CLARIFYING (OR IS IT CODIFYING?) THE "NOTABLY ABSTRUSE": STEP TRANSACTIONS, ECONOMIC SUBSTANCE, AND THE TAX CODE

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The economic substance and step transaction doctrines are two specific examples of courts' general willingness to sometimes look past transactions' technical form and impose taxes based on their underlying substance. As judicial creations, the two doctrines served as complements and functional equivalents. However, they also generated a wide variety of vague, overlapping, and conflicting formulations.

In 2010, Congress incorporated the economic substance doctrine into the Internal Revenue Code by defining its content and tying it to a heightened strict liability penalty. When it did so, Congress did not address when the doctrine is available. Instead, it left that determination to the preexisting common law and articulated a functional definition of the doctrine to which its new statutory scheme applies. However, the definition of the codified economic substance doctrine creates uncertainty by encompassing some, but not all, of the various formulations of the step transaction doctrine. Terminological messiness that used to have little effect beyond confusing dicta could now control the imposition of statutory requirements and heightened liability.

After laying out the doctrinal background, this Note applies the definition of the newly codified economic substance doctrine to the various formulations of the step transaction doctrine and demonstrates problematic inconsistency in the results. It then traces that inconsistency to the uncertain relationship between the doctrines and argues for conceptual clarification. Finally, it proposes that the codified economic substance doctrine should apply first and that the step transaction doctrine should stand behind it as a backstop.

INTRODUCTION

In 2010, Congress incorporated the economic substance doctrine from the common law into a new subsection—§ 7701(o)—of the Internal Revenue Code.[1] Section 7701(o) specifies the content of the doctrine but

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1. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, sec. 1409, 124 Stat. 1029, 1067–70 (codified at I.R.C. §§ 6662(b)(6), (i), 6662A(e)(2)(B), 6664(c)(2), (d)(2), 6676(c), 7701(o)) (effecting "Codification of Economic Substance Doctrine" and inserting I.R.C. § 7701(o) ("Clarification of Economic Substance Doctrine")).

leaves determination of its availability to the common law.[2] Seeking to minimize interference with that determination, and recognizing linguistic confusion in the field, the Code adopts a functional definition of the doctrine and its application.[3] However, though that approach may have preserved the common law aspects of the economic substance doctrine, it created uncertainty regarding the doctrine's siblings, including the step transaction doctrine.

The economic substance and step transaction doctrines are two instances of courts' willingness, in certain cases, to look past transactions' technical form and tax them based on their underlying substance. The principle of enforcing substance over form is a judicial response to the fact that "all of the combinations conceivable by a resourceful tax bar cannot be perceived in advance."[4] Invoking the principle, courts can penetrate "attempt[s] by . . . taxpayer[s] to ward off tax blows with paper armor"[5] and deflate "purported transfer[s] which give[] off . . . unmistakably hollow sound[s] when . . . tapped."[6] The economic substance doctrine implements the substance over form principle by allowing courts to ignore certain transactions because "[i]f a transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes."[7] Similarly, in the context of unitary series of transactions, the step transaction doctrine allows courts to render "the individual tax significance of each step . . . irrelevant when, considered as a whole, they all amount to no more than a single transaction."[8]

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2. See I.R.C. § 7701(o)(1), (5)(C) (Supp. IV 2011) ("The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.").

3. See id. § 7701(o)(5)(A) ("The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.").

4. Kuper v. Comm'r, 533 F.2d 152, 159 (5th Cir. 1976). The phrase "substance over form" (or "substance versus form") itself sometimes designates a particular judicial doctrine. See, e.g., Joshua D. Rosenberg, Tax Avoidance and Income Measurement, 87 Mich. L. Rev. 365, 386 (1988) (using phrase to describe "situation where . . . alternative tax transactions . . . can describe [given] interactions."). However, this Note uses the phrase in its more general, colloquial sense. See infra Part I.A (describing substance over form principle).

5. Waterman S.S. v. Comm'r, 430 F.2d 1185, 1185 (5th Cir. 1970), overruled on other grounds by Utley v. Comm'r, 906 F.2d 1033 (5th Cir. 1990).

6. United States v. Gen. Geophysical Co., 296 F.2d 86, 89 (5th Cir. 1961).

7. Lerman v. Comm'r, 939 F.2d 44, 45 (3d Cir. 1991); see infra Part I.B (describing economic substance doctrine).

8. Crenshaw v. United States, 450 F.2d 472, 476 (5th Cir. 1971); see infra Part I.C (describing step transaction doctrine).

As wholly judicial creations and functional equivalents, the economic substance and step transaction doctrines generated many varied, overlapping, and frequently conflicting formulations.[9] The definition of the codified economic substance doctrine exacerbates inconsistency within the step transaction doctrine by encompassing some, but not all, of the step transaction doctrine's formulations. Confusion, once mostly confined to judicial dicta, may now govern the application of a statutory framework and the imposition of statutory penalties. Resolving this newly significant inconsistency requires clarifying the interaction and relationship between the two doctrines.

This Note argues that the step transaction doctrine should focus on a separate and subsequent inquiry and should be available only if the newly codified economic substance doctrine does not apply. Despite doctrinal messiness and statutory vagueness, the step transaction doctrine should neither collapse into the economic substance doctrine nor generate heightened penalties as a "similar rule of law,"[10] but should instead serve as an independent backstop. This Note proceeds in three Parts. Part I describes the basic substance over form principle underlying much of tax law, the state of the economic substance doctrine before codification, the background, structure, and content of the step transaction doctrine, and the relationship between the doctrines. Part II interprets the codified economic substance doctrine, applies the new Code provisions to the step transaction doctrine, and demonstrates problematic inconsistency in the results. Part III traces that inconsistency to the uncertain relationship between the doctrines and argues that the codified economic substance doctrine should apply first, with the step transaction doctrine available as a backstop.

I. BACKGROUND ON SUBSTANCE OVER FORM PRINCIPLE AND ECONOMIC SUBSTANCE AND STEP TRANSACTION DOCTRINES

This Part provides an overview of the substance over form principle, in general, and the economic substance and step transaction doctrines, in particular. Section A examines the history and development of the substance over form principle in tax law. Section B then describes the development and structure of the economic substance doctrine before codification. Section C provides a more extensive description of the development, structure, and content of the step transaction doctrine, including an analysis of the doctrine's various formulations. Finally, section D notes the uncertain relationship between the economic substance and step transaction doctrines.

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9. See, e.g., Redding v. Comm'r, 630 F.2d 1169, 1175 (7th Cir. 1980) (noting step transaction doctrine's "tests are notably abstruse—even for such an abstruse field as tax law").

10. I.R.C. § 6662(b)(6) (Supp. IV 2011).

A. *Substance over Form Principle*

The general principle that taxation should give effect to transactions' substance, rather than their form, underlies much of tax law[11] and impels many more specialized doctrines, including the economic substance and step transaction doctrines.[12] The thread of substance over form as a factor relevant to tax decisions runs back at least as far as the beginning of U.S. federal income taxation in 1913.[13]

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11. See, e.g., Estate of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961) ("The principle of looking through form to substance . . . is the cornerstone of sound taxation . . . .").

12. See, e.g., King Enters. v. United States, 418 F.2d 511, 516 n.6 (Ct. Cl. 1969) ("[C]ourts have enunciated a variety of doctrines . . . [whose] common premise is that the substantive realities of a transaction determine its tax consequences."). The sham transaction doctrine, see, e.g., Mahoney v. Comm'r, 808 F.2d 1219, 1220 (6th Cir. 1987) ("If [a transaction] is a sham, then such niceties as whether it was 'primarily' for profit, or whether the test is an objective or subjective one are simply not involved."), is another sibling, at least when it is treated separately and not conflated with the economic substance doctrine, cf. infra note 29 (noting overlap in labeling).

13. See, e.g., S. Pac. Co. v. Lowe, 247 U.S. 330, 337 (1918) (refusing to impose new income tax on payment that, "in mere form only, bore the appearance of income accruing after [March 1, 1913 (first day of first tax year)], while in truth and in substance it accrued before"). By 1921, the Supreme Court expressly "recognize[d] the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder." United States v. Phellis, 257 U.S. 156, 168 (1921).

A contrary thread runs at least as far back through the case law and seeks to give clear, decisive effect to lines defining legal forms and categories. For example, in *United States v. Isham*, the Supreme Court considered the tax due on a written instrument and held that "[w]hatever upon its face it purports to be, that it is for the purpose of ascertaining the stamp duty." 84 U.S. (17 Wall.) 496, 505 (1873). The classic statements of the idea are by Justice Holmes, see Superior Oil Co. v. Mississippi ex rel. Knox, 280 U.S. 390, 395–96 (1930) ("The fact that [the taxpayer] desired to evade the law [by avoiding taxation], as it is called, is immaterial, because 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."), and Judge Hand, see Comm'r v. Newman, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting) ("Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands . . . .").

These two principles may well conflict with each other and, in such cases, "[t]he question of who should win in the context of a *mistake* [in clearly defining tax treatment ex ante] raises competing notions of fairness and competing notions of equity." Bret Wells, Economic Substance Doctrine: How Codification Changes Decided Cases, 10 Fla. Tax Rev. 411, 415 (2010); see also Ray A. Knight & Lee G. Knight, Substance over Form: The Cornerstone of Our Tax System or a Lethal Weapon in the IRS's Arsenal?, 8 Akron Tax J. 91, 107 (1991) (concluding "[t]he truth probably lies somewhere in between [their title's] extremes"). Doctrinal, and arguably conceptual, reconciliation comes from framing the substance over form inquiry as not implicating taxpayer motive at all but, rather, directly revealing the true factual relationship between the taxpayer's acts and the Code. See, e.g., Gregory v. Helvering, 293 U.S. 465, 470 (1935) ("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.").

When invoking the substance over form principle, the case law sometimes notes its earlier history[14] but usually begins in 1935 with the Supreme Court's formulation in *Gregory v. Helvering*.[15] Refusing to recognize "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character" or "to exalt artifice above reality," the Court held that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[16] After *Gregory*, the case law looks to *Higgins v. Smith*, in which the Court explained that "[t]he Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction."[17] The doctrinal foundation ends with the Court's holding, in *Commissioner v. Court Holding Co.*, that it would not "permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities," because "[t]he incidence of taxation depends on the substance of a transaction."[18]

Later decisions citing these three cases and their pronouncements generally do not elaborate on their content or rely on them for any specific points.[19] Rather, they invoke substance over form as a background

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14. See, e.g., Balt. Aircoil Co. v. United States, 333 F. Supp. 705, 710 (D. Md. 1971) (citing *Southern Pacific* for proposition "where a case presents peculiar circumstances, it is proper to disregard form and look to the substance of the transaction"), vacated as settled (1972); Storey v. United States, 193 F. Supp. 769, 772 (E.D. Ky. 1961) (quoting *Phellis*, 257 U.S. at 168), rev'd, 305 F.2d 733 (6th Cir. 1962).

15. 293 U.S. 465.

16. Id. at 469–70. Specifically, the question for determination was whether a taxpayer could use a transitory reorganization and liquidation, instead of a direct dividend, to incur less tax when extracting assets from her corporation. Id. at 467. The Court answered no. Id. at 470. See generally Joseph Isenbergh, Musings on Form and Substance in Taxation, 49 U. Chi. L. Rev. 859, 866–70 (1982) (book review) (describing *Gregory* as "perhaps the case most widely invoked as a source of first principles on form and substance" and analyzing case).

17. 308 U.S. 473, 477 (1940).

18. 324 U.S. 331, 334 (1945).

19. They also do not follow them blindly or absolutely. Courts are well aware of the limited usefulness of such general principles and of the need to "guard against oversimplification." Blueberry Land Co. v. Comm'r, 361 F.2d 93, 101 (5th Cir. 1966). "[A] glib generalization that substance rather than form is determinative of tax consequences not only would be of little assistance in deciding troublesome tax cases, but also would be incorrect" because "in numerous situations the form by which a transaction is effected does influence and may indeed decisively control the tax consequences." Id. As such, courts recognize that "*Gregory* should not be considered a 'talisman of magical powers.'" Waterman S.S. v. Comm'r, 430 F.2d 1185, 1192 (5th Cir. 1970), overruled on other grounds by Utley v. Comm'r, 906 F.2d 1033 (5th Cir. 1990). Courts also acknowledge that, even assuming there is some objective reality to find, "[a]scertaining the 'true nature' of the transaction while adhering to neutral principles of statutory construction is often difficult." Kornfeld v. Comm'r, 137 F.3d 1231, 1234 (10th Cir. 1998) (quoting *Court Holding Co.*, 324 U.S. at 334) (finding such difficulty "exemplified by the instant case, in which the

principle and then implement it through one or more specialized doctrines.[20] In fact, although courts seem to conceive of the principle as having at least some defining formal features and providing some guidance, its application in practice appears somewhat ad hoc and conclusory.[21]

B. *Economic Substance Doctrine*

The economic substance doctrine is a specialized application of the substance over form principle and seeks to prevent tax evasion by ignoring certain transactions. When it applies, the doctrine allows the government to disregard and disallow claimed benefits despite formal compliance with the Code.[22] Thus, for example, it let a court deny depreciation deductions to a taxpayer—a car dealership—that purchased a very expensive computer and immediately leased it back to the seller.[23] This section outlines the economic substance doctrine's background in the case law, describes the doctrine's structure and application, and summarizes its theoretical justification.

1. *Judicial Development of Economic Substance Doctrine.* — The economic substance doctrine grew out of the substance over form principle as courts sought to implement and elaborate on earlier courts' general pronouncements about uncovering transactions' "true nature[s]."[24] As such, the case law traces the economic substance doctrine, like the substance over form principle in general, from *Gregory* to *Court Holding Co.*[25]

Tax Court opinion and the two others closest factually—one relied on by taxpayer and the other by the Commissioner—were authored by the same judge").

20. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978) (invoking "general and established principles"); True v. United States, 190 F.3d 1165, 1173–74 (10th Cir. 1999) ("In order to ensure proper tax treatment . . . , we apply the substance over form principle.").

21. See Knight & Knight, supra note 13, at 106 (suggesting substance over form principle is example of courts "reaching a conclusion and then citing those cases that support the conclusion").

22. According to the Third Circuit, "[i]t is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it 'simply is not recognized for federal taxation purposes.'" IRS v. CM Holdings, Inc. (In re CM Holdings, Inc.), 301 F.3d 96, 102 (3d Cir. 2002) (quoting ACM P'ship v. Comm'r, 157 F.3d 231, 261 (3d Cir. 1998)).

23. Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 90–91, 96 (4th Cir. 1985). Though some sale-leaseback arrangements can be valid, the court accepted the Tax Court's finding that this particular transaction "was not motivated by any business purpose other than achieving tax benefits" and "had no economic substance because no reasonable possibility of profit existed." Id. at 91, 94–95.

24. *Court Holding Co.*, 324 U.S. at 334; see supra Part I.A (describing development of substance over form principle in earlier case law).

25. See, e.g., Coltec Indus. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006) (explaining "[economic substance doctrine] has its roots in several Supreme Court cases" (citing *Court Holding Co.*, 324 U.S. 331; Gregory v. Helvering, 293 U.S. 465 (1935))); supra text accompanying notes 15–16, 18 (noting cases' roles in development of general substance over form principles).

The Supreme Court began to distinguish economic substance as the basis of a discrete doctrine in *Knetsch v. United States*[26] and gave that doctrine its final (at least as far as the Court was concerned) and distinctive form in *Frank Lyon Co. v. United States* in 1978.[27] The *Frank Lyon* Court described the doctrine negatively, explaining that if

> there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[28]

The lower courts then drew on the Supreme Court precedent to formulate many more or less divergent versions of the economic substance doctrine.[29] Because the development of the doctrine's various permutations is closely tied to its structure, it is described below, in subsection 2.

2. *Application and Structure of Economic Substance Doctrine.*[30] — As the economic substance doctrine developed, courts generally drew on the Supreme Court's decision in *Frank Lyon* to articulate two main factors bearing on the doctrine's application.[31] In *Frank Lyon*, the Supreme Court recognized (and allowed benefits flowing from) a transaction "im-

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26. 364 U.S. 361 (1960). The Court "examine[d] 'what was done' here," found "there was nothing of substance to be realized . . . from this transaction beyond a tax deduction," concluded "this [arrangement] is a sham," and disallowed the associated deductions. Id. at 365–66 (quoting *Gregory*, 293 U.S. at 469).

27. 435 U.S. 561 (1978).

28. Id. at 583–84. This negative formulation helps to identify factors that may be relevant to the doctrine's availability and to define its outer limits. See generally David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Law. 235, 241–53 (1999) [hereinafter Hariton, Sorting Out the Tangle] (describing, in more detail, development of economic substance doctrine); infra notes 31–34 and accompanying text (describing derivation of doctrinal structure from *Frank Lyon*).

29. Actually, because the Supreme Court never explicitly labeled or defined the basis for its decisions, "even the name of the doctrine—which is sometimes called the sham transaction doctrine—has never been settled." Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 226 (D. Mass. 2010), aff'd on other grounds, 661 F.3d 667 (1st Cir. 2011). This linguistic confusion is apparent throughout the case law. See, e.g., Dow Chem. Co. v. United States, 435 F.3d 594, 598–605 (6th Cir. 2006) (explaining and conducting standard economic substance analysis but referring to "sham" transactions). This Note generally leaves the original phrasing and lets the context demonstrate its meaning.

30. The structural and substantive features described here underlie and largely persist in the codified economic substance doctrine. For analysis of the details of the doctrine as codified, see infra Part II.A.1.

31. See, e.g., Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91–92 (4th Cir. 1985) (noting "[t]he tax court read *Frank Lyon Co. v. United States* to mandate a two-pronged inquiry" and declaring "[w]e agree that such a test properly gives effect to the mandate of the Court" (citation omitted)).

bued with tax-independent considerations" and "compelled or encouraged by business or regulatory realities."[32] From that recognition and explanation, the lower courts derived two requirements, generally labeled "economic substance"[33] and "business purpose,"[34] whose precise meanings are unclear but which provide the basic framework for most economic substance analysis.

Despite agreement, at least linguistically, on the economic substance doctrine's constituent factors, courts disagreed about those factors' relationship to each other and to the doctrine as a whole.[35] The circuits were

32. 435 U.S. at 583–84.

33. Courts formulated the repetitively, and somewhat confusingly, named economic substance prong of the economic substance doctrine in different ways. For variations of the underlying inquiry, see, for example, IRS v. CM Holdings, Inc. (In re CM Holdings, Inc.), 301 F.3d 96, 103 (3d Cir. 2002) ("[A]bsent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."); United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001) ("The kind of 'economic effects' required to entitle a transaction to respect in taxation include the creation of genuine obligations enforceable by an unrelated party."); IES Indus., Inc. v. United States, 253 F.3d 350, 354 (8th Cir. 2001) ("[W]hether there was a 'reasonable possibility of profit . . . apart from tax benefits,' that is, whether the transactions had economic substance." (quoting Shriver v. Comm'r, 899 F.2d 724, 726 (8th Cir. 1990))). The unifying essence was some sort of objective determination. As suggested by the formulations quoted above, specific factual issues potentially bearing on that determination included profitability, see, e.g., *CM Holdings*, 301 F.3d at 103; *IES Indus.*, 253 F.3d at 354, obligations to third parties, e.g., *United Parcel Serv. of Am.*, 254 F.3d at 1018, risks of loss, see, e.g., id., and changes in income streams, see, e.g., id. at 1019.

34. Like its counterpart, the business purpose prong did not have a single agreed-upon formulation. For some of its variants, see, for example, *CM Holdings*, 301 F.3d at 102 n.4 ("This subjective inquiry . . . play[s] the . . . basic role of evaluating whether the taxpayer had a business reason, aside from tax avoidance, for engaging in the transaction."); *United Parcel Serv. of Am.*, 254 F.3d at 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business."); *IES Indus.*, 253 F.3d at 355 ("[T]he business purpose test is a subjective economic substance test."); *Rice's Toyota World*, 752 F.2d at 92 ("The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction."). Here, the essence was a subjective determination. Potentially relevant factual issues included otherwise unexplainable aspects of a transaction's structure, content, or pricing, see, e.g., *CM Holdings*, 301 F.3d at 107; *Rice's Toyota World*, 752 F.2d at 92–93, taxpayer behavior, see, e.g., id., investigation of risks, analysis of trades, and other demonstrations of business judgment, see, e.g., *IES Indus.*, 253 F.3d at 355, and the ultimate use of the income being taxed, see, e.g., *United Parcel Serv. of Am.*, 254 F.3d at 1019–20.

35. See Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 226 (D. Mass. 2010) ("Although the basic principle is clear, the precise nature of the doctrine has never been articulated by the Supreme Court, and has been framed in a bewildering variety of formulations by the courts."), aff'd on other grounds, 661 F.3d 667 (1st Cir. 2011). Unsurprisingly, the doctrine's complexity and uncertainty prompted much analysis. For more detailed descriptions of the precodification economic substance doctrine, see generally, for example, Staff of J. Comm. on Taxation, 111th Cong., JCX-18-10, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act" 142–51 (Comm. Print 2010) [hereinafter JCX-18-10] (summarizing prior law); Hariton, Sorting

split between three basic formulations, which differed in whether they treated the requirements of economic substance and business purpose conjunctively, disjunctively, or holistically.[36] Under the conjunctive version, courts allowed tax benefits only if a transaction had both economic substance and a business purpose;[37] under the disjunctive version, courts allowed benefits if a transaction had either economic substance or a business purpose;[38] and under the holistic version, courts allowed benefits based on consideration of several factors, including, but not limited to, economic substance and business purpose.[39] Adding to the confusion,

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Out the Tangle, supra note 28 (discussing development, operation, and role of doctrine); Yoram Keinan, The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?, 1 N.Y.U. J.L. & Bus. 371, 371–442 (2005) (describing doctrine and recent applications); Jeff Rector, Note, A Review of the Economic Substance Doctrine, 10 Stan. J.L. Bus. & Fin. 173, 175–87 (2004) (describing content, application, and manipulability of doctrine).

36. Although this is the accepted terminology, see, e.g., JCX-18-10, supra note 35, at 143 (referring to "conjunctive test"); Richard M. Lipton, 'Codification' of the Economic Substance Doctrine—Much Ado About Nothing?, 112 J. Tax'n 325, 326 (2010) (using "conjunctive" and "disjunctive" labels); Wells, supra note 13, at 416 (same), the conjunctive/disjunctive distinction is not informative in itself because it depends on the direction of the economic substance determination. The perspective assumed by the accepted labels begins with disallowance and asks what is required for allowance. The labels would be reversed if the inquiry were which factors' absence leads to disallowance. Many decisions frame the factors negatively and thus apply the doctrine in ways that appear to be the reverse of what their label implies. For example, the Eleventh Circuit's formulation—"[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose"—is phrased disjunctively but classified as conjunctive. *United Parcel Serv. of Am.*, 254 F.3d at 1018.

37. See, e.g., Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction . . . ."). Circuits differed in how they ordered the factors. Compare Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 544 (5th Cir. 2009) ("[I]f a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."), with Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006) ("If the transaction has economic substance, 'the question becomes whether the taxpayer was motivated by profit' . . . [but] '[i]f . . . the transaction is a sham, . . . the [subjective] inquiry is never made.'" (second insertion in original) (quoting Illes v. Comm'r, 982 F.2d 163, 165 (6th Cir. 1992))). Congress adopted a conjunctive formulation when it codified the doctrine. See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, sec. 1409(a), § 7701(o)(1), 124 Stat. 1029, 1067–68 (treating transaction "as having economic substance *only if* . . . the transaction changes in a meaningful way . . . the taxpayer's economic position, *and* . . . the taxpayer has a substantial purpose . . . for entering into such transaction" (emphasis added)).

38. See, e.g., Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006) ("Our court distilled . . . a two-part test: 'To treat a transaction as a sham, the court must find [(1)] that the taxpayer was motivated by no business purposes . . . , and [(2)] that the transaction has no economic substance . . . .'" (quoting *Rice's Toyota World*, 752 F.2d at 91) (insertions in original)).

39. See, e.g., Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990) (explaining "the Court's holding in *Frank Lyon* was not intended to outline a rigid two-step analysis"

not all circuits took a position on the doctrine's requirements.[40] Finally, since the whole doctrine was a purely judicial creation, applied (or not) to transactions ex post as courts considered appropriate, the extent to which differences in formulation generated differences in outcome is uncertain.[41]

3. *Justification of Economic Substance Doctrine.* — The basic idea motivating application of the economic substance doctrine, both in the foundational Supreme Court cases and in the doctrine's later development, is similar to the idea underlying the substance over form principle in general. According to the Eleventh Circuit, for example, the point is "to look beyond the form of a transaction and to determine whether its substance is of such a nature that [it should be recognized]."[42] Many courts treat the doctrine as protecting the congressional intent or purpose embodied in the Code.[43] Applied as such, it functions similarly to a substantive canon of statutory construction.[44]

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and concluding "'business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis'" (quoting Sochin v. Comm'r, 843 F.2d 351, 354 (9th Cir. 1988))).

40. See IES Indus., Inc. v. United States, 253 F.3d 350, 353–54 (8th Cir. 2001) (applying two-part test and noting "suggest[ion] that a failure to demonstrate either economic substance *or* business purpose—both not required—would result in the conclusion that the transaction in question was a sham," but declining to decide because both economic substance and business purpose were present).

41. See Wells, supra note 13, at 417 ("[I]t is unclear whether these divergent formulations of the economic substance doctrine resulted in any actual conflict in the decided cases.").

42. Kirchman v. Comm'r, 862 F.2d 1486, 1490 (11th Cir. 1989); accord, e.g., ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) ("[R]egardless of its form, a transaction that is 'devoid of economic substance' must be disregarded for tax purposes and 'cannot be the basis for a deductible loss.'" (quoting Lerman v. Comm'r, 939 F.2d 44, 45 (3d Cir. 1991))).

43. This treatment goes back to the very beginning of the doctrine. See, e.g., Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945) (claiming allowing tax benefits "would seriously impair the effective administration of the tax policies of Congress").

Framing the doctrine as a reflection of legislative intent, rather than as additional requirements grafted onto the Code, helps insulate it from constitutional challenges. In *Coltec Industries, Inc. v. United States*, the Court of Federal Claims entertained such a challenge and held that "where a taxpayer has satisfied all statutory requirements established by Congress, . . . the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." 62 Fed. Cl. 716, 756 (2004), vacated, 454 F.3d 1340 (Fed. Cir. 2006). The Federal Circuit firmly rejected that position and explained "the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance." 454 F.3d at 1354.

44. See, e.g., *Coltec*, 454 F.3d at 1353–54 (describing economic substance doctrine as "judicial effort to . . . prevent taxpayers from subverting the legislative purpose of the tax code" and thus "not unlike other canons of construction").

C. *Step Transaction Doctrine*

The step transaction doctrine is another specialized application of the substance over form principle.[45] When it applies, the doctrine allows a court to treat a series of closely related transactions as one for tax purposes and to disregard the independent tax effects of intermediate steps.[46] This section outlines the step transaction doctrine's background in the case law, describes the doctrine's content and structure, demonstrates its messiness and distinguishes between various formulations, and summarizes its justification.

1. *Judicial Development of Step Transaction Doctrine.* — Like the economic substance doctrine, the step transaction doctrine grew out of the application of the substance over form principle to the facts of individual cases.[47] As such, *Gregory* provides its foundation.[48] The step transaction doctrine draws more specific support from *Minnesota Tea Co. v. Helvering*, in which the Court disregarded a "meaningless and unnecessary incident" because "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."[49] From *Court Holding Co.*, the case law takes the proposition that a "transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant [to that whole]."[50] Finally, by 1989, in *Commissioner v. Clark*, the Supreme Court

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45. See, e.g., Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983) ("The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form.").

46. The Fifth Circuit explains, "When considered individually, each step in the series may well escape taxation. The individual tax significance of each step is irrelevant, however, if the steps when viewed as a whole amount to a single taxable transaction." Id.

47. More specifically, it emerged as a way to cope with the fact that "deciding whether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction, is a recurring problem in the field of tax law." King Enters., Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

48. See, e.g., Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 (10th Cir. 1991) ("The step transaction principle derives from the classic tax case *Gregory v. Helvering* and its progeny." (citation omitted)); supra text accompanying notes 15–16, 25 (noting *Gregory*'s role in development of general substance over form principle and economic substance doctrine).

49. 302 U.S. 609, 613 (1938). The taxpayer, a corporation, sold assets for cash and would have been taxed on its gain if it had retained and used the cash to pay its creditors. It sought to avoid that tax but reach the same result by immediately distributing the cash to its shareholders in return for an agreement that they would assume its debts. Id. at 611–12. Because "[t]he preliminary distribution . . . was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands," the Court taxed the cash as gain to the taxpayer. Id. at 613.

