

THE ECONOMIC SUBSTANCE DOCTRINE AGAINST ABUSIVE TAX SHELTERS IN THE UNITED STATES: LESSONS FOR SOUTH AFRICA

BENJAMIN KUJINGA*

*Senior Lecturer, Department of Mercantile Law, Faculty of Law,
University of Pretoria*

I INTRODUCTION

The avoidance of income tax is a practice that is common in tax systems across the whole world. As Jensen notes, '[n]othing is certain but death and taxes? Not true. If taxes are certain, then so too are tax avoidance, tax evasion, and governmental efforts to contain the avoidance and evasion'.¹ Being an inevitable concomitant of tax, tax avoidance, if left unchecked, can result in the substantial erosion of tax bases. A common way of controlling tax avoidance is introducing legislation that regulates the limits of permissible tax avoidance and targets impermissible tax avoidance. This legislation comes in the form of general anti-avoidance rules (GAARs) or specific anti-avoidance rules. The term GAAR means that the rule is broad and is a weapon against all forms of impermissible tax avoidance, which differentiates it from specific anti-avoidance rules, which are only applicable to specific forms of impermissible tax avoidance. In countries such as the United States, the United Kingdom (up until July 2013 when a GAAR was introduced) and the Netherlands (where both a GAAR and judicial doctrines are in place), reliance is placed on judicially created doctrines against impermissible tax avoidance. These judicial anti-avoidance doctrines function as GAARs because they serve a general anti-avoidance purpose and apply to all forms of impermissible tax avoidance.

In terms of general and broad measures against impermissible tax avoidance, South Africa relies on a GAAR while the United States relies on judicially created doctrines to curb impermissible tax avoidance.²

* LLB LLM (Fort Hare) LLD (UP).

¹ Jensen, 'Legislative and regulatory responses to tax avoidance: explicating and evaluating the Alternatives' (2012) 57 *St Louis University Law Journal* 1.

² In South Africa, the common law substance over form doctrine also known as the *plus valet quod agitur quam quod simulate concipitur* can be used to curb impermissible tax avoidance done through simulated transactions. This doctrine is however a general common

This means that in terms of form, these two countries have fundamentally different approaches. However, in terms of substance, these countries have certain indicators of impermissible tax avoidance that are closely related. The United States has what is known as the economic substance doctrine, while the South African GAAR, *inter alia*, contains what is known as the commercial substance indicator. This article will analyse the economic substance doctrine in the United States and its development and application through the cases and compare it with the South African commercial substance indicator. The economic substance doctrine has been in existence for a long time and has been applied in a multitude of cases. This article will seek to draw possible lessons on how the commercial substance indicator in South Africa can be interpreted and applied and to draw lessons on the potential efficacy of this indicator as a measure against impermissible tax avoidance.

II THE SOUTH AFRICAN APPROACH TO CURBING IMPERMISSIBLE TAX AVOIDANCE: THE GAAR

South Africa has relied on a GAAR to curb impermissible tax avoidance since 1941.³ The current GAAR is in s 80A–L of the Act and was introduced in 2006.⁴ Section 80A contains the basic structure of the GAAR and it reads as follows:

- ‘An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and —
- (a) in the context of business —
 - (i) it is entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or
 - (ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;
 - (b) in a context other than business, it was entered into or carried out by means or in a manner which would not normally be

law doctrine applicable to all contracts and will only be used in tax law to attack simulated transactions. This means that, unlike the judicial doctrines in the US, it was not created specifically to target all impermissible tax avoidance transactions and does not perform the same general anti-avoidance function, but is limited to transactions that seek to avoid tax by means of simulation. This doctrine is discussed in greater detail in para III (a)(i) below.

³ South Africa has had three GAARs, namely s 90 of the Income Tax Act 31 of 1941 (the 1941 Act), s 103(1) of the current Income Tax Act 58 of 1962 (the Act) and s 80A–L of the Act.

⁴ The current GAAR was inserted by s 34(1)(a) of the Revenue Laws Amendment Act 20 of 2006.

- employed for a bona fide purpose, other than obtaining a tax benefit; or
- (c) in any context —
- (i) it has created rights or obligations that would not normally be created between persons dealing at arm's length; or
 - (ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).⁵

The GAAR uses certain indicators to target the so-called ‘impermissible avoidance arrangements.’ Impermissible avoidance arrangements are tax avoidance arrangements with an objective sole or main purpose to avoid tax *and* any one of the various indicators of impermissible tax avoidance. These indicators may exist in a business context, in a context other than business, or in any context. The word ‘and’ is crucial because a sole or main purpose to avoid tax is insufficient as an indicator of impermissible tax avoidance. A sole or main purpose to obtain a tax benefit can also be found in permissible tax avoidance because tax is almost always avoided on purpose.⁵

(a) *Commercial substance in South Africa*

One of the indicators of impermissible tax avoidance in the context of business is the lack of commercial substance. This indicator is in s 80(a)(ii) of the Act. The concept of commercial substance is a novelty in the South African GAAR jurisprudence since it was not contained in previous South African GAARs. As such, there is currently no South African case law from which to understand the scope of this concept. Section 80C(1) of the Act defines commercial substance as follows:

‘For the purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows of

⁵ The current GAAR can be contrasted with South Africa’s first GAAR in s 90 of the 1941 Act. In its original form, s 90 was literally broad in the sense that it only required a tax avoidance purpose to be established in order to strike down a transaction. This meant that there was no distinction between permissible and impermissible tax avoidance. The court in *Commissioner for Inland Revenue v King* 1947 (2) SA 196 AD extensively analysed this GAAR and it was held at 196 that ‘purpose’ meant a sole or main purpose, not just incidental purpose. In a separate but concurring judgment, Schreiner JA at 296 stated that the GAAR needed something more than mere purpose to isolate impermissible tax avoidance. In this regard, he stated that the GAAR should target abnormal transactions that create abnormal rights and obligations.

that party apart from any effect attributable to the tax benefits that would be obtained but for the provisions of this Part.’

Section 80C(2) contains certain indicators of the lack of economic substance, but these are beyond the scope of this article.⁶ Section 80C(1) referred to above basically states that a transaction that results in a significant tax benefit, but does not simultaneously alter the business risk or net cash flows of the taxpayer involved, lacks commercial substance. In other words, a transaction that is justifiable or makes sense only by reference to the tax benefits it secures will be deemed to lack commercial substance. Section 80C(1) partially explains the characteristics of a transaction that lacks commercial substance. It however does not explain how the comparison between the tax benefits and the effect on the business risks or the net cash flows of the taxpayer in question should be done. In the absence of South African case law on the concept, it is useful to refer to foreign case law in a country that has relied on a closely related, if not identical, concept known as economic substance.

III THE US APPROACH TO CURBING IMPERMISSIBLE TAX AVOIDANCE: JUDICIAL DOCTRINES

The US approach to curbing impermissible tax avoidance is founded on judicial doctrines, and not on a GAAR. As the name implies, judicial doctrines against impermissible tax avoidance are judicially created, which distinguishes them from GAARs, which are created by the legislature.⁷ The US relies on judicial doctrines because, from an early stage, the courts took initiative in adjudicating tax avoidance cases and

⁶ These indicators entail an inconsistency between the transaction’s legal substance and legal form, round trip financing, the presence of tax indifferent or accommodating parties and self-cancelling transactions.

