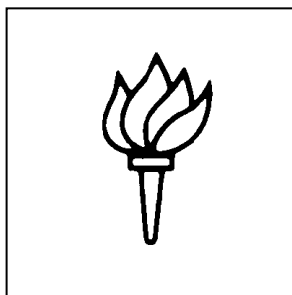


**NEW YORK UNIVERSITY SCHOOL OF LAW**  
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Corporate Shams

*Joshua D. Blank and Nancy C. Staudt*

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# CORPORATE SHAMS

Joshua D. Blank\* and Nancy Staudt\*\*

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

*In this Article, we focus on the government challenges to corporate financial plans—often labeled corporate shams—in an effort to understand how and why courts draw the line between legal and fraudulent behavior. Quite a few scholars and commentators have investigated this question and nearly all agree: judicial decision making in this area of the law is erratic and unpredictable. We build on the extant literature with the help of a large dataset—the first of its kind—and uncover important and heretofore unobserved trends. Indeed, courts have not produced a confusing morass of outcomes as some have argued, but have generated more than a century of opinions that collectively highlight the point at which ostensibly legal planning shades into abuse and fraud. After discussing our empirical results, we show how they can be exploited by both government and corporate attorneys and explore how they bolster many of normative views set forth by the scholarly and policymaking communities.*

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

\*\* Edward G. Lewis Chair in Law and Public Policy, University of Southern California Gould School of Law and Price School of Public Policy.

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## TABLE OF CONTENTS

I. INTRODUCTION.....	3
II. CORPORATE TAX ABUSE AND JUDICIAL UNCERTAINTY .....	7
A. <i>What Is Corporate Tax Abuse?</i> .....	7
1. <i>Anti-Abuse Standards</i> .....	9
2. <i>Judicial Uncertainty</i> .....	11
3. <i>Economic Substance Codification</i> .....	14
B. <i>Red Flags and Smell Tests</i> .....	15
1. <i>Government Officials</i> .....	17
2. <i>Tax Practitioners</i> .....	19
3. <i>Tax Scholars</i> .....	21
C. <i>The Stakes of Judicial Uncertainty</i> .....	23
III. AN EMPIRICAL STUDY OF CORPORATE TAX ABUSE IN THE SUPREME COURT .....	25
A. <i>The Data and the Models</i> .....	25
1. <i>Data Collection Strategy</i> .....	25
2. <i>Allegations of Corporate Tax Abuse: Why They Are Important and Where to Find Them</i> .....	26
3. <i>Three Statistical Models</i> .....	32
B. <i>Empirical Findings</i> .....	37
1. <i>Corporate Tax Abuse Cases Versus Other Types of Tax Cases in the Supreme Court</i> .....	38
2. <i>What Explains Supreme Court Decisions in the Corporate Tax Abuse Cases?</i> .....	43
a. <i>Transaction-Related Factors</i> .....	45
b. <i>Tax Return Factors: Accounting Irregularities and Refund Claims</i> .....	50
c. <i>Personnel Factor: Justice Scalia</i> .....	51
d. <i>The Control Variables</i> .....	53
C. <i>Model Evaluation: Its Successes and Its Limitations</i> .....	54
IV. IMPLICATIONS AND FUTURE RESEARCH .....	60
A. <i>Can Parties Exploit Our Findings?</i> .....	61
1. <i>Private Practitioners</i> .....	62
2. <i>Government Lawyers</i> .....	63
3. <i>Settlement</i> .....	64
B. <i>Should Business Purpose Matter?</i> .....	65
V. CONCLUSION .....	67
APPENDIX.....	69

## CORPORATE SHAMS

3

## I. INTRODUCTION

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

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

You might respond to these schemes in a manner that goes something like this: 1) “No way!” 2) “Is that legal?” 3) “Interesting . . . tell me more.” After all, many—perhaps most—people want to make money and lower their taxes, but few want to unabashedly break the law. Refusing to pay your taxes under the guise of being a tax protestor is illegal.<sup>1</sup> Setting up an off-shore business to avoid U.S. taxes seems more acceptable but still has the unsavory feel of unlawful behavior.<sup>2</sup> Buying assets and depreciating them, however, is not only legal but entirely routine.<sup>3</sup> Indeed, data indicate that while most people and firms do not seek to engage in outright fraud,<sup>4</sup> quite a few have taken their lawyers’ advice to buy city assets—such as buses, light rails, bridges, and on and on—for the sole purpose of obtaining huge depreciation tax deductions.<sup>5</sup>

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<sup>1</sup> Willful failure to pay taxes is a violation of the law. See I.R.C. § 7201 (tax evasion); see also *Cheek v. U.S.*, 498 U.S. 192 (1991) (a tax protestor’s “good faith” belief that he does not owe taxes is a defense to the crime). For a description of the “zero wages” position, see Int. Rev. Serv., *IRS Announces “Dirty Dozen” Tax Scams for 2006*, IRS.gov (Feb. 7, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=154293,00.html>.

<sup>2</sup> See Int. Rev. Serv., *Abusive Offshore Tax Avoidance Schemes - Talking Points*, IRS.gov (Feb. 25, 2012), <http://www.irs.gov/businesses/small/article/0,,id=106568,00.html>; see also RONEN PALAN, RICHARD MURPHY, & CHRISTIAN CHAVEAGNEUX, *TAX HAVENS: HOW GLOBALIZATION REALLY WORKS* (2010) (discussing sham operations in tax havens).

<sup>3</sup> See Int. Rev. Serv., *A Brief Overview of Depreciation*, IRS.gov (Feb. 25, 2012), available at <http://www.irs.gov/businesses/small/article/0,,id=137026,00.html>.

<sup>4</sup> See, Federal Bureau of Investigation, 2009 Financial Crimes Report, available at <http://www.fbi.gov/stats-services/publications/financial-crimes-report-2009> (discussing financial fraud statistics).

<sup>5</sup> Taxpayers have claimed more than \$35 billion in tax deductions associated with this type of transaction. See *Mayer Brown LLP v. IRS*, 562 F.3d 1190, 1194 (D.C. Cir. 2009). For

Notwithstanding the seeming distinctions between #1 and #2, on the one hand, and #3, on the other, the government has taken the position that they have a common attribute—they are shams. Or, more precisely, the schemes are motivated for no reason other than to avoid paying taxes.<sup>6</sup> Policymakers have noted that individuals and businesses have become alarmingly adept at using deception and pretense to extract money from the U.S. Treasury, all the while presenting themselves as law-abiding citizens and responsibly-run business enterprises.<sup>7</sup> The problem for the government, however, is that many sham activities *are* entirely consistent with the law. For example, no existing statute prohibits or sanctions the purchase of city transportation equipment, and the federal tax laws clearly permit owners to depreciate assets used in a trade or business.<sup>8</sup> In fact, the strictly legal nature of the third scheme above is precisely why it is so popular and why it has been the subject of extensive litigation in federal court.<sup>9</sup> While many policymakers label these and other similar transactions as “nothing more than good old-fashioned fraud,”<sup>10</sup> government lawyers are placed into the difficult position of challenging activities that literally adhere to the letter of the law.<sup>11</sup>

In this Article, we examine judicial responses to activities that may be perceived to be shams.<sup>12</sup> In particular, we focus on government challenges to

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a terrific discussion of the technique, see Robert W. Wood & Steven E. Hollingworth, *SILOs and LILOs Demystified*, 129 TAX NOTES 195 (Oct 11, 2010).

<sup>6</sup> See, e.g., *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4<sup>th</sup> Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profits exists.”).

<sup>7</sup> See *Baucus Opposes Provision Helping Banks Avoid Taxes* (Dec. 10, 2008), *Doc 2008-25957, 2008 TNT 239-28* (quoting former Senate Finance Committee Chair Max Baucus as describing these transactions as “shell games” and “three-card-monte transactions”).

<sup>8</sup> See I.R.C. § 167.

<sup>9</sup> See Robert W. Wood, *What Wells Fargo Brings to the SILO/LILO Debate*, 131 TAX NOTES 1389 (June 27, 2011) (discussion litigation and settlement agreements with respect to the tax plans).

<sup>10</sup> Press Release, U.S. Senate Committee on Finance (Nov. 18, 2003), *Doc 2003-24836, 2003 TNT 223-33* (quoting Senate Finance Committee ranking minority member Charles Grassley, R-Iowa).

<sup>11</sup> See, e.g., *Long Term Capital Holdings vs. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004); *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 622-23 (D. Md. 2004); *IES Industries, Inc. v. U.S.*, 253 F.3d 350 (8<sup>th</sup> Cir. 2001); *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992); *DeMartino v. Commissioner*, 862 F.2d 400 (2<sup>nd</sup> Cir. 1988); *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4<sup>th</sup> Cir. 1985); *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716, 755 (2004), rev'd, 454 F.3d 1340 (Fed. Cir. 2006).

<sup>12</sup> See, e.g., *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4<sup>th</sup> Cir. 1985).

## CORPORATE SHAMS

5

corporate shams.<sup>13</sup> While corporations have engaged in creative financial planning—or in the government’s view deceit and manipulation—in a wide range of legal areas, some of the most innovative, complex, and lucrative schemes have emerged with the help of the tax law.<sup>14</sup> Accordingly, we study corporate tax planning in an effort to understand and explain how and why courts draw the line between law-abiding activities and those that are abusive. Our goal is to identify the factors that convince judges that certain types of behavior cross the line of legal acceptability in the corporate tax context, thereby offering transparency and clarity to an area of the law long believed to be erratic, confusing and indeterminate.<sup>15</sup> Further, we hope that our study—the first of its kind—will offer insight into other legal contexts in which courts characterize ostensibly legal behavior as abusive and fraudulent.<sup>16</sup>

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<sup>13</sup> While courts have utilized the term “sham” to refer to a variety of transactions, *see, e.g., Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4<sup>th</sup> Cir. 1985), *Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959); *ASA Investering Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2002), *Knetsch v. United States*, 364 U.S. 361 (1960), our study examines Supreme Court cases in which the government alleged that the corporate transaction at issue was abusive in any way. *See infra* notes 137 - 159 and accompanying text.

<sup>14</sup> *See* U.S. DEP’T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS (1999); Int. Rev. Serv., Abusive Corporate Tax Shelters Background Paper, 2001, *available at* <http://www.irs.gov/pub/irs-utl/abbakppr.pdf> (“Corporate tax shelters cost the federal government billions of dollars each year,” and, by implication, saves corporations billions of dollars each year).

<sup>15</sup> David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 228 (2002); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 239 (1999); David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1, 11 (2003) (arguing that judicial anti-abuse doctrines “apply to everything and nothing”); Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45 (2007); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 S.M.U. L. REV. 195, 195 (2001) (describing differences between judicial anti-abuse doctrines as “fairly gossamer.”); Terrence R. Chorvat, *Tax Shelters, Dutch Books, and the Fundamental Theorem of Asset Pricing*, 26 VA. TAX REV. 859 (2007) (describing courts’ use of “inconsistent methods of applying the law to these transactions”); Yoram Keinan, *The Many Faces of the Economic Substance’s Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J. L. & BUS. 371, 373 (2005) (“[C]ircuits and courts have been divided with respect to the application of this two-prong test”); Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 391 (2010).

<sup>16</sup> Other instances of corporate shams include: anti-competitive litigation, *see* Christopher C. Klein, *The Economics of Sham Litigation: Theory, Cases, and Policy*, Bureau of Economics Staff Report to the Federal Trade Commission (April 1989), *available at* <http://www.ftc.gov/be/econrpt/232158.pdf>; liability avoidance, *see generally* Douglass G. Smith, *Piercing the Corporate Veil in Regulated Industries*, 2008 BYU L. REV. 1165; financial accounting, *see* Jacqueline Lang Weaver, *Can Energy Markets Be Trusted? The Effect of the*

Our study contributes to the literature on corporate shams by examining both qualitative and quantitative data in an effort to understand and explain the judicial mind. Previous studies have focused on a small number of cases and have contributed important insights,<sup>17</sup> but the narrow focus of the existing literature may have caused scholars to overlook decision-making trends observable only with the help of a large-*N* dataset. Accordingly, we reviewed every Supreme Court case issued since 1909—nearly 1,000 cases—and collected information on the cases in which the government alleged the presence of a corporate tax sham. With this data in hand, we uncovered surprising trends in the judicial decision-making process. Our study shows that certain identifiable factors clearly increase the likelihood that the Court will find a corporation has overstepped the bounds of acceptable financial planning and into the realm of abuse. Signals of questionable behavior, for example, include highly complex transactions,<sup>18</sup> inconsistent tax and accounting positions,<sup>19</sup> and requests for large tax refunds.<sup>20</sup> Moreover, notwithstanding the nearly obsessive attention paid by scholars and policymakers to the underlying business purpose of a transaction, our study shows that this factor does not play the key role in the judicial decision-making process that might be expected.<sup>21</sup> In short, our findings run counter to the conventional wisdom that courts do not follow predictable patterns when deciding these cases.

Our study unfolds as follows. Part II of this Article provides a brief overview of corporate tax abuse and describes the varied approaches to identifying the problem in the judiciary and regulatory agencies, and by practitioners and scholars. Part IIIA turns to the empirical component of our project and presents our methodology and findings; Part IIIB discusses the successes and limitations of our empirical strategy. Part IV investigates a series of normative and practical questions that emerge from our findings. We first explore how lawyers—those representing both corporations and the government—can exploit our empirical results when planning transactions and when devising litigation strategies. We

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*Rise and Fall of Enron on Energy Markets*, 4 HOUSTON BUS. & TAX L.J. 1 (2004); contract fraud, U.S. EPA, WHEN GOOD MONEY GOES BAD: TRUE STORIES OF CONTRACT FRAUD AT EPA (2011); environmental abuses, see John Copeland Nagle, *CERCLA's Mistakes*, 38 WM. & MARY L. REV. 1405 (1997); credit default swaps, see Janet Tavakoli, *Greek Credit Default Swaps Are A Sham And It's No Surprise*, BUS. INSID., Oct. 27, 2011, available at [http://articles.businessinsider.com/2011-10-27/markets/30327607\\_1\\_credit-default-credit-derivatives-international-swaps](http://articles.businessinsider.com/2011-10-27/markets/30327607_1_credit-default-credit-derivatives-international-swaps); and more general uses of “regulatory gamesmanship”, see Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010).

<sup>17</sup> See *infra* notes 118 - 129 and accompanying text.

<sup>18</sup> See *infra* notes 106 - 110 and accompanying text.

<sup>19</sup> See *infra* notes 96 - 97 and accompanying text.

<sup>20</sup> See *infra* notes 94 - 95 and accompanying text.

<sup>21</sup> See *infra* note 191 and accompanying text.

## CORPORATE SHAMS

7

then consider our findings in the context of existing scholarly and policymaking views, and find that many of our empirical results bolster the normative views set forth in the extant literature on how courts should make decisions vis-à-vis corporate shams. Part V concludes.

## II. CORPORATE TAX ABUSE AND JUDICIAL UNCERTAINTY

A. *What Is Corporate Tax Abuse?*

Corporate managers attempt to reduce their corporations' costs in a wide range of areas, and taxes are a prime focus of this planning. As discussed in detail below, the complexity of the tax law is precisely why tax planning offers a lucrative means to preserve corporate profits. Managers, for example, may take advantage of explicit corporate tax preferences in the Internal Revenue Code and advise their corporate clients to engage in specific activities, such as purchasing particular types of software or transportation vehicles that are entitled to highly accelerated depreciation for tax purposes.<sup>22</sup> On the other hand, they may pursue tax strategies that employ hyper-literal readings of the Internal Revenue Code that produce valuable tax benefits—tax deductions, tax credits and tax exemptions—without having any meaningful effect on the economic positions of their corporations.<sup>23</sup> The latter collection of tax strategies are widely perceived to be “abusive” because they fail to reflect economic reality and produce tax results that were never envisioned by Congress.

In the earliest forms of corporate tax abuse, corporations deployed relatively simple strategies to achieve characterizations of certain transactions or entities that yielded beneficial tax results. For example, business taxpayers often attempted to characterize themselves as partnerships, which were not subject to entity-level taxation, as opposed to corporations, which were subject to entity-level taxation.<sup>24</sup> Another early strategy was the frequent attempt by corporations to eliminate corporate taxation by disguising payments to shareholders as items that generated tax deductions, such as rental or salary payments, even though, in reality, these items constituted non-deductible dividends.<sup>25</sup> Other corporations attempted to manipulate the characterization of their tax years by exploiting differences between the calendar year and their fiscal years.<sup>26</sup> In each of these

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<sup>22</sup> See I.R.C. § 179(d)(1)(ii) (deduction for off-the-shelf software allowed for year placed in service).

<sup>23</sup> See U.S. DEP'T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS (1999).

<sup>24</sup> See, e.g., *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110 (1925).

<sup>25</sup> See, e.g., *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938).

<sup>26</sup> See, e.g., *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944).



cases, corporations aimed to exploit ambiguities in the newly forming statutory law to reduce, or eliminate altogether, corporate tax liability.

Over a century after the enactment of the federal corporate income tax,<sup>27</sup> abusive corporate tax strategies have evolved in complexity. The mass-marketing of these strategies by the major accounting firms and other promoters in the late 1990s and early 2000s<sup>28</sup> led to a corporate tax abuse boom that commentators described in terms such as “epidemic,”<sup>29</sup> “crisis,”<sup>30</sup> and “a beast” that must be “slayed.”<sup>31</sup> Modern corporate tax abuse strategies often involve multiple transaction steps, parties and tax jurisdictions. An abusive corporate tax strategy today, for instance, may feature a transaction in which a corporation purchases millions of dollars of stock, sells the stock back to its original owner several minutes later and then claims millions of dollars in foreign tax credits.<sup>32</sup> Or it may involve multiple steps in which a corporation participates in a transaction with a Luxembourg bank that enables it to increase its tax basis in stock, which it then sells to a third party, generating a large tax-deductible loss.<sup>33</sup> The government maintains a list of tax strategies that it believes constitute corporate tax abuse and the list contains dozens of colorfully named strategies,<sup>34</sup> such as COBRA (currency options bring reward alternatives)<sup>35</sup> and PICO (personal income company),<sup>36</sup> BOSS (bond and options sales strategies), and Son-of-BOSS.<sup>37</sup> While the latest forms of abusive corporate tax strategies are certainly more sophisticated than their predecessors, their basic objective—avoidance of

<sup>27</sup> Tariff Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112.

<sup>28</sup> See Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999); Janet Novack & Laura Saunders, *The Hustling of X-Rated Tax Shelters*, FORBES, Dec. 14, 1998, at 198.

<sup>29</sup> Frontline: Tax Me If You Can (PBS television broadcast Feb. 19, 2004) (referring to tax shelter “epidemic”).

<sup>30</sup> See Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 Va. Tax Rev. 1, 62 (“[T]extualism has affected the practice of tax law and has contributed to the recent tax shelter crisis.”).

<sup>31</sup> Interview, Gilbert S. Rothenberg, 29 ABA SECTION OF TAXATION NEWS QUARTERLY 2, 7 (2010).

<sup>32</sup> *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5<sup>th</sup> Cir. 2001) (dividend stripping tax shelter).

<sup>33</sup> IRS Notice 2001-45, 2001-2 C.B. 129 (basis shifting tax shelter).

<sup>34</sup> Treas. Reg. § 1.6011-4(b)(2). The IRS maintains the list of abusive tax shelters on its website. See Internal Revenue Service, *Abusive Tax Shelters and Transactions*, <http://www.irs.gov/businesses/corporations/article/0,,id=97384,00.html>.