50. 324 U.S. 331, 334 (1945). Many cases quote this statement as supporting the step transaction doctrine, e.g., *Associated Wholesale Grocers*, 927 F.2d at 1522, even though, on its terms, it does not seem to cover more than one transaction, see 324 U.S. at 334 (looking only "from the commencement of negotiations to the consummation of the sale"). The *Court Holding Co.* decision was broad and popular among later courts; it also played signifi-

recognized the step transaction doctrine as "well-established" and standing for the proposition that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."[51]

As with the economic substance doctrine, the Court has never clearly articulated the details of the step transaction doctrine, and lower courts have developed various formulations. Also like the economic substance doctrine, the development of those formulations is tied to the doctrine's content and structure. It is described below, in subsections 2 and 3.

2. *Application, Structure, and Content of Step Transaction Doctrine.* — The step transaction doctrine recharacterizes a series of steps as a single transaction.[52] For example, in *Stobie Creek Investments, LLC v. United States*, the Court of Federal Claims addressed a strategy in which a taxpayer used a partnership to generate a stepped-up basis for certain assets, thereby "reducing the capital gain . . . and the attendant capital gains tax."[53] The Federal Circuit, on review, summarized the strategy as "call[ing] for contributions to a partnership, followed by distribution of the partnership's assets to the taxpayers. This goal was accomplished through a sequence of six steps, carried out in a particular order to ensure the taxpayers received the desired tax benefit."[54] After determining

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cant roles in the development of the substance over form principle in general, see supra text accompanying note 18, and the economic substance doctrine, see supra note 25 and accompanying text.

51. 489 U.S. 726, 738 (1989).

52. Cf. Rosenberg, supra note 4, at 388 (characterizing doctrine, alternatively, as "the tool by which the courts determine what *actions* make up a single *transaction*"). See generally Yoram Keinan, Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification, 22 Akron Tax J. 45, 55–77 (2007) [hereinafter Keinan, Rethinking] (summarizing doctrine).

Application of the step transaction doctrine and recharacterization does not necessarily imply any effects in other contexts. For example, in *United States v. General Geophysical Co.*, the Fifth Circuit explained that its "decision was not based on any lack of good faith in the parties to the transaction," "did not pass on the legal effect of the transaction outside of the tax frame of reference," and "d[id] not question the integrity of the parties or suggest that there was any flim-flam." 296 F.2d 86, 90 (5th Cir. 1961) (per curiam) (denying petition for rehearing).

53. 82 Fed. Cl. 636, 645 (2008), aff'd on other grounds, 608 F.3d 1366 (Fed. Cir. 2010). In general, a taxpayer's gain on sale of property is the excess of the amount realized over the basis. I.R.C. § 1001(a) (2006). A higher basis thus means a lower gain and less tax.

54. 608 F.3d at 1370. The steps were (1) using an LLC to invest in an option spread by selling a short option and buying a long option for the same foreign currency, (2) forming a partnership to hold the assets that were ultimately to be sold, (3) contributing the option spread to the partnership, which increased the taxpayer's basis in the partnership by the cost of long option but did not decrease the basis by the amount of the obligation under the short option, (4) recognizing (through the partnership) an economic gain or loss by exercising the options or letting them expire, (5) terminating and liquidating the partnership, which transferred the assets to the taxpayer and caused the basis in the

that "the step transaction doctrine applies,"[55] the lower court disregarded the intermediate steps and treated the whole scheme as a sale of assets, such that the taxpayer "[was] unable to claim a basis increase in the . . . stock, and the capital gains must be taxed."[56]

At least in theory, the step transaction doctrine has a clear and well-defined structure. However, "[w]hile one may say, half seriously, that the step transaction doctrine is the most finely etched of judicial tax doctrines, the truth of this assertion lies more in the clarity of the doctrine's articulation than in its application."[57] Formally, the doctrine usually encompasses three variations or tests to determine whether a series of steps should be collapsed into a single transaction[58]: binding commitment, interdependence, and end result. The tests are neither mutually exclusive nor mutually dependent, such that "[m]ore than one test might be appropriate under any given set of circumstances" but "the circumstances need only satisfy one of the tests in order for the step transaction doctrine to operate."[59] This subsection summarizes the three tests and provides an example of the application of each.

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assets to be stepped up to the taxpayer's basis in the partnership, and (6) selling the assets. Id. at 1370–71.

55. 82 Fed. Cl. at 702. The case law does not define or discuss any limits on the doctrine's availability other than whether the question of possibly collapsing multiple steps into a single transaction is relevant to the facts of the case.

56. Id.

57. Daniel M. Schneider, Use of Judicial Doctrines in Federal Tax Cases Decided by Trial Courts, 1993–2006: A Quantitative Assessment, 57 Clev. St. L. Rev. 35, 48 (2009); see also infra Part I.C.3 (describing doctrinal messiness and distinguishing formulations). The obscurity in the doctrine's application is, at least partially, a result of its heavy dependence on context and transactional details. See, e.g., Waterman S.S. v. Comm'r, 430 F.2d 1185, 1194 (5th Cir. 1970) ("[W]hat frequently appears on cursory examination . . . precedent is actually a permutation spawned by facts of some particular case."), overruled on other grounds by Utley v. Comm'r, 906 F.2d 1033 (5th Cir. 1990).

58. See generally Rosenberg, supra note 4, at 400–17 (describing, explaining, and critiquing step transaction tests). Although superficially separated and categorized, the tests as applied under each label may vary between cases. Some courts suggest that "various expressions of the step transaction doctrine may have different meanings in different contexts." Falconwood Corp. v. United States, 422 F.3d 1339, 1350 (Fed. Cir. 2005). The application of the tests also varies between courts. See infra Part I.C.3 (distinguishing between formulations). Finally, the tests may not exhaust the factors relevant to the step transaction determination. See Keinan, Rethinking, supra note 52, at 74–77 (suggesting timing of steps as additional component of step transaction analysis).

59. True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999). Usually, depending on the circumstances, a court may apply any or all of the tests to a particular case. Compare Kanawha Gas & Utils. Co. v. Comm'r, 214 F.2d 685, 691–92 (5th Cir. 1954) (applying only end result test), with *True*, 190 F.3d at 1179 ("[W]e conclude under either the end result or interdependence test, the step transaction doctrine applies."), and with McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) ("Under any of the three applicable criteria, then, the merger and subsequent sale should have been stepped together."). The Sixth Circuit diverges from this approach, adopting the end result test as the whole of its step transaction doctrine. See Aeroquip-Vickers, Inc. v. Comm'r, 347 F.3d 173, 182 (6th Cir. 2003) ("This court has applied the 'end result' test in

a. *Binding Commitment Test.* — The binding commitment test looks to a more or less formal obligation to complete a series of steps.[60] Unlike the other tests, it derives from a specific decision: *Commissioner v. Gordon*.[61] In that case, Pacific, a corporation, owned all the shares of Northwest, another corporation, and sold those shares to Pacific's shareholders below market price, but, for corporate law reasons, divided the sale into two separate offers.[62] The Gordons held Pacific stock, purchased shares of Northwest in the first distribution, and were taxed on the difference between the price they paid and the shares' market price.[63] The Gordons sought protection under a provision excluding gain from income if "the distributing corporation distributes . . . all of the stock and securities in the controlled corporation held by it"[64] and argued that Pacific planned to, and did, distribute the remainder of its shares of Northwest soon after the first sale.[65] Applying what became the binding commitment test, the Court refused to collapse the steps and treat the two-part sale as a single transaction because, at the time of the first offer, Pacific had made "no promise to sell any particular amount of stock, at any particular time, at any particular price."[66]

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order to determine whether the steps of a transaction should be treated separately or as a single unit."); Brown v. United States, 782 F.2d 559, 564 (6th Cir. 1986) (explaining circuit "expressly rejected the 'binding commitment' standard and, even though the court did not likewise expressly reject the 'interdependence' test, it impliedly did so by focusing on the taxpayer's intent"). Because the court uses the broadest of the three tests, however, the magnitude and practical effect of its deviation is unclear.

60. The necessary degree of formality varies. Compare, e.g., Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983) (finding test applicable "only if a binding commitment exist[s]"), with *McDonald's*, 688 F.2d at 525 (applying test, even though party "was not legally obliged" to bring about next step, because "limitations made it extremely likely that the [next step] would—as it did—take place promptly").

61. 391 U.S. 83, 96 (1968) ("[I]f one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps.").

62. Id. at 85 & n.1, 86 (explaining Pacific "wanted to generate cash . . . but not to have excess cash left over," "feared that a simple distribution of the Northwest stock . . . without payment of consideration by Pacific's shareholders . . . would have to be charged to earned surplus," and "had insufficient earned surplus for this purpose").

63. Id. at 87–88. The difference was a dividend distributed by Pacific. See I.R.C. §§ 301(a), (c)(1), 316(a)(1), 317(a) (2006) (laying out technical framework).

64. I.R.C. § 355(a)(1)(D)(i); see also 391 U.S. at 88, 91–95.

65. 391 U.S. at 95.

66. Id. at 96–97. After *Gordon*, although courts usually include the binding commitment test in their summaries of the step transaction doctrine, they rarely apply it. See, e.g., Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 n.6 (10th Cir. 1991) ("The 'binding commitment' test, first enunciated in *Commissioner v. Gordon*, has seldom been applied since." (citation omitted)); Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983) ("[T]he *Gordon* 'binding commitment' test should be strictly limited to the facts of the case that gave it life."). Some courts limit its application to cases involving multiyear transactions. See, e.g., *Associated Wholesale Grocers*, 927 F.2d at 1523 n.6 ("Because this case does not involve a series of transactions which spans several years, we [reject the use of the binding commitment test] as well."). No courts accept the presence of a binding commitment as a necessary condition for the step transaction doc-

b. *Interdependence Test.* — The interdependence test looks to the relationships within a series of steps. The Fifth Circuit's decision in *Security Industrial Insurance Co.* provides an example of the test's application.[67] In that case, a life insurance company acquired two rival insurers but, rather than conduct straightforward purchases, performed "a dizzying array of legal maneuvers."[68] Pointing to the technical path by which it ended up holding its rivals' policies, assets, and liabilities, the acquirer sought to retain certain tax advantages by characterizing the transactions as reorganizations (rather than acquisitions and mergers).[69] In response, the IRS argued that "the original purchases of [the acquired companies], the transfers of their assets through [the holding company] to [the acquirer], and their ultimate dissolutions were merely intermediate steps in [the acquirer's] preconceived plans to acquire the[ir] assets . . . for cash."[70] Emphasizing the "complicated" and "symbiotic relationship" between the steps and concluding that "each step in the transactions led inexorably to the next," the court rejected the acquirer's position, applied the interdependence test, and disallowed the claimed advantages.[71]

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trine because it would make avoidance trivially easy. See, e.g., *Sec. Indus. Ins.*, 702 F.2d at 1245 ("General application of the 'binding commitment' standard would effectively permit taxpayers to evade the step transaction doctrine merely by abstaining from formal commitments. Such a result . . . would emasculate the doctrine itself . . . ."); King Enters., Inc. v. United States, 418 F.2d 511, 518 (Ct. Cl. 1969) (finding "not the slightest indication that the Supreme Court intended the binding commitment requirement as the touchstone of the step transaction doctrine in tax law" and observing "doctrine would be a dead letter if restricted to situations where the parties were *bound* to take certain steps"). The Seventh Circuit treats the presence or absence of binding commitment as "simply one factor to which [it] give[s] appropriate consideration." Redding v. Comm'r, 630 F.2d 1169, 1178 (7th Cir. 1980).

67. See 702 F.2d at 1246–47 (applying test).

68. Id. at 1246. Essentially, (1) the acquirer's shareholders formed a holding company, (2) the acquirer became a wholly owned subsidiary of the holding company, (3) the holding company acquired the targets' shares, (4) the holding company resolved to liquidate the newly acquired companies, (5) the acquirer agreed (with, effectively, itself) to assume and reinsure the acquired companies' policies, (6) in return for the acquirer's assumption and reinsurance of their policies, the acquired companies transferred some of their assets to the acquirer, (7) the holding company finished liquidating the acquired companies by transferring their remaining assets and liabilities first to itself and then to the acquirer, and, finally, (8) the holding company formally dissolved the acquired companies. See id. at 1236–38 (summarizing facts).

69. See id. at 1239; see also id. at 1240–42 (presenting technical framework and explaining "if the . . . acquisitions were . . . corporate reorganizations described in section 368(a)(1) . . . (F) . . . , [the acquirer] (as successor to [the acquired companies]) may carry over [certain tax favored accounts], and no tax may be imposed on [the acquired companies or the acquirer]").

70. Id. at 1239.

71. Id. at 1247. In particular, the court noted that the holding company "was a mere shell, formed only to facilitate the purchases," "the purchases . . . would have been impossible without elaborate financing arrangements between [the holding company] and the Bank," "the[] financing agreements were dependent in part on . . . reinsurance agree-

c. *End Result Test.* — The end result test looks to the relationship between steps and the taxpayer's purpose or intended outcome.[72] *Security Industrial Insurance* exemplifies this test's application as well.[73] On the same facts as described above,[74] the court found that the acquirer's "legal maneuvers . . . [could not] disguise the fact that the intended result of each series of transactions was the acquisition of [the acquired companies'] assets."[75] Deducing the acquirer's intent from "a clear and well-documented paper trail" and the fact that its "game plans for acquiring [the life insurance companies] were identical to the strategy [the acquirer] had pursued for over twenty years," the court applied the end result test to "amalgamate[] . . . the successive steps."[76]

3. *Variation and Messiness of Step Transaction Doctrine Formulations.* — Despite general agreement on the names and broad contours of the step transaction doctrine's three tests, the practical details of the doctrine are not at all settled. Application of three interrelated, overlapping, and nonexclusive tests itself generates complexity, but the tests themselves are not the focus of much disagreement.[77] Rather, after professing consensus on the doctrine's basic structure, courts tend to part ways (whether expressly or not) in how they apply the doctrine to particular cases and what factors they find relevant, whichever tests they apply. Courts are well aware of this divergence and uncertainty. The Federal Circuit, for example, notes that

> [v]arious opinions from the United States Tax Court have seemingly overlaid additional layers of analysis onto the three tests . . . . Other courts have rejected the notion that a valid business purpose necessarily bars application of the step transaction doctrine. Still others have considered an independent business purpose as part of the 'sham transaction doctrine,' a sister corollary of the same basic substance-over-form principle . . . .[78]

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ments," and "transfers of assets . . . were necessary to effectuate the reinsurance agreements." Id.

72. Courts sometimes express a preference for the end result test because of its breadth and conceptual flexibility. See, e.g., Penrod v. Comm'r, 88 T.C. 1415, 1429 (1987) ("At the other extreme [from the binding commitment test], the most far-reaching alternative is the 'end result' test.").

