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Trafficking-In and Harvesting Tax Benefits May Be Subject to Restrictions and Limitations

Ray A. Knight

Dr. Lee G. Knight

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Trafficking-In and Harvesting Tax Benefits May Be Subject to Restrictions and Limitations

RAY A. KNIGHT* & DR. LEE G. KNIGHT**

ABSTRACT

Trafficking in and harvesting preexisting or manufactured tax losses and credits may be both beneficial and lucrative, but it may be subject to restrictions and limitations. Internal Revenue Code ("IRC") Section 269 generally provides that acquisition of control of a corporation to gain the benefit of a deduction, credit, or other allowance is prohibited. Does the Section 269 prohibition present a concrete barrier or is it just a smoke screen? This article examines the business purpose and economic substance doctrines to explain ways to circumvent Section 269. Then, this article analyzes IRC Section 382 to describe its impact and limitations when an "ownership change" is involved. Finally, this article discusses whether Section 382 applies to S corporations.

ABSTRACT 51
INTRODUCTION 52
I. SECTION 269 52
    A. *Creation of a New Corporation* 54
    B. *Judicial Doctrines* 56
    C. *Redemptions of Stock* 58
    D. *Definitions* 59
    E. *Focus on Business Purpose* 60
    F. *Economic Substance* 69
II. LOSS LIMITATIONS: IRC SECTION 382 79
    A. *S Corporations May Be Exempt from Section 382* 80
    B. *Fundamental Inconsistencies: Application of Section 382* 83
    C. *Technical Inconsistencies: Section 382 and S Corporations* 85
    D. *Miscellaneous Limitations on S Corporation Losses* 85
CONCLUSION 86

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*D, MA, CPA, PFS, Professor of Accounting, Elon University.
**PhD, Professor of Accounting, Emeritus, Wake Forest University.

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Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

INTRODUCTION

The lure of tax benefits can be overwhelming. Trafficking in and harvesting preexisting or manufactured tax losses and credits may be both beneficial and lucrative, but it may be subject to restrictions and limitations. Internal Revenue Code ("IRC") Section 269 generally provides that acquisition of control of a corporation to gain the benefit of a deduction, credit, or other allowance is prohibited. Does the Section 269 prohibition present a concrete barrier or is it just a smoke screen? This article examines the business purpose and economic substance doctrines to explain ways to circumvent Section 269. Then, this article analyzes IRC Section 382 to describe its impact and limitations when an "ownership change" is involved. Finally, this article discusses whether Section 382 applies to S corporations.

I. SECTION 269

Section 269 provides that if any person acquires control of a corporation for "the principal purpose" of "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person, or persons, or corporation, would not otherwise enjoy," then such deduction, credit, or other allowance may be disallowed.[1] "Control" is defined as "the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation."[2] Tax avoidance is the principal purpose of a transaction if it "exceeds in importance any other purpose."[3]

Congress enacted the predecessor to Section 269 in 1943 to give the Internal Revenue Service (the "Service") a weapon to combat certain then-common tax avoidance transactions, particularly transactions where a corporation with large excess profits acquired a corporation with current,

1. I.R.C. § 269(a); Treas. Reg. § 1.269-3(a)(2) (as amended in 1992).

2. I.R.C. § 269(a); Treas. Reg. § 1.269-5(a).

3. Treas. Reg. § 1.269-3(a)(2); *see* I.R.C. § 269(a). Some courts have interpreted the statute to require that the tax avoidance purpose exceed all other purposes combined, not just any other purpose. *See* Bobsee Corp. v. United States, 411 F.2d 231, 239 (5th Cir. 1969); U.S. Shelter Corp. v. United States, 13 Cl. Ct. 606, 620–21 (1987) (quoting and basing its analysis on the holding in *Bobsee*).

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

past, or prospective losses or other tax benefits "for the purpose of reducing income and excess profits taxes."[4] As Section 269 has been applied,

> [m]ost of the cases that have arisen under Section 269 and its predecessor, Section 129, have dealt with the sale by one control group to another of a corporation with, typically, a net-operating loss carryover, and the efforts of the new control group to utilize this carryover by funneling otherwise taxable income to a point of alleged confluence with the carryover.[5]

Although the statute may have been aimed primarily at specific types of abuses, the Tax Court stated that "[S]ection 269 is not limited to any particular form of transaction . . . [but] was broadly drafted to include any type of acquisition which constitutes a device by which one corporation secures a tax benefit to which it is otherwise not entitled."[6]

Under Section 269, the acquisition of control of a corporation can occur at the moment a new corporation is created.[7] For example, if a person "organize[s] two or more corporations instead of a single corporation in order to secure the benefit of multiple surtax exemptions[,]" Section 269 would disallow the surtax exemptions of the additional corporations.[8] In *Coastal Oil Storage Co. v. Commissioner*, an oil storage company organized a subsidiary and transferred to it oil storage tanks in exchange for all of the subsidiary's stock and a note.[9] Subsequently, the subsidiary claimed a corporate "surtax exemption and minimum excess profits credit."[10] The Service asserted that the predecessor of Section 269 applied and disallowed the subsidiary's tax benefits.[11] The Fourth Circuit agreed that the disallowance was proper, reasoning "that the parent corporation acquired complete control of" the subsidiary such that there was no business purpose for creating the subsidiary.[12] The court explained that the parent

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4. S. REP. NO. 78-627, at 58 (1943).

5. Zanesville Inv. Co. v. Comm'r, 335 F.2d 507, 509 (6th Cir. 1964).

6. Briarcliff Candy Corp. v. Comm'r, 54 T.C.M. (CCH) 667, 671 (1987) (holding that Section 269 applied to a loss corporation's acquisition of a profitable subsidiary).

7. *See* I.R.C. § 269(a); Treas. Reg. § 1.269-3(b)(3).

8. Treas. Reg. § 1.269-3(b)(2); *see* I.R.C. § 269(a); *see also* Treas. Reg. § 1.269-3(b)(3) (Section 269 operates to disallow tax benefits when a person "with high earning assets transfer[s] them to a newly organized controlled corporation retaining assets producing net operating losses").

9. Coastal Oil Storage Co. v. Comm'r, 242 F.2d 396, 397 (4th Cir. 1957).

10. *Id.*

11. *Id.* at 399; *see* Zanesville Inv. Co. v. Comm'r, 335 F.2d 507, 509 (6th Cir. 1964) (stating that Section 129 is the predecessor of Section 269).

12. *Coastal Oil Storage Co.*, 242 F.2d at 398–99.

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

company "was able to obtain through this splitting up of its corporate business the benefit of an exemption and credit which it would not otherwise have enjoyed."[13]

Another case illustrating this is *Borge v. Commissioner*, which involved a poultry business operated by entertainer Victor Borge.[14] For several years, Borge's unincorporated poultry business lost money, which Borge offset against his entertainment income.[15] Under Section 270's former language, the long history of losses would trigger a recomputation of (and substantial increase in) Borge's income taxes for prior years.[16] In an attempt to avoid this result, Borge formed a new corporation, transferred the poultry business to it, and then personally contracted with this new corporation to provide entertainment services, which generated substantial income for the new corporation.[17] The new corporation offset its losses from the poultry operation against the entertainment income.[18] The court held Borge formed the corporation for the purpose of securing a tax benefit and applied Section 269 to deny such benefit.[19]

A. Creation of a New Corporation

Under this line of authority and cases, it is clear that Section 269 can apply to the creation of new corporations and when the taxpayer seeks to

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13. *Id.*; *see also* James Realty Co. v. United States, 280 F.2d 394, 399 (8th Cir. 1960) (finding no real business purpose for creation of a new corporation that claimed surtax exemption and profits tax credit but did not derive income from activities different from those of controlling the company); I.R.S. Gen. Couns. Mem. 33093, at 2 (Oct. 4, 1965) ("[M]ultiple incorporation seems permissible, PROVIDED THAT LEGITIMATE BUSINESS REASONS FOR SEPARATE INCORPORATION EXIST." (footnote omitted)).

14. Borge v. Comm'r, 405 F.2d 673, 674 (2d Cir. 1968).

15. *Id.* at 675.

16. *Id.* at 674. In a footnote, the court quoted Section 270's then-current language:

> If the deductions allowed by this chapter . . . and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years . . . exceeded by more than $50,000 the gross income derived from such trade or business, the taxable income . . . of such individual for each of such years shall be recomputed. For the purpose of recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

Id. at 674 n.4 (ellipses in original).

17. *Id.* at 674–75.

18. *Id.* at 675.

19. *Id.* at 678.

use corporate form. Thus, Section 269 can be applied to deny deductions if the principal purpose of creating a new corporation is to avoid or evade federal income taxes by securing the benefit of a deduction, credit, or other allowance for the shareholders that they otherwise would not have enjoyed. In a typical case, Section 269 is applied to restrict the use of pre-acquisition losses after an acquisition regardless of whether the losses arose in the target or the acquiror.[20] The courts, however, have not applied Section 269 to the use of post-acquisition losses against post-acquisition income.[21] The few occasions where courts applied Section 269 to post-acquisition losses are limited to situations where the acquired corporation incurred losses and continued to incur losses after the acquisition.[22] If a new company is formed for a valid business purpose, such as to facilitate the division of risks and rewards of business operations, the new company should withstand any challenge—for example, if the company shows that it utilizes the corporate form to obtain limited liability and to provide flexibility to its shareholders in a wide range of strategies with more associated risks.[23]

A separate legal and tax existence of a corporation can be a legitimate business purpose. The choice of an S Corporation, even if made to secure the tax benefits of S Corporation status, does not trigger application of Section 269.[24] In *Coastal Oil Storage Co.* a company split up an existing

20. *See* Supreme Inv. Corp. v. United States, 468 F.2d 370, 376 n.9 (5th Cir. 1972).

21. *See* Zanesville Inv. Co. v. Comm'r, 335 F.2d 507, 514 (6th Cir. 1964); Herculite Protective Fabrics Corp. v. Comm'r, 387 F.2d 475, 476 (3d Cir. 1968).