<sup>35</sup> IRS Notice 2002-35, 2002-1 C.B. 992.

<sup>36</sup> IRS Notice 2002-65, 2002-2 C.B. 690.

<sup>37</sup> See IRS discussion of BOSS and Son-of-Boss transactions at <http://www.irs.gov/newsroom/article/0,,id=123025,00.html>.

## CORPORATE SHAMS

9

corporate tax liability through an application of the tax law that Congress never envisioned—has not changed.

1. *Anti-Abuse Standards*

Corporate tax abuse is distinct from other forms of tax noncompliance—its illegitimacy is determined *ex post*. To appreciate this distinction, consider corporate tax behavior that involves the violation of an explicit tax rule, such as claiming a fraudulent tax deduction for a business expense that was never actually incurred, an activity that is illegal *ex ante*. Now consider a corporate tax strategy that corporate managers believe—or at least convince themselves they believe—complies with the literal language of the Internal Revenue Code. Although no explicit rule in the tax law prohibits the corporation from claiming the resulting tax benefits, the IRS is likely to challenge the strategy and ask a court to declare it abusive *ex post* on the grounds that it enables the corporation to obtain tax unintended benefits in that clash with the Internal Revenue Code’s revenue-raising policy objectives.<sup>38</sup> The most prominent anti-abuse standards that courts apply when considering whether or not to respect corporate tax strategies after they have already been implemented are described briefly below.

*Sham Transaction Doctrine.* Under the “sham transaction” doctrine, a court may disallow a taxpayer’s claimed tax treatment if it determined that the underlying transaction at issue never occurred.<sup>39</sup> For example, if a corporation’s tax position in a particular year stemmed from the corporation’s purchase of Treasury notes, but the corporation did not actually purchase the notes, a court could reject the corporation’s tax position as a sham.<sup>40</sup>

*Economic Substance Doctrine.* While the precise contours of the “economic substance doctrine” have historically varied from court to court,<sup>41</sup> under this standard, many courts will respect a corporation’s claimed tax treatment of a transaction only if (a) the corporation possessed a non-tax business purpose in pursuing the transaction and (b) the transaction resulted in a meaningful

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<sup>38</sup> For discussion, see Joshua D. Blank, *What’s Wrong With Shaming Corporate Tax Abuse*, 62 TAX L. REV. 541, 545-549 (2009).

<sup>39</sup> *Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959); *ASA Investering Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2002). For example, if a corporation’s tax position in a particular year stemmed from the corporation’s purchase of Treasury notes, but the corporation did not actually purchase the notes, a court could reject the corporation’s tax position as a sham.

<sup>40</sup> See *Knetsch v. United States*, 364 U.S. 361 (1960).

<sup>41</sup> See *infra* notes 47 to 85 and accompanying text for discussion.

improvement to the economic position of the corporation (apart from reducing its tax liability).<sup>42</sup>

*Substance Over Form Doctrine.* Consistent with the principle that the government should not tax economically similar transactions differently, a court may also apply the “substance over form” doctrine to ignore the corporation’s form of the transaction and, instead, to tax the transaction based on its underlying economic substance.<sup>43</sup> This standard generally works only in the government’s favor; it does not permit the corporation to abandon its chosen legal form.<sup>44</sup>

*Step Transaction Doctrine.* Last, the “step transaction” doctrine enables a court to reject a corporation’s tax position by integrating a “series of formally separate ‘steps’ as a single transaction” and by applying the appropriate tax treatment to the integrated transaction.<sup>45</sup> This judicial anti-abuse standard appears in several forms.<sup>46</sup>

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<sup>42</sup> ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998). For discussion of the development of the economic substance doctrine, *see generally* Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 391 (2010). This judicial anti-abuse standard originated in Gregory v. Helvering, 293 U.S. 465 (1935), in which the court held that the transaction at issue (a corporation’s distribution of stock of a subsidiary to its controlling shareholder followed by the sale of that stock, resulting in capital gains instead of dividend treatment) lacked a non-tax business purpose and was inconsistent with Congress’s intent underlying the relevant statutes. *Id.* For other applications of the doctrine, *see* Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); Sheldon v. Commissioner, 94 T.C. 738 (1990); Ginsburg v. Commissioner, 35 T.C.M. (CCH) 860 (1976).

<sup>43</sup> *See, e.g.*, Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938).

<sup>44</sup> *See Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967).

<sup>45</sup> Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

<sup>46</sup> Under the “binding commitment test,” a court may integrate one transaction with a second transaction if there was a binding commitment to undertake the second transaction at the time of the first transaction. *See, e.g.*, J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995). The “mutual interdependence test” provides that two transactions should be integrated if the legal relationships created by the first transaction would be meaningless without the completion of the second transaction. *See, e.g.*, Reef Corporation v. Commissioner, 368 F.2d 125 (5th Cir. 1966). The “end result test” enables a court to integrate a transaction’s steps if the court determines that the corporation intended to undertake the separate steps simply to achieve a specific end result. *See, e.g.*, King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

## CORPORATE SHAMS

11

2. *Judicial Uncertainty*

As tax lawyers and scholars have commented for generations, the courts often apply their anti-abuse standards in unpredictable ways.<sup>47</sup> Some commentators have focused on the vagueness of elements of particular standards, such as the business purpose requirement, arguing that as a result of their breadth, they “apply to everything and nothing.”<sup>48</sup> Others have focused more closely on the difficulty of distinguishing the standards, such as by defining how the different versions of the step-transaction doctrine are different from one another.<sup>49</sup> And many commentators have highlighted cases that involve similar facts, but that result in different judicial outcomes.<sup>50</sup> Regardless of the specific criticism levied, all of these commentators agree that the possible application of one or more judicial anti-abuse standards introduces uncertainty into the practice of corporate tax planning.

To better comprehend the difficulty in differentiating between transactions that represent corporate tax abuse from those that represent mere corporate tax avoidance, consider two well-known U.S. Supreme Court decisions involving corporate tax planning.

In *Commissioner v. Court Holding*,<sup>51</sup> the Court Holding Company held appreciated real property, which its managers wanted to sell.<sup>52</sup> If Court Holding Company had sold the property itself, it would have incurred tax on the sale of the property and its shareholders would have incurred tax liability on the distribution of any proceeds from the sale.<sup>53</sup> The management of the Court Holding Company, however, devised an alternative tax strategy.<sup>54</sup> They advised the Court Holding Company to distribute the real property first to its shareholders as a dividend distribution, which at the time, 1940, did not cause Court Holding Company to recognize gain, and then to have the shareholders immediately turn

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<sup>47</sup> See, e.g., Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457 (1999); Hariton, note 23; Keinan, *supra* note 15; Weisbach, *supra* note 15; Sheldon I. Banoff, *Mr. Popeil Gets ‘Reel’ About Conversions of Legal Entities: The Pocket Fisherman Flycasts for “Form” but Snags on Substance*, 75 TAXES 887, 887 (1997); Chorvat, *supra* note 15; Schler, *supra* note 15.

<sup>48</sup> Hariton, *supra* note 23 at 11.

<sup>49</sup> Martin McMahon has argued that “any fair minded person would have to admit that those differences are often fairly gossamer.” McMahon, *supra* note 15 at 195.

<sup>50</sup> See *infra* note 69 and accompanying text.

<sup>51</sup> 324 U.S. 331 (1945).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

around and sell the property to the ultimate purchaser.<sup>55</sup> By preventing the corporation itself from playing the part of seller, the Court Holding Company eliminated the corporate-level tax on the transaction and thus saved the shareholders substantial money. In response, the government argued that the shareholders had merely acted as agents or conduits of the corporation, and the U.S. Supreme Court agreed, holding that it would not allow the “true nature of [the] transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities.”<sup>56</sup>

Almost fifty years later, in 1991, the Court decided another corporate tax planning case, *Cottage Savings Association v. Commissioner*.<sup>57</sup> In that case, the taxpayer, a savings & loan association, owned single-family home mortgages that had declined in value as a result of a rise in interest rates.<sup>58</sup> If the savings & loan had attempted to sell the mortgages, it would have suffered an economic loss.<sup>59</sup> Instead of triggering an economic loss, the managers of the savings & loan designed a transaction that would allow it to incur only a tax loss. The savings & loan association engaged in a swap transaction with a group of other lenders in which it traded its depreciated single-family home mortgages for nearly identical mortgages held by the other lenders.<sup>60</sup> As a result of the economic similarity between the two groups of mortgages, the savings & loan association did not incur a real economic loss and reported no loss for regulatory or accounting purposes.<sup>61</sup> The key to the strategy is that the swap transaction enabled the savings & loan association to experience a realization event and that, even though its economic position did not change, it claimed a \$2.4 million tax loss.<sup>62</sup> The government asserted that the tax loss should be disallowed on the grounds that the underlying transaction failed to satisfy the economic substance doctrine.<sup>63</sup> Unlike the result in *Court Holding*,<sup>64</sup> however, the U.S. Supreme Court sided with the taxpayer, allowing the tax loss even though the exchange of mortgages was economically meaningless.<sup>65</sup>

While these cases resulted in different judicial outcomes, it is not at all clear why the U.S. Supreme Court applied a judicial anti-abuse standard in *Court*

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> 499 U.S. 554 (1991).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> See note 56 *supra*.

<sup>65</sup> *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).

## CORPORATE SHAMS

13

*Holding*, but refused to apply one in *Cottage Savings*. The taxpayer in each case pursued transactions for the sole purpose of avoiding corporate tax liability and in both cases, the transactions that they entered into had no real economic effect; moreover, the government set forth similar arguments in its briefs seeking to bar the taxpayer from obtaining the desired tax benefits.<sup>66</sup> And the record in both cases shows that the taxpayers clearly evidenced intent to avoid federal corporate tax liability, not serve any non-tax-related business purpose.<sup>67</sup> Consequently, when making comparisons of cases involving judicial anti-abuse standards, commentators often find the possible reasons for the disparate outcomes to be “inscrutable.”<sup>68</sup>

Commentators also attribute judicial uncertainty in the corporate tax abuse context to courts’ inconsistent application of particular anti-abuse standards, especially the economic substance doctrine.<sup>69</sup> While some courts have required satisfaction of both prongs of the economic substance doctrine,<sup>70</sup> other courts have required that the taxpayer show that a particular transaction achieved either a non-tax-related business purpose *or* had the potential to generate an economic profit<sup>71</sup> and some courts have refused to apply the economic substance doctrine

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<sup>66</sup> Commentators have attempted to offer distinctions between cases like these, such as that the taxpayer’s transaction in *Court Holding* was unrelated to any ongoing ordinary business while the taxpayer’s transaction in *Cottage Savings* was part of an ongoing mortgage business. See, e.g., Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 17 (2000) (“[T]he swap in *Cottage Savings*, while economically insignificant in itself, was tied to ordinary business operations, and what was measured for substantial economic effect was not just the swap, but the business operations to which it was tied”). Yet the presence of an ongoing business is not a requirement of any of the judicial anti-abuse standards.

<sup>67</sup> See *Commissioner v. Court Holding*, 324 U.S. 331 (1945); *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).

<sup>68</sup> Hariton, *supra* note 15 (“The efforts to tease out what the taxpayers did wrong in these cases and distinguish them from what taxpayers did right in other cases have been wholly inscrutable.”).

<sup>69</sup> See, e.g., Martin J. McMahon, *Economic Substance, Purposive Activity and Corporate Tax Shelters*, 94 TAX NOTES 1017 (referring to economic substance doctrine as “a useless mechanistic test”); Keinan, *supra* note 15; Hariton, *supra* note 15; Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, 94 TAX NOTES 511 (2002) (criticizing application of economic substance doctrine).

<sup>70</sup> See, e.g., *Long Term Capital Holdings vs. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004) (applying conjunctive economic substance test).

<sup>71</sup> See, e.g., *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 622-23 (D. Md. 2004); *IES Industries, Inc. v. U.S.*, 253 F.3d 350 (8th Cir. 2001); *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992); *DeMartino v. Commissioner*, 862 F.2d 400 (2nd Cir. 1988); *Rice’s Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985) (applying disjunctive economic substance test).

completely.<sup>72</sup> As a result, many commentators have shared Professor Leandra Lederman's sentiment that "the result is a test that does little to distinguish tax shelters and other abusive transactions from legitimate ones."<sup>73</sup>

The record of judicial outcomes over the past decade supports the view that corporate tax abuse is an uncertain area of the law. In the late 1990s and early 2000s, corporate taxpayers lost their cases at the trial-level in *United Parcel Service of America v. Commissioner*,<sup>74</sup> *Compaq Computer Corp. v. Commissioner*<sup>75</sup> and *IES Industries, Inc. v. United States*.<sup>76</sup> In each of these cases, the court applied one of the judicial anti-abuse standards to reject the taxpayer's claimed tax treatment. Upon appeal, however, the federal appellate courts reversed the trial courts' decisions and held in favor of the corporate taxpayer.<sup>77</sup> Several years later, in 2004, the government lost a trio of high-profile corporate tax abuse cases at the trial level, *Black & Decker Corp. v. United States*,<sup>78</sup> *Coltec Indus., Inc. v. United States*<sup>79</sup> and *TIFD III-E, Inc. v. United States*.<sup>80</sup> Again, upon appeal, the federal appellate courts held in favor of the government in each case.<sup>81</sup> Despite the ultimate outcomes of these cases, the split decisions between trial courts and appellate courts only provide further confirmation that judges are uneven when applying the judicial anti-abuse standards for purposes of determining whether a tax strategy represent corporate tax abuse.

### 3. Economic Substance Codification

In response to the courts' inconsistent application of the economic substance doctrine, in 2010, Congress enacted special legislation regarding this particular

<sup>72</sup> See, e.g., *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716, 755 (2004), rev'd, 454 F.3d 1340 (Fed. Cir. 2006).

<sup>73</sup> Lederman, *supra* note 15 at 391.

<sup>74</sup> 78 T.C.M. (CCH) 262 (1999).

<sup>75</sup> 113 T.C. 214 (1999).

<sup>76</sup> No. C97-206, 1999 U.S. Dist. LEXIS 22610 (N.D. Iowa 1999).

<sup>77</sup> *United Parcel Service of America v. Commissioner*, 254 F.3d 1014 (11<sup>th</sup> Cir. 2001); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5<sup>th</sup> Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8<sup>th</sup> Cir. 2001).

<sup>78</sup> 340 F. Supp. 2d 621 (D. Md. 2004).

<sup>79</sup> 62 Fed. Cl. 716 (2004).

<sup>80</sup> 342 F. Supp. 2d 94 (D. Conn. 2004).

<sup>81</sup> *Black & Decker Corp. v. United States*, 436 F.3d. 431 (4<sup>th</sup> Cir. 2006); *Coltec Indus., Inc. v. United States*, 454 F.3d. 1340 (Fed. Cir. 2006), cert. denied, 549 U.S. 1206 (2007); *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

judicial anti-abuse standard.<sup>82</sup> The legislation created a standard that courts must apply in cases in which they determine that the economic substance doctrine is relevant: they must treat a transaction as possessing economic substance if it changes the taxpayer's economic position in a meaningful way (apart from tax effects) and the taxpayer has a substantial purpose (apart from tax reasons) for entering into the transaction.<sup>83</sup>

While the new legislation creates a uniform economic substance doctrine, many commentators believe that it has little chance of reducing inconsistent judicial outcomes.<sup>84</sup> First, the courts must still reach subjective determinations, such as whether a particular business purpose is "substantial" and whether a change to a taxpayer's economic position is "meaningful." Second, the new statute provides that the "determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."<sup>85</sup> In other words, if a particular judge would not have decided to apply the economic substance doctrine before the enactment of this statute, the judge has no obligation to apply this particular judicial anti-abuse standard now.

#### B. *Red Flags and Smell Tests*

The prediction of whether a court would apply a particular judicial anti-abuse standard, or any standard at all, is a challenging exercise. While one court may respect the separate steps of a taxpayer's transaction as independent from each other, a different court may review the same transaction and determine that the steps should instead be viewed, and taxed, as one.<sup>86</sup> Figure 1 draws on the

<sup>82</sup> See Health Care and Education Reconciliation Act of 2010, H.R. 4872, 111th Cong. § 1409 (2010) (adding new I.R.C. § 7701(o)).

<sup>83</sup> I.R.C. § 7701(o)(1). In addition, to deter taxpayers from entering into abusive corporate tax strategies, Congress also enacted a 20% tax penalty, I.R.C. § 6662(b)(6), that applies whenever a taxpayer loses a tax benefit as a result of the application of the economic substance doctrine or "any similar rule of law." I.R.C. § 6662(b)(6). The tax penalty increases to 40% in the case of non-disclosed transactions. I.R.C. § 6662(i). Taxpayers are not entitled to raise reasonable cause as a defense to these new tax penalties, making them effectively strict liability tax penalties. I.R.C. § 6664(c)(2).

<sup>84</sup> See Richard M. Lipton, *Codification of the Economic Substance Doctrine—Much Ado About Nothing?*, 112 J. TAX'N 325 (2010); David Hariton, *Has Codification Changed the Economic Substance Doctrine*, 2 COLUM. J. TAX L. TAX MATTERS 5 (2011) ("codification has almost no substantive effect").

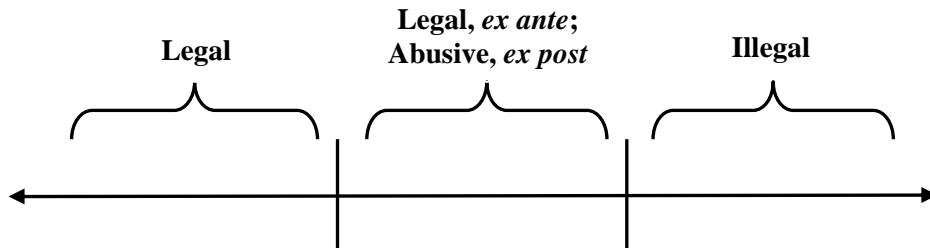
<sup>85</sup> I.R.C. § 7701(o)(5)(C).

<sup>86</sup> See *supra* notes 47 to 85 and accompanying text for discussion. As Judge Learned wrote famously in *Gregory v. Helvering*, "[a]ny one may so arrange his affairs so that his taxes shall be as low as possible." *Gregory v. Helvering*, 69 F.2d 809 (1934). Yet, in the same the



insights of Professor Kyle Logue,<sup>87</sup> and illustrates the challenge of identifying transactions that may be characterized as “abusive” by describing the judicial characterizations that may apply to corporations’ tax reduction strategies:

FIGURE 1  
Continuum of Corporate Tax Planning Controversies



At the left end of the continuum are legal activities, which include clearly permissible tax positions, such as a corporation’s decision to apply the correct tax rate to its established tax liability.<sup>88</sup> But they may also include more aggressive strategies that are nonetheless permissible. For example, a corporate parent may deliberately commence a complete liquidation of its corporate subsidiary at a time when it owns less than 80% of its vote and value, even though the corporate parent will eventually acquire 100% ownership, solely to enable the subsidiary to recognize a tax loss on the distribution of depreciated property.<sup>89</sup> At the right end of the continuum are clearly illegal activities, such as a corporation’s decision to claim a business expense for high salary expenses that it never actually incurred. The middle section of the continuum represents corporate tax abuse, tax positions that are consistent with the letter of the tax law and are legal *ex ante*, but produce tax benefits for the corporation that Congress did not intend and thus are viewed abusive *ex post*. Individuals involved in corporate tax planning expend

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opinion, before rejecting the taxpayer’s claimed treatment, Judge Hand offered the contradictory statement that “the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes.” *Id.*

<sup>87</sup> Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241 (2007) (presenting a useful continuum of uncertainty in tax abuse cases); Kyle D. Logue, *Tax Law Insurance and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 360 (2005) (presented a similar continuum to our Figure 1).