⁷ MacMahon, ‘Economic substance, purposive activity and corporate tax shelters’ (2002) 94(8) *Tax Notes* 1017 at 1019 is one of the commentators who argue that judicial doctrines are better than GAARs at curbing impermissible tax avoidance and that any uncertainty that results from their creation and application is a weapon. Pichhadze et al, ‘Economic substance doctrine: time for a legislative response’ (2007) 48(1) *Tax Notes International* 61 at 62 support the theory that the legislature cannot be expected to create a law of general application that can effectively curtail impermissible tax avoidance. They note that ‘the problem is that a legislature cannot anticipate all types of tax avoidance schemes to expressly provide that they should require economic substance. Therefore tax authorities have preferred that the courts assist them by deciding on a case-by-case basis when a transaction should require economic substance. The judiciary, which carries out the institutional function of interpreting and applying law, could carry out this function through a purposive interpretation of tax shelters’. For a discussion of the uncertainty created by GAARs and judicial doctrines, see generally Li, ‘Economic Substance: drawing the line between legitimate tax minimisation and abusive tax avoidance’ (2006) 54(1) *Canadian Tax Journal* 23 at 41 and Aprill, ‘Tax shelters, tax law, and morality: codifying judicial doctrines’ (2001) 54(1) *SMU Law Review* 9.

created the substance over form doctrine. The basis of this doctrine is that the tax implications of a transaction are to be determined by reference to its substance as opposed to the form which its participants have chosen to follow.⁸ In terms of the US substance over form doctrine, the substance of the transaction, which is the effect of the transaction as a whole, will be analysed, and not the form. As stated by the US Supreme Court in *United States v Phellis*:⁹

‘We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases we have under varying conditions followed the rule.’

In another case, *Weiss v Stearn*,¹⁰ it was stated that:

‘Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants. . . when applying the Sixteenth Amendment and income tax laws enacted we must regard matters of substance and not mere form.’¹¹

The economic substance doctrine is founded on the broader substance over form doctrine. The cases referred to above show that the courts were prepared to give effect to a transaction’s substance, and not its form. However, the case that entrenched this doctrine and established important tests to indicate the need to give effect to the substance of the transaction is *Gregory v Helvering*.¹² This case will be discussed in greater detail below.

(a) *The tenets of the economic substance doctrine*

The US relies on interlinked doctrines such as the economic substance doctrine, the business purpose doctrine, the sham transactions doctrine, and the step transactions doctrine to curb impermissible tax avoidance. According to Bankman, the economic substance doctrine is the most

⁸ Knight et al, ‘Substance over form: the cornerstone of our tax system or a lethal weapon in the IRS’s arsenal?’ (1991) 8 *Akron Tax Journal* 91.

⁹ US 156 (1921) 168.

¹⁰ US 242 (1924) 242.

¹¹ In *Weinert’s Estate v Commissioner* 294 F.2d 750 (5th Cir 1961) 755 the substance over form doctrine was described as ‘the cornerstone of sound taxation’. Also see generally *Minnesota Tea Co v Helvering* 302 US 609 (1938) 613 and *National Alfalfa Dehydrating and Mill and Co v Commissioner* 417 US 134 (1974) 147.

¹² US 465 (1935); 69 F 2d 809. For more discussion of this case, see generally Gunn, ‘Tax avoidance’ (1978) 76 *Michigan Law Review* 733 at 738–739.

important.¹³ In terms of this doctrine, the courts will disregard a transaction for lack of economic substance if the transaction gives rise to a tax benefit, but has no other economic value other than the value attributable to the tax benefits obtained.

In *Frank Lyon Co v United States*,¹⁴ the court stated that to establish economic substance, two questions must be answered. The first question is an objective one. It asks whether the taxpayer has proved that the transaction in question has resulted in a meaningful change in the taxpayer's economic position, without considering the economic impact of the tax benefits obtained. This question involves the consideration of issues such as the (reasonable) expectations of profit, the risk of loss and whether any taxpayer or entity sustained a loss or realised a profit from the transaction.¹⁵ The non-tax effect leg of the enquiry is unclear on the extent of the non-tax effect that is sufficient for a transaction to have economic substance.

The second question is a subjective one. It involves an inquiry into the purpose of the transaction and the question whether the taxpayer entered into the transaction for business purposes apart from obtaining the tax benefit.¹⁶ This stage of the inquiry requires an investigation of the

¹³ Bankman, 'The economic substance doctrine' (2000) 74(5) *Southern California Law Review* 5 at 6. Regarding the sham transactions doctrine, the term 'sham' was used by the Supreme Court in *Lilienthal's Tobacco v United States* 97 US 237 247 (1877). In this case a tobacco seller, wanting to avoid a higher tax rate, claimed to have sold tobacco to a broker before the date on which the tax rates were to be increased. However, in reality, the tobacco that had been 'sold' remained on the merchant's premises and within a few days the broker 'sold' the tobacco back to the tobacco seller. The transaction was held to be a 'perfect sham' at 247 and the Supreme Court stated at 270 that the purported sale was 'fictitious'. For more on the sham transactions doctrine see generally Moore, 'The sham transaction doctrine: an outmoded and unnecessary approach to combating tax avoidance' (1989) 41 *Florida Law Review* 659; *Helvering v Minnesota Tea Co* 296 US 378 (1935) and *ASA Investorings Partnership v Commissioner of Inland Revenue* 201 F.3d 505 (DC Cir 2000). Regarding the step transactions doctrine, Murray Jr, 'Step transactions' (1969–1970) 24 *University of Miami Law Review* 60 at 61–62 notes that 'step transactions relate to those cases where two or more transactions which are independent in form are deemed to be so dependent in substance as to require the tax consequences to be measured by viewing the overall transaction from beginning to end without according any independent significance to the steps in between'. For more on the step transactions doctrine see generally Gillen, 'The evolution of the step transaction doctrine' (1971–1972) 11 *Washburn Law Journal* 84; *Penrod v Commissioner* 88 TC 1415 (1987); *American Bantam Car Co v Commissioner* 11 TC 397 (1948); *Commissioner v Gordon* 391 US 83 (1968); *Von's Investorings Co v Commissioner* 92 F. 2d 861 (9th Cir 1937) and *Ericsson Screw Machine Products Co v Commissioner* 14 TC 757 (1950).

¹⁴ US 561 (1978).

¹⁵ VanderWolk, 'Codification of the economic substance doctrine: if we can't stop it, let's improve it' (2009) 55(7) *Tax Notes International* 547 at 549.