22. *See* R.P. Collins & Co. v. United States, 303 F.2d 142, 143–44, 147 (1st Cir. 1962) (applying Section 269's predecessor); Hall Paving Co. v. United States, 471 F.2d 261, 262 (5th Cir. 1973).

23. Courts consistently hold that the limiting liability by insulating the assets of one business activity from the potential losses of another business activity constitutes a business purpose. *See* Bush Hog Mfg. Co. v. Comm'r, 42 T.C. 713, 726–27 (1964) (limiting liability, obtaining increased borrowing power from a bank, and simplifying reporting requirements were business purposes); Alcorn Wholesale Co. v. Comm'r, 16 T.C. 75, 88–89 (1951).

24. *See* Mod. Home Fire & Cas. Ins. Co. v. Comm'r, 54 T.C. 839, 853 (1970) (*acq.*); Rev. Rul. 76-363, 1976-2 C.B. 90 (creating a new domestic corporation to carry on a specific portion of the business of an existing domestic corporation for the primary purpose of gaining the tax benefits of Subchapter S is not tax avoidance under Section 269). The Tax Court in *Mod. Home* noted that Section 269 has been found to be inapplicable to situations in which taxpayers organized special purpose corporations to take advantage of the special treatment granted to those corporations. *Mod. Home*, 54 T.C. at 853; *see also* I.T. 3757, 1945-17 C.B. 200, 200 (ruling that even though the principal purpose for the formation of a Western Hemisphere Trade Corporation was to obtain the tax benefits provided for those corporations, such motivation does not constitute tax avoidance within the meaning of the predecessor of Section 269); Alinco Life Ins. Co. v. United States, 373 F.2d 336, 341 (Ct. Cl. 1967) (rejecting the Service's argument that Section 269 should be applied to deny corporations special tax treatment provided to life insurance companies).

business solely to gain a tax benefit.[25] In *Borge*, the court addressed incorporation of a loss-generating business for the tax benefit of the incorporator.[26] In neither instance was the newly formed entity established to pursue a separate and distinct business from that which previously existed; rather, an existing business adopted new form solely to obtain tax benefits.[27]

B. Judicial Doctrines

There are several judicially created doctrines that the Service often asserts to curb what they deem to be abusive transactions.[28] Pursuant to these doctrines, if a taxpayer engages in an abusive transaction, the transaction will be ignored or recast, and the tax benefits that the taxpayer sought to enjoy will be denied.[29] The parameters of these doctrines are not entirely clear, the relationships among them have not been expressly addressed, and the Service and the courts often use different terms (for example, "business purpose," "pre-tax profit motive," "economic substance," or "sham")[30] to identify what appear to be applications of the same doctrine. Yet, courts fail to use any single term consistently, leading to uncertainty about both the existence of separate doctrines and the proper application of any one of these doctrines. For example, in *ACM Partnership v. Commissioner*, the court addressed the interaction of the business purpose and economic substance test as follows:

> The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. However, these distinct aspects of the

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25. *See* Coastal Oil Storage Co. v. Comm'r, 242 F.2d 396, 397 (4th Cir. 1957); *see also supra* notes 9–13 and accompanying text.

26. *See* Borge v. Comm'r, 405 F.2d 673, 674–75 (2d Cir. 1968).

27. *See Coastal Oil Storage Co.*, 242 F.2d at 397; *Borge*, 405 F.2d at 677–78.

28. *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 244 (3d Cir. 1998); Frank Lyon Co. v. United States, 435 U.S. 561, 568–69 (1978).

29. *See ACM P'ship*, 157 F.3d at 246 ("[A] transaction that is 'devoid of economic substance . . . simply is not recognized for federal taxation purposes.'" (ellipses in original) (quoting *Lerman v. Comm'r*, 939 F.2d 44, 45 (3d Cir. 1991))); *Frank Lyon*, 435 U.S. at 572–73 ("[T]he Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred." (citations omitted)).

30. *See ACM P'ship*, 157 F.3d at 245, 247 (discussing "sham" transactions, "economic substance," and "business purpose"); *see also Frank Lyon*, 435 U.S. at 572–73 (applying the economic "substance over form" doctrine).

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

> economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.[31]

Nevertheless, a general statement regarding these doctrines is contained in *Frank Lyon Co. v. United States*.[32] There, the Supreme Court upheld a tax-motivated and tax-advantaged sale-leaseback transaction, stating:

> [W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[33]

Commenting on the Supreme Court's holding in *Frank Lyon Co.*, the Tax Court has stated:

> *Frank Lyon* stands for the principle that, in a sale-leaseback context, a nonuser-owner recipient of tax benefits must prove that his entry into the transaction was motivated by a business purpose sufficient to justify the form of the transaction. And further, he must show that the underlying transaction was supported by economic substance, i.e., the possibility of profit.[34]

Taken together, these quotations distinguish the cases decided under these judicially created doctrines. In cases where a taxpayer cannot show a business purpose for a transaction, such as an expectation of profit, the Service generally succeeds in attacking the transaction and denying the anticipated tax benefits. Conversely, where a taxpayer can show an expectation of profit and therefore establish a non-tax, business reason for the transaction, the taxpayer generally prevails. Given that a profit is generally contingent upon exposure to economic forces, the expectation of profit and the possible extent of that profit are often examined in the context

31. *ACM P'ship*, 157 F.3d at 247 (internal citations omitted).

32. *See Frank Lyon*, 435 U.S. at 583–84.

33. *Id.*

34. Rice's Toyota World v. Comm'r, 81 T.C. 184, 201–02 (1983) (footnote omitted), *aff'd in part*, *rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

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Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

of an objective assessment of the "economic substance" of the transaction.[35] Such an objective assessment either reveals that where the taxpayer had a basis for his expectation of a profit, the taxpayer prevails (that is, the transaction had "real" economics and thus an opportunity for profit), or it reveals that where the taxpayer had no objective basis for his assertion of an expected profit, the Service prevails (for example, the transaction could not produce a profit). In most cases, discussions of business purpose, expected profit, economic substance, and sham collectively point in one direction or the other, and where the Service has been successful in attacking a transaction, a finding that the transaction constituted a sham is often accompanied by a finding that the taxpayer lacked a profit expectation or other non-tax motive or that the transaction lacked economic substance.

C. Redemptions of Stock

An acquisition of control of a corporation by a shareholder for purposes of Section 269 can occur through a redemption of stock of a corporation for another stockholder or stockholders. In *Younker Bros., Inc. v. United States*, the taxpayer corporation and a third-party corporation each acquired about 35% of the stock of a company, which eventually incurred losses.[36] Later, the third party needed funds to, in part, pay for this stock acquisition.[37] The Company agreed to redeem a limited number of the third party's shares in the Company (the number was set below the amount that would trigger Section 382 net operating loss limitations).[38] As a result of the redemption, the taxpayer was left with over 50% of the total share value of the Company.[39] The Service sought to disallow the Company's net operating loss under Section 269 on the ground that the taxpayer acquired control of the Company through the redemption of third-party shares and did so with the principal purpose of securing the benefit of the operating losses.[40]

Although the taxpayer contended that it had not acquired control of the Company, the court held that the redemption constituted an acquisition of control within the meaning of Section 269.[41] The court also held, however,

35. *See, e.g.*, Compaq Comput. Corp. v. Comm'r, 113 T.C. 214, 223 (1999) ("Transactions that involve no market risks are not economically substantial transactions; they are mere tax artifices." (citation omitted)), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

36. Younker Bros., Inc. v. United States, 318 F. Supp. 202, 205 (S.D. Iowa 1970).

37. *Id.* at 204.

38. *Id.* at 205.

39. *Id.*

40. *Id.* at 203.

41. *Id.* at 206.

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

that the third party's decision to sell its stock to the Company through the redemption was (1) "based on a business judgment to avoid further losses in the operation of the business[,]" and (2) because the third party "needed funds to pay off the loan used in acquiring [the Company's] stock and for other purposes."[42] Thus, the taxpayer did not acquire control of the Company for the principal purpose of evasion or avoidance of income tax.[43]

D. Definitions

Section 269 does not specifically address whether a person who has control of a corporation (through ownership of over 50% of its voting power) can nonetheless thereafter "acquire" control for purposes of the statute by acquiring over 50% of the total value of all the corporation's stock.[44] Further, the issue does not appear to have been addressed in any reported case or Service ruling.

The statute defines control of a corporation by reference to "vote" or "value."[45] If a person owns over 50% of the voting power (but not the value) of the stock of a corporation and thereafter acquires over 50% of the value, can it be that the person then "acquires control" of the corporation? In our view, such a conclusion would ignore the ordinary meaning of the word "acquire."

"Acquire" is not defined by the statute and does not appear to be a term of art, which strongly supports applying an ordinary or plain meaning definition of the term.[46] As a matter of plain meaning, one cannot acquire

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42. *Id.*

43. *Id.* at 207. Similarly, in *Residential Developers, Inc. v. United States*, the taxpayer was a corporation owned by a group of stockholders. 12 A.F.T.R.2d (RIA) 5576, 5577 (E.D. La. 1963). The corporation admitted two other groups of stockholders "so that each of the three groups held one-third of the corporation's stock." *Id.* at 5577. The two new groups of stockholders became dissatisfied with the performance of the corporation, and, under pressure from these groups, the corporation redeemed their stock. *Id.* After the redemption, the corporation carried on its business as before. *Id.* The Service disallowed a deduction to the corporation under Section 269. *Id.* The court held that the redemption resulted in a change in control of the corporation. *Id.* at 5578. As in *Younker Bros.*, however, the court also held that the redemption was for business purposes and not to evade or avoid income tax. *Id.*

44. *See* I.R.C. § 269(a); Treas. Reg. §§ 1.269-1(c), 1.269-5(a) (as amended in 1992).