<sup>88</sup> I.R.C. § 11(a).

<sup>89</sup> I.R.C. § 332; *George L. Riggs, Inc. v. Commissioner U.S. Tax Ct.*, 64 TC 474 (1975) (holding that “with advance planning and properly structured transactions, a corporation should be able to render §332 applicable or inapplicable”).

significant effort endeavoring to determine *ex ante* whether a court would view a particular tax strategy as crossing the line between aggressive, but legal. Or put differently the line between legal corporate tax minimization (on the left side of the continuum) and abusive corporate tax evasion (in the middle of the continuum).

Given the uncertain nature of the judicial anti-abuse standards, a variety of opinions exist regarding the factors that are most critical to the determination of whether a court would reject a corporation's claimed tax treatment. In this Subpart, we examine the respective methodologies that three different groups of individuals apply when attempting this inquiry: government officials, practitioners representing taxpayers and scholars.

### 1. *Government Officials*

Government officials have identified several factors that they believe are relevant to the question of whether a court will respect a corporation's tax position. One source of these factors is the broad set of disclosure requirements with which corporations (and other types of taxpayers) must comply.<sup>90</sup> Under these rules, corporations must file special disclosure forms with the IRS whenever they engage in transactions that bear certain "red flag" traits.<sup>91</sup> The purpose of these disclosure forms is to enhance the detection efforts of the IRS.<sup>92</sup> In addition, these disclosure requirements indirectly reveal the types of factors that government officials believe would influence a court in a tax controversy. Another source of government officials' beliefs is the administrative guidance that the IRS has released for its own agents regarding how it will address the newly codified economic substance doctrine and related tax penalties.<sup>93</sup> The following are some of the most significant of these factors:

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<sup>90</sup> Treas. Reg. § 1.6011-4(e).

<sup>91</sup> *Id.* The law requires taxpayers to file a disclosure statement with the IRS Office of Tax Shelter Analysis at its processing facility in Ogden, Utah, if they have participated in any "reportable transaction" during the taxable year. See Sheryl Stratton, *Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS*, 100 TAX NOTES 1246, 1246-47 (2003). Taxpayers are also required to attach the disclosure statement to their annual tax returns.

<sup>92</sup> For discussion, Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1637-1642 (2009) (describing "red flag" tax shelter detection strategy).

<sup>93</sup> Int. Rev. Serv., *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*, Jul. 15, 2011, available at <http://www.irs.gov/businesses/article/0,,id=242253,00.html>. For discussion, see *Economic Substance Guidance Issued to IRS Examiners*, J. OF ACCOUNTANCY, Oct. 2011.

*Loss Transactions.* The government requires corporations to file a special disclosure form, which describes their transactions in detail, whenever they claim a \$10 million or greater loss for tax purposes.<sup>94</sup> Not every tax loss claimed by a corporation is the result of corporate tax abuse, but government officials believe large tax losses signal the possibility that corporate tax abuse is at hand. In addition, in separate administrative guidance, government officials have commented that courts may consider a tax strategy to be abusive if the underlying transaction enables the corporation to accelerate a loss or duplicate a tax deduction.<sup>95</sup>

*Book/Tax Differences.* Corporations have two distinct income reporting mechanisms. They report income for tax purposes on their federal tax returns, but they also report income in corporate financial documents for purposes of informing shareholders and potential investors.<sup>96</sup> Corporations are required to reveal and explain differences between these two types of income, such as when a corporation's taxable income is lower than its book income, by filing a special disclosure form with the IRS.<sup>97</sup> This requirement indicates that policymakers believe a court should consider book/tax differences in a corporation's treatment of a particular item when determining whether the corporation had engaged in an abusive tax strategy.

*Third Parties.* Government officials have also indicated in administrative guidance that a court may find the application of the economic substance doctrine to be appropriate in cases where a corporation's transaction involved third parties and did not feature arm's length dealings.<sup>98</sup>

*Economic Change.* Last, government officials have stated in administrative guidance that the application of the economic substance doctrine may be appropriate for transactions that create no meaningful economic change on a net present value basis, before considering tax consequences.<sup>99</sup> This statement confirms that government officials believe that courts may reject tax positions that lack corresponding real world economic effects.

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<sup>94</sup> Treas. Reg. § 1.6011-4(b)(5).

<sup>95</sup> Int. Rev. Serv., Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties, *supra* note 93.

<sup>96</sup> For general discussion, see Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, in James M. Poterba, ed., TAX POLICY AND THE ECONOMY 169 (NBER 2003).

<sup>97</sup> Large corporate taxpayers file Schedule M-3 with the IRS, a form that requires them to reconcile inconsistencies between income they report for income tax and financial accounting purposes. I.R.S. Form 1120, Schedule M-3 (2010), *available at* <http://www.irs.gov/pub/irs-pdf/f1120sm3.pdf>.

<sup>98</sup> Int. Rev. Serv., Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties, *supra* note 93.

<sup>99</sup> *Id.*

## CORPORATE SHAMS

19

2. *Tax Practitioners*

Corporate tax lawyers devote significant time and energy to advising clients regarding the likelihood that courts would respect their transactions as consistent with the tax law or as abusive. The most preeminent corporate tax lawyers are often also the most outspokenly confident that they can predict whether a particular corporate tax reduction strategy would pass the judicial “smell test.” For example, when commenting on a series of cases in the late 1990s where courts rejected corporations’ tax positions as abusive, M. Carr Ferguson, a distinguished practitioner, queried, “Was it really so difficult for counsel planning the taxpayers’ transaction in those recent cases to make this prediction?”<sup>100</sup> Peter Canellos, another elite practitioner, has described the prognostic ability of experienced tax lawyers even more directly, stating, “Although in theory the line between a tax shelter and an aggressively structured real transaction may appear difficult to draw, in actuality the distinction is generally rather easy.”<sup>101</sup> Some of the factors that many “experienced tax professionals”<sup>102</sup> believe would cause a court to designate a corporation’s tax strategy as abusive are described below.

*Business Purpose.* When practitioners analyze the probability that a court will apply a judicial anti-abuse standard to unwind a corporation’s transaction, they often focus on the strength of the business purpose underlying the transaction.<sup>103</sup> As Ferguson has argued, courts are likely to respect transactions that “are grounded on long-understood principles of business purpose and economic substance.”<sup>104</sup> Regarding the specifics of the type of purpose that a transaction should serve, Canellos has advised that “real transactions, most obviously, have as their origins and purpose making money in the short-run or the long-run by increasing revenues or reducing (non-tax) expenses.”<sup>105</sup> For tax practitioners, business purpose (apart from tax avoidance) is often one of the most

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<sup>100</sup> M. Carr Ferguson, *How Will A Court Rule?*, 53 TAX LAW. 721, 730 (1999).

<sup>101</sup> Peter C. Canellos, *A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 51 (2001).

<sup>102</sup> *Id.*

<sup>103</sup> See, e.g., Kevin M. Keyes, *Evolving Business Purpose Doctrine*, in PRACTISING LAW INSTITUTE TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2007, PLI Order No. 11569 (2007); Jeffrey C. Glickman & Clark R. Calhoun, *The “States” of the Federal Common Law Tax Doctrines*, 61 TAX LAW. 1181, 1189 (2008) (discussing importance of business purpose analysis).

<sup>104</sup> Ferguson, *supra* note 100 at 51.

<sup>105</sup> Canellos, *supra* note 101 at 51.

important factors that they consider when analyzing the potential judicial merits of the tax treatment of the transaction.

*Multiple Parties and Convoluted Steps.* Another factor that tax practitioners tend to consider is whether the transaction at issue involves more than one party and whether this involvement leads to complex, or as some might say, “convoluted”,<sup>106</sup> transaction steps. Gary Wilcox, practitioner at a large firm, advises that “[m]ulti-step transactions designed to achieve a favorable tax result are often subject to more rigorous scrutiny when the results are significantly different depending on whether the steps are respected or collapsed.”<sup>107</sup> Tax practitioners are especially wary of constructing tax strategies that contain “unusual contrived steps”<sup>108</sup> or that involve “accommodation parties”,<sup>109</sup> such as tax-exempt or foreign entities, which corporations often use for absorbing taxable income resulting from their overall transactions.<sup>110</sup>

*Timing of Steps.* When predicting whether a court would respect the steps separately or attempt to integrate them as occurring in single transaction, tax practitioners often analyze not just the presence of multiple steps, but also the timing of these steps.<sup>111</sup> One critical question that tax practitioners often consider is the amount of time that occurs *between* steps.<sup>112</sup> As one practitioner has written, “[t]he amount of time elapsed between transactions...will be important with respect to whether transactions are stepped together. The shorter the period the more likely transactions will be stepped together.”<sup>113</sup> Lewis Steinberg, another established practitioner, has commented that if the steps of a transaction occur too close in time to one another, a court may view certain entities or steps as having “transitory existence”<sup>114</sup> and disregard them completely.

<sup>106</sup> *Id.*

<sup>107</sup> Gary B. Wilcox, *How and When to Apply Step Transaction Doctrine in Corporate and Partnership Restructuring Transactions*, 24 REAL ESTATE JOURNAL 266 (2008).

<sup>108</sup> Canellos, *supra* note 101 at 65.

<sup>109</sup> *Id.* at 54.

<sup>110</sup> *See, e.g.*, IRS Notice 2001-16, 2001-1 C.B. 730 (intermediary corporation tax shelter).

<sup>111</sup> *See, e.g.*, Aaron Rachelson, *Step-transaction doctrine—Planning to avoid the step-transaction doctrine*, in CORPORATE ACQUISITIONS, MERGERS AND DIVESTITURES, § 5:22 (Sept. 2011); Richard W. Bailine, *The Step Transaction Doctrine: Not Just a Matter of Time*, CORPORATE TAXATION, Jan./Feb. 2003; Mark J. Silverman, *2010 Recent Developments in the Step Transaction Doctrine*, PRACTISING LAW INSTITUTE THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2010, PLI Order No. 27151 (2010).

<sup>112</sup> *See* Wilcox, *supra* note 107 at 266; Steinberg, *supra* note 47; Richard W. Bailine, *supra* note 111.

<sup>113</sup> Rachelson, *supra* note 111.

<sup>114</sup> Steinberg, *supra* note 47.

*Choice of Forum.* In addition to the factors described above, tax practitioners also make predictions regarding the likelihood that a court would respect a corporation's tax position by considering the *type* of court that would review the transaction.<sup>115</sup> Some tax practitioners have expressed the view that if a corporation's transaction was motivated by a strong non-tax business purpose, then the corporation might fare better in U.S. District Court or the U.S. Court of Federal Claims, where a generalist judge, as opposed to a judge with tax expertise, will hear the case.<sup>116</sup> Conversely, some tax practitioners believe that if a client's case hinges on winning a highly technical argument, then litigating in U.S. Tax Court may produce the most favorable result for the corporation.<sup>117</sup>

### 3. Tax Scholars

A final group of individuals whose expectations should be considered is the academic community. Scholars of tax law generally do not advise clients on transaction structures or issue legal opinions. Instead, scholars tend to make normative claims with respect to how judges *should* decide corporate tax abuse cases and then provide prescriptive suggestions, such as concrete tests that judges should apply or legislation that Congress should enact. Implicit in these normative and prescriptive arguments, however, are positive claims regarding judicial behavior in corporate tax abuse cases. After all, scholars would not offer proposals for how judges should decide corporate tax abuse controversies unless they previously held some view of how judges actually decide these cases today. Several of these implicit positive claims are described below.

*Intent.* Scholars have implicitly argued that judges in corporate tax abuse controversies focus excessively, even incorrectly, on arguments regarding the

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<sup>115</sup> See, e.g., Joel V. Williamson et al., *Modern Tax Controversies*, in PRACTISING LAW INSTITUTE THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS, 2010 PLI Order No. 27151 (2010) (discussing forum selection strategies in corporate tax shelter litigation).

<sup>116</sup> See Marshall W. Taylor, et al., *How to Choose the Right Forum in Tax Litigation*, 37 PRAC. LAW. 39 (1991).

<sup>117</sup> See, e.g., Steven Ledgerwood, *Modern Tax Litigation: how to gain Tactical Advantage from the Initial Transaction through Case Resolution*, in TAX LITIGATION BEST PRACTICES 2006 ("The Tax Court is comprised of judges who have special expertise in tax matters, whereas judges in District Court and the Court of Federal Claims often have less technical expertise."). The underlying theory with respect to a generalist judge versus a judge with tax expertise cannot be investigated in this project, which focuses exclusively on the U.S. Supreme Court. We hope to investigate this theory about trial court judges in future work focusing on corporate abuse cases in lower federal courts.

intent of the taxpayer.<sup>118</sup> Professor Leandra Lederman, for example, has criticized the current practice of judges in economic substance cases for “shift[ing] from a focus on congressional intent to a focus on the taxpayer’s intent,”<sup>119</sup> and Professor Martin McMahon and others have echoed this view.<sup>120</sup> In addition, Professor Shannon Weeks McCormack has offered a detailed policy proposal, which would focus the attention of judges who hear corporate tax abuse controversies on the “purpose of the tax laws.”<sup>121</sup> Regardless of the specific policy prescription offered, each of these scholars implicitly argues that judges in corporate tax abuse cases do not examine the intent of the legislators that drafted the applicable tax statutes adequately, as they instead scrutinize the intent of the taxpayers in structuring and implementing their transactions.

*Textualism and Justice Scalia.* Another implicit positive claim that some scholars have offered is that increasingly in corporate tax abuse cases, textualism, where text of the statutes at issue are more important than their underlying legislative history or other factors, plays a role in judges’ decisions.<sup>122</sup> For example, when describing corporate tax abuse cases, Professor Noel Cunningham and James Repetti have argued that “[t]he recent proliferation of tax shelters has, at least in part, been facilitated by the ascendancy of textualism,”<sup>123</sup> in which judges’ adoption of the textualist approach “has dramatically affected the practice of tax law.”<sup>124</sup> Other scholars, such as Professor Steven Dean and Lawrence Solan, have voiced this opinion as well.<sup>125</sup> Further, these scholars all point to the judicial appointment of one individual, Justice Antonin Scalia, as having an effect on corporate tax abuse controversies.<sup>126</sup> As Dean and Solan have commented when writing on corporate tax abuse, “[s]ince his appointment to the Supreme

<sup>118</sup> See Lederman, *supra* note 15; Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697; McMahon, Jr., *supra* note 15.

<sup>119</sup> Lederman, *supra* note 15 at 39.

<sup>120</sup> McMahon, Jr., *supra* note 15 at 1017 (“The classic Supreme Court jurisprudence supports the application of a ‘purposive activity’ test that is closer to the analysis employed by the Tax Court in corporate tax shelter cases.”).

<sup>121</sup> McCormack, *supra* note 118.

<sup>122</sup> See generally Antonin Scalia, *Common Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, in A MATTER OF INTERPRETATION (1997).

<sup>123</sup> Cunningham & Repetti, *supra* note 30 at 2.

<sup>124</sup> Steve A. Dean & Lawrence M. Solan, *Tax Shelters and the Code: Navigating Between Text and Intent*, 26 Va. Tax. Rev. 879, 885 (“Since his appointment to the Supreme Court in 1986, Justice Scalia’s ‘new textualism’ has been seen as a challenge to an intent-oriented approach to statutory interpretation.”).

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at 885; Cunningham & Repetti, *supra* note 30 at 8, 28.

Court in 1986, Justice Scalia's 'new textualism' has been seen as a challenge to an intent-oriented approach to statutory interpretation."<sup>127</sup>

*Alternative Proposals.* Finally, tax scholars have offered a plethora of judicial, administrative and legislative proposals for controlling corporate tax abuse.<sup>128</sup> As some of these scholars have written, they believe that their proposal would be more successful than judicial anti-abuse standards are unable to "protect the collection of income tax from assault by abusive shelter planners."<sup>129</sup> By offering these alternatives, scholars implicitly argue that judges in corporate tax abuse controversies fail to apply the anti-abuse standards that are at their disposal currently in a reliable and effective manner.

### C. *The Stakes of Judicial Uncertainty*

As the discussion thus far reveals, judicial decision making in corporate tax abuse controversies is grounded in a range of interrelated anti-abuse standards and these standards appear to govern in a highly uncertain fashion. Government regulators, practitioners, and scholars have proffered a wide range of views with respect to judicial decision making in the corporate tax abuse context, but there is

<sup>127</sup> *Id.*, *supra* note 124 at 885.

<sup>128</sup> For a sampling, see Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005) (loss disallowance rule); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569 (2006) (self-adjusting penalty); Susan Cleary Morse, *The How And Why of the New Public Corporation Tax Shelter Norm*, 75 FORDHAM L. REV. 101 (transparency within corporate decision-making group); George Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 406 (2001) (reform of judicial anti-abuse standards); Bankman, *supra* note 66 at 29 (substantive law reform if nature of corporate tax shelters changes); Lederman, *supra* note 15 (congressional intent-based inquiry); McCormack, *supra* note 118 (purposive approach); Jay A. Soled & Dennis J. Ventry, Jr., *A Little Shame Might Just Deter Tax Cheaters*, USA TODAY, Apr. 10, 2008, at 12A (shaming); Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 CAN J. LAW & JUR. 95, 112 (2005) (shaming); Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. CORP. L. 219 (2004) (shaming); Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L. J. 423, 472-483 (2009) (50% adjustment of taxable income towards financial accounting income for public corporations); Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289 (2002) (enhanced tax shelter disclosure); Michael S. Knoll, *Compaq Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 26 VA. TAX REV. 821(2007) (consideration of implicit taxes in economic substance analysis); David Weisbach, *Disrupting the Market for Tax Planning*, 26 VA. TAX REV. 971, 974 (2007) (broad-based anti-abuse standards).

<sup>129</sup> Chirelstein & Zelenak, *supra* note 128 at 1962.



no consensus in the literature as to what courts *actually* do. Our study adds to the positive literature but adopts a different approach. Whereas the previous studies have focused on a small collection of cases and have provided qualitative insights, we have collected the entire population of corporate tax abuse cases in the U.S. Supreme Court and apply quantitative methods for purposes of understanding how judges understand corporate tax abuse. Before proceeding to our own study, we briefly consider what is at stake in this area of the law and the potential benefits of adding an empirical study to the already vast extant literature on the topic.

First, judicial decision making directly affects the negotiation of tax controversy settlements between the IRS and taxpayers. When IRS agents audit and then challenge a corporation's tax position, the parties negotiate in the shadow of an explicit or implicit threat of litigation down the road. Moreover, both corporate tax lawyers and IRS Appeals Division officers must make predictions regarding how a judge will respond to various factors present in the taxpayer's case while negotiating a settlement; the IRS explicitly considers the "hazards of litigation" when deciding issues such as the floor settlement offer that they are willing to accept and whether to seek the imposition of tax penalties.<sup>130</sup> A better and more informed understanding of how judges actually decide corporate tax cases could encourage settlement and, at the same time, prevent parties from accepting inappropriate settlement offers. A large-*N* quantitative study will add to the qualitative research discussed above by uncovering judicial decision-making trends that explain outcomes but that are hidden in a qualitative case-based approach.

