually stack the cards in favor of the taxpayer rather than against him; the advantages of sweeping definitions and of whatever presumptions may be available to the government will remain more than offset by the fact that the evidence as to motive is almost entirely in the possession of the taxpayer, unless psychology devises a better mental x-ray than has so far been discovered." Paul, SELECTED STUDIES IN FEDERAL TAXATION, SECOND SERIES 300 (1938).

"... It is an open secret that business purposes are often manufactured in the offices of attorneys. And it is from the taxpayer that proof of the purpose must come. Taxpayers should not be allowed to benefit from the option of producing or failing to produce documentation of a sufficient purpose." Michaelson, *Business Purpose and Tax-Free Reorganization*, 61 YALE L.J. 14, 25 (1952).

"... only the most unimaginative of tax counsel will find it difficult to project innumerable business reasons supporting any device to save taxes." Rice, *supra* note 7, at 1044.

"... [until a] change [in the law] takes place, practitioners will presumably continue to 'dream up' business reasons." Marold, *Current Problems and Issues in Dividing a Business*, N.Y.U. 17TH INST. ON FED. TAX. 857, 871 (1959).

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the doctrine. In *Granite Trust Co. v. United States*,[20] Judge Magruder refused to apply the doctrine and emphasized that inquiry into motives only "promotes duplicity." And, in an earlier corporate-reorganization case, *Lewis v. Commissioner*,[21] he said that the doctrine may function as a substitute for analysis. One writer has recently praised the *Lewis* opinion for "its characteristic rejection of that anodyne for the pains of reasoning . . . the 'business purpose test' . . . "[22]

Although a business-purpose finding in a particular case may not be the end product of the taxpayer's inventive genius, judicial emphasis on the finding may obscure the true issue.[23] In those areas in which the business-purpose doctrine ordinarily applies, this issue is frequently stated broadly in terms of whether the taxpayer's transaction is in fact what he claims it to be.[24] Obviously, the presence of a sound business purpose does not, for example, ensure that a claimed tax-free reorganization is in fact such.[25] And, although a sole shareholder may need cash to apply to an independent business venture, and therefore have a "business purpose" for a corporate distribution, this purpose should not enable him to avoid a tax on what would otherwise be a taxable distribution.[26] "If the courts were to rest their gaze, once good faith and serious motive are established, tax administration would be naive indeed."[27]

Some have argued, as a matter of morals, that to reduce taxes a taxpayer ought to be motivated primarily by a business purpose.[28] This argument is thoroughly unrealistic. Taxpayers will always try to reduce their taxes. In the late Judge Learned Hand's terms, "to demand more in the name of morals is mere cant."[29]

In support of the judicial business-purpose doctrine, some have contended that, since literal compliance with the provisions of the INTERNAL REVENUE CODE should not alone be sufficient to secure tax benefits, some doctrine such as the business-purpose doctrine is neces-

[20] 238 F.2d 670, 677 (1st Cir. 1957).

[21] 176 F.2d 646, 650 (1st Cir. 1948).

[22] Brown, *Viginti Annorum Lucubrationes; The Tax Decisions of Judge Calvert Magruder*, 72 HARV. L. REV. 1225, 1240 (1959).

[23] *But see* Mill Ridge Coal Co. v. Patterson, 264 F.2d 713 (5th Cir. 1959).

[24] It is not true that the substance v. form issue can be reduced to business purpose v. tax purpose. Determinations of "substance" are influenced by factors in addition to motive. *But see The Role of State Law in Federal Tax Determinations*, 72 HARV. L. REV. 1350, 1354 n. 30 (1959).

[25] See, for example, Riddlesbarger v. Commissioner, 200 F.2d 165 (7th Cir. 1952).

[26] *But see* the reasoning in Commissioner v. Pope, 239 F.2d 881 (1st Cir. 1957).

[27] Cahn, *Taxation: Some Reflections on the Quest of Substance*, 30 GEO. L.J. 587, 593 (1942).

[28] This view is probably not held consistently. For example, adherents of this view would probably endorse retention of a security an extra day solely to get long-term capital-gain treatment on the sale thereof.

[29] Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir. 1947).