45. I.R.C. § 269(a).

46. *See, e.g.*, W. Union Tel. Co. v. Lenroot, 323 U.S. 490, 503 (1945) (concluding that where statute defined term "produced" to mean "handled" or "worked on" but did not define "handled" or "worked on," "[t]hese are terms of ordinary speech and mean what they mean in ordinary intercourse in this context"); Nix v. Hedden, 149 U.S. 304, 306 (1893) ("There being no evidence that the words 'fruit' and 'vegetables' have acquired any special meaning in trade or commerce, they must receive their ordinary meaning."); Rector of Holy Trinity

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Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

something that one already has acquired.[47] Thus, if a person has "control" of a corporation by vote, he cannot again acquire control by augmenting his ownership of value. Put another way, the definition of control is in the alternative. Once one of the alternative tests has been met—either "value" or "voting power"—control has been acquired. A subsequent satisfaction of the other test should not be regarded as another acquisition of control.

The legislative history of Section 269's predecessor reinforces this conclusion. In discussing transfers within a controlled or affiliated group, the Senate Finance Committee stated that:

> Control once acquired could not be again acquired, unless the group was in some way broken. A mere shift in the form of control—from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect—cannot, therefore, amount to the acquisition of control within the meaning of [S]ection 115 of the bill.[48]

This portion of the legislative history has been cited approvingly.[49] Based on the ordinary meaning of "acquire" and the legislative history of Section 269, a person who acquires control under one prong of the test cannot again acquire control by subsequently satisfying the other prong of the test.

E. Focus on Business Purpose

Section 269 only applies if the principal purpose of the redemption was tax avoidance or evasion. Certain acquisitions of control may cause the Service to disallow tax benefits under Section 269. One type of acquisition described in Section 269 is acquisition of control of a corporation.[50] The Service can disallow tax benefits obtained through such an acquisition when the principal purpose for the acquisition is evasion or avoidance of tax.[51] The Service can argue that, even if the acquired corporation is an affiliated

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Church v. United States, 143 U.S. 457, 463 (1892) ("[I]t is to be assumed that words and phrases are used in their ordinary meaning.").

47. *See Acquire*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/acquire [https://perma.cc/K5PS-BP5H] ("[T]o come into possession or control . . . .").

48. S. REP. NO. 78-627, at 60 (1943).

49. *E.g.,* Challenger, Inc. v. Comm'r, 23 T.C.M. (CCH) 2096 (1964).

50. I.R.C. § 269(a); Treas. Reg § 1.269-3(a)(1) (as amended in 1992).

51. I.R.C. § 269(a); Treas. Reg. § 1.269-2(b).

group member, the group cannot make use of its tax benefits.[52] If the principal purpose for the acquisition was evasion or avoidance of tax, the Service's argument has a strong basis. Substantial business reasons for a redemption, for example, are relevant in determining underlying business purposes for the redemption.[53] The business purpose test requires that a transaction have a business purpose separate from its tax advantages.[54] For a transaction to have a business purpose, there must be a business or commercial reason for the taxpayer to engage in the transaction without regard to tax benefits.[55] The need for a business purpose as a condition for respecting transactions can be traced to the Supreme Court's opinion in *Gregory v. Helvering*.[56] In *Gregory*, the Court disregarded a reorganization that complied with the formal statutory requirements because no valid economic purpose existed for the creation and immediate liquidation of the transferee corporation.[57] The Supreme Court's decision was not based on the taxpayer's tax avoidance, but rather on the transaction's lack of business purpose.[58] The corporate reorganizations principle laid down in *Gregory* has gained such wide acceptance that courts frequently view the business purpose doctrine to be generally applicable to all federal tax statutes.[59] Thus, a transaction will fail the business purpose test where "the *only* purpose for entering into the transaction was the tax consequences."[60] Though the business purpose requirement was first developed in connection with corporate reorganizations, it is not limited to the reorganization

52. *See* Treas. Reg. § 1.1502-80(a) (as amended in 2023) ("The Internal Revenue Code (Code), or other law, shall be applicable to the group to the extent the regulations do not exclude its application.").

53. As a general matter, both the shareholder's and the corporation's purposes are relevant in determining business purpose. *See, e.g.*, Ballenger v. United States, 301 F.2d 192, 197 (4th Cir. 1962) ("[A] business purpose is not to be confined to one which furthers the successful conduct of the corporation; purposes stemming from the personal business affairs of the shareholders also warrant attention. An example of the latter is the redemption of stock as a part of a shareholder's complete withdrawal from the business." (footnote omitted)); *see also* Est. of Parshelsky v. Comm'r, 303 F.2d 14, 17 (2d Cir. 1962) (looking to both corporate and shareholder purposes in context of tax-free spin-off).

54. *See* Elko Realty Co. v. Comm'r, 29 T.C. 1012, 1026–27 (1958), *aff'd*, 260 F.2d 949 (3d Cir. 1958).

55. *See* Friedman v. Comm'r, 869 F.2d 785, 792 (4th Cir. 1989); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985).

56. Gregory v. Helvering, 293 U.S. 465 (1935).

57. *Id.* at 469.

58. *See id.* at 469–70.

59. *See* Weller v. Comm'r, 270 F.2d 294, 297 (3d Cir. 1959), *cert. denied*, 364 U.S. 908 (1960).

60. *Friedman*, 869 F.2d at 792.

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

context. As previously described, in *Younker Bros., Inc.*, the court held that substantially identical purposes for redeeming a shareholder's stock constituted legitimate non-tax purposes that prevented the application of Section 269.[61]

There are many cases addressing the judicially developed doctrines of "sham transaction," "business purpose," and "economic substance."[62] One of the highly regarded attempts to synthesize the rules appears in "Appendix II To JCX-82-99: Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters," prepared by the Staff of the Joint Committee On Taxation ("JCT Appendix").[63] The JCT Appendix helps to clarify confusion between the business purpose doctrine and the economic substance doctrine:

> In its common application, the courts use business purpose (in combination with economic substance . . .) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance.[64]

This language mirrors the language of the Fourth Circuit Court of Appeals in *Rice's Toyota World, Inc. v. Commissioner*.[65] Thus, for a transaction to have a business purpose, there must be a business or commercial reason for the taxpayer to engage in the transaction without regard to tax benefits.[66] A transaction will fail the business purpose test where "the *only* purpose for entering into the transaction was the tax

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61. Younker Bros., Inc. v. United States, 318 F. Supp. 202, 206–07 (S.D. Iowa 1970); *see also* Residential Devs., Inc. v. United States, 12 A.F.T.R.2d (RIA) 5576, 5578 (E.D. La. 1963).

62. *See* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 92 (4th Cir. 1985); IES Indus., Inc. v. United States, 253 F.3d 350, 353 (8th Cir. 2001); Boca Investerings P'ship v. United States, 314 F.3d 625, 630 (D.C. Cir. 2003).

63. STAFF OF JOINT COMM. ON TAX'N, 106TH CONG., DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES AND RECENT PROPOSALS RELATING TO CORPORATE TAX SHELTERS, at 7–18 (Comm. Print 1999).

64. *Id.* at 18 (footnote omitted).

65. *See Rice's Toyota World*, 752 F.2d at 91 ("To treat a transaction as a sham the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists." (citations omitted)).

66. Friedman v. Comm'r, 869 F.2d 785, 792 (4th Cir. 1989); *see also Rice's Toyota World*, 752 F.2d at 91.

consequences."[67] In *Boca Investerings Partnership v. United States*, the court reiterated that the existence of a partnership would depend upon whether, "considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[68] To support its decision, the court reiterated from earlier cases that the "'the absence of a nontax business purpose is fatal' to the argument that the Commissioner should respect an entity for federal tax purposes."[69] Furthermore, the court indicated that when determining if a partnership should be respected, there must be a non-tax business purpose for the partnership in order to accomplish the partners' goals.[70]

In *IES Industries, Inc. v. United States*, the Eighth Circuit held that certain deductions that IES took were valid.[71] IES purchased American Depository Receipts ("ADRs") with dividend rights and then sold the ADRs without dividend rights through a series of pre-arranged transactions.[72] Based on applicable treaties, foreign corporations paid the ADR dividend in jurisdictions with a 15% withholding rate on dividends paid to U.S. citizens.[73] Therefore, the record owner of the ADR was entitled to 85% of the dividend in cash but would be taxed in the United States on 100% of the dividend.[74] The record owner would also be entitled to a dollar-for-dollar foreign tax credit.[75] The sellers of the ADRs were all tax-exempt entities still required to pay the 15% foreign tax but not entitled to a foreign tax credit in the United States (as they owed no tax in the United States).[76] The purchase price of the ADRs was based upon the market price plus 85% of the value of the dividend, while the sale price simply matched the market price.[77] In summary, "IES purchased ADRs with dividend rights attached, or cum-dividend, for more than it sold them ex-dividend, thus incurring

67. *Friedman*, 869 F.2d at 792.

68. Boca Investerings P'ship v. United States, 314 F.3d 625, 631 (D.C. Cir. 2003) (alteration in original) (citations omitted).

69. *Id.* at 630 (quoting ASA Investerings P'ship. v. Comm'r, 201 F.3d 505, 512 (D.C. Cir. 2000)).

70. *Id.* at 632.

71. IES Indus., Inc. v. United States, 253 F.3d 350, 356 (8th Cir. 2001). The court did reverse and remand the case on the issue of another tax refund related to the transaction at issue. *Id.* at 359.

72. *Id.* at 352.

73. *Id.*at 351–52.

74. *Id.* at 351.

75. *Id.*

76. *Id.* at 352.