Second, the behavior of judges in corporate tax abuse cases, as perceived by tax practitioners and corporate managers, has a major impact on corporate planning of a wide array of transactions, including ordinary business transactions.<sup>131</sup> If courts do not actually focus on some of the features that tax practitioners tend to view as supremely important, such as the presence of business purpose, corporations may pursue unnecessary actions and spend higher costs than necessary in order to avoid the application of judicial anti-abuse standards. From a social cost perspective, the distortion of corporate tax planning is made even greater by the addition of unnecessary actions pursued in order to satisfy possibly faulty perceptions of how judges act in corporate tax abuse cases.<sup>132</sup>

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<sup>130</sup> See David M. Fogel, *The Inside Scoop About the IRS's Appeals Division*, 99 TAX NOTES 1503, 1503–04 (2003) (discussing "hazards of litigation" analysis).

<sup>131</sup> See *supra* notes 100 – 117 and accompanying text for discussion.

<sup>132</sup> For discussion of the social cost, see David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222 (2002).

Third, the academic proposals regarding corporate tax abuse described above are often based on perceptions of judicial behavior in these cases.<sup>133</sup> For example, the perception that judges may be swayed by business purpose arguments based on taxpayer intent has influenced several scholars to propose alternative methods of statutory interpretation.<sup>134</sup> Without more information regarding how judges actually act in these cases, it is difficult to determine which of the scholars' proposals should be explored further.

In this Article, we do not take a normative view with respect to the question of whether judicial uncertainty in corporate tax abuse cases is beneficial or harmful; other scholars have considered that question in great depth.<sup>135</sup> Rather, we investigate the extent to which judicial decision making is characterized by identifiable trends or is, in fact, uncertain and erratic, as so many scholars and commentators have argued.

### III. AN EMPIRICAL STUDY OF CORPORATE TAX ABUSE IN THE SUPREME COURT

#### A. *The Data and the Models*

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

##### 1. *Data Collection Strategy*

To identify and analyze the population of interest—corporate tax abuse controversies—we designed a data collection process, consisting of the following three steps:

- (1) Collect the superset of U.S. Supreme Court cases involving any type of federal taxation issue (*i.e.*, issues relating to individuals, corporations, non-profit entities, and so forth) and decided by the Court between the years 1909-2011.<sup>136</sup>

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<sup>133</sup> See *supra* note 117.

<sup>134</sup> See *supra* note 118.

<sup>135</sup> See McMahon, *supra* note 15; Bankman, *supra* note 66; Weisbach, *supra* note 132.

<sup>136</sup> We identified these cases in a Lexis search. The search that we conducted read as follows: (federal w/s tax!) or (excise w/s tax!) or (estate w/s tax!) or (user w/5 fee) or (user w/s

- (2) Identify the subset of federal taxation cases involving corporate tax issues.
- (3) Identify the sub-subset of cases involving alleged corporate tax abuse.

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

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

Our discussion in Part II suggested that that while scholars and commentators widely agree that corporate tax abuse exists, there is no universally accepted definition of the phenomenon and this ambiguity creates high levels of uncertainty in the federal courts.<sup>137</sup> Ironically, this fact does not pose a problem for our empirical study. Because we seek only to understand the factors that explain Supreme Court decisions, we need not settle on a single definition of corporate tax abuse. Rather, we need only identify the cases in which the government *alleged* abuse in Court and then determine just how the justices reached a decision in the controversy. Put most directly, our project investigates how and why the justices reach legal conclusions when the government presents them with the argument that a corporation has claimed an inappropriate tax position through an abusive tax strategy.

Accordingly, in the third and final step of our data collection process we focus on the group of corporate tax cases in which the government *alleged* abuse—not on the cases in which the Court actually *found* abuse. By adopting this strategy, we will be able to examine all the factors alleged by the government

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tax!) or (tax! w/s fraud) or (irc) or (i.r.c.) or (stamp w/s tax!) or (income w/s tax!) or (internal w/s revenue) or (tax! w/s lien) or (tax! w/s code) or (tax! w/s evad!) or (tax! w/s evasion) or (corporate w/s tax!) or (payroll w/s tax!) or (employment w/s tax!) or (social w/s security) or (26 usc) or (26 u.s.c.) or (tax! w/s refund) or (tax! w/s deficiency) or (unemployment w/s tax!) or (gift w/s tax!) or (fica w/s tax!) or (f.i.c.a. w/s tax!).

<sup>137</sup> See *supra* notes 22 – 129 and accompanying text.

vis-à-vis abuse and determine which factors are (and are not) convincing to the justices when making the decision to grant or deny the tax benefits sought by the corporate taxpayer. As empirical researchers, it is important to examine the entire collection of cases in which the Court *could have found* abuse in order to understand fully how and why the Court reaches its outcomes. We seek to understand and explain why the government wins *and* loses the cases it litigates in court.

To see why this approach to data collection is essential to our project, consider a hypothetical study in which a research team seeks to identify the factors that explain why some students earn high LSAT scores while others do poorly on the exam. The hypothetical research team does not seek to describe the successful students but, rather, to identify the factors that differentiate the successful group from all other test takers. If the investigators conducted their study by focusing only on the group of high scoring students and ignored those who failed the exam, their empirical findings would likely to be seriously flawed.<sup>138</sup> Spurious results would emerge because the researchers would not possess the appropriate sample of students: in order to accomplish the goal of differentiating high scoring from low scoring students—both groups must be represented in the study.

Similarly, in our project, we do not examine only the cases in which the government succeeded in convincing the Court to find tax abuse; rather, we examine *all* the cases in which corporate tax abuse was alleged and then seek to discern the factors that led the Court to find corporate tax abuse in some of these cases but not in others. With this strategy, we will be able to understand and explain how the Court conceptualizes the problem of corporate tax abuse and better understand the types of transactions perceived to be problematic and against public policy. More importantly, our strategy will enable us to predict how the Court will respond to future transactions challenged by the government as abusive. Again, if we examined *only* the cases in which the Court found abuse (rather than all the cases in which the government alleged abuse), we would be unable to accomplish these goals because the data would not permit comparative analytics.<sup>139</sup>

From an empirical standpoint it is quite obvious that we must investigate all the cases in which the government alleged abuse in order to understand the

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<sup>138</sup> Barbara Geddes, *How the Cases You Choose Affect the Answers You Get: Selection Bias in Comparative Politics*, 2 POL. ANALYSIS 131, 131-150 (1990) (providing useful examples for the selection bias problem that emerges when portions of data are purposefully excluded from a study); see also PETER KENNEDY, A GUIDE TO ECONOMETRICS 286-87 (2003) (discussing various selection problems that can produce biased results).

<sup>139</sup> Geddes, *supra* note 138 at 131-150.

judicial mind, but identifying this large collection of cases poses a difficult data collection problem. Recall from above that the first step of our data collection process led us to identify 919 federal taxation cases in the U.S. Supreme Court, and in the second step, we read the 919 opinions and identified 364 as corporate tax cases. Now, in the third step, we must identify the subset of corporate tax cases that involve alleged corporate tax abuse. To do this, it was not possible to examine the face of the judicial opinions because the Court often passes on legal issues without expressly addressing all the claims set forth in the brief, including allegations of abuse. Accordingly, for purposes of our third step of the data collection process, and to identify the cases in which corporate tax abuse was alleged (but not necessarily found by the Court), we turned to the government's briefs filed with the Court.<sup>140</sup>

We read the government's legal arguments presented in their Court filings in each of the 364 corporate tax cases, and found that few of the documents explicitly referred to "corporate tax abuse." Indeed only two briefs filed over the course of the last century referred to a corporate tax "shelter."<sup>141</sup> More often, when describing perceived inappropriate corporate behavior, the government used terms such as "distortion,"<sup>142</sup> "opportunistic,"<sup>143</sup> "avoidance,"<sup>144</sup> "manipulation,"<sup>145</sup> "evasion,"<sup>146</sup> "tax-motivated,"<sup>147</sup> and so forth. In our review of the legal arguments, we focused on the cases in which the government argued

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<sup>140</sup> We used the digital library called the U.S. Supreme Court Records and Briefs, 1832-1978 collecting and made available by the Thompson/Gale corporation, and the Lexis-Nexis Court Records, Briefs and Filing Sources for the briefs filed post 1978.

<sup>141</sup> Brief of Government-Respondent at 9, *Fulman v. U.S.* 434 U.S. 528 (1978). The government's brief in the 2012 case, *U.S. v. Home Concrete & Supply*, also references tax shelters but this case is not in our dataset because the specific issue to be addressed by the Supreme Court involves a procedural issue, the statute of limitations, and not the abusive nature of the tax shelter. Brief for Government-Petitioner, *U.S. v. Home Concrete & Supply*, No. 11-139 (oral argument scheduled for January 17, 2011).

<sup>142</sup> Brief of Government-Respondent at 19, *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932).

<sup>143</sup> Brief of Government-Petitioner at 21, *Burnet v. Aluminum Goods Mfg. Co.*, 287 U.S. 544 (1933).

<sup>144</sup> Brief for Government-Petitioner at 46, *U.S. v. Hughes Peroperties*, 476 U.S. 593 (1986); Brief of Government-Petitioner at 25, *Helvering v. National Grocery*, 304 U.S. 282 (1938); Brief of Government-Petitioner at 17, *McLaughlin v. Pacific Lumber Co.*, 293 U.S. 351 (1934).

<sup>145</sup> Brief of Government-Petitioner at 33, *Helvering v. Minnesota Tea*, 296 U.S. 378 (1935); *see also* Brief for Government-Respondent at, *Colonial American Life Ins. v. Commissioner*, 491 U.S. 244 (1989) ("manufacture tax losses).

<sup>146</sup> Brief for Government-Respondent at 8, *First Chrold v. Commissioner*, 306 U.S. 117 (1939).

<sup>147</sup> Brief for Government-Respondent at, *Atlantic Mutual Insurance v. Commissioner*, 523 U.S. 382 (1998).

that these types of transactions and tax positions, while possibly technically legal, nonetheless should not be respected. Through this process, we found that 38% (n=137) of the corporate tax controversies involved government allegations of abuse.<sup>148</sup> As we discuss in detail below, the government did not prevail in all 137 cases; the empirical question that we seek to answer, then, is this: what are the factors that lead the Court to agree with the government in some of these cases but to reject the claims of abuse in others?

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

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<sup>148</sup> Both authors read the 364 corporate tax cases to identify the subpopulation of corporate tax abuse cases. Our inter-coder reliability was high: we reached initial conflicting decisions in a small number of cases but upon review easily reached a consensus on these cases. We then re-read the briefs to confirm our initial coding decisions.

FIGURE 2  
Three groups of tax cases on U.S. Supreme Court docket

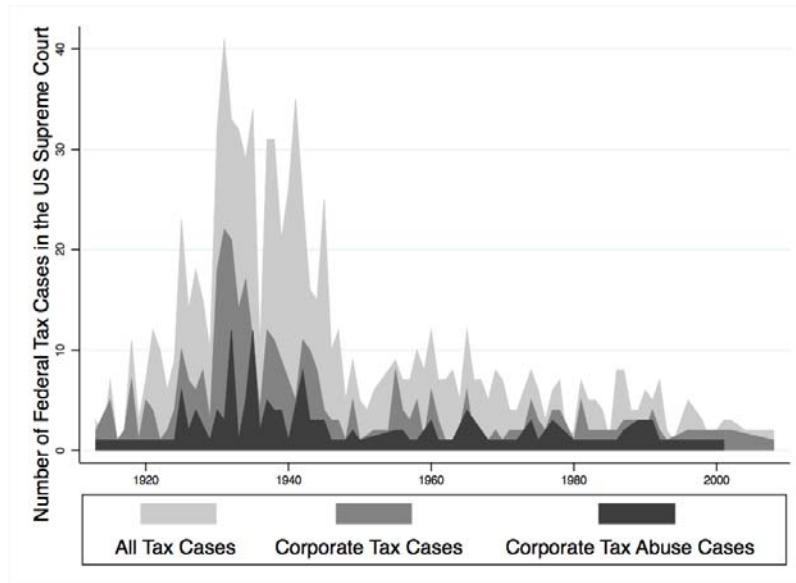


Figure 2 indicates that controversies in each set and subset—tax cases, corporate tax cases, and corporate tax abuse cases—have appeared on the Supreme Court’s docket in every era. While the number of cases in each category spiked in the early-to-mid 1930s, the decreasing frequency of cases in the more recent era reflects a change in the size of the overall docket—not the relative importance of taxation. In fact, federal tax issues have comprised roughly 5 percent of the Supreme Court’s agenda nearly every year over the course of the last century.<sup>149</sup> That the justices believe tax cases raise important legal questions is evident by the justifications set forth for granting review. In more than a few opinions, the majority has noted that tax cases raise important issues for both the taxpayer and for the administration of the nation’s revenue laws;<sup>150</sup> and the Court has noted that abuse cases are particularly important to

<sup>149</sup> See Nancy Staudt, Lee Epstein, and Peter Weidenbeck, *Judging Statutes: Interpretive Regimes*, 38 LOY. L.A. L. REV. 1909, 1228-1229 (2005) (presenting data and graphs on the size of the Supreme Court’s docket).

<sup>150</sup> See, e.g., *U.S. v. Hill*, 506 U.S. 546, 550 (1993) (because of the importance of the issue to the federal fisc, we granted certiorari); *U.S. v. Atlas Life Insurance*, 381 U.S. 233 (1965) (“We granted certiorari to consider this important question relating to the taxation of life insurance companies); *Magruder v. Washington, Baltimore & Annapolis Realty*, 316 U.S. 69, 72 (1942) (“We granted certiorari because of the importance of the question in the administration of the revenue acts.”).

## CORPORATE SHAMS

review because they generate heavy litigation in the lower courts.<sup>151</sup>

The data also indicate that corporations have sought to avoid paying taxes with the help of clever strategies since the adoption of the modern corporate tax laws in 1909 (if not earlier), although the tactics have evolved over time. For example, the 1913 case *McCoach v. Minehill* involved an incorporated railroad company that sought to avoid paying the corporate tax by leasing its assets to secondary company and then distributing the rental income directly to its shareholders.<sup>152</sup> Minehill argued that because its financial activities did not reflect typical corporate behavior and were not clearly set out in its incorporation documents, it should not be viewed as a corporation for tax purposes.<sup>153</sup> The 1927 case *Hellmich v. Missouri Pacific Railroad Co.* involved the use of inter-corporate barter and trades to avoid the receipt of income and thus the burden of the corporate income tax.<sup>154</sup> Forty years later, the court considered *Fribourg Navigation Company v. Commissioner*, a case in which a corporation claimed substantial and questionable depreciation deductions and then proceeded to sell the property (which had appreciated) in a complete liquidation, thereby enabling the corporation to decrease its ordinary income in the short term and avoid capital gains altogether in the long term.<sup>155</sup> The most recently decided case in our collection of alleged abuse cases, *United Dominion Industries v. U.S.*,<sup>156</sup> involved a group of related companies filing a consolidated return. The companies adopted a single entity approach to calculate product liability losses rather than a method that called for each affiliate member to calculate losses separately, a method that would have worked to their tax disadvantage.<sup>157</sup> The government argued in its brief that the position advocated by Old Dominion “would permit significant tax avoidance abuses” and further observed that as the “Court emphasized in a case that involved a similar abuse, ‘the mind rebels against the notion that Congress in permitting a consolidated return was willing to offer an opportunity for juggling so facile and so obvious.’”<sup>158</sup> These are just a few examples of the types of transactions that the government has challenged in

<sup>151</sup> See, e.g., *Thor Power Tool v. Commissioner*, 439 U.S. 522 (1970) (“We granted certiorari to consider these important and recurring income tax accounting issues.”).

<sup>152</sup> 228 U.S. 295 (1913).

<sup>153</sup> *Id.* (the corporation successfully argued that because it was not actively engaged in the railroad business it should be exempt from the tax).

<sup>154</sup> 273 U.S. 242 (1927).

<sup>155</sup> Brief for Government-Respondent at 5-10, *Fribourg Navigation Company v. I.R.S.*, 383 U.S. 272 (1966); see also Brief for the United States.

<sup>156</sup> 532 U.S. 822 (2001).

<sup>157</sup> *Id.*

<sup>158</sup> Brief for Government-Respondent at 22-23, *United Dominion Indus. v. U.S.*, 532 U.S. 822 (2001) (citing *Woolford Realty Co. v. Rose*, 286 US at 330).



Court, arguing that the statute may not be used to “defeat the manifest purpose of Congress” in raising revenue.<sup>159</sup> In short, while the form of a transaction or a position taken on a tax return may be perfectly legal *ex ante*, the government may nonetheless believe the corporation adopted an abusive position and thus should be denied the tax benefits it seeks, *ex post*.

### 3. Three Statistical Models

We begin our empirical study of the alleged abusive corporate tax strategies by first examining how the government fares in Court in the abuse cases versus all other types of tax controversies. More specifically, we seek to determine whether the government is more—or less—likely to prevail in the Supreme Court when it alleges corporate tax abuse compared to cases that do not involve such allegations.

The abuse cases, obviously, are a subset of the tax cases generally and the corporate tax cases particularly and thus we compare the outcomes in cases when the government alleged abuse to cases in which the government set forth alternative grounds for denying the taxpayer its preferred tax position. Put most directly, our first empirical question is the following: on average, do the justices tend to favor—or disfavor—the government in controversies that involve transactions that conform to the letter of the tax law but that are inconsistent with legislative intent and the general revenue-raising goals imbedded in the tax law? We can conceptualize this empirical question more formally with the help of two statistical models:

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

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

where *AllTaxOutcome<sub>i</sub>* in equation (1) is the Court’s decision in a given federal tax case (raising any type of issue, corporate or not) and is coded equal to 1 if the government prevails and equal to 0 otherwise, and *CorporateTaxOutcome<sub>i</sub>* in equation (2) is the Court’s decision in a given corporate tax case and is coded equal to 1 if the government prevails and equal to 0 otherwise.

In both equations, *CorporateAbuse<sub>i</sub>* is a variable indicating whether the government contended in its brief filed in Court that a corporation engaged in an abusive transaction or took an abusive accounting position and is coded equal to 1 if such an allegation was made, and 0 otherwise. *C<sub>ij</sub>* in both equations represents a collection of five control variables that scholars have already found to affect

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<sup>159</sup> Brief for Government-Petitioner at 34, *Helvering v. Minnesota Tea*, 296 U.S. 378 (1935).

judicial outcomes in the taxation context. One of the authors of this study, for example, has found that spikes in the nation's *Defense Spending* lead the Court to issue a greater number of pro-government decisions in tax cases.<sup>160</sup> Various other scholars have found that when the *Government is the Petitioner* (and not the respondent) in the Supreme Court, the justices are more likely to reach outcomes in favor of the government and against the taxpayer.<sup>161</sup> Studies have also identified a role for *Judicial Political Preferences*: Republican justices appear to favor the corporation over the government in the tax cases that show up on the docket.<sup>162</sup> Finally, we control for the *State of the Economy* and the *Year* the decision was rendered in order to capture any influences that may affect the Court's outcome but are not directly included in our model.<sup>163</sup>

<sup>160</sup> See generally, NANCY STAUDT, *THE JUDICIAL POWER OF THE PURSE* (2011). For purposes of our study, the variable, *DefenseSpending*, is coded equal to the nation's defense spending in 2009 dollars and in \$10 billion dollar increments.

<sup>161</sup> See Matthew L. Spitzer, *The Government Litigation Advantage: Implications for the Law*, 28 FLA. ST. U. L. REV. 391, 409-11 (2001); Robert L. Boucher and Jeffrey A. Segal, *Supreme Court Justices and Strategic Decisions Makers: Aggressive Grants and Defensive Denials on the Vinson Court*, 57 J. POL. 824, 833 (1995). The variable, *Government if Petitioner*, is coded =1 if the government is the petitioner in the U.S. Supreme Court and 0 otherwise.