¹⁶ Summers, 'A critique of the business purpose doctrine' (1961–1962) 41 *Oregon Law Review* 38 at 40.

taxpayer's circumstances, and a determination of his declared motives.¹⁷ It is basically the incorporation of the business purpose doctrine into the economic substance doctrine.¹⁸ In *Compaq Computers Corporation v CIR*,¹⁹ it was stated that '[t]o satisfy the business purpose requirement of the economic substance inquiry, the transaction must be rationally related to a useful non-tax purpose that is plausible in the light of the taxpayer's conduct and economic situation'.²⁰

(i) *Substance over form in the US and in South Africa*

The tenets of the substance over form doctrine that incorporates the economic substance doctrine means that the doctrine focuses on factors such as the business purpose of a transaction and its economic justifiability. This is what differentiates the doctrine from the identically termed substance over form doctrine in South Africa, which focuses on whether there is simulation or a transaction disguised under a façade to hide its true nature. In South African law, the situation where parties disguise their true intentions with simulated acts was aptly described as follows by Innes JA in *Zandberg v Van Zyl* as follows:²¹

'Now, as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give; or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect what the transaction really is: not what in form it

¹⁷ *Frank Lyon Co* at 583–584. In *Shriver v Commissioner* 899 F. 2d 724, 726 (8th Cir. 1990) it was noted that the proper inquiry is 'whether the taxpayer was induced to commit capital for reasons only relating to [business] considerations or whether a non-tax motive, or legitimate profit motive, was involved'.

¹⁸ For an in-depth analysis of the business purpose doctrine, see generally Summers, (1961–1962) 41 *Oregon Law Review* 38 and Michaelson, "'Business purpose" and tax-free reorganisation' (1952) 61 *Yale Law Journal* 14.

¹⁹ TC 214 (1999) 224.

²⁰ In *Shriver v Commissioner* 899 F. 2d 724, 726 (8th Cir. 1990) it was noted that the proper inquiry is 'whether the taxpayer was induced to commit capital for reasons only relating to [business] considerations or whether a non-tax motive, or legitimate profit motive, was involved'.

²¹ 1910 AD 302 at 309.

purports to be. The maxim then applies *plus valet quod agitur quam quod simulate concipitur*. But the words of the rule indicate its limitations. The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that the contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.’

The substance over form doctrine in South African law can be used to attack tax avoidance transactions that rely on simulation to confer tax benefits.²² However, its focus on simulation means that, at least in its pure original form, it has only limited application in tax law. It also means that, unlike the US substance over form doctrine which was created judicially as a general and broad anti-tax avoidance doctrine, it effectively serves as a specific anti-avoidance rule that is applicable only to simulated tax transactions.

The decision in *CSARS v NWK Ltd*²³ can be said to be a departure from the traditional simulation test in South Africa. In this case it was stated that when determining whether the transaction in question was simulated, the court had to go beyond the usual process of ascertaining the real intention of the parties and discarding the simulated transaction. The court stated that the test should extend to an analysis of the commercial sense of the transaction and its purpose.²⁴ This would radically change the substance over form doctrine and bring it more in line with the US doctrine. It remains to be seen whether the *NWK* decision is the beginning of the creation of judicial doctrines in South Africa that can serve a general anti-avoidance function.²⁵ A more

²² Some of the cases in which the substance over form doctrine was used to strike down tax avoidance transactions include *Relier (Pty) Ltd v CIR* 1997 60 SATC 1 (SCA) at 7 and *Erf 3183/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue* 1996 (3) SA 942 (SCA).

²³ (27/10) [2010] ZASCA 168.

²⁴ *NWK* para 55.

²⁵ According to Legwaila, ‘Modernising the “Substance over form” doctrine’ (2012) 24 *1 SA Merc LJ* 115 at 121, the *NWK* case modernised the substance over form doctrine. He states that ‘[p]rior to *NWK*, the application of the substance over form doctrine focused on the form that the taxpayers projected the transaction to be vis-a-vis the substance that was the real object of the transaction. If the parties intended to carry out what was agreed, the transaction could not be flawed. After *NWK*, the focus falls on the transaction, regardless of what the taxpayers intend to do. This case changes the view of the form that the taxpayers present the transaction to be as well as the substance that it is’. It is however submitted that the court, in

comprehensive discussion of the South African substance over form doctrine is beyond the scope of this article, which deals with the broader US substance over form approach and aspects of the South African GAAR.

(b) *The codification of the economic substance doctrine*

It is clear from the above that the economic substance doctrine involves a dual inquiry into the objective and subjective aspects of a transaction and this inquiry has been in existence for a long time.²⁶ However, there have been instances where the US courts have applied the objective and subjective tests of the doctrine inconsistently.²⁷ In cases such as *Rice's Toyota World, Inc v Commissioner*²⁸ and *Black and Decker Corp v United States*²⁹ the courts seemed to state that proving one leg of the inquiry is sufficient for the application of the economic substance doctrine. These inconsistencies prompted then Senator Carl Levin to state that:

‘The economic substance doctrine has become a powerful analytical tool used by courts to invalidate abusive tax shelters. At the same time, because there is no statute underlying this doctrine and the courts have developed and applied it differently in different judicial districts, the existing case law has many ambiguities and conflicting interpretations.’³⁰

The inconsistent application of the two-pronged test is not the only challenge to the integrity of the economic substance doctrine. The doctrine's constitutionality was questioned on the basis that a court has no right to conduct the economic substance enquiry in cases where the literal meaning of the provision of the Internal Revenue Code of 1986

introducing unconventional principles to this doctrine, may have overstretched the doctrine in order to apply it in the case because, for instance, commercial purpose should not be relevant when determining whether a transaction is simulated or not. Rather, the court should have limited its analysis to whether the parties had given effect to their intention. In this regard, it is argued that the approach taken in the *NWK* case is erroneous and has introduced uncertainty regarding the role of the substance over form doctrine in tax matters which needs to be clarified.

²⁶ Also see Hogg, Magee and Li, *Principles of Canadian Income Tax Law* 7 ed (Carswell 2010) 658, quoting *Frank Lyon Co* at 583–584 and *Casebeer v Commissioner of Internal Revenue* 909 F. 2d 1360 at 1363.

²⁷ Pichhadze et al, (2007) 48(1) *Tax Notes International* at 63 note that there were concerns with the doctrine's lack of consistency and meaning which made it difficult to predictably and consistently apply in different cases.

²⁸ TC 184 (1983).

²⁹ F. Supp. 2d 621 (D. Md. 2004).

³⁰ As quoted in Pichhadze et al, (2007) 48(1) *Tax Notes International* at 63.

(the Code) in question is clear as it amounts to taking over the legislative powers of Congress. This argument was however dismissed.³¹

In an effort to irrefutably install both the objective and the subjective tests of the economic substance doctrine, this doctrine was codified in s 7701(o) of the Code.³² In terms of s 7701(o)(1), a transaction has economic substance if:

- i. The transaction has a meaningful impact on the taxpayer's business. The impact of federal tax consequences of a transaction are not regarded when judging a transaction's impact.
- ii. The taxpayer operating the transaction has a substantial purpose for doing so. As with the first criteria, tax considerations do not amount to substantial purpose.³³

The Internal Revenue Service (IRS) has stated that it will continue to rely on applicable case law that deals with the common law economic substance doctrine when conducting this dual and conjunctive test.³⁴

In terms of s 7701(o)(5)(C), the determination of a transaction's economic substance will be done as if the doctrine had never been codified. This provision was requested by the Tax Section of the New York State Bar Association (NYSBA), which generally objected to the codification of the economic substance doctrine. The NYSBA objected on the grounds that codification would undermine the doctrine but stated that if the codification materialised, a provision stipulating that the codification will not disturb the doctrine from developing in case law and is not intended to stop the courts from developing the doctrine would be required.³⁵

³¹ *Coltec Industries Inc v United States* 62 Fed. Cl. 716 (2004). Popkin, 'Judicial anti-tax avoidance doctrine in England: a United States perspective' (1991) 8 *British Tax Review* 283 at 285 states that the American judiciary has a constitutional duty to determine the purpose of a statute. This means that the two-legged inquiry of the economic substance doctrine is not unconstitutional because it enables the court to fulfil its constitutional obligations.