77. *Id.*

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

capital losses."[78] IES sought to carry back the losses to offset capital gains received when it sold stock in tax years 1989 and 1990 to receive a refund of capital gains taxes paid in those years.[79]

In its examination of the business purpose issue, the court stated "[a] taxpayer's subjective intent to avoid taxes thus will not by itself determine whether there was a business purpose to a transaction."[80] The court also added that the fact that there was only a minimal risk of loss involved in the transactions did not undermine the business purpose but demonstrates that the taxpayer "did its homework before engaging in the transactions."[81] The court also noted that the other parties in the transactions were separate entities from IES and that they were all engaged in "legitimate business" before entering into these transactions.[82] All these factors led the court to conclude that there was a business purpose.[83]

The existence of such a purpose was addressed in *UPS v. Commissioner of Internal Revenue*.[84] In *UPS*, a taxpayer tried to avoid taxation with respect to certain fees by restructuring them as insurance.[85] Economically, the taxpayer was in substantially the same position as before the restructuring, but through the arrangements was able to exclude the payments from its income.[86] The taxpayer put forth a few purported commercial reasons for restructuring the fees.[87] The taxpayer argued that: (1) it was required to restructure the arrangements because such payments would fall afoul of restrictions under some state insurance laws; (2) it intended to leverage the profits into the creation of a new reinsurer that could become a full-line insurer; (3) by removing the fees from its operating ratios, it could obtain larger rate increases than had it received the fees directly; and (4) by restructuring the fees, it protected its transportation business from the risk increased liabilities.[88] However, the taxpayer offered

78. *Id.*

79. *Id.* According to the court, despite these capital losses, IES actually generated a profit on the transaction, as the full amount on the dividend exceeded the capital losses incurred. *Id.*

80. *Id.* at 355.

81. *Id.*

82. *Id.*

83. *Id.* at 356.

84. UPS v. Comm'r, 78 T.C.M. (CCH) 262 (1999), *rev'd*, 254 F.3d 1014 (11th Cir. 2001).

85. UPS v. Comm'r, 254 F.3d 1014, 1016 (11th Cir. 2001), *rev'g* 78 T.C.M. (CCH) 262 (1999).

86. *Id.* at 1017.

87. *Id.* at 1021 (Ryskamp, J., dissenting).

88. *Id.*

no credible evidence that the restructuring would in fact achieve goals (2), (3), and (4).[89] The Tax Court also found that goal (2) could have been accomplished by merely making an investment in a reinsurer.[90] The Tax Court found that the taxpayer offered no credible evidence that the restructuring would in fact achieve its goals.[91] On appeal, a split court for the Eleventh Circuit Court of Appeals reversed the decision, stating that the Tax Court's interpretation of business purpose was too narrow and that business purpose does not equate to a reason for a transaction that is free of tax considerations, but (at least in the context of a going concern) a transaction that "figures in a bona fide, profit-seeking business."[92]

Similarly, in *Winn-Dixie Stores, Inc. v. Commissioner*, the Tax Court disallowed interest deductions on policy loans in a corporate-owned life insurance ("COLI") program that insured the lives of approximately 36,000 workers.[93] The program resulted in a pre-tax loss for the taxpayer.[94] The taxpayer argued that the program: (1) enabled it to fund costs of one of its benefit programs; and (2) increased the benefits it could offer to its employees under such program.[95] As to (1), the Tax Court found that there was no contemporaneous evidence that the taxpayer purchased the COLI policies to provide such funding; that the COLI policies were not designed to fund the benefits; that the taxpayer's principal financial officer never told the entity that planned the COLI transactions that the purpose was to fund the benefit program; and that projections showed that the cash flow from the program was needed to pay future interest and premiums as opposed to being available to fund the benefits program.[96] As to (2), the Tax Court found that the described additional benefits were not related to the COLI program.[97]

In *Compaq Computer Corp. v. Commissioner*, the Tax Court disallowed foreign tax credits associated with dividends on certain

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89. *Id.*

90. UPS v. Comm'r, 78 T.C.M. (CCH) 262, 286 (1999), *rev'd*, 254 F.3d 1014 (11th Cir. 2001).

91. *UPS*, 254 F.3d at 1016.

92. *Id.* at 1019.

93. *See* Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 264, 293 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

94. *Id.* at 260–61.

95. *Id.* at 285, 288.

96. *Id.* at 284–86.

97. *Id.* at 288; *see also In re* CM Holdings, Inc., 254 B.R. 578 (D. Del. 2000), *aff'd*, 301 F.3d 96 (3d Cir. 2002); Am. Elec. Power v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001).

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

American Depositary Receipts ("ADR").[98] The court considered many factors, including the fact that the officer of the taxpayer in charge of the investments made no inquiry into the commercial aspects of the transactions.[99] The Fifth Circuit Court of Appeals reversed the Tax Court and found that the ADR transactions had economic substance and that Compaq had a business purpose for engaging in the ADR transactions.[100] With respect to business purpose, the Fifth Circuit repeated the Eighth Circuit Court of Appeals' statement in *IES Industries* that "[a] taxpayer's subjective intent to avoid taxes . . . will not by itself determine whether there was a business purpose to the transaction."[101] Moreover, the court noted that a taxpayer's attempt to reduce the risks of a transaction does not render the transaction a sham for federal income tax purposes.[102]

Compaq Computer Corporation entered into the ADR transactions in part to offset a large capital gain that it previously recognized.[103] The Fifth Circuit noted that this motive is not relevant in determining whether there is a business purpose for the transaction.[104] In particular, the court noted:

> [T]he fact that Compaq had a large unrelated capital gain in 1992 does not mean that Compaq had an impermissible motive in seeking to engage in the transaction. The capital gain, of course, made it possible for Compaq to obtain an otherwise unavailable tax benefit from the ADR transaction by offsetting its . . . capital losses from the transaction against the gain. . . . Put otherwise, the availability of a capital gain against which to offset the capital losses from the ADR transaction was a necessary precondition to the profitability of the transaction on an after-tax basis. A sensible taxpayer would have engaged in such a transaction only if it had a capital gain against which to offset the capital losses that the taxpayer knew would result from the transaction. All this is unremarkable and is no evidence that Compaq had an impermissible motive.[105]

98. Compaq Comput. Corp. v. Comm'r, 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

99. *Id.* at 227.

100. Compaq Comput. Corp. v. Comm'r, 277 F.3d 778, 788 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999).

101. *Id.* at 783 (quoting IES Indus., Inc. v. United States, 253 F.3d 350, 355 (8th Cir. 2001)).

102. *Id.* at 784.

103. *Id.* at 780.

104. *Id.* at 786 ("[E]ven assuming that Compaq sought primarily to get otherwise unavailable tax benefits in order to offset unrelated tax liabilities and unrelated capital gains, this need not invalidate the transaction.").

105. *Id.* at 786, n.8 (internal citations omitted).

Lastly, *ACM Partnership v. Commissioner* and *Saba Partnership v. Commissioner* involve similar transactions.[106] In each case, the courts found that the purported business purposes of the transactions were unsupported by the evidence, and, similar to the foregoing cases, the individuals involved with execution of the transactions did not exhibit behavior consistent with trying to achieve the purported commercial purposes.[107] In both cases, in order to have the requisite business purpose to support the tax benefits achieved, a business must show: a purported commercial reason for engaging in the various transactions; the transaction must be consistent with such reason; and such reason must be supported by contemporary evidence, including a showing that the transaction was handled in a business-like manner.[108] This analysis is supported by a number of cases. For example, in *Levy v. Commissioner*, the taxpayer entered into a sale-leaseback of computer equipment for the purported reason of diversifying its business and investments.[109] In upholding the tax benefits, the court stated:

> Based on our careful examination of the relevant facts and evidence in this case, we conclude that petitioners entered into the transaction in issue for sound business reasons (namely, to diversify their business investments by entering into a legitimate long-term investment involving the purchase and leaseback of computer equipment). Petitioners approached the decision to enter into this transaction in a businesslike manner. Petitioners' financial adviser thoroughly and in good faith investigated the proposed purchase-leaseback transaction. He prepared cash-flow analyses which included the components of the transaction that were critical to earning a profit on the investment. Those components included the current fair market value and projected residual value of the equipment, the fair rental value of the lease, and the rent-participation agreement. He explained to petitioners the significance of and risks associated with the projected residual value of the equipment and the rent-participation agreement. In addition, he explained to petitioners the tax consequences of the transaction. Petitioners also retained a law firm with expertise in leasing transactions to investigate the financial status and creditworthiness of each participant involved in the transaction, to investigate each participant's business reputation, and to handle the legal aspects of this complex transaction.

106. ACM P'ship v. Comm'r, 157 F. 3d 231 (3d Cir. 1998); Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684 (1999).

107. *ACM P'ship*, 157 F.3d at 247–48; *Saba P'ship*, 78 T.C.M. at 718.

108. *ACM P'ship*, 157 F.3d at 247; *Saba P'ship*, 78 T.C.M. at 717–19.

109. Levy v. Comm'r, 91 T.C. 838, 841–42, 855–56 (1988).

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

> We are satisfied that petitioners had a good-faith and substantial business purpose for entering into the transaction. Petitioners participated in the purchase-leaseback transaction only after they were convinced that the investment had the reasonable possibility of producing a profit.[110]

In *Carruth Corp. v. Commissioner*, the issue was whether a charitable contribution would be allowed for a contribution of stock of a controlled corporation to a charity after the dividend was declared, but before the dividend record date.[111] The court upheld the deduction in part upon finding that lag between the declaration and record dates had a business purpose:

> [Taxpayer] contends that the distinction between the two dates was designed to encourage his nephews . . . to sell their shares to him. . . . The lag between the declaration and record dates was designed to give the nephews an opportunity to sell. The plan failed in this respect; the nephews held their shares.
>
> The district court made factual findings that [taxpayer] wished to buy out his nephews' interests in North Park Incorporated, and that he believed declaration of a dividend might facilitate this objective. We review these findings pursuant to the clearly erroneous standard, and find clear support in the record. With these factual findings in place, we believe it obvious that the distinction between declaration and record date did, as [taxpayer] contends, serve a legitimate business purpose.[112]

Lastly, it should be noted that a transaction can have an appropriate business purpose even if the transaction itself does not generate a profit.[113] A long-standing judicial authority recognizes that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible[.]"[114] Under this doctrine, a taxpayer is free to choose the most tax-favorable method of accomplishing an economic result without any business justification for the method chosen, so long as that method is no more circuitous than another and the transaction itself has the requisite business purpose.[115] In one case,

110. *Id.* at 855–56; *see also* Pearlstein v. Comm'r, 58 T.C.M. (CCH) 699 (1989); Rubin v. Comm'r, 58 T.C.M. (CCH) 25 (1989).