<sup>162</sup> See Nancy Staudt, Lee Epstein & Peter Wiedenbeck, *The Ideological Component of Judging in the Taxation Context*, 84 WASH. U. LAW REV. 1797, 1815-1821 (2006). The variable, *Judicial Preferences*, is coded equal to 1 if a Republican president appointed the majority of the justices and 0, otherwise. We used this admittedly very rough measure because it was the only available measure for early justices in our database. Other more sophisticated measures of judicial preferences exist, but are not available for the justices on the Court as early as 1909. See, e.g. Andrew D. Martin & Kevin M. Quinn, *Dynamic Ideal Point Estimation via Markov Chain Monte Carlo for the U.S. Supreme Court, 1953-1999*, 10 POL. ANALYSIS 134 (2002) and Andrew D. Martin et al., *The Median Justice on the United States Supreme Court*, 83 N.C. L. REV. 1275 (2005). For a terrific discussion of judicial measurement issues, see Daniel E. Ho & Kevin M. Quinn, *How Not to Lie with Judicial Votes: Misconceptions, Measurement, and Models*, 98 CAL. LAW REV. 813 (2010) (discussing uses and abuses of judicial measures); see also Barry Friedman, *The Politics of Judicial Review*, 84 TEX. LAW REV. 257 (2006) (discussing value of accounting for judicial preferences in normative scholarship); see also BARRY FRIEDMAN, *THE WILL OF THE PEOPLE: HOW PUBLIC OPINION HAS INFLUENCED THE SUPREME COURT AND SHAPED THE MEANING OF THE CONSTITUTION* (2009) (moving beyond judicial politics to the role of public opinion on judicial outcomes).

<sup>163</sup> The variable, *State of the Economy*, is coded equal to 1 if the economy is growing and 0 if the economy is in a state of recession as measure by the NBER Dating Committee. For a discussion of this variable, see Thomas Brennan, Lee Epstein, and Nancy Staudt, *Economic Trends and Judicial Outcomes: A Macro-Theory of the Court*, 58 DUKE L.J. 1191 (2009). The variable *Year* is the year in which the decision was orally argued.

In earlier versions of this study, we included a control for the court in which the

Our variable of interest in these two preliminary models is *CorporateAbuse*—the coefficient on the variable will indicate whether corporate tax abuse cases are easier or harder to win for the government compared to the other types of tax cases that show up on the docket. In the abuse controversies, as discussed above, both the government and the corporate taxpayer have viable legal arguments. The government consistently argues that the corporation should not obtain the tax consequences it desires in light of the policy view that the tax laws should not be used in a manner that undermines their legislative intent and revenue-raising potential; the taxpayer, by contrast, consistently responds by arguing that it has followed the letter of the law and thus is entitled to its preferred tax outcome. We expect that the government will have a more difficult time prevailing in cases that rest primarily—often solely—on public policy considerations than other types of cases that implicate, say, disputes associated with statutory or regulatory interpretation. Accordingly, we predict that the coefficient on *CorporateAbuse* will be negative:  $b_1 < 0$ . When the government alleges abuse, the probability that the government will prevail will decrease.

Models (1) and (2) investigate a very simple question: does the government have an easier or more difficult time winning corporate tax abuse cases than other types of cases that it litigates in the Supreme Court? The more interesting inquiry—and the point of this study—is what are the factors that are most likely to convince the Court to decide in favor of the government when abuse is alleged? After all, we expect the government to have a more difficult time winning abuse cases but we know it does not lose every one of these cases. To answer our question, we must focus exclusively on the 137 abuse cases that we identified in the data collection process and use a statistical model that will predict and explain when and why the government wins in this unique subset of controversies.

For purposes of answering our empirical question, we again investigated the legal briefs filed in the Supreme Court.<sup>164</sup> We found that when government lawyers seek to convince the Court to invoke a judicial anti-abuse doctrine and then use that doctrine to actually find abuse, they routinely point to a small collection of very specific facts and circumstances.<sup>165</sup> Three of the factors are tied

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controversy originated on the theory that the justices may give more deference to the experts on the tax court (than to the generalist district court judges). The variable, however, did not produce statistically significant nor robust results—but this makes sense. Our dataset as currently constructed does not identify how the trial court ruled (whichever venue made this ruling) but only how the appellate court decided the tax issue—thus the justices' views of the appellate court cannot offer insight to their views of the substantive trials court outcomes. We plan to investigate this issue, however, in future empirical studies.

<sup>164</sup> See *supra* note 140.

<sup>165</sup> We discussed these factors above, *supra* notes 86 - 129 and accompanying text. A government recent publication has also listed the characteristics of abusive corporate tax

## CORPORATE SHAMS

35

to the nature of the transaction, itself, and two are linked to the position taken by the corporation on its tax return filed with the IRS. These five indicia of abuse include: 1) the presence of third parties in the transaction; 2) multi-step transactions; 3) the lack of a business purpose other than tax avoidance; 4) accounting irregularities, such as book-tax differences; and 5) a claim for a tax refund on the initial return. We found, as indicated in Table 1 below, that the government cited at least one of these factors in 79 percent of all the corporate tax abuse controversies litigated in Court. The briefs also indicate, as expected, that the government will point to these factors both alone and in tandem in an effort to win its case.

TABLE 1  
Indicia of corporate tax abuse and  
frequency of allegation in the government's briefs

Indicia of Corporate Tax Abuse	Number of Government's Briefs
(1) Third Party	65 (47%)
(2) Multi-Step Transaction	50 (36%)
(3) Lack of Business Purpose	34 (24%)
(4) Accounting Irregularity	39 (28%)
(5) Request for Tax Refund	19 (14%)
Any of the indicia <sup>166</sup>	111 (81%)
None of the indicia	26 (19%)

In addition to the facts and circumstances alleged in the briefs, scholars have argued that the government is less likely to prevail in the post-1986 era. As we discussed earlier, Professors Noel Cunningham and James Repetti, among others,

strategies, a list that we relied upon for purposes of identifying the factual claims set forth by the government with respect to its abuse arguments. *See* Dep't of Treasury, *The Problem of Tax Shelters: Discussion, Analysis, and Legislative Proposals* (July 1999); *see also* Dept. of Treasury, *The Problem of Tax Shelters: Discussion, Analysis, and Legislative Proposals* (July 1999) (citing Rev. Proc. 84-84, 1984-2 C.B. 782 (noting procedure of identifying potential abusive tax shelter returns by examining refund requests during the initial front-end processing before any refunds are paid out).

<sup>166</sup> We can parse the data even further. Thirty-seven percent of the cases had at least one indicia, 20% of the cases had two indicia, 20% had 3 three indicia, and 3% had four indicia of tax abuse. None of the cases and all five factors alleged.

have implied that Justice Scalia's ascension to the Supreme Court in 1986 and the attendant rise in the plain meaning approach to statutory interpretation have had an effect on judicial outcomes and votes.<sup>167</sup> Justice Scalia, it is implied, increased the probability that a corporate taxpayer will prevail (and the government would lose) because abusive tax strategies tend to adhere to the tax law literally, and thus the plain meaning approach works to the corporation's distinct advantage in Court.

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

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

where *CorpAbuseOutcome*<sub>*i*</sub> is the Court's decision in a case involving alleged corporate tax abuse and is coded equal to 1 if the government prevails and equal to 0 otherwise.<sup>168</sup> Note, we are now focused solely on the corporate tax abuse cases—no other cases are included in this part of our investigation and this is sensible because it is only the corporate tax abuse cases that raise the first four allegations found on the right hand side of equation (3). We will, of course, investigate all of the variables on the right-hand side of the equation in an effort to determine what effect, if any, they have on Supreme Court decision making.

The primary variables of interest in this study are *ThirdParty*, *MultiStep*, *NoBusPurpose*, *AccountingIrregularity*, and *RefundClaim*, and are all coded equal to 1 if the government alleged the factor and 0 otherwise. The variable, *JusticeScalia*, is also a binary variable equal to 1 if the year the Court heard oral

<sup>167</sup> Cunningham & Repetti, *supra* note 30.

<sup>168</sup> Investigating court outcomes is useful because they indicate the ultimate winner of the dispute and thus if we can identify factors that explain when and why one party prevails over the other—we will advance the extant understanding of how courts decided tax abuse cases. This approach, however, obscures the views of the individual justices and the factors that help to explain individual behavior. In the future, we will investigate the *individual justice's vote* in each case coded equal to 1 if the justice sided with the government and coded equal to 0 otherwise. For now, however, it is useful to note that our work in other venues suggest that the empirical findings with respect to individual justice's voting strongly confirms the findings with respect to outcomes. *See generally* Staudt, *supra* note 160.

arguments was post-1986 and as 0 otherwise. Finally,  $C_{ij}$  is the same collection of control variables discussed above with respect to models (1) and (2).<sup>169</sup> As to our modeling expectations, we have developed the following hypotheses. The presence of third parties, multi-step transactions, the lack of a business purpose, accounting irregularities, and refund claims are all indicia of corporate tax abuse, and consequently we expect that the presence of these variables will increase the likelihood that the justices will side with the government. They will *positively* correlate with judicial outcomes and, thus, when they are present the likelihood that the government will prevail will increase. We expect that the presence of Justice Scalia to *negatively* correlate with judicial outcomes given that his approach prioritizes the plain meaning of the tax statute over public policy concerns: when Justice Scalia is on the Court the government will be less likely to win. Specifically, we expect  $b_1, b_2, b_3, b_4, b_5 > 0$  and  $b_6 < 0$ . It is useful to note here that if we are unable to uncover the factors that correlate with judicial outcomes or they correlate in unexpected ways, the scholarly argument that corporate tax abuse controversies generate unpredictable results in the courtroom will be all the more convincing.

### B. Empirical Findings

We have explained our statistical models and now turn to our empirical findings. In this part, we seek to determine whether our models reflect the reality of Supreme Court decision making, or whether we should re-conceptualize the process that leads to a pro-government or pro-taxpayer outcome in the cases of interest. Before we begin our discussion, we would like to explain to readers how they should interpret our results. We use probit models (this is necessary because the dependent variable is binary)<sup>170</sup> and the tables below depict our statistical findings using this type of model. Although probit coefficients are difficult to interpret,<sup>171</sup> we present our results in a manner that is easy to interpret: the

<sup>169</sup> See *supra* notes 159 - 160 and accompanying text.

<sup>170</sup> A large literature discusses the advantages of using a probit (or a logit) over a linear probability model with a binary dependent variable. See, e.g., PETER KENNEDY, A GUIDE TO ECONOMETRICS 259-61 (2003) (linear probability model and produce estimated probabilities below 0 and above 1); J. SCOTT LONG, REGRESSION MODELS FOR CATEGORICAL AND LIMITED DEPENDENT VARIABLES 34- 85 (1997) (using a linear probability model with a binary dependent variable necessary violates many of the underlying assumptions of the former including those associated with heteroscedasticity, normality, and functional form).

<sup>171</sup> See JEFFREY M. WOOLRIDGE, INTRODUCTORY ECONOMETRICS: A MODERN APPROACH 588 (2006) (“from a practical perspective, the most difficult aspect of logit or probit models is presenting and interpreting the results); see also JACK JOHNSTON AND JOHN DINARDO, ECONOMETRIC METHODS 422 (1997) (noting probit coefficients are difficult to interpret and arguing “it is not generally useful merely to report the coefficients from a probit (as it is for a

findings reflect the marginal change in the probability that the government will win a case given a unit increase in the independent variable (*i.e.*, the variables on the right-hand side of the equations (1), (2), and (3)).<sup>172</sup> Recall from the discussion above that we explained how we coded each variable of interest—this is important information if our results are to be interpreted correctly. For example, a positive sign on a coefficient presented in a table below indicates that as the independent variable increases (moves from 0 to 1 if it is binary), the government is more likely to win; a negative sign indicates that the government is less likely to win as the independent variable increases.<sup>173</sup>

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

To begin our investigation, we focus on models (1) and (2) set out above, which enable us to compare how the government fares in the corporate tax abuse cases vis-à-vis all other types of tax cases that are litigated in the Supreme Court. We theorized that allegations of abuse are not winning arguments in the High Court,<sup>174</sup> and our results confirm this hypothesis. Column (1) of table 2 indicates that the government is 7 percent less likely to win a corporate tax abuse case than other tax cases generally and column (2) indicates the government is 8 percent less likely to win a corporate tax abuse case compared to the corporate tax cases, specifically. Our dataset includes Supreme Court controversies decided over the course of the last century and this raises the question of whether our results would be the same if we examined a subset of cases decided in the more recent era. We discuss this issue at length below,<sup>175</sup> but for preliminary purposes we re-examined the cases decided after World War II and presented our findings in columns (3)

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linear probability model) unless only the sign and significance are of interest); J. SCOTT LONG, *REGRESSION MODELS FOR CATEGORICAL AND LIMITED DEPENDENT VARIABLES* 61-83 (1997) (discussing four interpretive approaches).

<sup>172</sup> We generated these probability estimates by transforming the probit coefficients with the “dprobit” command in STATA. See STATA, *STATA BASE REFERENCE MANUAL*, Vol. 2, K-Q, at 475-77 (2005) (discussing dprobit as a useful means for transforming probit coefficients into easy to interpret probabilities). The marginal effects are calculated for each variable hold all other variables at their mean. The original probit models have an intercept, but we use “dprobit” and thus do not report marginal effects for the intercept on the theory that this would make no sense given all the variables are held at the mean with the “dprobit” command.

<sup>173</sup> For example, we coded the variable *CorpTaxAbuse* equal to 0 if the government did not allege abuse in the case and equal to 1 if the government did make such an allegation. Thus if the sign on the *CorpTaxAbuse* variable is positive (negative) then the presence of such an allegation makes it more (less) likely that the government will win in Court.

<sup>174</sup> See *supra* notes 168 - 169 and accompanying text.

<sup>175</sup> See *infra* notes 216 - 242 and accompanying text.

and (4) of table 2 below. Our results show an even stronger negative correlation: the government is 18 percent less likely to prevail when it alleges corporate abuse and this finding is statistically significant in both models at the 0.05 level, indicating strong empirical evidence that the type of argument set forth in the government's briefs is having an effect on outcomes.<sup>176</sup>

Our findings, as expected, indicate that the Court is sympathetic to corporations that adhere to the letter of the tax law, even if the transactions and tax positions undermine the revenue-raising potential of the Internal Revenue Code. It is, in short, substantially more difficult for the government to prevail when all the parties agree that the corporate taxpayer has complied with the legal rules set forth in the tax law but have nevertheless engaged in abuse than in disputes that raise other types allegations unrelated to abuse, such as procedural issues.

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<sup>176</sup> For a useful discussion of statistical significance and its interpretation for empirical results, see Woolridge, *supra* note 171, at 139-45.



TABLE 2  
Corporate tax abuse cases are more difficult for the government to win

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

Note: Results marked \*\*\* are statistically significant at the .01 level, \*\* are statistically significant at the .05 level, and \* are statistically significant at the .10 level. Errors are clustered by chief justice. All models include controls for judicial political preferences, the economy, defense spending, the identity of the petitioning party, and a time trend. For purposes of fitting the models, we included cases that involved only one legal issue in order to avoid any possible confounding.<sup>177</sup>

The use of statistics enables us to predict whether an allegation of corporate tax abuse will improve or detract from the government's case in Court, but we can also use the models to predict the likelihood that the government will prevail in *specific* case.<sup>178</sup> For example, conditional on the factors for which we have controlled in the model presented in column (4) table 2, we predict that the government had a 75 percent chance of winning *Corn Products v. Commissioner* (the government won),<sup>179</sup> a 48 percent chance of winning in *Cottage Savings v. Commissioner* (the government lost),<sup>180</sup> and a 45 percent chance of winning in

<sup>177</sup> For readers interested in the Pseudo R<sup>2</sup>, these findings are as follows for model 1, 2, 3, and 4 respectively: .03, .04, .03, .13.

<sup>178</sup> To generate the model's predictions with respect to individual cases, we used the "predict" syntax in STATA. See, STATA BASE REFERENCE MANUAL, Vol. 2, K-Q, at 445-48 (2005) (describing the "predict" syntax).

<sup>179</sup> 350 U.S. 46 (1955).

<sup>180</sup> 449 U.S. 554 (1991).

*Old Dominion Industry v. U.S.* (the government lost).<sup>181</sup> This small sampling of results suggests our initial models perform very well. Given that we know the outcome of every case in our database, we can investigate our model's performance in detail and we do so below.<sup>182</sup> For now we simply note that our models predict that the government has a substantially lower likelihood of prevailing in corporate tax abuse cases than in any other type of tax case litigated in the Supreme Court.

The results presented in table 2 indicate that, on average, the government is 7 to 8 percent less likely to win the abuse case generally, and 18 percent less likely to prevail when only the post-World War II cases are analyzed. Figure 3 below presents the results with respect to the distribution of probabilities over the course of the last century. The left-hand graph in figure 3 presents *all* taxation cases versus corporate tax abuse cases, and the right-hand graph presents *only* corporate tax cases versus corporate tax abuse cases. The y-axis in both figures is the average predicted probability of a pro-government outcome in the cases decided each year and x-axis is the year in which the case was decided. The solid line in both graphs depicts cases without an allegation of corporate tax abuse and the dashed line indicates that the government alleged corporate tax abuse—note in both graphs the solid line is above the dashed line, indicating a higher predicted probability of government success in the case in which case in which abuse was not a litigated issue.<sup>183</sup>

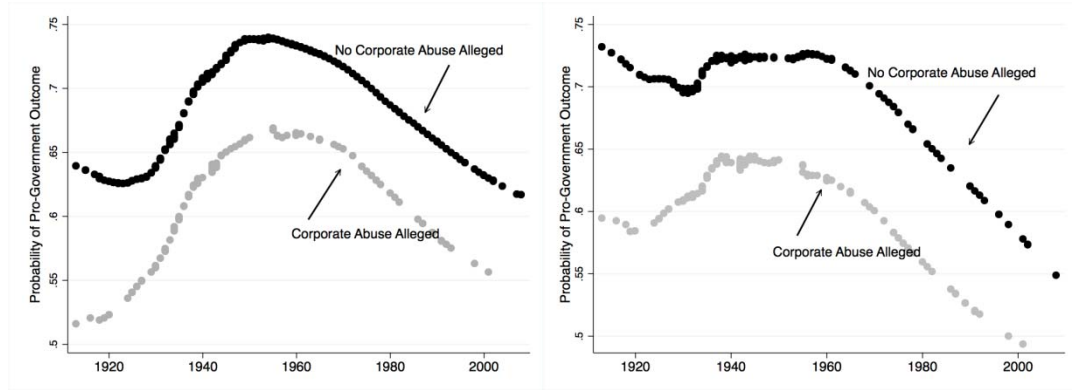
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<sup>181</sup> 532 U.S. 822 (2001).

<sup>182</sup> See *infra* notes 222 - 223 and accompanying text.

<sup>183</sup> We generated these graphs with the help of the “graph twoway lowess” syntax in STATA. See STATA, GRAPHICS 217-19 (2005).

FIGURE 3  
Probability of pro-government outcome in  
corporate tax abuse and non-corporate tax abuse cases



Note: The left graph depicts the probability of a pro-government outcome in the superset of all federal taxation cases and the right graph depicts the subset of corporate tax cases. Both graphs disaggregate the cases based on whether the government alleged corporate tax abuse. The graphs present the predicted probability of a pro-government outcome using a loess curve—a locally weighted smoothing approach. Note in both graphs our models predict a lower probability of a pro-government win if abuse is alleged.