³² The IRS also published guidelines on how it will apply the codified economic substance doctrine. The document with these guidelines is available online on <http://www.irs.gov/pub/irs-drop/n-10-62.pdf> (accessed on 4 December 2013) and is entitled 'Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010', generally referred to as IRS Notice 2010-62.

³³ 'Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010' 5.

³⁴ 'Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010' at 4.

³⁵ Aprill, (2001) 54(1) *SMU Law Review* 9 at 15. VanderWolk, (2009) 55(7) *Tax Notes International* 547 notes that the proposal to codify the economic substance doctrine was subjected to some criticism by authors who contended that the codification would disturb the court and government's ability to stop impermissible tax avoidance and simultaneously discourage permissible tax avoidance because taxpayers may be fearful that their plans may

(c) *The economic substance doctrine in selected cases*

The economic substance doctrine has been considered in many cases that illustrate the scope and application of this doctrine. A selection of these cases is discussed below.

(i) *Gregory v Helvering*

As has been noted earlier, the case generally credited with laying the foundation for the economic substance doctrine is *Gregory v Helvering*. In this case the taxpayer was the owner of the entire stock in an entity known as United Mortgage Corporation (UMC), which held 1 000 shares in Monitor Securities Corporation (MSC) as part of its assets. The taxpayer, for the sole purpose of effecting a transfer of these shares to herself for resale at a profit while simultaneously limiting her exposure to taxation on the income which would be levied if she obtained dividends, elected to reorganise a company in terms of the legislation at that time. The taxpayer then organised a new entity, Averill Corporation, and three days later, UMC transferred the 1 000 shares in MSC to Averill. Just three days later, the newly organised Averill Corporation was dissolved and liquidated by distributing all its assets, the 1 000 shares in MSC, to the taxpayer. Averill did not conduct any business and from the facts it was clear that it was never intended to conduct any business. The taxpayer then sold the shares immediately for \$133 333. 33 and returned a sum of \$76 007. 88, based on a reduction of \$57 325. 45, for taxation.

The Commissioner disregarded the whole scheme and stated that the taxpayer would be liable for tax as if UMC had paid her a dividend from the amount gained by the sale of MSC shares. This contention was based on the opinion that the organisation had to be disregarded for lack of substance. The taxpayer however responded that the reorganisation of Averill was technically compliant with the legal requirements for a reorganisation. She argued that her motives to escape the payment of tax had no impact on the reorganisation and could not make it unlawful because the statute allowed it. She also contended that her motive to

fall within the operation of the codification. This provision dismisses these fears because it essentially states that the codification will have no effect on the natural progression of the doctrine. Other important provisions of the codified economic substance doctrine entail s 7701(o)(5)(D) which states that a transaction includes a series of transactions and s 7701(o)(2)(A) which mandates the consideration of a transaction's potential for profit when determining whether the transaction has a meaningful impact on the taxpayer's business or whether the taxpayer had a substantial purpose when entering into it.

avoid tax was immaterial because she had a legal right to legally decrease her taxes from what they otherwise would be.

The court stated that the question for determination was whether what was done, apart from the tax motive, was what the statute intended. The court held that when the provisions the taxpayer used to obtain a tax benefit provided for a transfer of assets from one entity to another they essentially meant a transfer made in executing a plan to reorganise a corporate business. This was opposed to a transfer of assets by one entity to another in the execution of an arrangement that did not have any connection with the business of either entity, as was evident from the facts in the case. The court concluded that what actually happened was that the taxpayer conceived and carried out a scheme with no business or corporate purpose. The scheme was a device which put on a reorganisation front to conceal its real character. The sole objective was to achieve a certain objective for the taxpayer, which was to transfer shares to her, and not to reorganise a business or any part of a business. In this regard, the Supreme Court stated as follows:

‘When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made “in pursuance of a plan of reorganization” (section 112(g) of corporate business: and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business but to transfer a parcel of shares to the petitioner. No doubt, a new, valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purposes; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death. In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which

excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.³⁶

The court interpreted the provisions in question purposively and focused on the substance of the transaction. In so doing the court found that the transaction had no appreciable economic benefits on the taxpayer apart from the impact of the tax benefits (economic substance objective test) and had no business justification either (subjective business purpose test).

(ii) *Knetsch v United States*³⁷

This case is also one of the major cases that shaped the judicial doctrines against impermissible tax avoidance. In this case, Knetsch (K) obtained a loan to buy deferred annuity savings bonds. He then borrowed back the discrepancy between his indebtedness and the value, in cash, of the bonds. There was nothing of substance K could realise in this transaction. The court used this fact to rule that the loans were a 'façade' and that the transaction was a sham, which meant that the interest incurred on the loan was not allowed as a deduction.³⁸

It is clear from the decision that the courts will recognise a taxpayer's right to avoid taxes. However, the court showed that it will disregard a transaction that is inconsistent with the purpose of the provisions relied on to avoid tax. This case reaffirmed the fact that the economic substance doctrine is founded on the purposive interpretation of legislation. Since the taxpayer did not derive anything of substance from the transaction, the court ruled that the transaction was a façade or a sham. The court noted that the absence of an independent economic benefit showed that the transaction was deceptive in that it unduly entitled the taxpayer to deductions he did not actually qualify for.

(iii) *Frank Lyon Co v United States*³⁹

In this case, the court discussed the substance over form doctrine and noted that the analysis under the doctrine would involve a determina-

³⁶ *Gregory v Helvering* at 469. For more on the connection between the economic substance doctrine and the purposive interpretation of statutes, see generally *Santa Monica Pictures LLC v Commissioner* TCM (CCH) 1157 (2005).

³⁷ (1960) 364 US 361.

³⁸ *Knetsch* at 366.

³⁹ *Frank Lyon Co.*

tion of ‘the objective economic realities of a transaction rather than . . . the particular form the parties employed’.⁴⁰ The court found that the transaction in question was not a sham and investigated the ‘substance and economic realities of the transaction’.⁴¹ It came to the conclusion that:

‘We hold that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honour the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.’⁴²

(iv) *Rice’s Toyota World Inc v Commissioner*⁴³

This case also contained an analysis of the economic substance doctrine. It was noted that for a transaction to be disregarded for lacking economic substance, ‘the court must find that the taxpayer was motivated by no business purpose other than obtaining the tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists’.⁴⁴ This finding indicates that the court subscribed to the two-legged test before disregarding the transaction as a sham. After applying these tests, the court found that when the taxpayer entered into the transaction the sole reason was to obtain a tax benefit. The court proceeded to the second test and noted that the fact that the transaction had no reasonable possibility of profit and no other economic benefit apart from the revenue saved by the sought tax benefits meant that the second leg of the inquiry had been satisfied. As a result, the transaction was found to lack economic substance.