111. Carruth Corp. v. United States, 865 F.2d 644, 646 (5th Cir. 1989), *aff'g* 688 F. Supp. 1129 (N.D. Tex. 1987).

112. *Id.* at 650.

113. *See id.*; Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992).

114. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

115. *See id.* at 810–11.

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

the Tax Court indicated that there must not only be a reasonable possibility of making a profit, but also the expected profit must be greater than de minimis.[116]

F. Economic Substance

The seminal case for determining whether a transaction will be disregarded for tax purposes for lack of economic substance is *Gregory v. Helvering*, where the Supreme Court stated that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[117] Although the taxpayer in *Gregory* had followed the steps required by the Code for treatment as a tax-free corporate reorganization, the Court held that the purported reorganization was a "mere device" for the "consummation of a preconceived plan" and not a reorganization within the intent of the Code.[118] Because the transaction lacked economic substance, it was not "the thing which the statute intended."[119] Acknowledging *Gregory*, the Eleventh Circuit Court of Appeals stated, "[i]f a transaction's form complies with the Code's requirements for deductibility, but the transaction lacks the factual or economic substance that form represents, then expenses or losses incurred in connection with the transaction are not deductible."[120] Thus, pursuant to *Gregory*, courts look beyond the form of a transaction to determine whether it has economic substance, and a transaction that lacks economic substance will be disregarded for tax purposes.[121]

The substance-over-form requirement is a principle that is widely accepted for business transactions. The application of the substance-over-form doctrine to partnership transactions dates to the

116. Sheldon v. Comm'r, 94 T.C. 738, 767–69 (1990).

117. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

118. *Id.*

119. *Id.* at 469–70. The taxpayer in *Gregory* was the sole owner of a corporation that held appreciated stock in another corporation. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934). The taxpayer wanted to avoid the appreciated property directly to her because she would have received a dividend, taxable as ordinary income. *Id.* Instead, she arranged for a transfer of the appreciated stock to a newly formed corporation, of which she would hold all of the stock. *Id.* Following the transfer, the newly formed corporation distributed the appreciated stock to the taxpayer in a complete liquidation of the new corporation. *Id.* The new corporation existed for only three days and never conducted any business. *Id.* The taxpayer treated the liquidating distribution as a sale or exchange, subject to the lower capital gains rates. *Id.*

120. Kirchman v. Comm'r, 862 F.2d 1486, 1490 (11th Cir. 1989). The court went on to analyze *Gregory*. *See id.* at 1490–92.

121. Lerman v. Comm'r, 939 F.2d 44, 45, 52 (3d Cir. 1991).

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

Supreme Court's 1949 decision in *Commissioner v. Culbertson*.[122] In deciding whether to respect the partnership form selected by the parties, the Court framed the question as "whether, considering all the facts . . . [the parties] intended to join together in the present conduct of the enterprise."[123] Thus, it is well established that a transaction or series of transactions will not be respected for tax purposes unless the transaction or transactions have economic substance separate and distinct from the economic benefit derived from the tax reduction.[124] Transactions failing to meet this standard lack the requisite "economic substance" (often interpreted as having a reasonable possibility of pre-tax profit) and will not be respected for tax purposes (referred to as "sham transactions").[125] However, the Supreme Court has held that a transaction should be respected if it has "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."[126] Thus, transactions have been upheld where the transactions were designed to achieve a tax benefit but were endowed with positive pre-tax economics.[127]

Courts interpreting this standard have held that for a transaction to be respected for tax purposes, it must have a business purpose apart from tax benefits and must have economic substance (e.g., a reasonable possibility of profit). "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."[128] A transaction will be held to have a business purpose unless "the *only* purpose for entering into the transaction was the tax consequences."[129]

In *Yosha v. Commissioner*, the court articulated the standard slightly differently:

122. *See* Comm'r v. Culbertson, 337 U.S. 733, 742 (1949).

123. *Id.* (footnote omitted).

124. *See id.* at 741–42.

125. *Id.*; *see also Kirchman*, 862 F.2d at 1490–95 (analyzing the "Sham Transaction Doctrine").

126. Frank Lyon Co. v. United States, 435 U.S. 561, 583–584 (1978).

127. *See, e.g.*, N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341, 348 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).

128. Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) (citations omitted).

129. Friedman v. Comm'r, 869 F.2d 785, 792 (4th Cir. 1989).

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

> A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages—may indeed have had no other interest in the transaction.[130]

To determine whether a transaction is a sham transaction, courts analyze whether the taxpayer has a business purpose—other than the tax benefits—in entering the transaction, or whether "the transaction has no economic substance because no reasonable possibility of profit exists."[131] The decision in *Horn v. Commissioner* is clear that if a transaction satisfies either of these tests, then it is not a sham transaction.[132]

It should be noted that a taxpayer need not be correct in its judgment of possible economic benefits; it needs only to be reasonable or rational. Profit motive depends on the taxpayer's subjective, good faith intent to earn a profit.[133] When a venture fails to produce a profit in the anticipated amount, or at all, it does not indicate the venture was not profit-motivated.[134] However, profit potential cannot be illusory. A transaction can have economic substance if it is entered into for the purpose of furthering the taxpayer's business interests, even if not directly producing income.[135]

In *Boca Investerings Partnership v. United States*, the District Court for the District of Columbia upheld the taxpayer's treatment of a tax-advantaged transaction, rejecting the government's business purpose argument because each portion of the transaction was subject to the taxpayer's internal approval process and was done with the intent of producing a financial benefit to the taxpayer.[136] On appeal, however, the D.C. Circuit reversed the holding in *Boca Investerings Partnership v. United States*.[137]

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130. Yosha v. Comm'r, 861 F.2d 494, 499 (7th Cir. 1988).

131. Friedman, 869 F.2d at 792 (quoting *Rice's Toyota World*, 752 F.2d at 91); Horn v. Comm'r, 968 F.2d 1229, 1237 (D.C. Cir. 1992) (citation omitted); *see also* ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2217 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998).

132. *See Horn*, 968 F.2d at 1237–38 (citing Kent N. Schneider & Ted D. Englebrecht, 6 J. TAX'N INVESTMENTS 308, 310 (1989)).

133. *See* Finoli v. Comm'r, 86 T.C. 697, 722 (1986).

134. *See* King v. United States, 545 F.2d 700, 708 (10th Cir. 1976).

135. *See id.*

136. Boca Investerings P'ship v. United States, 167 F. Supp. 2d 298, 377 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003).

137. Boca Investerings P'ship v. United States, 314 F.3d 625, 627 (D.C. Cir. 2003), *rev'g* 167 F. Supp. 2d 298 (D.D.C. 2001).

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Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

The district court in *Boca* based its decision on the *Horn* economic substance standard and stated that, to be respected, the transaction would have economic substance "if either (1) using a subjective analysis, the transaction has a nontax business purpose, *or* (2) using an objective analysis, the transaction has a reasonable possibility of generating a profit, *ex ante*."[138] Although only one of these requirements needed to be met under *Horn*, the court found that both tests were met in *Boca*.[139] As to the first requirement, the court concluded that each step in the transaction was taken with the intent of giving a financial benefit to the taxpayers, and the taxpayers would not have entered into the transaction in the first place had they not believed they could make a profit.[140] As to the second requirement, the court concluded, due to the volatile nature of the investments involved, there was a reasonable possibility the transaction could have resulted in substantial profits for the taxpayers rather than losses.[141]

In reversing the district court in *Boca*, the court of appeals did not explicitly disagree with the legal reasoning or the tests for economic substance stated by the district court.[142] Rather, the court based its reversal on its interpretation of the facts developed at trial.[143] The court of appeals agreed with the statement in the government's pleadings that "given the substantial costs incurred, AHP's use of this elaborate 'partnership' cannot be justified by a non-tax business purpose."[144]

Evidently persuaded by that argument, as well as the belief that its outcome in *Boca* should not differ from the outcome on similar facts in *ASA Investerings Partnership v. Commissioner*, the court of appeals reversed the district court.[145] The court of appeals did not explicitly find that the taxpayer had failed to satisfy the second of the two tests set forth in *Horn*.[146] Thus, it is possible that the decision constitutes a ruling *sub silentio* that satisfying only the second test is not sufficient for a transaction to have economic substance. However, it appears more likely that the court of appeals left undisturbed the district court's finding that the transaction had

138. *Boca Investerings P'ship*, 167 F. Supp. 2d at 376 (footnote omitted) (citing Horn v. Comm'r, 968 F.2d 1229, 1237–38 (D.C. Cir. 1992)).

139. *Id.* at 377.

140. *Id.* at 377–80.

141. *Id.*

142. *See Boca Investerings P'ship*, 314 F.3d at 632.

143. *Id.*

144. *Id.* at 630–31.

145. *Id.* at 627, 630–32; *see* ASA Investerings P'ship v. Comm'r, 201 F.3d 505 (D.C. Cir. 2000).

146. *See Boca Investerings P'ship*, 314 F.3d at 632 (noting that "the record would not support a finding that the partnership form served any non-tax business purpose").

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

economic substance, and instead, simply determined that the partnership's participation in the transaction would be disregarded. Because of the nature of the reversal, it appears that the definitions and tests enunciated by the district court remain valid.

In *ACM Partnership v. Commissioner*, the Tax Court found that at the time a taxpayer entered into a foreign partnership that purchased Citicorp notes, and then sold the notes three weeks later in a contingent installment sales transaction for cash and notes, the taxpayer's only real opportunity to earn a profit was through an increase in the credit quality of the issuers of certain notes, or a 400 to 500 basis point increase in three-month LIBOR interest rates.[147] Income from the sale of the Citicorp notes went primarily to the foreign partner.[148] A capital loss from a related transaction was substantially allocated to Colgate-Palmolive, the United States partner.[149] The court found no impact on credit quality was possible as the lenders were extremely highly rated at the time of the transaction.[150] Moreover, the court did a six-year review of three-month LIBOR rates and did not find an increase of even 300 basis points in the necessary time frame.[151] Because the analysis of the historical data showed no reasonable basis for expecting a profit,[152] the court ruled against the taxpayer, stating:

> We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance.[153]

The Tax Court in *ACM Partnership* restated the test as follows:

> Key to this determination [of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated

147. ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2218–19 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998).