Although corporate tax abuse cases are more difficult for the government to win than other types of cases, it is useful to note that, with few exceptions throughout the period under investigation, the government has had a greater than 50 percent chance of winning. In fact, on average, the government has prevailed in 61 percent of all the corporate tax abuse cases it has litigated since 1909! This suggests that while the government may have a weaker case in corporate abuse controversies—it nevertheless is more likely to prevail than the taxpayer if the dispute reaches the Supreme Court. Thus, while the corporate taxpayer's chance of prevailing increases in the abuse cases, the corporation nonetheless always suffers a disadvantage.<sup>184</sup>

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

<sup>184</sup> Numerous studies have investigated the government's chances of success and have argued that as a repeat player, it enjoys advantages that other litigants lack. See, e.g., Linda Cohen and Matthew L. Spitzer, *The Government Litigation Advantage: Implications for the Law*, 28 FLA. ST. U. L. REV. 391-425 (2001); Kevin McGuire, *Repeat Players in the Supreme Court: The Role of Experienced Lawyers in Litigation Success*, 57 J. OF POL. 1870196 (1995).

development because scholars have argued that the make-up of the Court, in particular the appointment of Justice Scalia, may have caused the observed pro-taxpayer turn in judicial outcomes.<sup>185</sup> This claim may have merit, but the data unambiguously indicate other factors were also at work.

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

We now move from comparisons between abuse and non-abuse controversies, and focus solely on the abuse cases in an effort to illuminate the judicial decision-making process in this specific context. We use model (3)<sup>186</sup> described above to determine which factors enhance and which factors undermine the government's chances of winning the abuse cases; table 3 below presents our empirical findings. For discussion purposes, we begin by focusing on the transaction-related variables associated with corporate tax abuse,<sup>187</sup> we then turn to the cases involving accounting irregularities and refund claims, and then to Justice Scalia's role in the decision-making process.<sup>188</sup> Finally, we discuss the five control variables and their effects on Supreme Court outcomes. We conclude with a summary of our findings and an analysis of how well our models performed compared with the actual outcomes in the cases that we analyzed.

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<sup>185</sup> See *supra* note XX and accompanying text.

<sup>186</sup> See *supra* note 168 and accompanying text.

<sup>187</sup> See *supra* note 169 and accompanying text.

<sup>188</sup> See *id.*

TABLE 3  
Factors that explain outcomes in corporate tax abuse cases

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

Note: Results marked \*\*\* are statistically significant at the .01 level, \*\* are statistically significant at the .05 level, and \* are statistically significant at the .10 level. Errors are clustered by chief justice. To avoid any possible confounding, we included case with only one legal issue in our modeling process.<sup>189</sup>

<sup>189</sup> For readers interested in the Pseudo  $R^2$ , these findings are as follows for model 1, 2, and 3, respectively: .13, .11, and .18.

## CORPORATE SHAMS

45

a. *Transaction-Related Factors*

Recall from the discussion above that the legal briefs filed in Court indicate that the government continually points to three indicia of abuse when litigating cases involving alleged abusive transactions: 1) the presence of a third party, 2) multi-step transactions, and 3) the lack of a non-tax business purpose.<sup>190</sup> Column (1) in table 3 presents somewhat surprising results vis-à-vis these variables. We found that the presence of third parties and multi-step transactions decrease the probability that the government will win in Court by 21 and 3 percent respectively, although only the finding on third parties is statistically significant and thus it is the only finding in which we can have confidence. With respect to the lack of a business purpose, the government is 7 percent more likely to prevail when it alleges this factor, but this finding is not statistically significant and provides weak evidence against the null hypothesis that this variable is playing no role in the decision-making process.<sup>191</sup> *These findings suggest that the facts and circumstances widely believed to strongly and positively correlate with corporate tax abuse are simply not all that convincing to the Court.* Only one finding achieves significance—the presence of third parties—and while this fact may look suspicious to government litigators, it appears that the justices disagree, perhaps believing that the presence of an outside party indicates an arm’s length transaction that should be respected and not disregarded as advocated by the government. These results are not what we expected, yet they may suggest what many tax scholars and commentators have argued for years: courts are unpredictable when it comes to corporate tax abuse controversies.<sup>192</sup>

The results presented in column (1) of table 3 depict the effects of each of these three case-related factors separately, but what if the government alleges two or more factors simultaneously? Perhaps the Court is more likely to unwind an otherwise legal corporate tax strategy when the government musters a strong case with numerous indicia of abuse. To test this hypothesis, we created a *Count* variable that represents the number of factors alleged. It is coded as equal to 0, 1, 2, or 3 indicating whether the government failed to allege third parties, multi-steps, or the lack of business purposes; or alleged one, two, or all three of these factors concurrently in its case. Column (2) of table 3 presents our findings with respect to the *Count* variable and indicates that the presence of more than one abuse factor actually decreases the probability that the Court will side with the government, although this finding is not statistically significant. The results

<sup>190</sup> See *supra* notes 90 - 99 and accompanying text.

<sup>191</sup> For a useful discussion of statistical significance and its interpretation for empirical results, see Wooldridge, *supra* note 171, at 139-45.

<sup>192</sup> See *supra* notes 47 - 85 and accompanying text.

associated with the *Count* variable indicate that as the number of transaction-related allegations increase, the probability of a pro-government outcome decreases by 6 percent. This finding suggests that even if the government believes certain factors indicate abuse, pointing to an increasing number of the factors is not a winning strategy. Again the model implies support for the critics of judicial decision making in the abuse context: the outcomes are unpredictable and perhaps counterintuitive.<sup>193</sup> Stated most directly: why does the taxpayer's case get stronger as the government points to more and more indicia of abuse? We expected that the taxpayer's case would weaken in these circumstances, but we were wrong.<sup>194</sup>

To further probe the effects of the transaction-related variables, we examine specific combinations of the factors on the theory that while the Court is not convinced by an increasing number (or count) of allegations, the justices may be persuaded by specific combinations or groupings. Put most directly, specific combinations of factors may serve as convincing evidence of abuse whereas factors cited alone or factors randomly grouped together may not have the same probative value. Accordingly, we investigate cases in which the government alleged the following combinations: 1) third parties and multi-step transactions, 2) third parties and the lack of business purpose, and 3) multi-step transactions and the lack of business purpose.<sup>195</sup> Column (3) of table 3 presents our findings and suggests that the precise blend of factors is important to the decision-making process.

To understand the results presented in column (3) of table 3, first note the column reports empirical findings for each variable separately and then in the three unique combinations just spelled out. The three variables listed separately indicate the effects of the variable when it is alleged and when the others are *not* alleged. Thus, we see that when the government *only* alleges the presence of a third party, it is 36 percent less likely to win; when it alleges *only* a multi-step transaction it is 35 percent less likely to win; when it alleges *only* the lack of a business purpose it is 29 percent more likely to win. The first two factors, standing alone, hurt the government at statistically significant levels, but when the government alleges only the lack of a business purpose the finding is not statistically significant and thus we cannot have confidence in the finding.<sup>196</sup>

Now consider the three unique combinations of the variables, also labeled "interaction effects"<sup>197</sup> in statistics idiom and presented in column (3) of table 3.

<sup>193</sup> See *id.*

<sup>194</sup> See *supra* notes 169 - 170 and accompanying text.

<sup>195</sup> We were unable to examine these three variables simultaneously due to the small number of cases in our dataset.

<sup>196</sup> See Wooldridge, *supra* note 171, at 139-45.

<sup>197</sup> See Wooldridge, *supra* note 171, at 204-206.

While the interpretation of these terms is somewhat more complex than the other terms in the model,<sup>198</sup> we can begin by noting that the results presented indicate the following: When third parties *and* multi-step transactions are alleged together, the government is 50 percent more likely to win. This combination convinces the Court, at statistically significant levels, that the corporation has engaged in a transaction that should not be supported by the judiciary.<sup>199</sup> The other two combinations, by contrast, do not exert the same positive effect on the Court. When third parties *and* the lack of business purpose are combined in the government's argument, the government is 22 percent less likely to prevail, and when the government alleges multi-step transactions *and* the lack of business purpose it is 26 percent less likely to prevail although neither of these two findings is statistically significant. The government's actual win rate confirms these findings: the government prevailed in 60 percent of the cases that involved third parties and multistep transactions; it prevailed in 50 percent of the cases involving third parties and the alleged lack of a business purpose; and in just 45 percent of the cases that involved multistep transactions and the alleged lack of a business purpose.

The results, however, are somewhat more nuanced than just suggested. Interaction terms in this type of statistical model may have different effects for different cases and thus speaking of "average effects" associated with the interaction terms may not be accurate.<sup>200</sup> To understand fully the effects of a government litigation strategy that combines two transaction-related factors together, we should consider the effect on various cases taking into consideration the overall probability that the government will prevail.<sup>201</sup> Consider figure 4.<sup>202</sup>

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<sup>198</sup> See Edward Norton, Hua Wang, and Chungron Ai, *Computing Interaction Effects and Standard Errors in Logit and Probit Models*, 4 STATA J. 154-67 (2004) (arguing that most applied researchers misinterpret the coefficients on interaction terms and proposing useful interpretive procedures); see also William Greene, *Testing Hypotheses About Interaction Terms in Nonlinear Models*, 107 ECON. LETTERS 291-96 (2010) (arguing graphical presentations are the most effective means for presenting the results).

<sup>199</sup> Familiar cases such as *Commissioner v. P.G. Lake*, 356 U.S. 260 (1958) and other less known cases such as *John Kelly Co. v. Commissioner*, 326 U.S. 521 (1946) and *Handy and Harmon v. Burnet*, 248 U.S. 136 (1931) confirm our statistical finding: these factors work to the distinct advantage of the government.

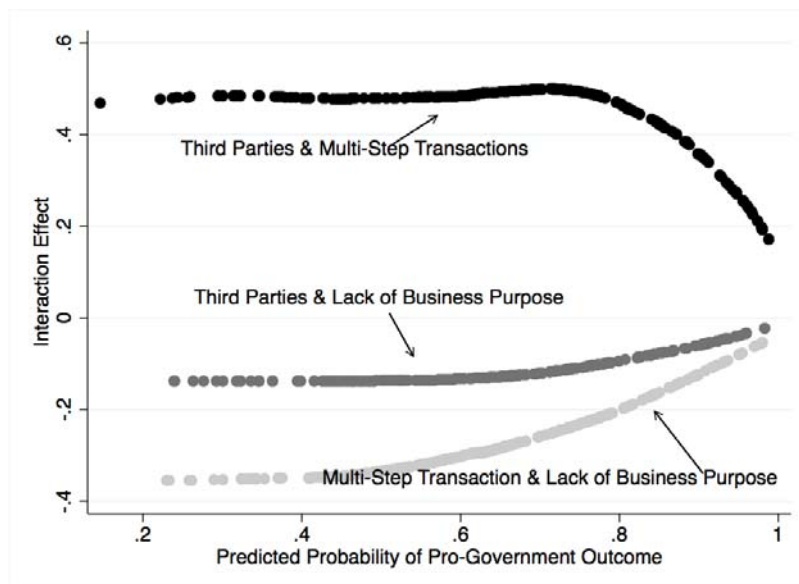
<sup>200</sup> See Edward Norton, Hua Wang, and Chungron Ai, *Computing Interaction Effects and Standard Errors in Logit and Probit Models*, 4 STATA J. 154-67 (2004) (arguing that most applied researchers misinterpret the coefficients on interaction terms and proposing useful interpretive procedures); see also William Greene, *Testing Hypotheses About Interaction Terms in Nonlinear Models*, 107 ECON. LETTERS 291-96 (2010) (arguing graphical presentations are the most effective means for presenting the results).

<sup>201</sup> See Edward Norton, Hua Wang, and Chungron Ai, *Computing Interaction Effects and Standard Errors in Logit and Probit Models*, 4 STATA J. 154-67 (2004) (arguing that most



The  $y$ -axis in the figure indicates whether the two-pronged argument helps or hurts the government's case, and the  $x$ -axis depicts these results based on the overall probability of a government win conditional on all the variables in the model. Note that when the government alleges both third parties *and* multi-step transactions, its likelihood of winning is always well above zero, though the effect begins to decline as the probability of winning closes in on 80 percent. This suggests that when the government has a strong case, based on other factors discussed above, these transaction-related variables have a positive effect but decreasing in overall strength. Stated most directly, the model indicates that when the government's case is weak, these transaction-related variables will increase the probability of a pro-government win by more than 40 percent but by less than 20 percent when the government's case is strong based on other factors.

FIGURE 4  
Government strategy of combining multiple factors  
can help *and* hurt its case



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

applied researchers misinterpret the coefficients on interaction terms and proposing useful interpretive procedures).

<sup>202</sup> We generated these graphs with the help of the “graph twoway lowess” syntax in STATA. See STATA, GRAPHICS 217-19 (2005).

Notice that the other two combinations, the lack of a business purpose combined with third parties and the lack of business purpose combined with multi-step transactions, exert a negative effect on the government's case. The effect is always negative but closes in on 0, suggesting no effect, as the probability of a government win moves closer and closer to 100 percent. These findings indicate that when the government has a weak case, the transaction-related variables play a stronger role in the decision-making process, but as the government's case improves (due to the factors we discussed above) the transaction-related variables have a minor effect on the justice's decisions.

We believe the best model of judicial decision making is presented in column (3) of table 3 because it accounts for a range of realistic government litigation strategies.<sup>203</sup> As we will discuss in greater depth in Part IV, these findings can be used strategically by both corporate lawyers who advise clients on the tax consequences of their deals and by government litigators who subsequently challenge a deal in Court. First, we can see that a single indicator of abuse does not convince the Court that the justices should deny the corporation its preferred tax outcome. The government is more credible and persuasive when it alleges multiple indicia of abuse—but only if certain combinations are present—not simply an increasing number of allegations as indicated by the results associated with the *Count* variable.<sup>204</sup> Specifically, the government should point to third parties and multi-step transactions—two objective fact-based allegations—in order to increase its chances of winning the preferred pro-government outcome in Court. But third parties combined with the lack of a business purposes or multiple steps combined with the lack of business purpose—one fact-based allegation and the other a matter of opinion—is not a winning combination and together operate to decrease the likelihood that the Court will unwind the transaction in favor of the government. These findings, all taken together, suggest that the presence of the third-parties and multi-step transactions in general make the government's case substantially weaker with one exception: when they are present together in a transaction that appears abusive in the view of the government. Finally, the results presented in table 3 above indicate that the business purpose test is not playing a strong and unambiguous role in the Court's

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<sup>203</sup> We believe the model avoids any possible omitted variable bias. See Wooldridge, *supra* note 171, at 139-45, 89-98 (2006) (discussing the omitted variable bias in general terms). It also has the highest pseudo R-squared, although we do not put too much weight on this measure. *Id.* at 206-07, 589-91 (2006) (R-squared is an estimate of how much variation in the dependent variable is explained by the independent variables, and the pseudo R-squared is used for the probit models).

<sup>204</sup> See *supra* note 194 and accompanying text.

decision-making process. Indeed, it appears to play little or no role when standing alone, and a negative role when combined with other factors.<sup>205</sup>

b. *Tax Return Factors: Accounting Irregularities and Refund Claims*

We now turn to the items on the corporate tax return that raise a red flag of abuse in the government's view, and investigate how these factors affect the Court. Beginning first with accounting irregularities, such as an asymmetry in the amount of income reported on corporate financial accounting documents and on the corporate tax return filed with the IRS.<sup>206</sup> Columns (1), (2), and (3) of table 3 indicate that when the government points to an accounting irregularity in its legal brief filed in Court, it is 15 to 22 percent more likely to prevail. This finding is statistically significant in two of the three models suggesting that accounting irregularities are fairly convincing to the Court and increase the chances that the justices will find the corporation has sought an inappropriate tax advantage. The raw numbers in our database confirm this finding: the government prevailed in 80% of the cases in which it pointed to accounting irregularities—a high win rate to be sure.<sup>207</sup>

Turning now to the loss transactions that lead the corporation to claim a refund on its tax return filed with the IRS, and where the IRS subsequently denied the corporation's claim. As noted above, corporate refund claims signal to the government that the taxpayer *possibly* may have participated in an abusive transaction in order to generate a tax loss.<sup>208</sup> All three models presented in table 3 above indicate that when the corporate taxpayer seeks a refund and when the IRS denies the refund claim, the government is more likely to prevail in the event that the controversy reaches the Court. To be clear, this factor refers to instances where the taxpayer requested a refund on its initial return or in a separate return and not to those where the taxpayer sought to recover an amount that it paid following the finding of a deficiency by the IRS during an audit of the taxpayer's return. Columns (1), (2), and (3) of table 3 indicate that the government's win rate increases by 34 to 42 percent at highly statistically significant levels. When numerous models produce consistent and significant findings, the results can be interpreted as robust and strongly probative of the effects of the variable on the outcome of interest. Our results with respect to refund claims are consistent

<sup>205</sup> Many scholars have examined and critiqued the business purpose text as being difficult to apply objectively and thus not particularly useful for judicial decision making. See discussion *infra* notes 118 - 129 and accompanying text.

<sup>206</sup> For discussion of this variable, see *supra* notes 96 - 97 and accompanying text.

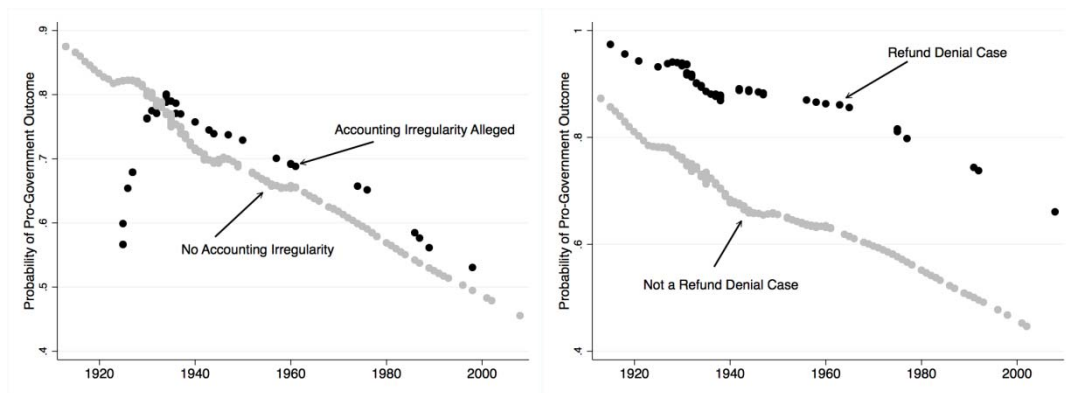
<sup>207</sup> Cases such as *Massey Motors v. U.S.*, 346 U.S. 92 (1960), *Hertz Corp. v. U.S.*, 364 U.S. 122 (1960), and *U.S. v. Hughes Properties*, 476 U.S. 593 (1986) all suggest that when the government attacks inventive tax reporting strategies it is likely to win in Court.

<sup>208</sup> See *supra* notes 94 - 95 and accompanying text.

across all three of the models and suggest that when the Court observes corporate taxpayers seek payment from the Treasury, and when the IRS rejects the refund claim, the Court is much more likely to find the transaction abusive than in cases in which the corporation simply seeks to pay a lower amount of tax than the government deems owed. In terms of raw numbers, the government prevailed in 77 percent of the cases that involved a refund denial as we have defined it, and this win rate increases to 84 percent when the refund denial includes allegations of abuse.