(v) *Falsetti v Commissioner*⁴⁵

The transaction in this case involved a ‘sale’ in terms of which legal title was not passed. It was also found that the transaction was not concluded

⁴⁰ *Frank Lyon Co* at 573.

⁴¹ *Frank Lyon Co* at 582.

⁴² *Frank Lyon Co* at 583–584.

⁴³ F. 2d 89 (4th Cir. 1985).

⁴⁴ *Rice’s Toyota World Inc* at 91.

⁴⁵ TC 332 (1985).

at arm's length, the purchase price for the property far exceeded its fair market value at the time, the terms of the agreement were flouted willingly and the parties to the transaction did not treat the transaction as a transfer of property. The court found that the transaction lacked economic substance and held that '[c]onsidering the totality of the facts and circumstances surrounding the purported sale transactions . . . [the] petitioners engaged in the expedient of drawing up papers to characterise the transaction in question as something contrary to the economic realities thereof, solely to obtain unallowable tax benefits'.⁴⁶

(vi) *Yosha v Commissioner of Internal Revenue*⁴⁷

In this case it was stated that the *Gregory v Helvering* decision showed that the starting point in an economic substance case is that a taxpayer has a right to avoid tax. It was stated as follows:

'There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes . . . Many transactions are largely or even entirely motivated by the desire to obtain a tax advantage. But there is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer such an advantage.'⁴⁸

Regarding the definition of economic substance, the court noted that:

'A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages — may indeed have had no other interest in the deduction.'⁴⁹

This description of the doctrine, essentially noting that a transaction that has economic substance must be one that a reasonable person would enter into normally without a tax motive, is in line with the tests that have been part of the establishment of the doctrine. The element of objectivity is present. The court showed that to establish the first leg of the economic substance doctrine, a taxpayer may argue that the transaction is normal and would be undertaken by any taxpayer in similar circumstances with or without tax motives. In other words, the

⁴⁶ *Falsetti* at 355.

⁴⁷ 1988 USCA 7 787.

⁴⁸ *Yosha* 1988 USCA 7 787 paras 7–8.

⁴⁹ *Yosha* 1988 USCA 7 787 para 13.

transaction would be economically viable if its tax effects are set aside even though the tax effects strongly influence the decision to carry out the transaction.

The *Yosha* case is an example of the aggression with which taxpayers sometimes seek tax benefits. In this case, brokers from the London Metal Exchange (LME) marketed to American taxpayers a scheme that took advantage of the IRS's incongruent treatment of granted and purchased options without exposing the taxpayers to the usual uncertainties of trading on the LME. The taxpayers were promised that the brokers would arrange events so that the taxpayers would in the first year obtain income loss and no capital gain. Since the commodity prices were expected to rise in the second year these losses were promised for this period as well. In return the taxpayers were required to deposit funds that would act as consideration to the brokers. Further consideration was in the form of any gains made in the transaction. Accidental trading losses were to be absorbed by the brokers.

The transaction was consequently structured in a way that the deposit the investors made was the only money that was passed between the parties. No amounts were paid to the investors and investors were not at any stage required to supplement their initial deposits. The investors did not have any risk in the transaction and the brokers seized any money that was gained as profit in an investor's account. Despite this, the investors did not claim any of the profits made because it was clear from the start that the investors were paying for a tax benefit by paying a deposit. The court found that the accounts gave the investors full discretion but the lack of economic substance was proved by the fact that the investors did not have any prospects for profit or loss in the transaction. They were in the investment solely for the tax losses since this was what the brokers were selling to the investors.⁵⁰

(vii) *Long Term Capital Holdings v United States*⁵¹

This case is important because it contains an in-depth analysis of the application of the economic substance doctrine. The taxpayer argued that when applying the economic substance doctrine the court (Second Circuit) had traditionally used the disjunctive test. In terms of the disjunctive test the economic substance doctrine would be applied to deny a tax benefit after establishing only one of the two tests in the

⁵⁰ *Yosha* 1988 USCA 7 787 para 17.

⁵¹ F.Supp.2d 122 (D Conn 2004).

doctrine.⁵² This would constitute a different approach from the traditional economic substance doctrine where both the objective and subjective legs of the inquiry were required before the doctrine could be applied. The taxpayer also argued that in terms of the objective economic substance test, the only relevant inquiry was whether there had been a meaningful change in the economic position of the taxpayer.⁵³ The court however rejected this contention and stated that a meaningful change in a taxpayer's economic position was insufficient for the transaction to have economic substance. The court applied a cost benefit analysis to the transaction and found that the taxpayer had no realistic prospect of obtaining a profit from the transaction. The court analysed the expenses the taxpayer had incurred in the transaction and opined that the taxpayer, being aware of these costs and having planned the transaction, could not reasonably have expected to obtain a pre-tax profit.⁵⁴ Regarding the subjective test, the court found that the transaction was entirely tax motivated because the transaction was brought to the taxpayer's attention as a tax product. The complexity of the transaction was also held to be far more than was necessary to achieve the objectives stated.⁵⁵

(viii) *Black and Decker Corporation v United States*⁵⁶

In *Black and Decker Corporation* the District Court applied the disjunctive test in terms of which the tax benefits obtained would be upheld if the taxpayer showed either subjective business purpose or objective economic substance. The court in applying this test ruled in favour of the taxpayer and this decision was based on the ruling that if a corporation and its transactions are objectively reasonable, the presence of any tax avoidance motive is irrelevant as long as the transaction is bona fide and is economically sound.⁵⁷

⁵² *Long Term Capital Holdings* at 171.

⁵³ *Long Term Capital Holdings* at 185.

⁵⁴ *Long Term Capital Holdings* at 175–182. The court noted at 173 that 'examining the transaction for economic substance (is) an objective test. This requires that we first analyse the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences'. The cost benefit analysis applied in this case was the objective measure that ultimately led to the ruling against the taxpayer.

⁵⁵ *Long Term Capital Holdings* at 186–187. The court noted that 'the construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term's true motivation, tax avoidance'.

⁵⁶ *Black and Decker Corporation*.

⁵⁷ *Black and Decker Corporation* at 623–624.

On appeal in the Fourth Circuit,⁵⁸ the same disjunctive test was used and the court referred to *Hines v United States*⁵⁹ where it was stated:

‘The ultimate determination of whether an activity is engaged for profit is to be made . . . by reference to objective standards, taking into account all of the facts and circumstances of each case. A taxpayer’s mere statement of intent is given less weight than objective facts.’