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sary to prevent abuse of technical statutory provisions.[30] Obviously, literal compliance alone should not, in most cases, be considered sufficient. However, it does not follow from this view that the business-purpose doctrine is therefore essential to sound tax administration. Research has failed to uncover a single case decided partially on the basis of the taxpayer's purposes that could not have been soundly decided without reference to his purposes.[31] Moreover, the statutory provisions that embody various versions of the business-purpose doctrine could be readily redrafted in nonsubjective terms. To demonstrate that a wholly objective approach would be feasible, it is necessary to discuss briefly several areas, both judicial and statutory, in which the business-purpose doctrine is operative.

Corporate reorganizations,[32] corporate distributions,[33] disregard of partnership entities,[34] and sales and leasebacks[35] are areas in which the judicial business-purpose doctrine has been significantly operative. In the leading reorganization case of *Gregory v. Helvering*,[36] the taxpayer, as sole owner of the United Mortgage Corporation, caused the corporation to transfer one of its assets to a newly formed corporation that the taxpayer also owned. Immediately after this transfer, the tax-

[30] "... these are not the Gregory v. Helvering type of situation, where judicial action is certainly proper to protect technical rules from distortion through tax motivated transactions lacking a business purpose or other substantial economic reality. That situation is controlled by the 'business purpose' rule, which has a valid and important role in the system." Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 995 (1956). Elsewhere, Professor Surrey has said: "The Gregory decision is expressed in many ways and words, all of which come to the pointed warning, 'Beware—Proceed with Caution,' that faces tax reduction plans having any element of artificiality or nonconformance with normal business or family conduct." SURREY & WARREN, FEDERAL INCOME TAXATION, CASES AND MATERIALS 1285 (1955).

[31] *But see*: "Motive is a criterion in those transactions only, whose reality stems from it." Cahn, *Taxation: Some Reflections on the Quest of Substance*, 30 GEO. L.J. 587, 593 (1940). "Furthermore, not every reorganization can be given a meaningful examination in terms of effect." Michaelson, *Business Purpose and Tax-Free Reorganization*, 61 YALE L.J. 14, 41 (1952). If the statutory provision imposes a motive test, then the "reality" of the transaction must be determined by inquiry into motive. But Congress need not and should not impose such a test.

[32] See, for example, Gregory v. Helvering, 293 U.S. 465 (1935); Estate of Lewis B. Meyer, 15 T.C. 850 (1950); Riddlesbarger v. Commissioner, 200 F.2d 165 (2d Cir. 1955); Rena B. Farr, 24 T.C. 350 (1955); Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959); Walter L. Morgan, 33 T.C. 30 (1959); Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir. 1959).

[33] Bazley v. Commissioner, 331 U.S. 737 (1947); Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954); Earle v. Woodlaw, 245 F.2d 119 (9th Cir. 1957); Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957).

[34] Culbertson v. Commissioner, 337 U.S. 733 (1949); Slifka v. Commissioner, 182 F.2d 345 (2d Cir. 1950); Schneider v. Kelm, 237 F.2d 721 (8th Cir. 1956); Finley v. Commissioner, 255 F.2d 128 (10th Cir. 1958).

[35] Armston v. Commissioner, 188 F.2d 531 (5th Cir. 1951); Shaffer Terminals, Inc. v. Commissioner, 194 F.2d 539 (9th Cir. 1952); Standard Envelope Mfg. Co., 15 T.C. 41 (1950).

[36] 293 U.S. 465 (1935).

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payer liquidated the newly formed corporation and thereby acquired the aforesaid asset. The taxpayer then sought capital-gain treatment on this asset, the value of which would have been taxed as a dividend if the transferor corporation had distributed it to the shareholder directly. The Supreme Court treated the distribution as a dividend and emphasized that the spin-off and liquidation were operations "having no business or corporate purpose."[37] Though the decision has generally been viewed as the origin of the judicial business-purpose doctrine, one writer has interpreted it as having turned on the impermanence of the newly formed corporation.[38] This feature of impermanence is a feasible nonsubjective basis for the decision. Congress does not intend to accord nonrecognition treatment where there is no readjustment of continuing interests in a continuing enterprise.