73. See 702 F.2d at 1246 (applying test); cf. supra note 59 and accompanying text (noting possibility of applying multiple tests to single case).

74. See supra note 68 and accompanying text (summarizing facts).

75. 702 F.2d at 1246.

76. Id.

77. Cf., e.g., id. at 1244 (explaining "[a]lthough no test seems to be universally accepted, it is possible to articulate several standards used by the courts in determining when and how to apply the step transaction doctrine" and listing three tests).

78. Falconwood Corp. v. United States, 422 F.3d 1339, 1350 (Fed. Cir. 2005) (citations omitted). Some courts explain the variation as compelled by the multitude of factual and transactional situations to which the doctrine must respond. See, e.g., *Sec. Indus. Ins.*, 702 F.2d at 1244 ("The types of step transactions are as varied as the choreographer's art:

This subsection distinguishes between various formulations of the step transaction doctrine.[79] Where the doctrine's three tests, as discussed in the previous subsection, help answer the question of what courts look *for* when applying the step transaction doctrine, these formulations diverge in terms of what courts look *at*. Although the line is not entirely clean, the circuits tend to split over whether to give the individual steps in a series independent significance when deciding the threshold question of whether to apply the step transaction doctrine.[80] In some formulations, described in subsection a, the decision to apply the doctrine and collapse a series of transactions depends on the nature of each constituent step. In other formulations, described in subsection b, the decision depends on the nature of the series as a whole.[81]

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there are two steps, waltzes, fox trots, and even Virginia reels. As a consequence, the courts' applications of the step transaction doctrine have been enigmatic."); supra note 57 (noting this explanation). For academic discussion of the messiness point, see, for example, Ronald H. Jensen, Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351, 11 Va. Tax Rev. 349, 366–67 (1991) (finding doctrine "a mixture of inconsistency and ambiguity" because "[t]hree different tests exist for determining its applicability, but the courts have articulated no standard for determining which test should be applied" or "whether a narrow or a broad application is appropriate"); Knight & Knight, supra note 13, at 101, 107 (emphasizing uncertainty in application).

79. In general, this Note divides and describes the formulations by circuit. District courts sometimes apply the doctrine differently from, though not necessarily contradictorily to, the relevant circuit precedent (especially when the controlling court of appeals has not addressed the issue recently or clearly). Cf., e.g., infra notes 82, 84 (discussing relationship between court of appeals and district court formulations in First Circuit). However, if details of formulation become important, see, e.g., infra Part II.B (finding application of codified economic substance doctrine to depend on details of step transaction doctrine), lower courts will face heightened pressure to follow their respective reviewing circuits more carefully, and circuits will face similar pressure to control their districts. Likewise, panels of the Tax Court will have more reason to "[f]ollow[] the lead of . . . the circuit to which [each] case is appealable." Estate of Christian v. Comm'r, 57 T.C.M. (CCH) 1231, 1241 (1989).

80. This distinction, between treating steps in a series as discrete points and as a continuous line, resembles a recursive step transaction determination. However, unlike the actual doctrine, it represents courts' basic conceptual approach and does not vary or depend on the facts of each case. But see David P. Hariton, The Frame Game: How Defining the "Transaction" Decides the Case, 31 Va. Tax Rev. 221, 225–26 (2011) [hereinafter Hariton, The Frame Game] (suggesting courts may "t[ake] it for granted [w]hat the relevant transaction [is]" and their definitions may be "elicited" by case-specific facts).

81. The Fourth, Eighth, and Eleventh Circuits have not articulated clear versions of the step transaction doctrine and are not discussed beyond this note.

The Fourth Circuit addressed the step transaction issue in two early cases, see Helvering v. Elkhorn Coal Co., 95 F.2d 732, 738 (4th Cir. 1938) ("[P]arts of a single plan . . . should be treated as parts of one transaction."); Starr v. Comm'r, 82 F.2d 964, 968 (4th Cir. 1936) ("Where transfers are made pursuant to . . . a plan of reorganization, they are ordinarily parts of one transaction and should be so treated . . . ."), but neither decision contains a clear statement of the doctrine or makes clear what particular factors the court found decisive.

The Eighth Circuit has also addressed the doctrine occasionally and conclusorily, without elaborating on its content. See, e.g., Senda v. Comm'r, 433 F.3d 1044, 1048 (8th

a. *Discrete Steps: Step Transaction Doctrine Formulations in the First, Ninth, Tenth, D.C., and Federal Circuits.* — Several courts look at individual steps, rather than the series as a whole, when deciding whether to apply the step transaction doctrine. The First Circuit has found determinative that the challenged steps were "legal transactions not fictitious or . . . lacking in substance."[82] Because the individual steps were not "anything different from what they purported to be," the court held that "they must be given effect."[83] Reaching this conclusion, the court expressly rejected the argument that it should consider whether "the entire procedure comes within the intendment of the statute."[84] The D.C. Circuit also treats the individ-

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Cir. 2006) (declaring step transaction treatment appropriate because "transactions here were integrated and simultaneous").

The Eleventh Circuit recognizes *Court Holding Co.* as "creating [the] step transaction doctrine, whereby courts must consider all steps of [a] transaction," Kirchman v. Comm'r, 862 F.2d 1486, 1491 (11th Cir. 1989), but has not formulated the doctrine for itself. This suggests that Fifth Circuit precedent through 1981, see infra note 98 (describing older Fifth Circuit cases), may still be good law in the Eleventh Circuit. However, judges' clear willingness to pick and choose from the case law when articulating the doctrine likely diminishes the usefulness of such precedent.

82. Granite Trust Co. v. United States, 238 F.2d 670, 678 (1st Cir. 1956).

The First Circuit has not articulated a tripartite version of the doctrine. Recent district court opinions adopt the usual tests. See, e.g., Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 234 (D. Mass. 2010) ("The step transaction doctrine has three tests . . . ."), aff'd on other grounds, 661 F.3d 667 (1st Cir. 2011).

83. *Granite Trust*, 238 F.2d at 678.

84. Id. at 674. However, this rejection may depend on the facts of the case, see id. at 675 ("[T]he very terms of [the applicable Code section] make it evident that it is not an 'end-result' provision . . . ."), and thus may not be absolute.

The leading district court decision generally embraces this focus on separate transactions. The court "examined whether each of the steps under scrutiny had a 'reasoned economic justification standing alone'" and declared "[a]ny intermediate step that lacks such a justification is a candidate for elimination." *Fid. Int'l Currency Advisor*, 747 F. Supp. 2d at 234 (quoting Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1247 (5th Cir. 1983)). However, applying the interdependence test, it also based its conclusion on the relationship of each step to the entire series, suggesting a somewhat different focus. Id. at 207 ("[E]ach individual step would have been fruitless, and indeed pointless, without the completion of the entire preplanned service [sic] of steps.").

The exact status of the doctrine and the *Granite Trust* decision in particular is unclear. *Fidelity* read the decision as possibly "support[ing] the proposition that a taxpayer's subjective intent is irrelevant" in the context of the economic substance doctrine and found that it was "effectively overruled . . . at least as to the broad contours of the economic substance doctrine" by Dewees v. Commissioner, 870 F.2d 21 (1st Cir. 1989). 747 F. Supp. 2d at 231. However, unlike *Dewees*, *Granite Trust* was not an economic substance doctrine case. Compare *Dewees*, 870 F.2d at 36 (finding losses from stand-alone transactions not deductible because "transactions so clearly lack any significant possibility of profit"), with *Granite Trust*, 238 F.2d at 673, 675 (explaining "[t]he precise issue before us is whether or not to give effect for tax purposes to [intermediate steps]" and addressing "'step transaction' theory advanced in this case"). Moreover, the First Circuit did not review the *Fidelity* decision on either step transaction or economic substance grounds. See 661 F.3d at 671 ("[Taxpayer] does not seriously contest the district court's basis adjustment . . . [and] its arguments are directed only to the . . . penalty."), aff'g 747 F. Supp. 2d 49.

ual steps in a series as discrete targets for challenge and disallowance. In its most recent formulation of the step transaction doctrine, the court explained that it "will ignore a step in a series of transactions if that step does 'not *appreciably* affect [the taxpayer's] beneficial interest.'"[85] According to the Court of Federal Claims, the Federal Circuit takes a similar approach, at least as to the interdependence test.[86] In *Stobie Creek*, the court based its conclusion that "[t]he transactions making up the steps . . . have no independent functional justification" on its "findings regarding lack of business purpose for the individual steps."[87] The Tenth Circuit's formulation of the end result test similarly depends on the characterization of individual steps.[88] Applying the end result test, the Ninth Circuit asks "'whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way.'"[89] Although this might suggest an evaluation of the series as a whole, the court answers the question by looking to whether "[t]he result sought by [the taxpayers] is consistent with the tax treatment that they seek" as to each step.[90]

The Ninth Circuit decides whether to apply the interdependence test by "'compar[ing] the transactions in question with those [it] might usually expect to occur in otherwise bona fide business settings.'"[91] The court looks at individual steps and determines whether each "is an ordinary and objectively reasonable business activity that makes sense with or without any subsequent [step]."[92] The Tenth Circuit applies the interdependence test similarly, looking to whether "the individual steps . . . [are]

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85. Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 214 (D.C. Cir. 2001) (alteration in original) (quoting ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 514 (D.C. Cir. 2000)) (internal quotation marks omitted).

86. Stobie Creek Invs., LLC v. United States, 82 Fed. Cl. 636, 699 (2008), aff'd on other grounds, 608 F.3d 1366 (Fed. Cir. 2010). The court of appeals has recognized the doctrine and the three tests but has not articulated its specific details. See, e.g., Falconwood Corp. v. United States, 422 F.3d 1339, 1349 (Fed. Cir. 2005) (describing doctrine and noting "courts generally have enunciated three basic tests that define the criteria upon which application of the step transaction doctrine applies"). For discussion of the end result test in the Federal Circuit, see infra note 100 and accompanying text.

87. 82 Fed. Cl. at 699–700. The court had found that the transactions, standing alone, "had no objectively reasonable possibility of returning a profit." Id. at 698. The court of appeals's most recent step transaction decision, although not directly on point, is consistent with the lower court's formulation. See *Falconwood*, 422 F.3d at 1351–52 (refusing to disregard step mandated by regulation).

88. See True v. United States, 190 F.3d 1165, 1175 n.9 (10th Cir. 1999) ("[A taxpayer] cannot request independent tax recognition of the individual steps unless he shows that at the time he engaged in the individual step, its result was the intended end result in and of itself.").

89. Linton v. United States, 630 F.3d 1211, 1224 (9th Cir. 2011) (quoting *True*, 190 F.3d at 1175).

90. Id.

91. Id. (quoting *True*, 190 F.3d at 1176).

92. Id.

the type of business activity [it] would expect to see in a bona fide, arm's length business deal between unrelated parties" and whether they "make[] any objective sense standing alone."[93]

b. *Continuous Steps: Step Transaction Doctrine Formulations in the Second, Third, Fifth, Sixth, Seventh, and Federal Circuits.* — Several courts take a contrary approach. The Second Circuit decides whether to apply the step transaction doctrine by looking to the whole series of steps. The end result test is not available without some sort of demonstration that the steps "were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result."[94] The court will not apply the doctrine if there is "no evidence of a prearranged plan."[95] Conversely, "application of the step transaction doctrine is warranted" if "all of the steps . . . were pre-planned, guaranteed, and lacking in 'independent significance.'"[96] The Fifth Circuit took a similar approach in the most recent case to which it found the step transaction doctrine applicable.[97] Deciding whether to apply the end result test, the court viewed the whole series in light of "a clear and well-documented paper trail" and the taxpayer's established "game plans."[98] The Federal Circuit has not overruled Court of Claims precedent applying a similar version of the end result test.[99] Applying that test in *King Enterprises, Inc. v. United States*, the old

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93. *True*, 190 F.3d at 1179. This approach may not be entirely consistent with the court's earlier precedent, which was more willing to look to the relationship between steps. See, e.g., Kornfeld v. Comm'r, 137 F.3d 1231, 1235 (10th Cir. 1998) (applying interdependence test because "[a]lthough the gifts here could stand on their own without relation to the investments, it is difficult to conceive that the parties would have made the investments as they did . . . in the absence of the gifts taxpayer made").

94. Greene v. United States, 13 F.3d 577, 583 (2d Cir. 1994).

95. Id.

96. Long-Term Capital Holdings, LP v. United States, 150 Fed. App'x 40, 43 (2d Cir. 2005) (quoting *Greene*, 13 F.3d at 584).

97. See Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244–47 (5th Cir. 1983). The court's more recent statement that "[t]he step transaction doctrine allows the disregard of steps that have no substance" might suggest otherwise. G.M. Trading Corp. v. Comm'r, 121 F.3d 977, 979 n.2 (5th Cir. 1997). However, the court was simply setting up a counterpoint to emphasize that "[i]t does not allow the invention of steps that did not happen," not explaining doctrinal details. See id.

98. *Sec. Indus. Ins.*, 702 F.2d at 1246. This treatment is generally consistent with earlier cases that are on point and which the court has not expressly overruled or replaced. For example, in *Kuper v. Commissioner*, the court entertained defenses based on attempts to justify the "exact structuring" and "transactional path" of the taxpayers' steps. 533 F.2d 152, 158, 159 n.12 (5th Cir. 1976). Similarly, the court has emphasized that a taxpayer had not shown any reason for "the utilization of such a convoluted sequence of preplanned paper exchanges." Crenshaw v. United States, 450 F.2d 472, 475 n.5 (5th Cir. 1971). However, the circuit's case law may not be entirely consistent; in one earlier case the court suggested that if individual transactions "could not have been explained by valid nontax reasons, they . . . could not have been effective." United States v. Gen. Geophysical Co., 296 F.2d 86, 90 n.5 (5th Cir. 1961).

99. At least according to its lower courts, the Federal Circuit formulates the step transaction doctrine differently depending on which test it is applying. Cf. Stobie Creek

court looked for some sort of unitary plan encompassing the whole series of steps.[100] The Sixth Circuit, applying the end result test exclusively,[101] also focuses on the taxpayer's intent.[102]

In its most recent step transaction doctrine case, the Seventh Circuit applied the interdependence test after looking at all the steps together in light of the taxpayer's "historic stance in . . . negotiations and . . . the hammered-out terms of the agreement" and concluding the terms embodied in the steps "were the quid pro quo of the merger agreement."[103] An earlier case demonstrates the relevance of the ordering and relationship between steps.[104] The interdependence test in the Second Circuit is similarly unconcerned with isolated transactions. Instead, it "focuses on whether each . . . would have been fruitless had not the subsequent steps occurred."[105] The Third Circuit has not expressly articulated the requirements of the step transaction doctrine,[106] but in an early case, the court of appeals affirmed the Tax Court's treatment of a step transaction question in which the lower court looked at the questioned transaction in relation to the rest of the series.[107] A recent district court decision is con-

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Invs., LLC v. United States, 82 Fed. Cl. 636, 699–700 (2008) (looking at "lack of business purpose for the individual steps"), aff'd on other grounds, 608 F.3d 1366 (Fed. Cir. 2010); supra notes 86–87 and accompanying text (discussing interdependence test in Federal Circuit).