The appeal court also opined in the same vein, noting that the mere assertion of subjective belief that is contrary to significant objective evidence showing that a loss will be sustained will not by itself establish that a transaction should stand.⁶⁰ The taxpayer in this case admitted from the very beginning that it did not have a business purpose in the transaction. However, the court’s application of the disjunctive test led to the ruling that the transaction could stand because it had objective economic substance. This case added to the confusion on whether the tests in the economic substance doctrine were conjunctive or disjunctive.⁶¹

(ix) *Coltec Industries Inc v United States*⁶²

This is an interesting case that encapsulates the interaction between tax avoidance, literalism and the purposive interpretation of statutes. It shows the merit in arguments that tax avoidance thrives in instances where statutes are interpreted literally. In this case the court began its judgment by referring to the Supreme Court case of *Atlantic Coast Line v Phillips*⁶³ and noted as follows:

‘Many years ago, the United States Supreme Court in *Atlantic Coast Line v Phillips* . . . quoting from prior decisions of Justice Holmes and Judge Learned Hand, observed: As to the astuteness of taxpayers in ordering their affairs so as to minimise taxes we have said that “the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it” this is so because

⁵⁸ F.3d 431 (4th Cir 2006).

⁵⁹ F.2d 736 at 739.

⁶⁰ F.3d 431 (4th Cir 2006) at 433.

⁶¹ Keinan, ‘Is it time for the Supreme Court to voice its opinion on economic substance?’ (2006–2007) 7 *Houston Business and Tax Law Journal* 93 at 113.

⁶² Fed. Cl. 716 (2004).

⁶³ US 168 (1947) at 172–173.

[there is no] public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions.⁶⁴

The court concluded that the transaction under scrutiny had business purpose. This decision was partly influenced by the fact that the entity used in the transaction was not dissolved and continued to exist after the transaction.⁶⁵ The court also stated that the economic substance doctrine is a composite of the business purpose doctrine, the substance over form doctrine and the sham transaction doctrine.⁶⁶ The IRS argued that the economic substance doctrine required a taxpayer to comply with the purpose behind the provisions of the Code. Mere compliance with its literal text was argued to be insufficient. The court however rejected this submission and noted that a careful study of the cases that deal with economic substance showed that the court solved the tax issue first by referring to the Code and only then utilised the doctrines to support its findings.⁶⁷ The court also held that the common law doctrine would only be applied in instances where the Code was unclear and ambiguous.

The Federal Court⁶⁸ however overturned this decision and held that the economic substance doctrine was essentially a judicial attempt to give effect to the purpose of the Code. The court reverted to the traditional basis of the economic substance doctrine and held that regardless of the taxpayer's literal compliance with the provisions of the Code, the transaction still needed to be scrutinised with reference to the common law economic substance standard.⁶⁹ The court also stated that the approach to the application of the economic substance doctrine was conjunctive, following the requirements set in *Frank Lyon Co.*

(x) *CMA Consolidated Inc v Commissioner*⁷⁰

This case involved the so-called lease strips where rental income accrued to a party that was tax-indifferent or not subject to tax. This transaction

⁶⁴ *Coltec Industries Inc* at 718.

⁶⁵ *Coltec Industries Inc* at 743.

⁶⁶ *Coltec Industries Inc* at 752.

⁶⁷ *Coltec Industries Inc* at 753. In this regard the dicta in the case *King Enterprises, Inc v United States* 418 F.2d 511 (Ct Cl. 1969) is in point. It was stated in this case at 516 that 'in coping with this and related problems, courts have enunciated a variety of doctrines such as step transaction, business purpose and substance over form. Although the various doctrines overlap and it is not always clear in a particular case which one is most appropriate, their common premise is that the substantive realities of a transaction determine its tax consequences'.

⁶⁸ F. 3d 1340 (Fed Cir 2006).

⁶⁹ F. 3d 1340 (Fed Cir 2006) at 1451.

⁷⁰ TCM (CCH) 701 (2005).

was aimed at enabling another party to claim a substantially disproportionate share of the tax benefits available. The structure of the transaction was such that the interest from the lease strip would generate about \$4.2 million in potential tax deductions. The transaction however cost only \$40 000.⁷¹ In determining whether the transaction lacked economic substance the court applied the traditional two- legged test but noted that the tests had much in common and should not be taken to apply rigidly and separately. These tests were held to be important when applied to determine whether the transaction lacked economic substance. The court preferred the unitary approach to the economic substance analysis.⁷²

When applying the tests to the facts, the court used the profit test and ruled that the taxpayer did not behave in a manner that was consistent with obtaining a genuine pre-tax profit. The strip lease deals were held to be 'mere tax avoidance devices or subterfuges mimicking a leasing transaction'.⁷³ The court also noted that according to the facts, the transaction was operated through different entities, many of which were either connected to the taxpayer or controlled by parties that had a history of cooperation with the taxpayer. The court held that this factor was significant in finding that the transaction lacked economic substance.

(xi) *ACM Partnership v Commissioner*⁷⁴

In this case, the court extensively described the operation of the economic substance doctrine. The reference to the substance of the transaction was reaffirmed. The court stated that even where 'the form of the taxpayer's activities indisputably satisfies the legal requirements' of the applicable statutory language, the courts must examine 'whether the substance of those transactions was consistent with their form' because a transaction that is 'devoid of economic substance . . . simply is not recognised for federal tax purposes'.⁷⁵

In applying the principles of the doctrine, the court stated that the transaction must be viewed as a whole and each step, from the conception of the transaction to its completion, is relevant to the

⁷¹ *CMA Consolidated Inc* at 703

⁷² *CMA Consolidated Inc* at 714.

⁷³ *CMA Consolidated Inc* at 722.

⁷⁴ F.3d 231 (3d Cir. 1998).

⁷⁵ *ACM Partnership* para 79, referring to *Lerman v Commissioner* 939 F. 2d 44 (3d Cir 1991) 45.

inquiry.⁷⁶ The court also stated that when viewing the transaction as a whole, the inquiry will turn on both the objective economic substance of the transaction and the subjective commercial motivation driving it.⁷⁷ The court analysed the economic substance of transactions which involve the disposal of property. It was stated that the economic substance doctrine could be applied to transactions which involve the disposition of property if such disposition had no net economic effect on the taxpayer's economic position. The court stated that disposal of property at a loss lacked economic substance if the taxpayer retained the opportunity to reacquire the property at the same price, or if the taxpayer offset the economic effect of the disposal by acquiring assets virtually identical to those relinquished.⁷⁸

(d) *The economic substance doctrine as a measure against impermissible tax avoidance*

The (codified) economic substance doctrine has been successfully invoked in many cases, including some of the cases discussed above. There are, however, certain cases where taxpayers successfully defended an economic substance attack by the IRS, which have raised questions about the efficacy of the economic substance doctrine against impermissible tax avoidance. One of these cases is *Cottage Savings Association v Commissioner*.⁷⁹ Commenting on this case, Weisbach⁸⁰ states as follows:

'*Cottage Savings* did not involve a real transaction. Absolutely nothing happened except for tax. The economics of the ACM transaction, an admitted shelter, swamp those of *Cottage Savings*. In fact it would be difficult to imagine arranging a transaction so that less actually happens. And there is no point to the deal other than to raid the Treasury. The business purpose was precisely zero, not even one tenth of percent. These transactions were marketed widely. All

⁷⁶ *Weller v Commissioner* 1959 USCA 3 207.

⁷⁷ *Commissioner v Court Holdings Co* r 324 U.S. 331 (1945).