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

FIGURE 5  
Accounting discrepancies and corporate refund claims increase government's chances of winning in Court



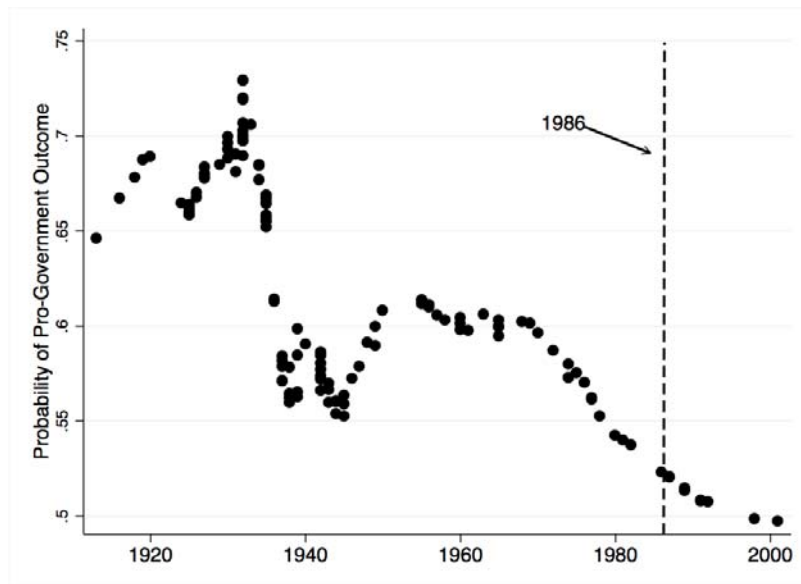
Note: Y-axis indicates predicted probability of a pro-government outcome and x-axis is the term in which the cases are orally argued.

*c. Personnel Factor: Justice Scalia*

As we have discussed, several scholars have suggested that Justice Scalia's appointment to the Court has led to an increase in judicial deference to the

literalist interpretations of the tax law that frequently underlie taxpayers' arguments in corporate tax abuse cases.<sup>209</sup> The evidence suggests this claim *may* have some merit. Our models indicate that a corporation's chance of winning increased between 1 and 9 percent in the post-1986 era. The negative sign on Justice Scalia's coefficient in all three models presented in table 3 indicates that Justice Scalia has had an effect on the government's win rate, but the results never achieve statistical significance. The empirical findings presented in table 3 are presented graphically in figure 6 below.

FIGURE 6  
Justice Scalia's appointment and corporate tax abuse case outcomes



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

We cannot confidently conclude that Justice Scalia and the plain meaning approach to statutory interpretation has had the predicted impact, in part, because the results are not significant, but also because our dataset includes just nine cases in the time period under investigation. Moreover, and perhaps more problematic to the theory highlighting Justice's Scalia's role in tax abuse cases, figure 6 indicates the government's probability of winning began to decline well before the Justice ascended to the Supreme Court, casting further doubt on our

<sup>209</sup> See *supra* notes 122 - 127 and accompanying text.

<sup>211</sup> See *supra* notes 90 - 129 and accompanying text.

quantitative findings. It bears noting, however, that while the Supreme Court appears to have taken a pro-taxpayer turn in the late 1950s or early 1960s, the government's probability of winning consistently exceeds the taxpayer's probability of winning. Finally, the appointment of Justice Scalia in 1986 occurred during the same period as other significant developments in the federal tax law, namely the enactment of Tax Reform Act of 1986, which may have had an effect on judges' interpretation of tax avoidance strategies.<sup>210</sup>

d. *The Control Variables*

We have been focusing thus far on the variables in our model that directly relate to the corporate transaction, the tax return, and a specific Supreme Court justice—all discussed and debated by tax scholars and tax commentators in the extant literature.<sup>211</sup> We now turn to the set of control variables that commentators, with just a few exceptions, have largely ignored,<sup>212</sup> but that we believe exert influence on the Court's decision-making process. For purposes of discussion, we focus on table 3 and note, as a preliminary matter, that the three models presented in the table produce consistent results across all the control variables, indicating that our findings are robust to different model specifications and giving us confidence in our results.

We begin with a review of the effects of defense spending. We find that every \$10 billion increase (measured in 2009 dollars) in national defense spending leads to a 0.3 to 0.4 percent increase in the likelihood of a pro-government outcome at highly statistically significant levels.<sup>213</sup> At first cut, this finding may not appear substantively interesting given the small size of the coefficient, but consider the magnitude of the defense spending spikes that have occurred over time. During world war one, world war two, the Vietnam War, and President Reagan's defense build-up in the 1980s, for example, Congress and the president increased spending by \$70 billion, \$97 billion, \$10 billion, and \$17 billion, respectively.<sup>214</sup> These increases, in turn, lead to an expected increase in the government win rate by *at least* 21, 29, 3, and 5 percent respectively and possibly substantially more. In times of war and foreign policy crises—the government's chances of winning increase at notable levels.

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See *supra* notes 90 - 129 and accompanying text.

<sup>211</sup> See *supra* notes 90 - 129 and accompanying text.

<sup>212</sup> See *id.*

<sup>213</sup> See also Staudt, *supra* note 160 (also finding strong evidence against the null hypothesis that defense spending has *no* effect on Supreme Court outcomes).

<sup>214</sup> For a detailed discussion of historical defense spending trends, see Budget of the United States Government, Historical Tables available at <http://www.gpoaccess.gov/usbudget/fy05/pdf/hist.pdf>.

With respect to our second control, the identity of the party petitioning for review in the Supreme Court: we find that when the government is the petitioner (not the respondent), the likelihood of a pro-government outcome increases by 11 to 14 percent, although this finding is statistically significant in only one of our three models. This substantive result is consistent with a large body of literature that has theorized and empirically found that the Court is more likely to reverse a lower court decision than uphold it, giving a boost to the petitioning party's chances if the Court grants certiorari.<sup>215</sup>

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

### C. Model Evaluation: Its Successes and Its Limitations

We now examine just how well our model predicts the court outcomes that we actually observe over the course of the last century. We are able to assess our model's performance because it generates the probability that the government will win (or lose) in each case conditional on our set of independent variables (that is, the variables listed on the right hand side of equations (1), (2), and (3) above).<sup>216</sup> Consider, for example, two well-known cases involving corporate taxpayer attempts to avoid the tax costs associated with selling property directly to a third party, *U.S. v. Cumberland Public Service Company*<sup>217</sup> and *Commissioner v. Court Holding*,<sup>218</sup> which we discussed earlier.<sup>219</sup> In both cases, the corporation sought to avoid the tax by distributing the designated property to shareholders, who then sold the property to an outside third party, thereby avoiding the corporate-level taxation.<sup>220</sup> In both cases, the government took the position that the corporations used the tax law in a manner that would undermine its revenue-raising purpose and thus the justices should refuse to award the tax

<sup>215</sup> See, e.g., Linda Cohen and Matthew L. Spitzer, *The Government Litigation Advantage: Implications for the Law*, 28 FLA. ST. U. L. REV 391-425 (2001).

<sup>216</sup> See *supra* notes 159-160, 167-168 and accompanying text.

<sup>217</sup> 338 U.S. 451 (1950).

<sup>218</sup> 324 U.S. 331 (1945).

<sup>219</sup> See *supra* notes 57 - 65.

<sup>220</sup> *Cumberland*, 338 U.S. at 452; *Court Holding*, 324 U.S. at 332.

benefits sought by the corporations due to the abusive nature of the transaction.<sup>221</sup> Using the model presented in column (3) of table 3, we find that the government had a 28 percent chance of prevailing in *Cumberland Public Service Company* (the government lost) and a 62 percent chance of winning in *Court Holding* (the government won). We are able to examine the probability of a government win in each and every case and compare this prediction to the true outcome generated by the Court. Readers interested in the list of abuse cases included in our study should consult the Appendix.

In addition to examining individual cases, we can examine the model's performance in more general terms. With respect to our 137 corporate abuse cases, our model predicts that the government had a greater than 50 percent chance of winning 92 of these cases, and a less than a 50 percent chance of prevailing in 45 of the cases. In short, the model predicted that the government had a high probability of prevailing in 67 percent of the cases (that is, in 92 out of 137 cases, the government had a greater than 50% chance of winning)—in reality the government won 65 percent (the government actually won 89 of 137 cases). These preliminary numbers suggest the model performed well—though far from perfect. For example, the lowest probability of a pro-government win was 11 percent and emerged for the case, *U.S. v. Goodyear Tire & Rubber*—a case the government actually won.<sup>222</sup> The highest probability was 99 percent generated for the *Hertz v. U.S.*, which the government also won.<sup>223</sup> Table 4 disaggregates the data and presents the predictions and observed outcomes along an inter-quartile continuum. The first column indicates the predicted probabilities from our statistical model for each quartile, the second column indicates the number of cases that fell within that quartile, and the third column indicates the percentage of cases that actually went in favor of the government. Of course, as the predicted probability increases in the first column, the percentage of actual wins should also increase in the third column. A brief look at the two columns indicates our model performed well: as the model predicts an increased likelihood that the government will prevail in Court, the government in fact was winning more and more cases.

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<sup>221</sup> Brief for Government-Petitioner at 9-32, *U.S. v. Cumberland Public Service Company*, 338 U.S. 451 (1950); Brief for Government-Petitioner at 7-31, *Commissioner v. Court Holding*, 324 U.S. 331 (1945).

<sup>222</sup> 493 U.S. 132 (1989).

<sup>223</sup> 364 U.S. 122 (1960).



TABLE 4  
 Predicted versus observed outcomes in cases involving alleged abuse

Model <i>Prediction</i> as to the Likelihood that the Government Will Win	Number of Corporate tax abuse cases	<i>Observed</i> Percent of Cases in which the Government Actually Won
Predicted Probability < 25%	6	16%
25% < Predicted Probability < 50%	39	33%
50% < Predicted Probability < 75%	45	76%
Predicted Probability > 75%	47	87%

Our analysis indicates that our model offers useful predictions with respect to Supreme Court decision making in the corporate tax abuse cases that show up on the docket. But the model also suffers from various limitations that are important to note.<sup>224</sup>

First and most important, our dataset may suffer a selection problem. That is, litigants (either the government or the taxpayer) may choose to appeal a distinctive set of cases to the Supreme Court thereby biasing our dataset and potentially leading to spurious empirical results.<sup>225</sup> To understand this problem, consider the possibility that the government does not appeal cases that involve allegedly abusive transactions when they have a strong business purpose on the theory that it will lose in the Supreme Court. If the government in fact selects cases to appeal on the strength of the business purpose then our finding that the business purpose factor is not playing the expected role in the High Court's decision-making process should not be surprising—after all the cases with strong arguments have been selected out of the process.<sup>226</sup> Of course, this potential problem is offset by the counter-strategy that taxpayers will adopt: they will appeal cases that have factors that work in their favor. In fact, we expect cases that have strong arguments in *one* direction or another are more than likely to be settled before they reach the Supreme Court—leaving only the collection of cases

<sup>224</sup> In general, we believe advantages and disadvantages exist to all empirical research. See, e.g., GREG MITCHELL, *THE PROMISE AND LIMITATIONS OF AN EMPIRICAL APPROACH TO LAW*, 2-37 (2008) (legal context); Roger Gagnon, *Empirical Research: The Burdens and the Benefits*, 12 *INTERFACES* 98 (1982) (empirical research in business context).

<sup>225</sup> For a useful discussion of sample selection problems, see Woolridge, *supra* note 171.

<sup>226</sup> We thank Professor Ted Seto for pointing out this particular example of a selection bias problem.

that have strong arguments in *both* directions.<sup>227</sup> Moreover, we have conducted preliminary studies of the selection issue and have found that if the problem exists—it operates to confirm and not undermine our findings presented above.<sup>228</sup> Although we plan to further investigate judicial decision making in the context of corporate tax abuse in the future, we believe that our study is useful for understanding and explaining the outcomes in the cases that actually reach the Supreme Court, irrespective of the strategies that underlie the litigants' choices to appeal.<sup>229</sup>

Second, even if our study is free of the selection bias, we have focused on Supreme Court decision making over the course of the last century and thus our findings reflect statistical effects averaged over the course of many years. This raises the question: are the decisions and outcomes rendered in the mid-1900s and earlier relevant for understanding today's Supreme Court? To begin, it is useful to note that the technical reason for examining the abuse cases over such a long period of time was necessary to obtain a sufficient number of observations to fit the data to the models.<sup>230</sup> This explanation, of course, leaves the substantive question unanswered and thus we conducted a qualitative investigation of the early cases and court opinions to understand and explain how the docket, arguments, and legal analyses have changed over time. As we discuss immediately below, and to our surprise, we found high levels of consistency over different eras on the relevant dimensions.

With respect to the types of corporate abuse cases that have been litigated over the course of the century, we found that while the specific details of the transactions and tax positions have changed over the years, the government has consistently looked to the same five factors for purposes of identifying abuse. The government, for example, has pointed to the presence of third parties in cases decided as early as 1913 and as late as 1991; to multiple-step transactions in cases

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<sup>227</sup> A large extant literature explores the selection problem both in an out of the taxation context. See, e.g., Leandra Lederman, *Which Cases Go to Trial?: An Empirical study of Predictors of Failure to Settle*, 49 CASE WESTERN L. REV. 316 (1999); George Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984); Theodore Eisenberg, *Litigation Models and Trial Outcomes in Civil Rights and Prisoner Cases*, 77 GEO. L.J. 1567 (1989).

<sup>228</sup> See Staudt, *supra* note 160 (using the Heckman selection model to empirically investigate the selection effects operating in tax cases in the Supreme Court).

<sup>229</sup> We thank Professor Leandra Lederman for emphasizing this point.

<sup>230</sup> We identified 137 tax abuse cases using the methodology described above. See *supra* notes 135 - 159 and accompanying text. The Supreme Court decided 93 of these cases prior to 1950, leaving only 44 to analyze with our models in the post-1950 era. When we attempted to do this with STATA we found the model dropped numerous variables and produced unintelligible results.

decided as early as 1925 and as late as 1991; to the lack of a business purpose from 1920 through 1991; to accounting irregularities from 1925 through 2011; and to inappropriate refund requests from 1927 through 1991. These findings indicate that the taxpayers have altered the details of their avoidance strategies over the course of the last century, but they have also continually incorporated the same general attributes that have served as signals of abuse since at least 1913.

We also examined the Supreme Court's opinions for purposes of understanding the transformations in precedent and legal analyses. This was necessary because even if the signals of abuse have remained constant, if the Court has updated and transformed its view of the five factors, then the early opinions may have very little relevance for understanding today's decision-making process. Our qualitative investigation, however, indicates that early judicial opinions continue to affect contemporary Courts. Consider *U.S. v. Hughes Properties*, a case that involved accounting irregularities and decided in 1986.<sup>231</sup> The majority opinion cites to several abuse cases decided in 1926, 1930, and 1961 as setting out the fundamental principles of tax accounting and continually useful for identifying the legal analytic touchstones.<sup>232</sup> *United Dominion Indus. v. U.S.*, a 2001<sup>233</sup> case in which the government argued the taxpayer had taken a tax position that rose to the level of abuse, also relied on early cases such as *Woolford Realty Co. v. Rose* decided in 1932,<sup>234</sup> and *Libson Shops v. Koehler* decided in 1957.<sup>235</sup> Indeed, one of our cases, *North American Oil v. Burner*<sup>236</sup> decided in 1932, has been cited well over one hundred times in the post-World War II era, including in numerous corporate abuse cases showing up in the Supreme Court.<sup>237</sup> The 76 judicial opinions addressing corporate tax abuse cases and issued between the years 1909 and 1945 have generated 9,863 citations—and more than half of these citations occur in the post-World War II era. Our qualitative analysis, in short, leads us to conclude that the corporate tax abuse cases generate opinions that do not become antiquated but, rather, serve as useful precedent for generations. This conclusion is consistent with the views and intuitions of the tax experts. Professor James Eustice noted that modern corporate tax abuse is “packaged in new and exotic wrappers,” but its basic

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<sup>231</sup> 476 U.S. 593 (1986).

<sup>232</sup> The Court, for example, cited to *U.S. v. Anderson*, 269 422 (1930); *Lucas v. Kansas City Structural Steel*, 281 U.S. 264 (1930); and also noted *U.S. v. Consolidated Edison Co of New York*, 366 U.S. 380 (1961).

<sup>233</sup> 532 U.S. 822 (2001).

<sup>234</sup> 286 U.S. 319 (1932).

<sup>235</sup> 353 U.S. 382 (1957).

<sup>236</sup> 286 U.S. 417 (1932).

<sup>237</sup> See e.g., *Commissioner v. Indianapolis Power & Light*, 493 U.S. 203 (1990); *American Auto Assoc. v. U.S.*, 364 U.S. 687 (1961).

elements are “still the same old, same old thing.”<sup>238</sup> To this observation, we would add, they also require the same old, same old jurisprudential considerations.

The third and final limitation which we will discuss involves the question of whether our empirical findings with respect to the Supreme Court are generalizable to lower courts. This question is particularly important because most of the litigation with respect to corporate tax abuse takes place in the lower federal courts.<sup>239</sup> On the one hand, the Supreme Court’s decisions govern all lower courts and for this reason we believe that the factors that persuade the justices are also likely to have an effect on lower federal court judges.<sup>240</sup> On the other hand, we are mindful of the fact that lower federal courts may face an entirely different collection of cases and thus weigh factors very differently.<sup>241</sup> Thus, we believe it is important to extend or study to the lower federal courts in order to determine several questions left unanswered, including the following: 1) how do the lower courts (both appellate and trial) weigh the collection of factors that we found to affect the Supreme Court?; 2) do the lower courts consider different factors in the judicial decision-making process?; and 3) do the U.S. Tax Court and federal district court judges weight factors differently in the judicial decision-making process? These are just three of the questions that we plan to address in future analysis of the decisions of the federal appellate and trial courts as we develop a more comprehensive theory that explains the judicial decision-making process in corporate tax abuse cases.<sup>242</sup>

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<sup>238</sup> James S. Eustice, *Abusive Corporate Tax Shelters: Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 135 (2002). Empiricists in other contexts, however, have found notable doctrinal changes. See generally Daniel E. Ho & Erica L. Ross, *Did Liberal Justices Invent the Standing Doctrine? An Empirical Study of the Evolution of Standing, 1921-2006*, 62 STAN. LAW REV. 591 (2010).

<sup>239</sup> See Administrative Office of the United States Courts, Federal Judicial Caseload Statistics, Mar. 31, 2011, available at <http://www.uscourts.gov/Statistics/FederalJudicialCaseloadStatistics/FederalJudicialCaseloadStatistics2011.aspx>.

<sup>240</sup> For discussion, see Frank B. Cross & James F. Spriggs II, *The Most Important (and Best) Supreme Court Opinions and Justices*, 60 EMORY L.J. 409, 501 (2010) (discussing influence of the U.S. Supreme Court, and Justice Scalia in particular, on other courts).

<sup>241</sup> For discussion of different influences on lower courts compared to Supreme Court, see Nancy Staudt, *Modeling Standing*, 79 N.Y.U. L. REV. 612 (2004); Frank B. Cross & Emerson H. Tiller, *Judicial Partisanship and Obedience to Legal Doctrine: Whistleblowing on the Federal Courts of Appeals*, 107 YALE L.J. 2155, 2158-59 (1998).

<sup>242</sup> In our next studies, we first plan to analyze a sample of the corporate tax abuse decisions of the federal appellate courts and then plan to analyze decisions of the U.S. District Court, U.S. Tax Court and the U.S. Court of Federal Claims.