100. 418 F.2d 511, 519 n.11 (Ct. Cl. 1969) ("A formal plan or reorganization is not necessary if the facts of the case show a plan to have existed."); see also id. at 519 (explaining "the plan to merge was something more than inchoate, if something less than announced").

101. See supra note 59 (noting Sixth Circuit's anomalous approach).

102. See, e.g., Brown v. United States, 782 F.2d 559, 564 (6th Cir. 1986) (emphasizing end result test "clearly makes intent a necessary element for application of the doctrine"). The relevant intent encompasses the whole series of steps and "must be evaluated at the outset, i.e., the time [the taxpayer] entered into the [purported first step]." Brown v. United States, 868 F.2d 859, 864 (6th Cir. 1989).

103. McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 524–25 (7th Cir. 1982).

104. Redding v. Comm'r, 630 F.2d 1169, 1177 (7th Cir. 1980) ("While the exercise of the warrants here was obviously dependent upon warrants having been issued, the issuance of warrants did not require their exercise by shareholders in the purchase of stock . . . .").

105. Greene v. United States, 13 F.3d 577, 584–85 (2d Cir. 1994). As such, the court's assessment of a given transaction may depend on the order of the steps in the series. See id. at 585 ("The relevant issue . . . is not whether the [later step] would have had significance absent [the earlier step], but rather whether the [earlier step] would have had significance absent the [later step].").

106. It has, however, expressly acknowledged the "step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step." Lerman v. Comm'r, 939 F.2d 44, 54 (3d Cir. 1991) (citing Comm'r v. Court Holding Co., 324 U.S. 331 (1945)).

107. Am. Bantam Car Co. v. Comm'r, 177 F.2d 513 (3d Cir. 1949), aff'g per curiam 11 T.C. 397, 406 (1948) (finding step "not a sine qua non in the general plan, without which no other step would have been taken"). Neither court invoked the step transaction doctrine by name, but the Tax Court made clear it was "determining whether a series of

sistent with this approach: In *Schering-Plough Corp. v. United States*, the court applied the end result test because the steps "were pre-arranged and indispensible parts of a broader initiative."[108] The court also applied the interdependence test because initial steps "would have been pointless" without later ones.[109]

4. *Justification of Step Transaction Doctrine.* — Courts often explain and justify the step transaction doctrine as protecting legislative purpose.[110] In that way, its rationale is similar to that of the economic substance doctrine.[111] However, courts also tend to conceive of the step transaction doctrine more mechanistically than other doctrines and, at times, treat it as a neutral tool for revealing the "true" facts of a transaction.[112] For example, one court found it odd "that the Government seems to request that the Court apply the step transaction doctrine only if [the Government does not prevail on another theory]."[113] According to the court, the doctrine was not just a theory of the case that the government could invoke as it saw fit.[114] Rather, whatever its conclusions on other issues, "the Court must nevertheless consider whether the step transaction doctrine applies in this case. If the step transaction [sic] does apply, the Court must alter its analysis accordingly."[115]

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steps are to be treated as a single indivisible transaction or should retain their separate entity." 11 T.C. at 405.

108. 651 F. Supp. 2d 219, 261 (D.N.J. 2009), aff'd on other grounds sub nom. Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011).

109. Id. The court reached this conclusion by viewing the steps in relation to each other and finding "back-solv[ing]," "interlocking figures . . . governed by . . . the end result," and "amount[s] [that] . . . dovetailed neatly, and not accidentally." Id.

110. See, e.g., Kuper v. Comm'r, 533 F.2d 152, 156 (5th Cir. 1976) ("We do not believe that Congress intended that under the circumstances of the present case taxpayers could utilize this series of steps to artificially avoid the tax incidents of a simple stock exchange."); Helvering v. Elkhorn Coal Co., 95 F.2d 732, 735 (4th Cir. 1937) ("We do not think the statutory exemption may be thus broadened by such an artifice."), aff'd on reh'g, 95 F.2d 732 (4th Cir. 1938).

111. See supra notes 42–44 and accompanying text (describing economic substance doctrine's rationale).

112. This conception is suggested by language such as "the telescopic lens of the step transaction doctrine." Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1247 (5th Cir. 1983).

113. MAS One Ltd. v. United States, 271 F. Supp. 2d 1061, 1067 (S.D. Ohio 2003).

114. Id. ("[A]pplication of the step transaction doctrine should not depend on whether the Government can prevail on an alternative theory.").

115. Id. As a corollary to viewing the step transaction doctrine as independent of any particular outcome, courts make clear that the doctrine "is not merely a method preventing tax avoidance, but can also be used for a taxpayer's benefit." Id.; accord Kanawha Gas & Utils. Co. v. Comm'r, 214 F.2d 685, 691 (5th Cir. 1954) ("[A] series of transactions designed and executed as parts of a unitary plan to achieve an intended result . . . will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation."). The general acceptance of the step transaction doctrine's availability to taxpayers is anomalous in the substance over form context. Cf. William S. Blatt, Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form, 70 Or. L. Rev. 381, 384 (1991)

Alternatively (or additionally), some courts emphasize that the step transaction doctrine "disregard[s]" individual steps "if the taxpayer could have achieved its objective more directly."[116] This treatment suggests a more policy-based (perhaps favoring efficiency or directness), rather than factual, justification for the doctrine and may also be more obviously consistent with the project of protecting legislative intent. Some decisions suggest that courts believe Congress wants certain transactions to receive certain treatment, whatever technical form they may take, and see the doctrine as a way to overcome technical obstacles to that desired outcome.[117]

D. *Relationship Between Economic Substance and Step Transaction Doctrines*

No one disputes that the economic substance doctrine and the step transaction doctrine are both applications of the principle that substance should prevail over form or that both provide mechanisms for courts to determine and give effect to the substance that is to prevail.[118] However, the exact relationship between the two doctrines is unclear. Disagreement centers on the relevance to the step transaction inquiry of whether each step in a series, and the series as a whole, has economic substance or a business purpose.[119] The Tenth Circuit acknowledges that "no firm

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("Courts are deeply divided over whether an appeal to substance should receive a different reception depending on whether the taxpayer or the government makes it."). See generally Schneider, supra note 57 (surveying and summarizing litigants' invocations of substance over form doctrines).

116. Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 213 (D.C. Cir. 2001).

117. See, e.g., Kuper v. Comm'r, 533 F.2d 152, 156 (5th Cir. 1976) (implying "the tax incidents of a simple stock exchange" are predetermined and fixed and preventing "taxpayers [from] utiliz[ing] [a] series of steps to artificially avoid [them]"). A political justification also renders the step transaction doctrine less vulnerable to arguments that it "adds nothing to our ability to determine 'what happened'" because "[t]he facts are just as readily determinable without resort to the doctrine as they are with it." Jensen, supra note 78, at 425 (claiming "[t]he step transaction doctrine—like any legal doctrine—is a mechanism for determining legal consequences"). Conceptualized and defended on policy grounds, the step transaction doctrine can provide both a mechanism for presenting the facts (whether or not "readily determinable") and a reason for giving them certain legal consequences.

118. See, e.g., True v. United States, 190 F.3d 1165, 1176 n.11 (10th Cir. 1999) (explaining "both the step transaction and sham transaction doctrines are corollaries of the basic substance over form principle"); Keinan, Rethinking, supra note 52, at 47–48 ("Generally, the doctrines that have emerged can be divided into two subtests under the substance-over-form doctrine: (i) the economic substance/sham transaction doctrines (with the business purpose doctrine included as the subjective prong), and (ii) the step transaction doctrine." (footnote omitted)).

119. The converse issue—the relevance to the economic substance inquiry of the steps comprising a transaction—arises in the context of what David Hariton calls "framing." See Hariton, The Frame Game, supra note 80, at 222 ("[A]ny tax-motivated financial structure can be made to look like a tax shelter by defining the transaction as consisting solely of the relevant tax-motivated structuring steps (rather than of the broader business objective or operations to which those steps are applied)."). Although the step transaction

line delineates the boundary" between the doctrines but maintains a distinction and "reject[s] the contention that a valid business purpose bars application of step transaction analysis," emphasizing the doctrines' different rationales.[120] On the other hand, the D.C. Circuit adopted key aspects of its formulation of the step transaction doctrine from a decision invalidating a transaction as a sham,[121] and the Court of Federal Claims has expressly relied on economic substance analysis to answer a step transaction inquiry.[122] Practitioners and academics have also contributed to the debate: Yoram Keinan observes that the step transaction doctrine may serve as a "backstop" in economic substance cases[123] and Professor Joshua Rosenberg suggests that the business purpose doctrine "seems to

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doctrine and Hariton's frame game resemble each other in their potential to disallow tax benefits by determining which steps constitute the relevant transaction, they take conceptually distinct approaches. Under the step transaction doctrine, finding a step closely related to and integrated into a larger series may be reason to disregard it. When framing transactions for economic substance analysis, however, disallowance depends on characterizing a step as "outside . . . routine business activities" or "engineered . . . solely for tax purposes." Shell Petroleum Inc. v. United States, Civil Action No. H-05-2016, 2008 WL 2714252, at *36, *38 (S.D. Tex. July 3, 2008). Thus, in order to reach the same result, the two need to look at different facts and ask different questions. The alternative holdings in *Stobie Creek* illustrate this divergence in their reliance on slightly different characterizations of the taxpayer's relevant actions. Compare 82 Fed. Cl. 636, 701 (2008) (looking at "all the steps undertaken pursuant to the [challenged] strategy" and "structured and implemented to reach a single result" and applying step transaction doctrine to "amalgamate[]" them into "the sale of . . . [appreciated] stock"), aff'd on other grounds, 608 F.3d 1366 (Fed. Cir. 2010), with id. at 672 (isolating "the transaction which gave rise to the alleged tax benefit" and requiring taxpayer to "show[] . . . that the series of transactions that increased the basis of the . . . stock . . . had economic reality").

120. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1526–27 (10th Cir. 1991) (surveying cases, acknowledging "[i]n some cases, the existence of a business purpose is considered one factor in determining whether form and substance coincide" while "[in] others, the lack of business purpose is accepted as reason to apply the step transaction doctrine," but concluding "[m]ost cases applying the step transaction doctrine . . . do not even include discussion of business purpose"). Elsewhere, the court has explained that "the sham transaction doctrine focuses on whether a questionable transaction has a business purpose and economic effects" and "the step transaction doctrine is particularly tailored to the examination of transactions involving a series of potentially interrelated steps." *True*, 190 F.3d at 1176–77 n.11.

121. See *Del Commercial Props.*, 251 F.3d at 214 (adopting requirements of "purpose for the 'business activity'" and "'*appreciabl[e]* [e]ffect [on] [the taxpayer's] beneficial interest'" (last alteration in original) (quoting ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 512, 514 (D.C. Cir. 2000) (affirming Tax Court's "decision rejecting the bona fides of the *partnership* [as] the equivalent of a finding that it was, for tax purposes, a 'sham'")) (internal quotation marks omitted)).

122. See *Stobie Creek*, 82 Fed. Cl. at 699 ("Underlying this [interdependence test] approach are the court's earlier findings regarding lack of business purpose for the individual steps . . . .").

123. Keinan, Rethinking, supra note 52, at 88, 95 ("[W]here the transaction is challenged on both grounds, the economic substance challenge takes priority and, normally, the step transaction analysis will be heavily influenced by the decision on the first ground.").

have consistent meaning only when seen as a test for application of the step transaction doctrine," such that "if an action has no business purpose, then that action is not entitled to be taxed as a distinct exchange, but is deemed to be part of a larger transaction."[124]

The doctrines clearly overlap, although the extent of the overlap varies between courts' formulations.[125] However, at least on a conceptual level, each doctrine does have unique and independent content,[126] and even when the tests coincide in practice, courts conduct purportedly separate analyses and treat the doctrines as distinct, alternative grounds for their decisions.[127]

II. APPLICATION OF CODIFIED ECONOMIC SUBSTANCE DOCTRINE TO STEP TRANSACTION DOCTRINE

This Part analyzes the newly codified economic substance doctrine as it applies to the step transaction doctrine. Section A describes the codification of the economic substance doctrine and interprets the new Code provisions. Section B applies those provisions to the various formulations of the step transaction doctrine. Section C closes by summarizing the problems implied by that application.

A. *Codification of Economic Substance Doctrine*

Congress codified the economic substance doctrine in the Health Care and Education Reconciliation Act of 2010.[128] Congress had considered taking such action many times before[129] and faced resistance on

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124. Rosenberg, supra note 4, at 398.

125. For illustration of different degrees of overlap between the economic substance and step transaction doctrines, compare, for example, Esmark, Inc. v. Comm'r, 90 T.C. 171, 195 (1988) (characterizing step transaction doctrine as eliminating only "meaningless or unnecessary steps"), aff'd, 886 F.2d 1318 (7th Cir. 1989), with, for example, Greene v. United States, 13 F.3d 577, 584 (2d Cir. 1994) (refusing to apply doctrine after finding "no evidence of a prearranged plan").

126. For a proposal to clarify and refine the conceptual and functional relationship between the doctrines, see infra Part III.

127. See, e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 128 (D. Conn. 2004) (holding transaction "lacked economic substance and therefore must be disregarded for tax purposes, and, in the alternative, must be recast under the step transaction doctrine"), aff'd, 150 Fed. App'x 40 (2d Cir. 2005).

128. Pub. L. No. 111-152, sec. 1409, 124 Stat. 1029, 1067–70 (codified at I.R.C. §§ 6662(b)(6), (i), 6662A(e)(2)(B), 6664(c)(2), (d)(2), 6676(c), 7701(o)).