⁷⁸ The court referred to cases illustrating this point namely *Lerman, Merryman v Commissioner* 1989 USCA 834; *Kirchman v Commissioner* 862 F.2d 1486, 1493 (11th Cir. 1989) and *Yosha v Commissioner* 861 F. 2d 494. Although the taxpayers in these cases actually and objectively disposed of their property, the courts examined the dispositions in their broader economic context and refused to recognise them for tax purposes because the other aspects of the taxpayers' transactions offset the consequences of the disposition, resulting in no net change in the taxpayer's economic position.

⁷⁹ US 554 (1991).

⁸⁰ Weisbach, 'The failure of disclosure as an approach to shelters' (2001) 54 *SMU Law Review* 73 at 75.

the factors, except the use of an accommodation party (which was not necessary) are present. Yet the taxpayer won in *Cottage Savings*.⁷

In another case, *IES Industries Inc v United States of America*,⁸¹ the taxpayer successfully defended an attack by the IRS in a transaction the court said had a minimal risk of loss. It was held that the negligible risk of loss was not due to the fact that the transaction was a sham or lacked economic substance but was mainly due to the fact that the taxpayer had taken steps to minimise the risk of loss. This case shows that even though the risk of loss is one of the hallmarks of a transaction with economic substance it does not necessarily follow that taxpayers are precluded from eliminating risk from their transactions.

In *Compaq Computers Corporation v Commissioner of Inland Revenue*,⁸² the taxpayer purchased the stock of a corporation in the Netherlands whose dividend had already been declared. The taxpayer resold the stock almost immediately, within an hour of the purchase, to the original seller. The Fifth Circuit noted that the purchase price of the stock was about \$888 million, with a net dividend of \$19 million. The price at which the stock was sold just an hour later was about \$868 million, which was computed by deducting the dividend payable to Compaq from the purchase price. The cost of carrying out the transaction was \$1.5 million. All in all the transaction generated a loss which could be said to have deterred the average taxpayer from the transaction. Considering the transaction as a whole, however, Compaq stood to benefit from foreign tax credits, the dividend was taxable in the United States and the loss of \$19 million resulting from the sale sheltered Compaq's profits in other unrelated transactions. The Tax Court found that the transaction lacked business purpose and any possibility of pre-tax profit.

On appeal, however, the Fifth Circuit overturned the Tax Court's decision, and noted that even if it was to be assumed that the taxpayer primarily sought to obtain tax benefits that were not otherwise available to counterbalance other income, this fact alone did not invalidate the transaction. The court relied on the *Frank Lyon Co*⁸³ case where it was stated that:

‘The fact that favourable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallow-

⁸¹ F. 3d 350 (8th Cir 2001).

⁸² 2001 USCA 5 507.

⁸³ *Frank Lyon Co* at 580.

ing these consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.’

The court also referred to the *ACM Partnership* case where it was stated that ‘[w]here a transaction objectively affects the taxpayer’s net economic position, legal relations, or non- tax business interests, it will not be disregarded merely because it was motivated by tax considerations’.⁸⁴

The court’s reference to these statements shows that it believed that the transaction in the *Compaq* case was a legitimate exercise of the right to avoid tax. The court went on to state that cases such as *ACM Partnership* and *Frank Lyon Co* were not necessarily directly applicable because the evidence did not prove that the taxpayer’s sole motivation was to obtain a tax benefit. The court was satisfied that the taxpayer also sought to gain the profit available.⁸⁵ The court also found that:

- i. The parties in the transaction attempted to minimise the risks usually associated with the transaction.
- ii. There were significant risks in the transaction despite the attempts to minimise them because the transaction was carried out in an open market, with the usual risks associated with it. Due to this fact, the transaction was not subject to the taxpayer’s control or manipulation and the market value of stock could have changed any time, and actually changed during the course of the transaction. The taxpayer also bore the risk of not receiving the dividend it anticipated.
- iii. The court noted that absence of risk was inconspicuous because risk could be eliminated legitimately. The court also noted in this regard that the mere fact that the taxpayer had eliminated the risk did not make the transaction a sham.⁸⁶

Regarding the operation of the transaction in an open market, the court drew a contrast with the circumstances in *Freytag v Commissioner*⁸⁷ where the tax benefits were disallowed because the taxpayer’s investment agent had ‘absolute authority over the pricing and timing of the transaction at issue, which occurred in [a] self contained market of its own making’.

The decisions in *Compaq* and *IES Industries Inc* were criticised and the economic substance and business purpose tests that were applied in these cases were described as ‘virtually useless because it has lost the

⁸⁴ *ACM Partnership* at 248.

⁸⁵ *Compaq Computers Corporation* para 30.

⁸⁶ *Compaq Computers Corporation*.

⁸⁷ F. 2d 1011 at 1016 (5th Cir. 1990).

forest for the trees'.⁸⁸ This is because the test that was applied in these cases was characterised by a mechanistic approach, as opposed to the purposive activity approach that was applied in the *ACM Partnership* case. According to MacMahon, the purposive approach would have led to a different result since it is 'much better suited to the task of sorting the pigs from the hogs than any of the various two part tests applied by the Fifth Circuit in *Compaq* and the Eighth Circuit in *IES*'.⁸⁹

Prebble and Prebble have a deeper concern with the victories of the taxpayer in the *Compaq* and *IES Industries* cases. They note that this decision is foremost at suggesting a weakening of the judicial doctrines against tax avoidance and state as follows:

'The significance of *Compaq* is that, on its facts, it is one of the most extreme settings of the cases producing taxpayer victories. If there were ever a case which, before the turn of the century, would have been as virtually certain to fall prey to the judicial safeguards, it was *Compaq*. The duration of the transaction was less than 24 hours; it had little or no relevance or connection to the taxpayer's business; the transaction costs were significant; the economic profit was virtually non-existent; and the tax savings were extraordinary. Most tax practitioners in the 1990s, if confronted with the facts of the case as a proposed transaction of their client, would have had grave difficulties in endorsing it. Nevertheless, reflective of a new era of broad judicial latitude and deference to tax transactions, excessive interpretive literalism and increasing judicial restraint, the transaction and its dramatic tax savings were upheld.'⁹⁰

It can be argued that the cases discussed above show the negative effects of uncertainty in relation to the economic substance doctrine. This uncertainty stems from transactions that have both business and tax purpose in equal measure and whose justification is equally economic and tax avoidance are difficult to decide on. The *Compaq* and *IES Industries Inc* cases show that where a transaction has these characteristics the uncertainty regarding the application of the economic substance

⁸⁸ MacMahon, (2002) 94(8) *Tax Notes* 1017 at 1022.

⁸⁹ MacMahon, (2002) 94(8) *Tax Notes* 1017.

⁹⁰ Prebble et al, 'Comparing the general anti-avoidance rule of income tax law with the civil law doctrine of abuse of law' (2008) 62(4) *Bulletin For International Tax* 151 at 165. Postlewaite, 'The status of the judicial sham doctrine in the United States' (2005) 25 *Revenue Law Journal* 140 at 146 also describes the *Compaq* decision in the same light. He notes that it is an exposition of the court's hesitancy to use judicial doctrines to disregard transactions. He also describes the transaction as a prime target for judicial doctrines if the facts were confronted by the courts in the *Gregory v Helvering* era.

doctrine might affect its efficacy against impermissible tax avoidance. The transaction in *Compaq* had many features of an impermissible transaction. However the fact that it also had certain economic benefits that were highlighted by the court gave it immunity from the economic substance doctrine. This case shows that borderline cases can be decided in favour of taxpayers, which can adversely affect the doctrine's efficacy against impermissible tax avoidance.