The numerous cases construing the phrase "essentially equivalent to a dividend"[39] are in conflict on the relevance of business purpose as a decisional factor,[40] but the decision in *Northup v. United States*[41] typifies a discernible trend toward a satisfactory objective approach. According to this approach, the only question for determination is whether the "net effect" of the distribution is substantially the same as the effect would have been if the corporation had declared and paid a dividend.

Whether a partnership entity exists for tax purposes is a frequent subject of litigation. In the leading case of *Culbertson v. Commissioner*,[42] the Supreme Court held that a father could split his income with his sons by making them "partners" only if "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[43]

The Court of Appeals for the Second Circuit has suggested an alternative approach to this type of case. In *Haas v. Commissioner*[44] the test was stated in terms of whether the "partnership" agreements effected any objective economic consequences other than to reduce taxes.[45] The court sought to specify, though not exhaustively, some consequences that it thought should be determinative.

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[37] *Id.* at 469.

[38] Michaelson, *Business Purpose and Tax-Free Organization*, 61 YALE L.J. 14, 28 (1952).

[39] The substance of the phrase appears in INTERNAL REVENUE CODE OF 1954, secs. 302, 346, and 355.

[40] Compare the approaches in Northup v. United States, 240 F.2d 304 (2d Cir. 1957), and Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957).

[41] 240 F.2d 304 (2d Cir. 1957).

[42] 337 U.S. 733 (1949).

[43] *Id.* at 742.

[44] 248 F.2d 487 (2d Cir. 1957).

[45] The *Haas* case was decided against the taxpayer on remand. The rationale of the opinion is not readily comprehended. Benjamin Haas, 18 CCH Tax Ct. Mem. 401 (1959).

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In *Armston v. Commissioner*,[46] lack of a business purpose was one of two factors that the court emphasized in deciding that a sale and leaseback by a closely held corporation to a shareholder would not create rental deductions to the corporation. This type of case can be readily decided by considering objective factors such as whether the sale involved any change in dominion and control. Although the concepts of dominion and control are themselves imprecise, alleged changes in dominion and control can be disproved more easily than alleged business purposes.

The primary aim of the foregoing discussion has been to show that there is no need for the judicial business-purpose doctrine. Is there any need for its legislative counterpart? Some of the provisions of the INTERNAL REVENUE CODE OF 1954 that expressly embody various versions of the business-purpose doctrine are sections 269, 341, and 1551.

Subsection (a) of section 269 is sufficiently broad[47] to apply to numerous situations, including "loss carryover" cases in which a corporation seeks to reduce its taxes by deducting from its income the operating losses sustained by an acquired corporation. Because of the difficulty of proving that the taxpayer's purpose was to evade taxes[48] and because of an unsympathetic judicial attitude,[49] the commissioner has been relatively unsuccessful in his efforts to apply this provision to prevent tax avoidance through traffic in loss-carryover corporations. Congressional committees of both the House and Senate observed in 1954 that "the effectiveness of this provision has been impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition."[50] Accordingly, Congress then

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[46] 188 F.2d 531 (5th Cir. 1951).

[47] The subsection reads as follows:

"*(a) In General.*—If—

"(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

"(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed...."

[48] Rice, *Internal Revenue Code, Section 269: Does the Left Hand Know What the Right Is Doing?*, 103 U. PA. L. REV. 579, 583 (1955).

[49] See, for example, Alprosa Watch Corp., 11 T.C. 240, 245 (1948). *But see* British Motor Car Distributors, Ltd. v. Commissioner, 278 F.2d 392 (9th Cir. 1960).

[50] H.R. REP. No. 1337, 83d Cong., 2d Sess. 32 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 39 (1954).

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enacted a nonsubjective provision (section 382), which provides that availability of some of the tax benefits of loss-carryover acquisitions depends primarily on the existence of shareholder continuity of interest in the loss corporation. Although section 269 remains sufficiently general to be applicable, only section 382 should be applied to resolve loss-carryover issues.[51]

Congressional committees have described the collapsible corporation as "a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 per cent."[52] The American Law Institute has drafted a feasible collapsible-corporation provision[53] that, unlike the present provision, subsection (b)(1) of section 341,[54] does not require a finding as to taxpayer motivation or intention. This provision imposes no tax on liquidation distributions, but instead taxes at ordinary rates the resale of noncapital assets received on liquidation. A sale of 80 per cent of the stock in a closely held corporation is treated in the same manner as a liquidation followed by the sale of liquidated assets.[55]