129. Previous proposals varied somewhat in their particulars over the years. See, e.g., S. 2242, 110th Cong. §§ 511–513 (2007) (proposing "Clarification of Economic Substance Doctrine," "Penalty for Understatements Attributable to Transactions Lacking Economic Substance, Etc.," and "Denial of Deduction for Interest on Underpayments Attributable to Noneconomic Substance Transactions"); S. 1321, 109th Cong. §§ 801–802 (2006) (proposing "Clarification" and "Penalty"); S. 476, 108th Cong. §§ 701, 704, 717 (2003) (proposing "Clarification," "Penalty," and "Denial of Deduction"); H.R. 5095, 107th Cong. §§ 101, 104 (2002) (proposing "Clarification" and "Penalty"); H.R. 2255, 106th Cong. §§ 3–4 (1999)

many fronts: The Bush White House, practitioners, and the IRS and Treasury Department all opposed codification.[130] However, while framed and advocated for as a reform that would help prevent tax avoidance,[131] codification of the economic substance doctrine was also expected to increase revenue.[132] This consideration likely contributed to the proposal's persistence and eventual success.[133]

The statute added new subsections, including §§ 7701(o) and 6662(b)(6), to the Internal Revenue Code. Those subsections, respectively, define and provide heightened penalties under the economic substance doctrine. This section presents and interprets the details of the

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(proposing "Disallowance of Noneconomic Tax Attributes" and "Increase in Substantial Underpayment Penalty with Respect to Disallowed Noneconomic Tax Attributes").

130. See, e.g., Office of Mgmt. & Budget, Exec. Office of the President, Statement of Administration Policy: H.R. 2419—Food and Energy Security Act of 2007, at 2 (2007) [hereinafter Policy Statement on H.R. 2419] ("[T]he Administration opposes the provision to codify the 'economic substance' doctrine and urges Congress to eliminate this provision from the final legislation. The economic substance doctrine is a judicial rule that is best left for the courts to apply in appropriate cases."); Tax Section, N.Y. State Bar Ass'n, Summary Report on the Provisions of Recent Senate Bills that Would Codify the Economic Substance Doctrine 3 (2003) (doubting whether "codifying the 'economic substance' doctrine will be an effective vehicle to combat the tax shelter problem" and predicting codification "will have unwarranted and unintended effects on legitimate transactions"); Crystal Tandon, Economic Substance Codification Would Create More Problems than It Solves, Says Korb, 118 Tax Notes 777, 777 (2008) (reporting IRS Chief Counsel Donald Korb called codification "'a solution in search of a problem'" and questioning "'what [economic substance codification] would add'" to IRS's tax enforcement toolset); Dennis J. Ventry Jr., Save the Economic Substance Doctrine from Congress, 118 Tax Notes 1405, 1410 (2008) (describing Treasury position that "a judicially controlled doctrine provides judges the tools they need to protect the revenue").

131. See, e.g., H.R. Rep. No. 111-443, at 295 (2010) [hereinafter House Report] (explaining, despite IRS's success in litigation under common law, "it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences"); Ventry, supra note 130, at 1410 (reporting Senator Chuck Grassley explaining "'I'm not doing this to raise taxes,' but rather to clarify the definition for taxpayers and courts").

132. See J. Comm. on Taxation, 111th Cong., JCX-17-10, Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872, the "Reconciliation Act of 2010," as Amended, in Combination with the Revenue Effects of H.R. 3590, the "Patient Protection and Affordable Care Act ('PPACA')," as Passed by the Senate, and Scheduled for Consideration by the House Committee on Rules on March 20, 2010, at 3 (Comm. Print 2010) (estimating revenue increase of $1.8 billion over five years and $4.5 billion over ten years).

133. See, e.g., Ventry, supra note 130, at 1410 (claiming "[m]oney talks" and "revenue expected to flow from codification is manna for a cash-strapped Congress" and reporting Senate Finance Committee Tax Counsel Joshua Odintz writing "'it's money on the table'"). Revenue considerations and desires to offset costs may also help explain why an arcane tax doctrine was combined with health care and farm bills. Compare Office of Mgmt. & Budget, Exec. Office of the President, Statement of Administration Policy: H.R. 4872—Health Care and Education Reconciliation Act of 2010 (2010) (supporting passage and not mentioning codification), with Policy Statement on H.R. 2419, supra note 130, at 2 (opposing passage and listing codification under "Tax Provisions/Funding Gimmicks").

codified doctrine. Subsection 1 addresses the doctrine's substantive requirements, and subsection 2 addresses the relevant penalty provision.

1. *Content of Codified Economic Substance Doctrine.* — When it applies, § 7701(o) imposes the conjunctive version of the economic substance doctrine.[134] The Code specifies that a "transaction shall be treated as having economic substance *only if* . . . the transaction changes in a meaningful way . . . the taxpayer's economic position, *and* . . . the taxpayer has a substantial purpose . . . for entering into such transaction."[135] Although the provision's effect is clear, when it applies is less obvious.

Section 7701(o) professes to aim at the substance, and not the underlying availability, of the economic substance doctrine. The Code refers to "any transaction to which the economic substance doctrine is relevant" and emphasizes that "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."[136] However, claiming to preserve the common law is not sufficient to define when the codified doctrine applies. To give some content to "relevance," the Code adopts a functional definition, according to which the economic substance doctrine is "the common law doctrine under which [income] tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose."[137] This definition has three key elements: (1) a common law doctrine, (2) disallowance of income tax benefits, and (3) lack of economic substance or business purpose as the reason for the disallowance. The Code does not suggest any other alternative or additional bases for determining the coverage of the economic substance doctrine. The codified economic substance doctrine thus encompasses any common law doctrine that disallows income tax benefits with respect to a transaction (or series of

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134. See supra note 37 and accompanying text (describing conjunctive economic substance doctrine).

135. I.R.C. § 7701(o)(1) (Supp. IV 2011) (emphasis added); see also JCX-18-10, supra note 35, at 153 ("The provision clarifies that the economic substance doctrine involves a conjunctive analysis . . . . Under the provision, a transaction must satisfy both tests . . . ."); House Report, supra note 131, at 297 (identical language).

136. I.R.C. § 7701(o)(1), (5)(C).

137. Id. § 7701(o)(5)(A). The Code defines "transaction" to include "a series of transactions." Id. § 7701(o)(5)(D). It does not define either "economic substance" or "business purpose." Cf. id. § 7701(o). The section's operative provision may provide some guidance by requiring "change[] (apart from Federal income tax effects) [to] the taxpayer's economic position" (economic substance) and "substantial purpose (apart from Federal income tax effects) for entering into [the] transaction" (business purpose). Id. § 7701(o)(1)(A), (B). These formulations are generally consistent with courts' requirements as to each factor. Cf. supra notes 33–34 (noting judicial formulations and identifying potentially relevant factual issues).

transactions) because the transaction (or series) lacks economic substance or a business purpose (or both).[138]

2. *Penalty Under Codified Economic Substance Doctrine.* — Section 6662(b)(6) imposes a 20% penalty corresponding to the codified economic substance doctrine.[139] Unlike other underpayment penalties, which generally do not apply to underpayments caused by positions that were reasonable for taxpayers to take,[140] the penalty does not have a reasonable cause exception.[141]

The penalty applies to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law."[142] The Code does not define "similar rule of law." If the term is to have any meaning, it must include at least other common law substance over form doctrines.[143] The scope of the heightened penalty thus depends on the vague term "similar." The provision's phrasing implies that it reaches beyond the definition in § 7701(o)(5)(A).[144] The Joint Committee on Taxation explains,

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138. See JCX-18-10, supra note 35, at 154 n.353 ("[T]he definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both."); House Report, supra note 131, at 297 n.134 (identical language).

139. I.R.C. § 6662(a), (b)(6) (2006 & Supp. IV 2011). The penalty rises to 40% if the taxpayer did not disclose and report the challenged transaction ex ante. I.R.C. § 6662(i)(1), (2) (Supp. IV 2011).

140. See, e.g., I.R.C. § 6664(c)(1) (2006) ("No penalty shall be imposed . . . with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.").

141. I.R.C. § 6664(c)(2) (Supp. IV 2011) ("[Reasonable cause exception] shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6)."); see also JCX-18-10, supra note 35, at 156 ("No exceptions (including the reasonable cause rules) to the penalty are available . . . ."); House Report, supra note 131, at 304 (identical description).

142. I.R.C. § 6662(b)(6). The penalty does not extend to underpayments due to fraud, I.R.C. §§ 6662(b), 6663 (2006), or certain "reportable transactions," I.R.C. §§ 6662(b), 6662A, 6707A (2006 & Supp. IV 2011).

143. In its report on the provisions, the Joint Committee on Taxation implies general agreement with this interpretation of the phrase, referring to "any other rule of law, including any common-law doctrine." JCX-18-10, supra note 35, at 155; accord House Report, supra note 131, at 298 (identical language); see also Heather C. Maloy, Large Bus. & Int'l Div., IRS, LB&I-4-0711-015, Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (2011), http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties [hereinafter LB&I Directive] (on file with the *Columbia Law Review*) (contemplating, though administratively prohibiting, "impos[ition] [of § 6662(b)(6) penalty] due to the application of any other 'similar rule of law' or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction)").

144. See I.R.C. § 6662(b)(6) (Supp. IV 2011) (covering "transaction[s] lacking economic substance . . . *or* failing to meet the requirements of any similar rule of law" (emphasis added)).

> It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.[145]

This still does not define "similar" but suggests that the focus should be "factors" and "analysis."[146] Those terms, in turn, suggest reference to the facts courts find relevant and the reasoning they build on those facts. The penalty provision thus seems to cover disallowances under common law doctrines to which determinations of substance or purpose are relevant, factually or analytically, although the exact degree of relevance required is unclear.

B. *Application of Codified Economic Substance Doctrine to Step Transaction Doctrine Formulations*

This section applies the definition of the codified economic substance doctrine and finds that it encompasses some, but not all, of the various formulations of the step transaction doctrine. The text, history, and regulatory treatment of the codified economic substance doctrine suggest a desire to avoid interfering with the common law substance over form doctrines beyond the statute's specific terms. The Code makes clear that courts should determine the doctrine's relevance "as if this subsection had never been enacted."[147] The Joint Committee Report explains that "[t]he provision is not intended to alter or supplant any other rule of law, including any common-law doctrine."[148] The IRS has suggested that it does not seek to expand application of the economic substance doctrine under the new provision,[149] and some divisions have limited their imposition of the new penalties.[150]

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145. JCX-18-10, supra note 35, at 155 n.359; cf. House Report, supra note 131, at 304 n.161 (referring to "*same* factors and analysis" but otherwise identical (emphasis added)).

146. The report does not define either term. See JCX-18-10, supra note 35, at 155 n.359. However, it does refer to "factors" as means, such as profit potential, "to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-income-tax purpose." Id. at 154.

147. I.R.C. § 7701(o)(5)(C).

148. JCX-18-10, supra note 35, at 155; accord House Report, supra note 131, at 298 ("No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, the provision shall not be construed as alter [sic] or supplanting any other rule of law, including any common-law doctrine . . . .").

149. See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411, 412 ("If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant . . . .").

150. See LB&I Directive, supra note 143 ("[T]he penalties provided in sections 6662(b)(6) . . . are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other 'similar rule of law' or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).");

However, although these points suggest restraint in the codified doctrine's application, they do not provide much guidance as to its scope. The underlying difficulty is defining the starting point from which the codified doctrine operates. Expressions of intent to limit the statute to the economic substance doctrine are not useful without knowing what that doctrine is. As such, application of the codified economic substance doctrine depends on the Code's definition of the doctrine.[151]

The statutory definition of the economic substance doctrine does not reach any formulations of the binding commitment test. Application of that test always depends on the presence or absence of a more or less formal obligation to carry out a series of steps.[152] The steps' lack of substance or purpose is not relevant to, let alone the reason for, disallowance under the binding commitment test.

Application of the codified economic substance doctrine to the rest of the step transaction doctrine varies between and within courts,[153] splitting roughly along the line dividing discrete and continuous approaches to the step transaction inquiry.[154] Courts that decide whether to apply the step transaction doctrine by looking at each step individually tend to base their decisions on the steps' substance and purpose (or lack thereof); those that decide by looking at the series as a whole tend to focus on other factors.[155] Subsection 1 describes formulations of the step transaction doctrine that are encompassed by the codified economic substance doctrine. Subsection 2 describes a formulation that is "similar" to the codified doctrine. Subsection 3 describes formulations that are wholly separate.[156]

Heather C. Maloy, Large & Mid Size Bus. Div., IRS, LMSB-20-0910-024, Codification of Economic Substance Doctrine and Related Penalties (2010), http://www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties (on file with the *Columbia Law Review*) ("[A]ny proposal to impose a section 6662(b)(6) penalty . . . must be reviewed and approved by the appropriate Director . . . before the penalty is proposed.").

151. See supra notes 137–138 and accompanying text (analyzing definition).

152. See supra Part I.C.2.a (describing test). The Seventh Circuit's unusually broad application of the test maintains the underlying commitment inquiry and just relaxes its strictness. See McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982) (looking to parties' incentives and finding facts "satisfy the spirit, if not the letter" of test). In some cases, the test also requires that the series span a minimum amount of time. See, e.g., id. (finding test formulated to address multiyear transactions).

153. See infra Part II.C (summarizing inconsistency).

154. See supra Part I.C.3 (distinguishing between formulations of step transaction doctrine).

155. The Fifth Circuit is the exception. See infra notes 167–172 and accompanying text (applying codified economic substance doctrine to Fifth Circuit's formulation of step transaction doctrine). For discussion of the impact of economic substance and business purpose on application of the step transaction doctrine, see generally Keinan, Rethinking, supra note 52, at 78–95.

156. As explained above, supra note 81, the Fourth, Eighth, and Eleventh Circuits have not clearly articulated the step transaction doctrine.

1. *Step Transaction Doctrine as Economic Substance Doctrine: Formulations in the First, Fifth, Tenth, D.C., and Federal Circuits.* — The Court of Federal Claims' application of the Federal Circuit's interdependence test[157] exemplifies formulations of the step transaction doctrine that fall under the definition of the codified economic substance doctrine. Considering the steps in the series individually, the court noted that "[e]ach of these steps produced the tax effects that [the taxpayers] claim" but determined that "none is supported by any tax-independent business purpose."[158] The court made the overlap with the economic substance doctrine obvious by expressly importing the results from its analysis of the steps' business purpose into its step transaction inquiry.[159] Because disregarding the intermediate steps meant that "[the taxpayer] [was] unable to claim a basis increase," the court concluded that "the capital gains must be taxed according to the reality of the transaction"[160] and "disallowed the stated basis" and "increased the [taxpayer's] capital gain income with respect to the [transaction]."[161] This version of the step transaction doctrine fits comfortably within the statutory definition of the economic substance doctrine as a "common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction . . . lacks a business purpose."[162]

The definition of the codified economic substance doctrine applies similarly in other courts taking discrete approaches to the step transaction inquiry. The First Circuit declines to apply the step transaction doctrine when the individual steps are "legal transactions not fictitious or so lacking in substance as to be anything different from what they purported to be," strongly implying that it would not respect fictitious or insubstantial transactions.[163] The Tenth Circuit directly states that "the absence of economic effects or business purposes may be fatal to a taxpayer's step transaction refund suit."[164] Similarly, in the D.C. Circuit,

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157. See Stobie Creek Invs., LLC v. United States, 82 Fed. Cl. 636, 698–702 (2008), aff'd on other grounds, 608 F.3d 1366 (Fed. Cir. 2010); supra notes 86–87 and accompanying text (describing formulation).