(e) *Lessons for South Africa*

From the analysis of the economic substance doctrine above, it can be stated that various lessons can be learnt both on the potential scope and interpretation of s 80C(1) of the Act and on the potential efficacy of the commercial substance indicator in the South African GAAR. The lessons on the scope and interpretation of s 80C(1) that can be gleaned from the discussion above can be summarised as follows:

- i. An avoidance arrangement that is inconsistent with the purpose of the tax provisions it relies on to obtain the tax benefits it obtains lacks commercial substance.⁹¹ Conversely, an avoidance arrangement that is consistent with the purpose of the relevant provisions cannot be said to lack commercial substance.
- ii. An avoidance arrangement does not lack commercial substance merely because the taxpayer(s) in question considered the tax implications of the arrangement and took steps to counter them.⁹²
- iii. The fact that an avoidance arrangement has an impact on a taxpayer's financial position does not necessarily mean that it has commercial substance.⁹³
- iv. An avoidance arrangement that does not have a pre-tax profit more often than not lacks commercial substance.⁹⁴
- v. An avoidance arrangement has commercial substance if it is a business transaction that a reasonable business person would enter into without a tax motive.⁹⁵
- vi. The fact that an avoidance arrangement contains real and intended sub-arrangements and is not on the whole simulated does not necessarily mean that it has commercial substance since the

⁹¹ *Gregory v Helvering; Knetsch; Coltec Industries Inc and Santa Monica Pictures.*

⁹² *Frank Lyon Co.*

⁹³ *Long Term Capital Holdings.*

⁹⁴ *CMA Consolidated Inc.*

⁹⁵ *Yosha* 1988 USCA 7 787.

avoidance arrangement as a whole may still not result in a change in the taxpayer's position.⁹⁶

- vii. An avoidance arrangement that is more complex than necessary more often than not lacks commercial substance.⁹⁷
- viii. An avoidance arrangement that does not have a profit possibility more often than not lacks commercial substance.
- ix. An avoidance arrangement that cannot be justified as a business transaction and is simultaneously tax motivated lacks both business purpose and commercial substance.
- x. An avoidance arrangement that was presented or marketed to the taxpayer as a tax avoidance scheme whose tax benefits significantly overshadow the taxpayer's investment in the transaction lacks commercial substance.

Regarding the potential efficacy of the commercial substance provision as an indicator of impermissible tax avoidance, it has been seen in the United States that there is uncertainty on the nature and extent of a transaction's impact on a taxpayer's economic position that will cause the transaction to have economic substance. In other words, it is not clear how many economic benefits a transaction must have over and above its tax benefits in order to tilt the balance towards economic substance. Transactions such as those in *IES Industries Inc.*,⁹⁸ *Compaq Computers*⁹⁹ and *Cottage Savings Association*¹⁰⁰ could be justified by reference to either the economic benefits for the taxpayers in question or the tax benefits sought and obtained. The decisions in these cases show that the economic substance doctrine can be difficult to apply where there is a fine balance between tax benefits and economic benefits.

In South Africa, the commercial substance indicator will be established if a transaction results in a significant tax benefit for a taxpayer but does not have a corresponding, significant impact on the taxpayer's economic position that is not attributable to the tax benefit. It is submitted that a similar issue to that described above could arise in the South African context in relation to avoidance arrangements with both significant tax benefits and a significant impact on the economic position of the taxpayer in question. This is because, as in the United States, there is uncertainty on the point where the tax benefits of an avoidance arrangement outweigh the economic impact of the arrange-

⁹⁶ *Yosha* 861 F. 2d 494.

⁹⁷ *CMA Consolidated Inc.*

⁹⁸ *IES Industries Inc.*

⁹⁹ *Compaq Computers Corporation.*

¹⁰⁰ *Cottage Savings Association.*

ment to warrant a commercial substance attack or vice versa. Section 80C(1) of the Act establishes a two-pronged test before a transaction can be said to lack commercial substance. This test is as follows:

- a. The avoidance arrangement must have a significant tax benefit.
- b. The avoidance arrangement must not have a significant impact on the taxpayer's business risks and the net cash flows, which is basically the taxpayer's economic position.

One way of reducing the uncertainty noted above is to interpret this section as requiring a more mechanical approach to establish the above points and not as requiring a balance to be struck between the tax benefits and the economic impact of the avoidance arrangements and basing a decision on that balance. Where an avoidance arrangement passes the commercial substance test above but obtains the significant tax benefits in an impermissible fashion then other indicators of impermissible tax avoidance such as misuse or abuse or abnormality, inter alia in terms of s 80A(c)(ii) and s 80A(c)(i), of the Act, respectively, may be used. If reference to other indicators is not sustainable, then it should be accepted that the avoidance arrangement is a genuine exercise of the freedom to avoid tax within the limits set by the law.

IV CONCLUSION

It has been seen that the economic substance doctrine in the United States and the commercial substance indicator in the South African GAAR are closely related indicators of impermissible tax avoidance, even though they are couched in fundamentally different approaches to impermissible tax avoidance, namely judicial doctrines and a GAAR. This similarity means that valuable lessons on the interpretation and application of the commercial substance indicator in South Africa can be drawn from the major United States cases such as *Gregory v Helvering*,¹⁰¹ *Frank Lyon Co*,¹⁰² *Knetsch*,¹⁰³ those discussed in para III(c) above, and many others in the long history of this doctrine. Some of the lessons identified in this article in para III(e) above are that an avoidance arrangement that is consistent with statutory purpose should not be found to lack commercial substance and that an avoidance arrangement that a reasonable business person would not enter into if its tax benefits are taken away more often than not lacks commercial substance.

¹⁰¹ *Gregory v Helvering*.

¹⁰² *Frank Lyon Co*.

¹⁰³ *Knetsch*.

This article also dealt with the uncertainty that limits the efficacy of the economic substance doctrine in transactions with both economic and tax benefits. It has been seen in cases such as *Compaq Computers*,¹⁰⁴ *IES Industries Inc*¹⁰⁵ and *Cottage Savings Association*¹⁰⁶ that the courts may be reluctant to apply the economic substance doctrine to transactions justifiable by reference to both the tax and economic benefits obtained. The major lesson to be drawn from this United States experience is that in interpreting s 80C(1) a balance between the economic benefits and the tax benefits of an avoidance arrangement should not be sought because this creates uncertainty on when an avoidance arrangement's tax benefits trump its economic benefits. Rather, this section should be interpreted as requiring a mechanical approach to establish whether there are significant tax benefits and whether a significant impact on the business risks and net cash flows of the taxpayer is also present. It is submitted that the latter approach will reduce uncertainty and cause the commercial substance indicator to be more effective in isolating impermissible tax avoidance.

¹⁰⁴ *Compaq Computers Corporation*.

¹⁰⁵ *IES Industries Inc*.

¹⁰⁶ *Cottage Savings Association*.