148. *Id.* at 2191–94, 2203.

149. *Id.*

150. *Id.* at 2218–19.

151. *Id.* at 2219.

152. *See id.* at 2217–22.

153. *Id.* at 2215.

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

> purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.[154]

On appeal, the Third Circuit Court of Appeals upheld the Tax Court's economic substance test but clarified that in determining whether there was economic substance, a court must look at "both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them."[155] The court analyzed the purchase and sale of the Citicorp notes as the relevant transaction, concluding this transaction lacked economic substance and should not be respected for tax purposes.[156] In its analysis, the Third Circuit focused upon the foregoing finding of the Tax Court, stating: "Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."[157] The Third Circuit also noted:

> On November 3, 1989, [the partnership] invested $175 million of its cash in private placement Citicorp notes paying just three basis points more than the cash was earning on deposit, then sold the same notes 24 days later for consideration equal to their purchase price, in a transaction whose terms had been finalized by November 10, 1989, one week after ACM acquired the notes. These transactions . . . offset one another and with no net effect on ACM's financial position.[158]

The court found that the transaction lacked objective economic consequences because (1) the Citicorp notes were sold for their purchase price, a result inherent in the terms of the note and not the result of market forces, and (2) the interest earned on the Citicorp notes was only nominally higher than the invested funds earned in a deposit account and was substantially less than the transaction costs.[159] The transaction was a

154. *Id.* at 2217 (internal citations omitted).

155. ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3rd Cir. 1998) (quoting Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990)), *aff'g* 73 T.C.M. (CCH) 2189 (1997).

156. *Id.* at 247–49.

157. *Id.* at 252.

158. *Id.* at 249–50.

159. *Id.*

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Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

"fleeting and economically inconsequential investment" that left ACM in the same position it had occupied before engaging in the offsetting acquisition and disposition of those Citicorp notes.[160] The court also upheld the Tax Court's conclusions that (1) the transactions lacked any non-tax purposes and (2) the transactions were not reasonably designed to yield a pre-tax profit because the transactions were planned and executed without regard to their pre-tax consequences.[161]

In *ACM Partnership*, the Service asserted that even if a taxpayer reasonably expects economic profit, the transaction should be treated as lacking economic substance because the tax benefits substantially exceed the economic benefits.[162] In *Saba Partnership v. Commissioner*, the Tax Court accepted this rationale, stating:

> Relatively modest profits are insufficient, standing alone, to clothe the disputed CINS transactions with economic substance. In particular, even assuming for the sake of argument that the partnerships reasonably could have expected profits of up to $10,800,000 on a 5-year investment in the LIBOR notes, such profits would be inconsequential when compared with the capital losses of approximately $170,000,000 that the CINS transactions were designed to generate [for the investor].[163]

Despite the Tax Court's language in the excerpt above, the Tax Court in *Saba* did not conclude that a transaction lacks economic substance merely because the ratio of tax benefits to economic benefits is high.[164] Moreover, the Tax Court in *Saba* cites three cases for the proposition that a potential profit of several million dollars is, standing alone, inadequate to confer economic substance on a transaction.[165] None of these cases, in fact, support this proposition.

In *Sheldon*, while the taxpayer made $18,000 on a small group of transactions, he lost $60,000 on other transactions, and the court noted that "there was insufficient potential in any gain to offset the losses locked in for the 1981 transactions."[166] Moreover, while the court also noted that the potential for gain was "infinitesimally nominal and vastly insignificant

160. *Id.* at 250.

161. *Id.* at 258.

162. *Id.* at 244.

163. Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684, 721 (1999) (citations omitted).

164. *See id.* at 722.

165. *Id.* at 721 (citing Sheldon v. Comm'r, 94 T.C. 738, 767–68 (1990); *ACM P'ship*, 157 F.3d at 258; Goldstein v. Comm'r, 364 F.2d 734, 739–40 (2d Cir. 1966)).

166. *Sheldon*, 94 T.C. at 768–69.

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

when considered in comparison with the claimed deductions[,]" this was because the potential for gain—apparently $18,000—was insignificant in an absolute sense when compared with an interest deduction of $5 million.[167] The *ACM Partnership* court, citing only *Sheldon*, stated that:

> Even accepting ACM's assertion that it could have recovered its costs upon a significantly smaller rise in interest rates than that calculated by the Tax Court, this assertion is immaterial in the event of falling interest rates and at best demonstrates a prospect of a nominal, incidental pre-tax profit which would not support a finding that the transaction was designed to serve a non-tax profit motive.[168]

Importantly, the *ACM Partnership* court failed to consider the ratio of the tax benefits to the economic benefits.[169]In *Goldstein*, the Second Circuit Court of Appeals discounted testimony that the investment could have resulted in an economic gain, not because tax benefits vastly exceeded it, but because it was contradicted by a written memorandum prepared for the taxpayer regarding the transaction that asserted that there was no potential for economic gain at all.[170]

In *Compaq Computer Corp. v. Commissioner*, in addition to finding no business purpose for the transactions, the Tax Court also found a lack of economic substance because as the transactions were designed and executed, the taxpayer was bound to suffer a pre-tax loss.[171] The Tax Court reached a similar conclusion for the same reason in *Winn-Dixie Stores Inc. v. Commissioner*.[172] Despite being inconsistent with the economic substance cases, one case suggests that not only must the transaction have a reasonable possibility of making a profit, but that possibility must relate to a profit that is greater than *de minimis*.[173] A handful of other decisions have indicated that the court should consider whether the profit motive for a transaction was greater or less than the tax motive.[174] However, these cases

167. *Id.*

168. *ACM P'ship*, 157 F.3d at 258 (citing *Sheldon*, 94 T.C. at 768).

169. *See id.* at 262–63.

170. *Goldstein*, 364 F.2d at 739–40.

171. Compaq Comput. Corp. v. Comm'r, 113 T.C. 214, 225–26 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

172. *See* Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 294 ("The transactions associated with petitioner's COLI program lacked economic substance and business purpose (other than tax reduction)."), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

173. *See Sheldon*, 94 T.C. at 769.

174. *See, e.g.*, Fox v. Comm'r, 82 T.C. 1001, 1019 (1984) ("When a taxpayer enters a particular transaction with the mixed motives of obtaining a profit and obtaining tax benefits,

https://scholarship.law.campbell.edu/clr/vol46/iss1/2

seem to represent a minority view. Thus, when applying the economic substance doctrine, courts should not deny the tax benefits achieved in a transaction merely because the transaction's principal purpose was to achieve such tax benefits.[175] Congress precluded such a broad test for all disallowance by incorporating a principal purpose test into specific code sections, such as Section 269.[176] Long-standing judicial authority has also recognized that "[a]ny one may so arrange his affairs [so] that his taxes shall be as low as possible[.]"[177]

In *Nicole Rose Corp. v. Commissioner*, formerly *Quintron Corp. v. Commissioner*, the Tax Court disallowed a loss because it found a transaction that lacked economic substance.[178] The facts in *Rose* involved two simultaneous transfers of very complex leasing interests such that when the interests became worthless, a taxpayer who received and simultaneously transferred them could claim a loss.[179] The Tax Court found, as a factual matter, that (1) interests that had been transferred in the transaction were worthless at the time they had been transferred, and (2) there was no economic or business purpose for carrying out the transaction.[180] The court found all evidence supporting the taxpayer as inaccurate and lacking in credibility.[181] The court found as a matter of fact that the petitioner could not possibly make enough money to cover its transaction costs, so the transaction had no profit potential whatsoever.[182] In this connection, the court took note of the fact that the taxpayer had not treated the transaction in a businesslike manner, noting, among other things, that the taxpayer had not been able to produce the underlying documentation for the transactions, never attempted to determine the correct value of the underlying assets, and never verified the amount of cash flows expected from the assets.[183]

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the question exists whether profit motive must be the primary motive . . . , or whether the profit motive may be merely significant or substantial."); Est. of Baron v. Comm'r, 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986).

175. *See* N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).

176. *See* I.R.C. § 269; *see* Treas. Reg. § 1.269-3 (as amended in 1992).

177. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934); *see also* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991) (involving a transaction executed solely for tax purposes).

178. Nicole Rose Corp. v. Comm'r, 117 T.C. 328, 337 (2001), *aff'd*, 320 F.3d 282 (2d Cir. 2002).

179. *Id.* at 331–33.

180. *Id.* at 340.

181. *Id.* at 339.

182. *Id.* at 340.

183. *Id.* at 339.

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

The Service has issued several published announcements in which it questions the economic substance of various transactions.[184] Those actions relate to disclosure rather than the substantive law.[185] However, each pronouncement does contain some discussion about a transaction's lack of economic substance.[186] Unfortunately, those pronouncements do not contain any analysis that would assist the reader in determining what economic substance standard the Service should apply.[187] The only general conclusion is that if the Service objects to the result of a transaction, it may seek to challenge the result on the ground of economic substance.[188] Notice 2002-65 states that the transaction could be attacked on a variety of grounds, including acquisition of a corporation with the principal purpose of avoiding tax, lack of profit motive, economic substance, business purpose, and substance-over-form.[189] The Notice does not furnish adequate factual information to determine whether and when such attacks would be likely to succeed. Again, Notice 2002-50 threatens to attack on grounds of economic substance, lack of business purpose, and substance-over-form, and partnership anti-abuse rules, to name a few, but does not provide the facts needed to determine whether and when those attacks would be valid.[190]

As noted above, some courts have stated that the existence of a tax motive for entering into a transaction does not negate the existence of economic substance or a profit motive as along as the primary motivation

184. *See* Prop. Treas. Reg. § 1.6664-4(c), 68 Fed. Reg. 75128 (Dec. 30, 2003) (proposed to be effective for transactions entered into after December 31, 2002); I.R.S. Notice 2002-65, 2002-41 I.R.B. 690 (relating to "straddle" tax shelters using pass-through entities); I.R.S. Notice 2002-50, 2002-28 I.R.B. 98 (relating to other "straddle" structures with pass-through entities); I.R.S. Notice 2002-35, 2002-21 I.R.B. 992 (involving non-periodic payments under notional principal contracts); I.R.S. Notice 2002-21, 2002-14 I.R.B. 730 (relating to the use of loan assumption agreements to affect basis in property); Treas. Reg. §§ 301.6111-2 (2003), 301.6112-1 (as amended in 2011); and other notices issued pursuant to listing and related provisions of Temp. Treas. Regs. § 1.6011-4 (2004), 301.6111-1T (as amended in 1984).