158. 82 Fed. Cl. at 700.

159. Id. at 699 ("Underlying this approach are the court's earlier findings regarding lack of business purpose for the individual steps . . . .").

160. Id. at 702.

161. Id. at 640.

162. I.R.C. § 7701(o)(5)(A) (Supp. IV 2011); see also id. § 7701(o)(5)(D) ("The term 'transaction' includes a series of transactions.").

163. Granite Trust Co. v. United States, 238 F.2d 670, 678 (1st Cir. 1956); see also supra notes 82–84 and accompanying text (describing formulation). The result is the same for the leading recent district court step transaction decision. See Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49, 206–10 (D. Mass. 2010) (applying doctrine for lack of "business purpose," encompassing economic effect and business justification), aff'd on other grounds, 661 F.3d 667 (1st Cir. 2011).

164. True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999); see also supra notes 88, 93 and accompanying text (describing formulation). That the court rejects the con-

"'the absence of a nontax business purpose is fatal'" and "the courts . . . will ignore a step in a series of transactions if that step does 'not *appreciably* affect [the taxpayer's] beneficial interest.'"[165] Under each of these formulations of the step transaction doctrine, "tax benefits . . . are not allowable if the transaction does not have economic substance or lacks a business purpose."[166]

Despite approaching a series of steps as a continuous whole, the Fifth Circuit's formulation of the step transaction doctrine[167] likely falls under § 7701(o). The court has suggested that the doctrine functions to "allow[] the disregard of steps that have no substance"[168] and, in earlier cases, undertook economic substance and business purpose inquiries into whole series. For example, the court entertained and rejected a taxpayer's claim that "the exact structuring of the . . . arrangement was dictated by a valid business purpose."[169] The court noted that "rejection of taxpayer's argument . . . makes unnecessary a present determination of the circumstances, if any, in which a legitimate business purpose would justify [the taxpayer's] legal characterization of the discrete steps."[170] This implies that while lack of business purpose may not be necessary for applying the step transaction doctrine, it is relevant (or the court would not have considered it at all) and perhaps sufficient (because the court may be suggesting that finding no business purpose ends the inquiry) for disallowance.[171] In another case, the court emphasized the conclusion that "the relative positions of the parties following th[e] well-engineered series of exchanges was . . . substantially the same as it would have been had they chosen the direct rather than the circuitous route" and noted that the taxpayer had "not once suggested any conceivable legitimate

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verse proposition, 190 F.3d at 1177 ("To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose . . . or (2) point to an economic effect . . . , would frequently defeat the purpose of the substance over form principle."), is not relevant because the statutory definition only looks to the circumstances "under which tax benefits . . . are not allowable," I.R.C. § 7701(o)(5)(A).

165. Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 214 (D.C. Cir. 2001) (alteration in original) (quoting ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 512, 514 (D.C. Cir. 2000)) (internal quotation marks omitted); see also supra note 85 and accompanying text (describing formulation).

166. I.R.C. § 7701(o)(5)(A).

167. See supra notes 97–98 and accompanying text (describing formulation).

168. G.M. Trading Corp. v. Comm'r, 121 F.3d 977, 979 n.2 (5th Cir. 1997).

169. Kuper v. Comm'r, 533 F.2d 152, 158–59 (5th Cir. 1976).

170. Id. at 159 n.12.

171. The court has also highlighted the asymmetric impact of business purpose as a factor: Its absence is sufficient for disallowance, but its presence is not sufficient for recognition. See United States v. Gen. Geophysical Co., 296 F.2d 86, 90 & n.5 (5th Cir. 1961) (noting "[i]f these transactions could not have been explained by valid nontax reasons, they obviously . . . could not have been effective," accepting assertion "that the transactions were prompted by a valid business purpose and were effected without a motive of tax avoidance," and explaining that acceptance "do[es] not control the disposition of the case").

business purpose that might have dictated the utilization of such a convoluted sequence."[172] In each case, tax benefits were not allowed because transactions lacked economic substance or a business purpose.

2. *Step Transaction Doctrine as "Similar" to Economic Substance Doctrine: Formulation in the Ninth Circuit.* — Although the Ninth Circuit also approaches the step transaction inquiry discretely, looking at each step individually,[173] its formulation of the doctrine does not fit within the definition of the codified economic substance doctrine. Applying the interdependence test, the court looks to whether each step "is an ordinary and objectively reasonable business activity;"[174] applying the end result test, it focuses on whether "[t]he result sought" as to each step "is consistent with the tax treatment that [the taxpayers] seek."[175] The factors that determine whether the court will allow claimed tax benefits are not economic substance or business purpose but ordinariness and consistency. Thus the formulation does not fall under § 7701(o).[176]

However, the Ninth Circuit's factors function much like economic substance and business purpose inquiries. A transaction with no business purpose likely could not be "an ordinary and objectively reasonable business activity."[177] Likewise, the court's comparison of "[t]he result sought" with "the tax treatment that [the taxpayers] seek" likely implicates both the substance and the purpose of the transaction.[178] The court is unlikely to find any tax benefit to be "consistent with" a transaction with no economic effects and no motivation other than tax considerations.[179] The Ninth Circuit's formulation thus makes economic substance and business purpose relevant, as "factors and analysis,"[180] to the step transaction doctrine and likely qualifies as a "rule of law" "similar" to the codified economic substance doctrine.[181]

3. *Step Transaction Doctrine as Separate from Economic Substance Doctrine: Formulations in the Second, Third, Sixth, Seventh, and Federal Circuits.* — The Second Circuit's treatment of the step transaction doctrine provides a clear example of a formulation that gives determinative weight to factors other than economic substance and business purpose and thus exceeds the codified economic substance doctrine's reach.[182] Applying the end

172. Crenshaw v. United States, 450 F.2d 472, 476, 475 n.5 (5th Cir. 1971).

173. See supra notes 89–92 and accompanying text (describing formulation).

174. Linton v. United States, 630 F.3d 1211, 1224 (9th Cir. 2011).

175. Id.

176. Cf. I.R.C. § 7701(o)(5)(A) (Supp. IV 2011) (defining "economic substance doctrine" as "common law doctrine under which tax benefits . . . are not allowable if the transaction does not have economic substance or lacks a business purpose").

177. *Linton*, 630 F.3d at 1224.

178. Id.

179. Id.

180. Cf. JCX-18-10, supra note 35, at 155 n.359.

181. I.R.C. § 6662(b)(6).

182. See supra notes 94–96, 105 and accompanying text (describing formulation).

result test, the court requires "a prearranged plan for [completion of the series of steps]" and elaborates that "although the arrangement . . . need not be a legally binding one, there must at least be a showing of an informal agreement or understanding."[183] Even under the interdependence test, the court asks whether taxpayers "undert[ook] a series of steps according to an overall plan in order to obscure the character of the transaction."[184] In addition to planning, the Second Circuit's version of the interdependence test emphasizes the sequence of the steps.[185] The ordering and relationship between the steps as taken, rather than the substance and purpose of each standing alone, is determinative. According to this formulation, disallowance of benefits under the step transaction doctrine does not depend on an inquiry into the transactions' substance or purpose and does not fall under § 7701(o). Moreover, the relevant factors—planning and the relationship between steps—do not necessarily coincide with, and are not analytically related to, substance or purpose. Thus the formulation likely is not "similar" to the codified economic substance doctrine under § 6662(b)(6).[186]

Other courts taking continuous approaches to the step transaction inquiry similarly escape the new statute. The Third Circuit focuses on steps' relationship to each other and to the planned outcome.[187] The Sixth Circuit focuses on the taxpayer's intent to achieve a certain end result.[188] The Seventh Circuit looks to taxpayers' intent and the relation-

183. Greene v. United States, 13 F.3d 577, 583 (2d Cir. 1994); cf. Long-Term Capital Holdings, LP v. United States, 150 Fed. App'x 40, 43 (2d Cir. 2005) (applying doctrine when "all of the steps . . . were pre-planned").

184. *Greene*, 13 F.3d at 585.

185. See id. at 584 (explaining inquiry as "whether each step in a series of transactions would have been fruitless had not the subsequent steps occurred").

186. Of course, a broad enough reading of "similar" could encompass this (and any other) formulation. The step transaction doctrine is, after all, similar to the economic substance doctrine in many ways: Both are extrastatutory judicial doctrines in tax law, and both derive from the substance over form principle. See supra Part I.D (describing relationship between doctrines). This Note assumes some sort of meaningful limit to similarity under § 6662(b)(6). Cf. supra Part II.A.2 (interpreting provision). In any case, if this assumption does not hold, the alternative would have an obvious effect (heightened penalties for disallowance under any substance over form doctrine) and leave no room for interesting analysis.

187. See Am. Bantam Car Co. v. Comm'r, 11 T.C. 397, 405–06 (1948) (asking "[w]ere the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?" and respecting transaction that was "secondary and supplemental to the principal goal of the plan"), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949); supra notes 106–109 and accompanying text (describing formulation); cf. Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 262 (D.N.J. 2009) (applying doctrine although "the government identified no meaningless or unnecessary steps"), aff'd on other grounds sub nom. Merck & Co. v. United States, 652 F.3d 475 (3d Cir. 2011).

188. See Brown v. United States, 782 F.2d 559, 564 (6th Cir. 1986) (emphasizing end result test "clearly makes intent a necessary element for application of the doctrine"); supra notes 101–102 and accompanying text (describing formulation). The court acknowl-

ships between steps, emphasizing particular facts like "the history of the parties' relationships," parties' "historic stance in . . . negotiations," and "hammered-out terms."[189] The Federal Circuit, under Court of Claims precedent, formulates the end result test to require that "the facts of the case show a plan to have existed," although "[a] formal plan . . . is not necessary."[190] These formulations base disallowance on findings other than lack of economic substance or business purpose and employ different factors and analyses in their determinations.

C. *Inconsistency*

Applying the codified economic substance doctrine to the various formulations of the step transaction doctrine reveals and exacerbates inconsistency in multiple dimensions. The coverage of each step transaction test[191] and of the doctrine as a whole[192] varies between courts. The coverage of the doctrine also varies within some courts.[193]

The codified economic substance doctrine thus makes variations in courts' formulations of the step transaction doctrine significant. Prior to codification, the problem was doctrinal messiness, mostly limited to dicta, with little clear impact on the outcomes of cases.[194] Now, under §§ 7701(o) and 6662(b)(6), different formulations of the step transaction doctrine may subject taxpayers to different requirements, analyses,

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edges the substance and purpose inquiries but does not treat them as central to the step transaction doctrine. See Aeroquip-Vickers, Inc. v. Comm'r, 347 F.3d 173, 183 (6th Cir. 2003) (applying doctrine "[n]otwithstanding th[e] [transactions'] business purpose" and without disputing taxpayer's contention that "the whole transaction and each step along the way had economic substance" (internal quotation marks omitted)).

189. McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 524 (7th Cir. 1982); see also supra notes 103–104 and accompanying text (describing formulation).

190. King Enters., Inc. v. United States, 418 F.2d 511, 519 n.11 (Ct. Cl. 1969); see also supra note 100 and accompanying text (describing formulation).

191. The interdependence test falls under § 7701(o) in the First, Fifth, Tenth, D.C., and Federal Circuits, falls under § 6662(b)(6) in the Ninth Circuit, and remains separate in the Second, Third, Sixth, and Seventh Circuits. The end result test falls under § 7701(o) in the First, Fifth, Tenth, and D.C. Circuits, falls under § 6662(b)(6) in the Ninth Circuit, and remains separate in the Second, Third, Sixth, Seventh, and Federal Circuits. See supra Part II.B.

192. The whole step transaction doctrine falls under § 7701(o) in the First, Fifth, Tenth, and D.C. Circuits, falls under § 6662(b)(6) in the Ninth Circuit, and remains separate in the Second, Third, Sixth, and Seventh Circuits. See supra Part II.B.

The IRS has taken the position that, at least in certain contexts, "the substance of each of a series of steps will be recognized and the step transaction doctrine will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes." Rev. Rul. 79-250, 1979-2 C.B. 156, 157. To the extent this formulation implies its converse, the doctrine easily fits under § 7701(o).

193. In the Federal Circuit, the interdependence test falls under § 7701(o) while the end result test remains separate. See supra Part II.B.1, 3.

194. See supra Part I.C.3 (describing variation in step transaction doctrine).

and penalties and may determine which, if any, defenses are available. Depending on the jurisdiction, the same series of transactions may face a 40% strict liability penalty under conjunctive economic substance analysis, the same penalty under a substance- or purpose-focused version of step transaction analysis, or a 20% penalty with a reasonable cause exception under one of the countless other variations on the step transaction inquiry. This variation and lack of predictability will present a substantial obstacle to efficient planning and decisionmaking by taxpayers.

III. PROPOSAL TO CLARIFY ROLES OF CODIFIED ECONOMIC SUBSTANCE DOCTRINE AND STEP TRANSACTION DOCTRINE BY PUTTING ECONOMIC SUBSTANCE DOCTRINE FIRST

Applying the codified economic substance doctrine to variations of the step transaction doctrine reveals inconsistency; different formulations of the doctrine elicit different treatments under the statute.[195] Although manifesting as inconsistency within the step transaction doctrine, the underlying problem is disagreement about the relationship between the economic substance and step transaction doctrines.[196]

This disagreement existed before Congress codified the economic substance doctrine. Courts disagreed about whether a lack of economic substance or business purpose was necessary, sufficient, both, or neither for applying the step transaction doctrine.[197] Before codification, however, most questions about the relationship between the doctrines had low stakes. The doctrines essentially presented two paths to the same outcome,[198] and the questions often implicated little more than which findings overlapped and how much independent analysis was necessary for an alternative holding.[199]

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195. See supra Part II.C (summarizing divergent outcomes).

196. See supra Part II.B (finding coverage by codified economic substance doctrine to track approach to step transaction inquiry). But see supra notes 167–172 and accompanying text (acknowledging Fifth Circuit as exception). See generally supra Part I.D (discussing relationship between doctrines).

197. See supra Part I.D (describing disagreement).

198. Courts could even avoid choosing between them by deciding cases in the alternative. See, e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 128 (D. Conn. 2004) (disallowing benefits on both theories), aff'd, 150 Fed. App'x 40 (2d Cir. 2005).