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[51] "As long as Section 269 is on the books in its present form there is a prospect that it may be invoked at some time by the courts. Nevertheless, some showing of a business purpose is easy to make in all the examples discussed and the burden of proof on the taxpayer is slight under decided cases interpreting the language in the section. Accordingly, the possibility of a court invoking Section 269 to disallow a deduction seems extremely remote in any carefully planned transaction involving carryover, whether or not Sections 381 or 382 apply. The possibility does, however, exist. This means that only the foolhardy will approach transactions which will eventuate in carryover of a loss without all available evidence, documentary if possible, of commercial non-tax motivations for the transaction." Rice, *Internal Revenue Code, Section 269: Does the Left Hand Know What the Right Is Doing?*, 103 U. PA. L. REV. 579, 600 (1955).

[52] H.R. REP. No. 2319, 81st Cong., 2d Sess. 96 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 88 (1950).

[53] ALI FED. INCOME TAX STAT. secs. X550-52 (Tent. Draft No. 7, 1952). See MacLean, *Collapsible Corporations—The Statute and Regulations*, 67 HARV. L. REV. 55, 88 (1953).

[54] The subsection reads:

"(b) Definitions.—

"(1) *Collapsible Corporation.*—For purposes of this section, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to—

"(A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and

"(B) the realization by such shareholders of gain attributable to such property."

[55] See MacLean, *supra* note 53, at 88.

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Congress intended section 1551[56] to thwart transfers by one corporation to a controlled corporation for the purpose of securing additional accumulated earnings credits and surtax exemptions. The provisions of section 355(a)(1)(C) relating to corporate separations suggest a feasible nonsubjective approach: Availability of the desired tax benefits could be made to depend on (1) operation by the transferee of one of two or more separate businesses formerly conducted by the transferor, one of which continues to be operated by the transferor, or (2) commencement of a related business by the transferee, or (3) operation by the transferee of a part of one of the businesses of the transferor where that part is a natural division of the transferor's business.

The primary aim of the foregoing discussion of statutory provisions has been to demonstrate the possibility of drafting satisfactory provisions that do not embody the business-purpose concept either explicitly, or implicitly in the form of provisos against tax-avoidance motivation. There has been no effort to formulate precise alternatives; instead, my aim has been only to suggest alternative approaches. The ones suggested are not the only possible approaches. Others may, upon examination, appear preferable. Be that as it may, it should, however, be reasonably clear that there is nothing sacrosanct about the business-purpose concept or statutory provisos against tax-avoidance motives.

III

Moreover, there appears to be no need for a substitute doctrine. Courts can and should decide the close cases without purporting to apply a general formula. However, in *Gilbert v. Commissioner*, decided in 1957, the late Judge Learned Hand proposed an alternative formula: the taxpayer will be denied the tax benefits he is seeking if his transactions do not "appreciably affect his beneficial interest except to reduce his tax."[57] The future of this formula is difficult to predict. The Supreme Court has recently adopted it in the case of *Knetsch v. United States*.[58]

[56] The section as amended by 72 Stat. 1680 (1958) reads as follows: "If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269(b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535(c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. . . ."

[57] 248 F.2d 399, 411 (2d Cir. 1957).

[58] 364 U.S. 361 (1960).

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The scope of the formula appears to be about the same as the scope of the business-purpose doctrine. In cases in which the taxpayer acts solely for tax reasons, it will probably also be true that his actions will not appreciably affect his nontax position, and vice versa. The new formula is not as likely to promote duplicity as the business-purpose doctrine, and taxpayers will find it more difficult to prove facts satisfying this formula than to prove business purposes. However, such a formula can be used profitably only as a very general guide. As is true of the business-purpose doctrine, there is always the danger that the formula may be used as a substitute for analysis or that emphasis on it may obscure the true issues.

Conclusion

Both the courts and Congress should abandon the business-purpose doctrine. The doctrine is not essential to sound tax administration and it is largely ineffective because taxpayers can ordinarily "manufacture" business purposes at will. Emphasis on taxpayer motivation tends to obscure the true issues and to promote duplicity. Moreover, there is no need for a substitute doctrine.

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