185. *See* Prop. Treas. Reg. § 1.6664-4(c); I.R.S. Notice 2002-65, 2002-41 I.R.B. 690; I.R.S. Notice 2002-50, 2002-28 I.R.B. 98; I.R.S. Notice 2002-21, 2002-14 I.R.B. 730.

186. *See* Prop. Treas. Reg. § 1.6664-4(c); I.R.S. Notice 2002-65, 2002-41 I.R.B. 690; I.R.S. Notice 2002-50, 2002-28 I.R.B. 98; I.R.S. Notice 2002-21, 2002-14 I.R.B. 730.

187. *See* Prop. Treas. Reg. § 1.6664-4(c); I.R.S. Notice 2002-65, 2002-41 I.R.B. 690; I.R.S. Notice 2002-50, 2002-28 I.R.B. 98; I.R.S. Notice 2002-21, 2002-14 I.R.B. 730.

188. *See* Prop. Treas. Reg. § 1.6664-4(c); I.R.S. Notice 2002-65, 2002-41 I.R.B. 690; I.R.S. Notice 2002-50, 2002-28 I.R.B. 98; I.R.S. Notice 2002-21, 2002-14 I.R.B. 730.

189. I.R.S. Notice 2002-65, 2002-41 I.R.B. 690, 691.

190. I.R.S. Notice 2002-50, 2002-28 I.R.B. 99, 99.

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

for the transaction is economic profit.[191] A merely incidental profit motive is not sufficient for this purpose.[192]

It is clear that the taxpayer need not be correct, reasonable, or rational in its judgment of possible economic benefits. Profit motive depends on the taxpayer's subjective, good-faith intent to earn a profit.[193] The fact that a venture fails to produce a profit in the anticipated amount or at all does not indicate that the venture was not profit-motivated.[194] A transaction can have economic substance if entered into for the purpose of furthering the taxpayer's business interests, even if not directly producing income.[195]

II. LOSS LIMITATIONS: IRC SECTION 382

Even if the application of Section 269 is avoided, Section 382 generally limits the ability of a corporation to take advantage of net operating losses and certain built-in losses that have accrued prior to an ownership change.[196] Section 382 sets limits on the deductibility of a corporation's pre-existing net operating losses and built-in losses following an "ownership change."[197] In very general terms, an "ownership change" takes place if, during a three-year period, the percentage of stock of the corporation owned by one or more "5-percent" stockholders has increased by more than fifty percentage points over the lowest percentage of stock of the corporation owned by such stockholders at any time during the testing period.[198] An "ownership change" can take place where the stock of the loss corporation is acquired in a taxable purchase or in a tax-free transaction.[199] An "ownership change" can also take place where the assets of a corporation are transferred in a tax-free asset reorganization described in Sections 368(a)(1)(A), (C) or (D).[200] For example, because the redemption of stock is treated as an ownership change,[201] Section 382 could

191. *See* Miller v. Comm'r, 836 F.2d 1274, 1280 (10th Cir. 1988); Helvering v. Nat'l Grocery Co., 304 U.S. 282, 289, n.5 (1938), *reh'g denied*, 305 U.S. 669 (1938).

192. Fox v. Comm'r, 82 T.C. 1001, 1019 (1984) (citing Ewing v. Comm'r, 20 T.C. 216, 233 (1953)).

193. Finoli v. Comm'r, 86 T.C. 697, 722 (1986).

194. King v. United States, 545 F.2d 700, 708 (10th Cir. 1976).

195. *See id.* at 708–09.

196. *See* I.R.C. § 382.

197. *Id.*

198. *Id.* § 382(g)(1)(A)–(B).

199. *Id.*§ 382(g)(3); Treas. Reg. § 1.382-5(d).

200. I.R.C. § 382(g)(3); Treas. Reg. § 1.382-5(d).

201. *See* I.R.C. § 382(h).

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

limit an investor's ability to take advantage of unrealized losses that escape application of Section 269.

The amount of losses available under the annual Section 382 limitation is generally equal to the value of the old loss corporation immediately before the ownership change multiplied by the long-term tax-exempt interest rate.[202] A "loss corporation" is defined as "a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs."[203] A loss corporation also includes any corporation with a "net unrealized built-in loss."[204] A corporation has a net unrealized built-in loss if, immediately before the date of the ownership change, the aggregate adjusted basis of the corporation's assets exceeds the fair market value of such assets.[205] "If a loss corporation has a net unrealized built-in loss on the change date (the date on which an ownership change occurs), the corporation's recognized built-in losses are treated as pre-change losses and may be utilized against post-change income only to the extent of the Section 382 limitation amount."[206] "A recognized built-in loss is any loss recognized on the disposition of an asset during the five-year period beginning on the change date" (except that "[t]he amount of recognized built-in losses treated as pre-change losses is limited to the amount of net unrealized built-in loss").[207]

A. S Corporations May Be Exempt from Section 382

Net operating loss carryovers or carrybacks generally cannot arise in, or be carried to, S corporation taxable years for two reasons.[208] First, with limited exceptions, the income of an S corporation is not taxed at the corporate level but passes through to its shareholders.[209] Second, Section 1371(b)(2) specifically provides that no loss carryforward or carryback may be applied "at the corporate level for a taxable year for which a corporation is an S corporation."[210] Therefore, the Section 382 limitations on net operating losses cannot have any meaning with respect to an entity that was

202. *See id.* § 382(b)(1).

203. *Id.* § 382(k)(1).

204. *Id.*

205. *See id.* § 382(h)(3)(A)(i).

206. Thomas M. Stephens, *Section 382 is Inconsistent with Subchapter S*, 8 J. S CORP TAX'N 48, 51 (1996) (footnote omitted); *see* I.R.C. § 382(h)(1)(B).

207. Stephens, *supra* note 206, at 51; I.R.C. § 382(h)(2)(B).

208. *See* Stephens, *supra* note 206, at 57.

209. *Id.*

210. I.R.C. § 1371(b)(2); *see* Stephens, *supra* note 206 at 57.

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

an S corporation from its inception.[211] However, as discussed, Section 382 also applies to limit a corporation's recognized built-in losses following an ownership change.[212]

Commentators have generally addressed three scenarios when discussing the interplay between Subchapter S and Section 382.[213] The first scenario involves a situation where a shareholder of an S corporation has suspended losses under Section 1366(d).[214] If an S corporation incurs a loss during a taxable year, each shareholder is entitled to deduct a pro rata share of the loss.[215] The amount of the shareholder's deduction, however, is limited to the sum of "the adjusted basis of the shareholder's stock in the S corporation" and the "adjusted basis of any indebtedness" owed by the S corporation to the shareholder.[216] If the shareholder's pro rata share of the corporation's loss exceeds the tax basis, the excess may be carried forward indefinitely and will be deductible by the shareholder only if and when the basis in the stock or indebtedness increases.[217] More specifically, Section 1366(d)(2) provides that any loss or deduction disallowed as a result of Section 1366(d)(1) is "treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder."[218] Thus, suspended losses are specifically identified with specific shareholders.

The second scenario addressed by commentators involves an S corporation with net operating loss carryovers arising from years prior to filing its S corporation election.[219] It is believed that Section 382 should apply to limit losses upon an "ownership change" of an S corporation unless the corporation has elected to be an S corporation from its inception. [220]

The third scenario involves a situation where an S corporation that was never a C corporation sells an asset at a loss (or recognizes a loss with respect to an asset) within five years from the date of an ownership

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211. *See* Stephens, *supra* note 206 at 57.

212. *See* I.R.C. § 382(h); *see* discussion *supra* Part II.

213. *See, e.g.*, Stephens, *supra* note 206, at 57–58, 56–57 (discussing two of the scenarios); James D. Lockhart, *Do Loss-Trafficking Limitations Apply to S Corporations?*, 79 J. TAX'N 242 (1993); William M. Richardson & Samuel P. Starr, *Task Force Report on Taxable and Tax-Free Acquisitions Involving S Corporations*, 45 TAX L. 435 (1992).

214. *See* Stephens, *supra* note 206, at 50, 59–60; Lockhart, *supra* note 213, at 248; Richardson & Starr, *supra* note 213, at 471–72.

215. I.R.C. § 1366(a)(1); Stephens, *supra* note 206 at 57–58.

216. I.R.C. § 1366(d)(1)(A)–(B).

217. *See id.* § 1366(d)(3)(B)–(C).

218. *Id.* § 1366(d)(2)

219. *See* Stephens, *supra* note 206, at 49; Lockhart, *supra* note 213, at 242–44; Richardson & Starr, *supra* note 213, at 490–91.

220. *See* Stephens, *supra* note 206, at 49; Richardson & Starr, *supra* note 213, at 491.