199. The relationship between the judicial economic substance and step transaction doctrines under the common law could occasionally implicate a more important issue: the ultimate scope of the substance over form principle. The extent, if any, to which the step transaction doctrine extended beyond transactions lacking substance or purpose created variation in how far courts could reach when disregarding formal compliance with the Code. Compare, e.g., True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999) (making clear step transaction doctrine reaches some transactions with substance and purpose), with, e.g., Del Commercial Props. v. Comm'r, 251 F.3d 210, 213–14 (D.C. Cir. 2001) ("In step-transaction cases, . . . 'the inquiry turns on the existence of a nontax business motive.'" (quoting ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 512 (D.C. Cir. 2000))).

The codified economic substance doctrine has two main effects on the disagreement. First, it makes the inconsistency significant. By adopting a functional definition of the economic substance doctrine, the Code encompasses certain formulations of the step transaction doctrine.[200] Thus, some variations of the step transaction doctrine must incorporate the statutory requirements of the codified economic substance doctrine. Second, codification raises a new question about the relationship between the economic substance and step transaction doctrines. Because the Code now clearly differentiates the results of applying the two doctrines,[201] the determination of which doctrine to apply when both might be relevant takes on central importance.

This Note does not address the first effect beyond demonstrating it[202] and suggesting the obvious solution: Courts should formulate the step transaction doctrine more consistently.[203] As to the second effect, this Part argues that the step transaction doctrine should be available only if the economic substance doctrine does not apply. Section A justifies sequencing the doctrines. Section B addresses implementation.

A. *Why To Put Economic Substance Doctrine First*

Few courts or academics have addressed the ordering of the economic substance and step transaction doctrines.[204] As explained above, they had no reason to; the doctrines were complements, not substitutes, and could apply simultaneously.[205] Under §§ 7701(o) and 6662(b)(6), however, the Code now dictates special treatment if the economic substance doctrine applies[206] but does not say what to do if the step transac-

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200. See supra Part II.A.1, B (describing effect and applying codified doctrine).

201. Under § 6662(b)(6), the economic substance doctrine generates a strict liability penalty; the step transaction doctrine might not. I.R.C. § 6662(b)(6) (Supp. IV 2011).

202. See supra Part II.B–C (presenting and summarizing inconsistency).

203. Adopting a clear formulation of the step transaction doctrine raises the threshold question of whether the doctrine should have a separate existence at all or should (as it might in some courts, see supra Part II.B.1) collapse into the economic substance doctrine. In the absence of any clear indication to the contrary in the case law, see supra Part I.D (noting separate treatment even when doctrines overlap), or legislative history, see supra notes 147–150 and accompanying text (noting vagueness of legislative intent as to codified economic substance doctrine), this Note assumes the step transaction doctrine's survival. If this assumption is correct and the doctrine retains some independent content, Part II.B recommends favoring a formulation of the step transaction inquiry that looks to the nature of a series of steps as a whole, rather than to individual steps, compare supra Part I.C.3.b (describing continuous approach), with supra Part I.C.3.a (describing discrete approach). What, specifically, the consensus formulation should be is beyond the scope of this Note.

204. But see Rosenberg, supra note 4, at 398 (interpreting business purpose doctrine "as a test for application of the step transaction doctrine").

205. See supra Part I.D (describing relationship before codification).

206. See I.R.C. § 7701(o)(1) (determining when, "[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance"); id. § 6662(a), (b)(6) (imposing penalty on underpayments

tion doctrine might also apply. Sequencing the doctrines, with an inquiry into economic substance coming before any step transaction analysis, addresses this issue. This section justifies, first in conceptual terms and then as a statutory matter, placing the doctrines in a sequential framework.

1. *Conceptual Justification of Sequencing Doctrines.* — Logically, the economic substance doctrine can precede the step transaction doctrine. In many situations, the former performs the same function as the latter[207] but acts more directly. If intermediate steps in a series lack economic substance or a business purpose, there is no reason to look any further. The steps, and any tax benefits they generated, may be disregarded. Analysis of the steps' relationship to each other or to the taxpayer's overall plan is unnecessary because, under the economic substance doctrine, their insubstantiality or purposelessness is sufficient for disallowance.[208]

The doctrines differ in their degree of this sort of autonomy. Discussion of steps' interdependence or contribution to taxpayers' desired end results does not add anything to economic substance analysis because the economic substance doctrine is essentially self-defining. Very little separates the proposition that certain transactions must have an economic effect or justification to generate tax benefits from the idea that economic substance and business purpose should be relevant factors. It takes work, though, to go from the idea of ignoring unnecessary, circuitous steps to a method for identifying those steps. Because the step transaction determination likely incorporates an inquiry into the transactions' substance and purpose,[209] recharacterizing transactions under the step transaction doctrine before applying the economic substance doctrine does not get anywhere any more directly.

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attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o))"); supra notes 134–135, 139–141 and accompanying text (describing new provisions).

207. See, e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 128 (D. Conn. 2004) (reaching same result by "disregard[ing]" transaction for "lack[] [of] economic substance" and "recast[ing] [it] under the step transaction doctrine"), aff'd, 150 Fed. App'x 40 (2d Cir. 2005).

208. See supra notes 31–34, 134–135 and accompanying text (noting doctrine's requirements and codification of conjunctive version). Steps' susceptibility to the economic substance doctrine may depend on whether each (or some subset) can be framed as an individual transaction. See Hariton, The Frame Game, supra note 80, at 221–22 (observing "all tax-motivated financial structures" involve "taking additional . . . steps to structure [the taxpayer's] business affairs in a manner that allows [the taxpayer] to avoid some of the tax that it would otherwise have to pay" and "the battle in the courts is primarily about 'framing' the transaction as consisting of either the narrower tax-motivated structures or steps . . . or of the broader business objectives"). That framing, however, is distinct from, see supra note 119 (distinguishing inquiries), and (by hypothesis here) prior to analysis under the step transaction doctrine.

209. Cf. cases cited supra notes 120–122 (disagreeing about effect but implicitly accepting potential relevance).

If (1) the economic substance and step transaction doctrines reach the same result when they overlap, (2) the economic substance doctrine is the direct (and now statutorily mandated[210]) way to reach that result, and (3) the step transaction doctrine is to survive,[211] then the step transaction doctrine must reach beyond the economic substance doctrine.[212] To reach beyond the economic substance doctrine, the step transaction doctrine must apply to transactions with both economic substance and a business purpose. It must be a backstop, the substance over form principle's last line of defense.[213] As a backstop, the step transaction doctrine would apply to series of transactions, all of which get past the economic substance doctrine, but whose aggregate effects "permit the true nature of a transaction to be disguised by mere formalisms."[214]

The considerations that justify addressing the economic substance doctrine before the step transaction doctrine also argue against treating the step transaction doctrine as a "similar rule of law" for the sake of imposing higher penalties and strict liability.[215] The term "similar" is not informative or helpful.[216] The basic issue underlying application of the penalty provision is the degree of separation between the step transaction and economic substance doctrines. This same issue underlies all aspects of the relationship between the doctrines and, each time it arises, this Note argues for a stronger distinction: The step transaction doctrine (if it is to survive) should have content separate from the economic substance doctrine;[217] it should occupy a different analytical stage than the economic substance doctrine;[218] and its availability should be expressly conditioned on the inapplicability of the economic substance doctrine.[219] Moreover, if the step transaction doctrine acts as a backstop, it will neces-

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210. Cf. infra Part III.A.2 (making statutory argument for putting economic substance doctrine first).

211. See supra note 203 (explaining assumption of doctrinal survival).

212. Courts have not articulated principled boundaries for either doctrine's availability, but the case law implies some limit to both. Cf., e.g., Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991) (upholding tax-motivated and intentionally insubstantial transaction without addressing economic substance doctrine); infra note 232 (considering "'relevance'" as possible statutory limit but dismissing term as not informative or useful (quoting I.R.C. § 7701(o) (Supp. IV 2011))).

213. Cf. Keinan, Rethinking, supra note 52, at 88 (using term "backstop" to describe tendency to give economic substance doctrine primacy and "rais[e] the step transaction argument as an alternative (rather than primary) argument to disallow tax benefits"). Because applying both doctrines alternatively is no longer possible, this Note gives "backstop" a slightly different meaning.

214. Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945).

215. I.R.C. § 6662(b)(6).

216. See supra Part II.A.2 (trying to interpret phrase); supra text accompanying notes 177–181 (trying to apply phrase); supra note 186 and accompanying text (same).

217. See supra note 203; supra Part III.A.1.

218. See supra Part III.A.1.

219. See infra Part III.B.

sarily apply only to transactions lacking both of the two defining characteristics (no economic substance and no business purpose[220]) that might explain punishing disallowances under the economic substance doctrine especially harshly. In the absence of a clear statutory indication to the contrary, the doctrines are not "similar."

2. *Statutory Justification of Sequencing Doctrines.* — Placing the economic substance doctrine before the step transaction doctrine is generally consistent with the new statutory scheme under §§ 7701(o) and 6662(b)(6). Requiring courts to use the codified economic substance doctrine if it is applicable prevents judges from having complete discretion over what analysis, penalty, and standard of liability to apply in any case where the doctrines might overlap.[221] This approach makes sense in terms of fostering clarity and predictability in the application of both doctrines. It is also consistent with the mandatory language of the Code,[222] which states that the 20% penalty "shall apply" if an underpayment is "attributable" to disallowance under the codified economic substance doctrine,[223] that the 40% penalty "shall be applied" to underpayments "attributable to . . . nondisclosed noneconomic substance transactions,"[224] and that the reasonable cause exception "shall not apply" to penalties under the codified economic substance doctrine.[225]

Similarly, forcing courts to decide the economic substance issue before reaching the step transaction doctrine puts pressure on the question of whether the economic substance doctrine applies.[226] The determination of transactions' economic substance and business purpose has, and will continue to develop, some more or less objective content.[227] Evaluating substance and purpose, courts look to factors that tend to recur across cases and remain somewhat consistent. They thus face strong incentives to take the inquiry seriously and to avoid setting precedent that might distort the economic substance determination going forward. But if courts are free to decide cases under the step transaction doctrine instead,[228] they have an obvious alternative to ruling on economic sub-

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220. See infra Part III.B (advocating conditions for application).

221. Cf. Lipton, supra note 36, at 333 (wondering "whether a court will be required to impose the penalty under Section 6662(i) if the tax benefits for a transaction also could be disallowed on other grounds").

222. See supra Part II.A.2 (interpreting penalty provisions).

223. I.R.C. § 6662(b)(6) (Supp. IV 2011).

224. Id. § 6662(i)(1).

225. Id. § 6664(c)(2).

226. Cf. id. § 7701(o) (limiting codified doctrine to "transaction[s] to which the economic substance doctrine is relevant").

227. See supra notes 33–34 (describing factors, formulations, and potentially relevant factual issues).

228. Cf., e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 128 (D. Conn. 2004) (deciding under both doctrines, in the alternative), aff'd, 150 Fed. App'x 40 (2d Cir. 2005).

stance. Putting the economic substance inquiry first removes the possibility of such an easy escape and helps give full effect to the codified doctrine.

Sequencing the doctrines and using the step transaction doctrine as a backstop is also consistent with justifying the doctrines as means for furthering legislative intent or policy considerations, rather than as tools for somehow revealing transactions' objective "true nature."[229] Framed in these terms, the economic substance doctrine gives effect to a general legislative policy decision, implied throughout the Code, that tax benefits require economic substance and a business purpose, and the step transaction doctrine gives effect to additional similar implied decisions that certain tax benefits can be generated only in certain ways.[230]

B. *How To Put Economic Substance Doctrine First*

This Note argues that the economic substance doctrine should come before the step transaction doctrine;[231] courts must try to apply the codified economic substance doctrine before turning to the step transaction doctrine. Practically, this means that application of the step transaction doctrine requires first finding that the challenged transactions had both economic substance and a business purpose.[232] This condition severely constricts the step transaction doctrine's availability while also clarifying and focusing its function. Thus formulated, the step transaction doctrine acts as a backstop. The doctrine catches cases in which a series of transactions, each of which has some economic substance and a business purpose and would be respected standing alone, combine to generate an

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229. See supra notes 43–44, 117 and accompanying text (presenting and noting strengths of intent- and policy-based justifications).

230. Also, to the extent that Congress implied a preference for the economic substance doctrine by choosing to codify it before any other application of the substance over form principle, giving the doctrine primacy furthers that specific intent. However, given the general confusion about the relationship between the economic substance and step transaction doctrines under the common law, see supra Part I.D (describing disagreement), ambiguity of the legislative intent regarding the codified economic substance doctrine's effect on other judicial doctrines, see supra notes 147–151 and accompanying text (finding indications of intent unhelpful in defining scope of codified doctrine), and possibility of other motivations for passing the new legislation, see supra note 133 (suggesting relevance of revenue considerations), the additional persuasiveness of this point is unclear.

231. See supra Part III.A.

232. Cf. I.R.C. § 7701(o)(1) (Supp. IV 2011) (imposing conjunctive version of economic substance doctrine); supra Part II.A.1 (describing content of codified doctrine). The Code's reference to "any transaction to which the economic substance doctrine is relevant," I.R.C. § 7701(o)(1), may suggest "relevance" as another limit on the codified doctrine's application (and thus, if absent, a possible ground for the step transaction doctrine's availability). However, in the context of a wholly judicial doctrine with no external source or well-defined explanation, "relevance" is not an informative term or a useful constraint.

unacceptable result.[233] Of course, the number of cases caught by such a backstop depends on courts' willingness to disregard transactions that not only comply with all formal requirements but also have real economic effects and business justifications. This Note does not attempt to articulate the optimal content or formulation of the doctrine.[234]

CONCLUSION

Attempting to resolve messiness in one doctrine, Congress exacerbated inconsistency in another. But the root of the problem lies in judicial formulations of the economic substance and step transaction doctrines; Congress's choice to codify the economic substance doctrine merely accentuated it. Since long before Congress intervened in 2010, courts applied related and overlapping doctrines without clearly or consistently articulating the relationship between them. When the doctrines were both wholly judicial creations and equivalent, the confusion was mostly limited to dicta. Now that Congress has incorporated the economic substance doctrine from the common law into the Code and given it its own penalty provision, the doctrinal uncertainty can generate practical inconsistency. The solution is straightforward: Courts should clarify the relationship between the doctrines. This Note has argued that the best way to do so is to put the doctrines in a sequence, with the economic substance inquiry occurring first and the step transaction doctrine acting as a backstop.

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233. Cf. True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999) ("To ratify a step transaction [doctrine] that exalts form over substance merely because the taxpayer can . . . articulate some business purpose . . . or . . . point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle.").

234. Cf. supra note 203 (mentioning Note's limits).

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