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Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

change.[221] Because pre-change losses under Section 382 include net unrealized built-in losses, if Section 382 otherwise applies to an entity that was always an S corporation, it would be possible for the S corporation to have pre-change losses subject to Section 382. Commentators reach different conclusions on the issue of whether Section 382 limits the built-in losses of an S corporation with no C corporation tax history that has "ownership change." The following language is taken from a well-regarded Subchapter S treatise in which the authors take the position that Section 382 should not limit an S corporation's losses:

> S corporations and partnerships have another major advantage over C corporations regarding the use of net operating losses. A C corporation may have the use of its losses reduced or eliminated by Section 382 if the ownership of the C corporation changes. Losses arising under subchapter S or subchapter K are not subject to the same risk (except in the hands of a corporate partner).[222]

Other commentators take a different view, as shown from the following excerpt taken from the ABA Task Force Report in which the authors posit that Section 382 does apply to limit the built-in losses of an S corporation following an ownership change: "[B]ecause pre-change losses include (1) net unrealized built-in losses exceeding a specified threshold and (2) NOL's for the taxable year of the ownership change to the extent allocable to the pre-change period, an S corporation without any C corporation tax history could have pre-change losses subject to Section 382."[223]

Despite the stance taken by the authors in the ABA Task Force Report, they do recognize that:

> As a technical matter, [S]ection 382 arguably does not apply to an S corporation's loss deductions because [S]ection 382(a) by its terms applies to the determination of the *corporation's* taxable income, whereas Section 1363(b) provides that an S corporation's taxable income is to be computed in the same manner as for an *individual*."[224]

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221. *See* Stephens, *supra* note 206, at 50, 60–61; Lockhart, *supra* note 213, at 244; Richardson & Starr, *supra* note 213, at 491.

222. JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 2.03(3)(d) (3d ed. 1993); *see also* Stephens, *supra* note 206, at 62 ("Section 382, with its corporate-level approach, cannot apply to S corporations.").

223. Richardson & Starr, *supra* note 213, at 491.

224. *Id.* at 491, n.169.

The authors state that, despite this technical argument, "[t]he general application of Subchapter C, however, including nonrecognition provisions such as section 361(a), to S corporations pursuant to section 1371(a)(1) suggests that such a distinction lacks merit."[225]

Another commentator has taken the position that the loss limitation provisions contained in "Section 382 are not inconsistent with Subchapter S" since S corporations, as well as C corporations, could "benefit from trafficking in unrealized built-in losses."[226] The commentator concludes his article by stating that S corporations with pre-change losses should be subject to the anti-trafficking provisions of Section 382.[227]

Although there are arguments to the contrary, in our view, it is more likely than not that Section 382 does not apply to limit the built-in losses of an entity that has been an S corporation since inception. The reasons for this conclusion, as explained in detail below, are threefold. First, we believe that Section 382 is fundamentally inconsistent with the treatment of S corporations as pass-through entities. Second, technical inconsistencies and other problems would arise if Section 382 were to apply to limit the built-in losses of an S corporation. Third, the Code provides rules (other than those found in Section 382) that limit a shareholder's ability to utilize S corporation losses.

B. Fundamental Inconsistencies: Application of Section 382

Under Section 1366, the losses (and income) of an S corporation flow through to the shareholders in proportion to the stock held in the S corporation, and these shareholders account for these items on their individual income tax returns.[228] The losses of an S corporation are available to shareholders to the extent of their stock and debt basis, and any losses that cannot be utilized are suspended and carried over for the benefit

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225. *Id.*

226. *See* Lockhart, *supra* note 213, at 246. In a 1989 Report, the American Institute of Certified Public Accountants found Section 382 to be generally consistent with Subchapter S. *See AICPA Discusses Subchapter C'S Consistency with Subchapter S Provisions*, 89 TAX NOTES TODAY 91-48 (Apr. 18, 1989), https://www.taxnotes.com/research/federal/other-documents/public-comments-on-regulations/aicpa-discusses-subchapter-c%27s-consistency-with-subchapter-s-provisions/1723x?highlight=AICPA%20Discusses%20Subchapter%20C%E2%80%99s%20Consistency%20With%20Subchapter%20S%20Provisions [https://perma.cc/Y8Q9-GEA6].

227. Lockhart, *supra* note 213, at 246.

228. *Id.* at 243; I.R.C. § 1366(d).

Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

of the shareholders in succeeding years.[229] Subject to certain exceptions not relevant here, an S corporation is not subject to a corporate-level tax.[230] Section 382, on the other hand, is solely a corporate tax provision that was enacted "to prevent perceived abuses of taxpayers trafficking in" corporate net operating losses and built-in losses to reduce corporate tax and, therefore, generally should not apply to S corporations that do not generate losses at the corporate level.[231] Although it may make sense to apply Section 382 to an S corporation that has unused losses from when it was a C corporation, it would seem inappropriate for Section 382 to limit losses of a corporation that was an S corporation from its inception.

The Subchapter S provisions were enacted to permit businesses to select the form of organization desired without the necessity of taking into account major differences in tax consequences.[232] The legislative history enumerated two additional reasons for enacting Subchapter S. First, allowing shareholders to directly report their proportionate share of the corporate income—in lieu of taxation at two levels—would substantially aid small businesses.[233] Second, Congress wanted to allow shareholders who have other income to offset the losses from the S corporation against the other income.[234] The corporate loss limitations found in Section 382 conflict with the treatment of an S corporation as a pass-through entity in general, and, more specifically, the ability of shareholders to directly take into account the losses of an S corporation.[235]

Further, the corporate level approach of limiting losses found in Section 382 is fundamentally inconsistent with the scheme of shareholder taxation specified in Subchapter S. Subject to certain enumerated exceptions not relevant here, Section 1363(b) provides that the taxable income of an S corporation is computed in the same manner as that of an individual.[236] According to the Staff of the Joint Committee on Taxation, under Section 1363(b)(3), "the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations."[237]

229. Lockhart, *supra* note 213, at 243; I.R.C. § 1366(d).

230. *See* Lockhart, *supra* note 213, at 243; *see also* Treas. Reg. § 1.1366-2 (as amended in 2014).

231. Lockhart, *supra* note 213, at 242.

232. *See* S. REP. NO. 85-1983, at 216 (1958).

233. *Id.* at 223.

234. *See id.* at 220.

235. *See* I.R.C. § 382.

236. I.R.C. § 1363(b).

237. STAFF OF JOINT COMM. ON TAX'N, 104TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS, at 124 (Comm. Print 1996).

Knight and Knight: Trafficking-In and Harvesting Tax Benefits May Be Subject to Rest

Section 382(a) provides that the "amount of the taxable income of any new loss corporation for any post-change year which may be offset by pre-change losses shall not exceed the [S]ection 382 limitation for such year."[238] Thus, Section 382 expressly deals with the computation of a corporation's taxable income, which, according to legislative history, should not apply to S corporations. Accordingly, Section 382 should not apply to S corporations because Section 1363(b) computes an S corporation's income as an individual's while Section 382 applies to reduce losses in computing the taxable income of a corporation.

C. Technical Inconsistencies: Section 382 and S Corporations

Aside from the fundamental theoretical inconsistencies between Section 382 and the taxation of S corporations, a substantive problem would arise if Section 382 were applied to limit the built-in losses of an S corporation following an ownership change. Section 382(h)(4) provides that a disallowed built-in loss may be carried forward in a similar manner as the rules applicable to carryovers of net operating losses (or net capital losses).[239] As previously discussed, however, Section 1371(b)(2) prohibits any corporate-level carryforward from an S corporation taxable year.[240] Thus, the interplay between Sections 382 and 1371(b)(2), when Section 382 is applied, would appear to eliminate unused losses subject to the Section 382 limitation rules, so that any disallowed pre-change losses would be unavailable to the S corporation in subsequent years. This draconian result could not be intended, demonstrating that the Section 382 rules permitting a corporation to carry forward its disallowed losses are inconsistent with the S corporation rules which forbid carryovers at the corporate level. As one commentator noted, "[s]uch a result is inconsistent with the policy of neutrality that underlies subchapter S."[241]

D. Miscellaneous Limitations on S Corporation Losses

An S corporation, the stock of which is acquired by an individual, may have a built-in loss in its assets, some or all of which would be allocated to the purchasing shareholder on a later sale of the assets. Thus, built-in loss and deduction items may pass between buying and selling shareholders of S corporation stock. Unlike in the C corporation context, provisions in the Code other than Section 382 mitigate any effect of trafficking in the built-in

238. I.R.C. § 382(a).
239. *Id.* § 382(h)(4).
240. *Id.* § 1371(b)(2).
241. *See* Lockhart, *supra* note 213, at 248.

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Campbell Law Review, Vol. 46, Iss. 1 [2023], Art. 2

losses and deduction items of an S corporation. First, Section 1366(d) limits a shareholder's ability to utilize losses from an S corporation to the shareholder's adjusted basis in his S corporation stock and indebtedness owed to him by the S corporation.[242] Second, Section 465 generally limits an S corporation's losses to the shareholder's "at-risk" amount.[243] Third, Section 469 limits an S corporation shareholder's ability to deduct losses arising from a passive activity.[244] Fourth, "to the extent that the [S corporation] shareholder is allocated built-in losses that reduce his [or her] basis" in the S corporation, "a subsequent liquidation of the corporation, redemption [or sale] of the shareholder, or distribution of cash or property will result in a 'recapture' of those losses."[245] Therefore, as one commentator recognizes, "[a]lthough built-in loss and deduction items may pass between buying and selling shareholders in an S corporation context, the most serious loss trafficking concerns that existed in the C corporation context are not present with S corporations."[246]

CONCLUSION

Applying the theory and underpinnings of Section 269 to transactions is a rigorous challenge. The satisfaction of the business purpose and economic substance doctrines will defeat Section 269's prohibition against using corporations to harvest and gain the benefits of corporate tax losses. However, the dominant reasons for transactions should not be tax. In addition, the loss limitations of Section 382 must be considered in loss trafficking to determine and examine the immediate benefits and limitations on corporate losses. Understanding whether Section 382 applies to S corporations is invaluable. A working knowledge of the application of Sections 269 and 382, along with the interplay of business purpose and economic substance doctrines, is mandatory.

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242. *See* I.R.C. § 1366(d).
243. *See id.* § 465.
244. *See id.* § 469.
245. Stephens, *supra* note 206, at 58.
246. *Id.* at 59.