## IV. IMPLICATIONS AND FUTURE RESEARCH

This study provides insights regarding the nation's most influential jurists and their approach to corporate tax abuse over a time period spanning more than a century. As such, the findings may have implications for a variety of different parties, including private practitioners who design corporate tax strategies, IRS agents who audit corporations, government and private lawyers who litigate corporate tax abuse cases, and policymakers and scholars who study the judiciary's role in controlling corporate tax abuse.<sup>243</sup>

In this Part, we present the questions raised by our study and the potential implications of our findings but before we do so, we would like to comment briefly on the role of statistics in the everyday practice of law. Many lawyers believe their own expertise and knowledge is sufficient when advising clients and litigating cases. Empirical studies, it is often argued, are interesting but not altogether relevant to the actual practice of law.<sup>244</sup> We agree that knowledge and expertise are *necessary* to achieve legal success but we are not convinced it is always *sufficient*. That is to say, general trends identified with the help of data and statistics, such as those presented in our study, can provide useful information that can—and should—supplement and refine the insights provided by individual lawyers.<sup>245</sup> Put differently, we believe lawyers are not so different from other professionals, such as those in the health context or managing baseball teams. Most individuals, for example, prefer a doctor who is up-to-date on the latest studies and uses of drugs, yet desire to be treated by a person that also understands the unique attributes and concerns of the individual patient at-hand. We believe that the qualitative information and knowledge acquired

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<sup>243</sup> These are the groups we discussed above. See *supra* notes 90 - 129 and accompanying text.

<sup>244</sup> We thank Michael Desmond, a widely regarded partner at Bingham McCutchen for making this point. Mr. Desmond presented excellent comments on an earlier draft of this Article.

<sup>245</sup> See Theodore Ruger et al., *The Supreme Court Forecasting Project: Legal and Political Science Approaches to Predicting Supreme Court Decisionmaking*, 104 COL. LAW REV 1150 (2004) (demonstrating that in some circumstances, scientific models can and do outperform individual experts when it comes to predicting Court behavior). For a terrific example of practicing lawyers' use of data and statistics, see John S. Summers and Michael J. Newman, *Towards a Better Measure of Understanding of U.S. Supreme Court Review of Courts of Appeals Decisions*, 80 U.S.L.W. 393 (2011); see also John S. Summers & Michael J. Newman, *Matrixx, Materiality and Statistical Significance*, 243 THE LEGAL INTELLIGENCER 1 (April 28, 2011) (discussing the role of "statistical significance" in judicial decision making). John Summers and Michael Newman are conducting a large empirical study of Supreme Court decision making and its review of the 13 U.S. courts of appeals. See [http://www.hanglely.com/Supreme\\_Court\\_Project/](http://www.hanglely.com/Supreme_Court_Project/). For a fun investigation into the role of statistics in a profession long perceived to rely on individual expertise and knowledge, see MICHAEL LEWIS, *MONEYBALL: THE ART OF WINNING AN UNFAIR GAME* (2003).

through hard work and experience is essential to success in most professions, but systematically and completely ignoring scientific findings is not a strategy that best serves clients' interests.

A. *Can Parties Exploit Our Findings?*

Our study identifies a range of factors that both hurt and help the government's case in the Supreme Court, and for this reason may be helpful to lawyers who do corporate transactional work and to litigators who defend corporations following an audit. We first note that the variables that we analyze, such as the allegation of a lack of non-tax business purpose, the use of multiple transaction steps, or accounting irregularities have played a significant role in corporate tax abuse controversies for generations<sup>246</sup> and will continue to influence the government's decision to challenge corporate tax strategies as abusive.<sup>247</sup> Consequently, our results may enable tax lawyers to develop strategies that account for how judges identify corporate tax abuse, a concept historically considered nebulous at best and unknowable at worst.<sup>248</sup> In short, notwithstanding the fact that our study is limited to cases that appeared before the Supreme Court, this new understanding of how the justices respond to corporate tax abuse allegations can serve important practical purposes.

Before proceeding, it is necessary to acknowledge the limitations on the potential application of our findings for corporate tax transactional work. Specifically, we concede that most tax lawyers will not incorporate certain of our findings regarding external factors into their planning analysis. For example, our study indicates that an increase in defense spending has a statistically significant effect on the government's likelihood of winning a corporate tax abuse case.<sup>249</sup> Not only are most lawyers likely unaware of the relative levels of government spending on national defense (though this data is widely available), but a significant time lag usually occurs between a corporation's pursuit of a tax strategy and litigation before any court, let alone the Supreme Court.<sup>250</sup> These findings may have important implications for scholars, policymakers, and litigators, but they are admittedly of little use to practitioners during the planning

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<sup>246</sup> See Eustice, *supra* note 238 at 135.

<sup>247</sup> See Dept. of Treasury, *The Problem of Tax Shelters: Discussion, Analysis, and Legislative Proposals* (July 1999).

<sup>248</sup> See *supra* notes 47 – 85 and accompanying text.

<sup>249</sup> See *supra* notes 215 – 216 and accompanying text.

<sup>250</sup> See Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 87 (2006) (describing “lengthy time lag” between the execution of a tax shelter and its eventual detection by the Service); Blank, *supra* note 38 at 575-576 (discussing “tax shelter time lag”).

stages of corporate transactions. This is one caveat, and we will note others. Nonetheless we expect many of our findings will have important and interesting applications for private practitioners and government lawyers in various contexts as we describe immediately below.

### 1. *Private Practitioners*

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

First, our study suggests that, at least in the Supreme Court, private practitioners can increase the likelihood that judges will respect their planning choices if they structure transactions that do not feature the participation of third parties *and* multiple transaction steps simultaneously.<sup>251</sup> Put differently, practitioners should be aware that the use of simpler transaction structures that involve only a third party *or* only multiple transaction steps appear to best protect their corporate clients from judicial anti-abuse standards.<sup>252</sup> Again, in our future research, we will investigate whether this specific effect occurs in the other federal appellate courts and at the trial court level.

In addition, our study of Supreme Court decisions reveals that the procedural posturing of a tax controversy has a significant effect on its outcome.<sup>253</sup> As noted above, when a tax controversy arises from the IRS's denial of a corporation's claim for a refund, instead of from an IRS agent's own discovery of a deficiency item during an audit, the government's chances of success in litigation increase significantly.<sup>254</sup> One possibility for this outcome is that the framing of the controversy as a dispute over the corporation's request for a "refund" of taxes from the government as opposed to one that involves an "underpayment" of tax to the government may influence the justices' views of abuse.<sup>255</sup> A possible implication of our study is that private practitioners may protect against the application of judicial anti-abuse standards by designing tax strategies that do not require the corporation to file a refund claim with the IRS on its original or amended return. For example, rather than structuring a transaction where a

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<sup>251</sup> See *supra* notes 198 – 206 and accompanying text.

<sup>252</sup> See *supra* notes 191 – 197 and accompanying text.

<sup>253</sup> See *supra* notes 207 – 211 and accompanying text.

<sup>254</sup> See *id.*

<sup>255</sup> For discussion of the framing of refunds and tax payments, see John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, in *WHY PEOPLE PAY TAXES* 43, 60 (1992); Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 *STAN. L. REV.* 695, 731, n. 205 (2007).

corporation files a refund claim as a result of using a net operating loss carry back (which would necessitate the filing of a separate refund claim<sup>256</sup>), practitioners should design tax strategies that involve a decrease in the corporation's reported taxable income on its return. Our findings show that, at least in the Supreme Court, a corporation will fare much better if the controversy centers on an underreporting controversy than on the amount of money a corporation can extract from the federal fisc.<sup>257</sup>

Finally, the Court has not looked favorably on corporate tax strategies that result in divergent positions on financial accounting documents and in filed tax returns. While book-tax differences, as they are known in the discipline,<sup>258</sup> do not necessarily mean the corporation will be denied its preferred tax position, they raise a red flag to IRS auditors and judges alike that tax avoidance may be at hand. Our findings are yet another indication that corporate transactional lawyers should be wary of transactions that result in book-tax differences, or should at least inform clients of the potential risks of judicial recharacterization.

## 2. *Government Lawyers*

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

Our findings suggest that government lawyers should be hesitant to pursue litigation against corporate taxpayers in the Supreme Court if the core basis of their case rests on the assertion that the taxpayer lacked a non-tax business purpose for pursuing the transaction at issue. Our results indicate that the Supreme Court justices generally rely on the corporation's view of business purpose and are generally not convinced to unwind a deal simply because the government alleges it is lacking.<sup>259</sup> Our study also indicates that government lawyers make a strategic litigation error when they focus excessively on a single factor of abuse—or build their case by pointing to as many indicia of abuse as possible.<sup>260</sup> Instead, government lawyers should focus on the two most objective factors, multiple steps and third parties, and use these factors not alone but in

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<sup>256</sup> See IRS Form 1120X (Jan. 2011).

<sup>257</sup> See *supra* notes 207 – 211 and accompanying text.

<sup>258</sup> See *supra* notes 96 – 97 and accompanying text.

<sup>259</sup> See *supra* notes 192 – 193 and accompanying text.

<sup>260</sup> For example, the government provides a lengthy list of possible indicia of abuse in its guidance to its agents regarding the newly codified economic substance doctrine. See Int. Rev. Serv., *supra* note 93.



combination when challenging a transaction.

Further, our models consistently suggest that when the nation's defense spending spikes, the likelihood that the government will prevail also increases. The underlying judicial motivation for this pro-government position has been extensively explored elsewhere;<sup>261</sup> for our purposes we simply note that just as private practitioners should consider the external environment, government lawyers should consider factors beyond the parameters of the case in order to succeed in Court.<sup>262</sup>

### 3. *Settlement*

Knowledge and understanding of the findings that we present in our study could shape corporate tax planning strategies in the short term and litigation strategies over the long term, but they may also affect settlement discussions.<sup>263</sup> For instance, if a corporation has filed a tax refund claim with the IRS, has engaged in a multi-step transaction with outside parties, and is defending its plan in the Supreme Court after winning in the lower appellate court—that corporation should expect to lose in the Supreme Court.<sup>264</sup> If the case reaches the docket during a wartime emergency, the taxpayer's chances of success fall further and, thus, settlement should be viewed as a good option given the high risk of losing.<sup>265</sup> Indeed, even if the transaction avoids the factors that lead the Court to decide in the government's favor, but the justices decide to hear the case upon an appeal by the government and the nation is at war—the corporation should again seriously consider settlement. Our empirical findings, of course, must be refined and modified by other factors known by lawyers due to their own background knowledge and expertise and possibly excluded by our statistical models.

The same type of analyses can be conducted with respect to the government. If the government relies on the lack of a business purpose to convince the Court to unwind a transaction, and the Court agrees to hear the case on an appeal by the taxpayer in a period of peace—this suggests that the government is unlikely to prevail.<sup>266</sup> Government lawyers, consequently, should focus on other factors discussed above in designing their litigation strategies or, alternatively, consider settlement—again in the absence of competing concerns known by the lawyers due to their own professional experience vis-à-vis Supreme Court litigation.

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<sup>261</sup> See generally Staudt, *supra* note 160.

<sup>262</sup> See *supra* notes 215 – 216 and accompanying text.

<sup>263</sup> See CLIFF JERNIGAN, CORPORATE TAX AUDIT SURVIVAL 79-84 (2005) (describing audit and settlement process for large corporations).

<sup>264</sup> See *supra* notes 191 – 244 and accompanying text.

<sup>265</sup> See *supra* notes 215 – 216 and accompanying text.

<sup>266</sup> See *supra* notes 192 – 193 and accompanying text.

Not only do we believe that our modeling efforts can advance the interests lawyers and litigators when it comes to strategizing and settling, but we also believe the judiciary itself will benefit. Our study illuminates judicial decision making in corporate tax abuse cases, a process that has long been viewed as elusive. This study, then, provides a greater level of predictability to the decision-making process, a feature widely believed to be associated with fair and just decision making.<sup>267</sup> We do not express a normative view regarding whether judicial uncertainty increases tax compliance or serves any other purpose. However, we are confident that the judiciary itself would benefit from an increased understanding of judicial decision making in the corporate tax abuse context given that this transparency would encourage parties in federal appellate disputes to reach settlements and, consequently, avoid the use of judicial resources.<sup>268</sup>

#### B. *Should Business Purpose Matter?*

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

Our findings show that when the government alleges in its brief that the

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<sup>267</sup> See discussion of these issues and a review of the literature, see Nancy Staudt, *Taxpayers in Court: A Systematic Study of a (Misunderstood) Standing Doctrine*, 52 *Emory L.J.* 771, 835-46 (2003).

<sup>268</sup> For a striking example of the federal judiciary's interest in settlement, see Fed. R. Civ. P. 16(a) (providing that the court may order attorneys to appear at pre-trial conferences for purposes such as "facilitating settlement").

<sup>269</sup> *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 561 (1978).

<sup>270</sup> See, e.g., Ferguson, *supra* note 100 at 51; Canellos, *supra* note 101 at 51.

<sup>271</sup> Chirelstein & Zelenak, *supra* note 128.

<sup>272</sup> See *supra* notes 118 – 121.

taxpayer lacked a non-tax business purpose, which almost always results in a counter-argument from the corporate taxpayer,<sup>273</sup> the issue has no statistically significant effect on the judicial outcome.<sup>274</sup> A possible explanation for this finding is that when the issue of a non-tax-related business purpose arises in a corporate tax abuse controversy, the government and the corporate taxpayer may offer equally convincing arguments, such that they cancel out a possible positive effect of the allegation on the government's chances of success.<sup>275</sup> Another possibility is that in corporate tax abuse controversies that reach the Supreme Court, the issue of whether the transaction possesses a non-tax business purpose is not as central to the dispute as other issues.<sup>276</sup> A final intriguing possibility is that the justices may not believe that a non-tax-motivated purpose for a transaction can be separated from a tax-motivated purpose as neatly as some commentators suggest.<sup>277</sup> In any case, this finding appears to confirm the criticism of many commentators that the justices may view the business purpose requirement as a standard that can be manipulated by both the taxpayer and the government and thus neither probative nor decisive for legal analytic purposes.

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

Our discussion suggests that policymakers should consider adopting an alternative mechanism to the business purpose standard if they desire to prevent

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<sup>273</sup> See David P. Hariton, *The Frame Game: How Defining the "Transaction" Decides the Case*, 63 TAX LAW. 1 (2009) ("the battle in the courts is primarily about "framing" the transaction as consisting of either the narrower tax-motivated structures or steps...or of the broader business objectives...).

<sup>274</sup> See *supra* notes 192 – 193 and accompanying text.

<sup>275</sup> See Hariton, *supra* note 273.

<sup>276</sup> See *supra* note (discussing possible selection effects).

<sup>277</sup> See, e.g., Ferguson, *supra* note 100 at 51; Canellos, *supra* note 101 at 51.

<sup>278</sup> See *supra* notes 192 – 193 and accompanying text.

<sup>279</sup> See *supra* notes 118 – 121.

corporate tax abuse and its ratification by the courts.<sup>280</sup> Potential policy candidates include proposals that attempt to identify corporate tax abuse without requiring a subjective, intent-based analysis. For example, the objective loss disallowance rule that Professors Marvin Chirelstein and Lawrence Zelenak have proposed would prohibit tax losses that do not mirror economic losses and would not require a court to analyze the corporation's business purpose for pursuing particular transactions.<sup>281</sup> Professor Daniel Shaviro has also offered a proposal that highlights objective differences between a corporation's reported taxable income and its financial income along with tax penalties based on the difference as a means to deter abuse.<sup>282</sup> Several other proposals employ similar objective approaches in an effort to detect and deter corporate tax abuse.<sup>283</sup> Our study bolsters the arguments set forth by critics of the business purpose standard and provides further justification for the argument in favor of anti-abuse proposals that eliminate subjective analysis of the taxpayer's intent.

## V. CONCLUSION

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

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

<sup>281</sup> Chirelstein & Zelenak, *supra* note 128.

<sup>282</sup> Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L. J. 423, 472-483 (2008).

<sup>283</sup> See *supra* notes 118 – 121.

<sup>284</sup> See *supra* notes 38 – 85 and accompanying text. The use of standards to combat literalist use of rules to achieve unintended results occurs in other areas of the law as well. See Kristin E. Hickman & Claire A. Hill, *Concepts, Categories, and Compliance in the Regulatory State*, 94 MINN. L. REV. 1151, 1156 (2010) (“Law typically seeks to avoid the potentially absurd extremes of rules or formalistic interpretations of statutory text through the use of *ex post* standards”).

studies.

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

## CORPORATE SHAMS

69

## APPENDIX

Corporate Tax Abuses Cases in the U.S. Supreme Court  
1909-2011

This Appendix contains the cases that we designated as “corporate tax abuse cases” in our study, those which involve a corporate tax controversy in which the government alleged in its brief that the corporation’s tax strategy was abusive.<sup>285</sup>

Case	Citation	Year
McCoach v. Minehill & S. H. R. Co.	228 U.S. 295	1913
Von Baumbach v. Sargent Land Co	242 U.S. 503	1917
U.S. v. Biwabik Mining Co.	247 U.S. 116	1918
U.S. v. Supplee-Biddle Hardware Co.	265 U.S. 189	1924
Lederer v. Fidelity Trust Co	267 U.S. 17	1925
Duffy v. Central R. Co. of New Jersey	268 U.S. 55	1925
Edwards v. Cuba R. Co.	268 U.S. 628	1925
Burk-Waggoner Oil Ass’n v. Hopkins	296 U.S. 110	1925
U.S. v. Boston Ins. Co.	269 U.S. 197	1925
U.S. v. Anderson	269 U.S. 422	1926
Edwards v. Chile Copper Co.	270 U.S. 452	1926
Bowers v. Kerbaugh-Empire Co.	271 U.S. 170	1926
Hellmich v. Missouri Pac. R. Co.	273 U.S. 242	1927
American National Co. v. United States	274 U.S. 99	1927
Willcuts v. Milton Dairy Co.	275 U.S. 215	1927
Lewellyn v. Electric Reduction Co	275 U.S. 243	1927
U.S. v. Boston & M.R.R.	279 U.S. 732	1929
U.S. v. American Can Co.	280 U.S. 412	1930
Niles Bement Pond Co. v. U.S.	281 U.S. 357	1930
Lucas v. Ox Fibre Brush Co.	281 U.S. 115	1930
Lucas v. Kansas City Structural Steel Co.	281 U.S. 264	1930
Handy & Harman v. Burnet	284 U.S. 136	1931
American Hide & Leather Co. v. United States	284 U.S. 343	1932

<sup>285</sup> As we have stated, these cases involved *corporate* rather than individual tax liability. Consequently, the list does not contain certain “classic” Supreme Court cases involving abusive tax strategies, such as *Gregory v. Helvering*, 69 F.2d 809 (1934). In that famous case, for example, the principal issue was the tax treatment of Mrs. Gregory, an individual shareholder, on her receipt and sale of Monitor Corporation stock and not on the tax treatment of the corporations that Mrs. Gregory owned. *Id.* As a result, we did not designate this tax case, and several others like it, as “corporate tax cases” or “corporate tax abuse cases.”

## CORPORATE SHAMS

U.S. Cartridge Co. v. U.S.	284 U.S. 511	1932
Bowers v. Lawyers' Mortg. Co.	285 U.S. 182	1932
Continental Tie & Lumber Co. v. U.S.	286 U.S. 290	1932
Woolford Realty Co. v. Rose	286 U.S. 319	1932
Texas & P. Ry. Co. v. U.S.	286 U.S. 285	1932
North Am. Oil Consolidated v. Burnet	286 U.S. 417	1932
Murphy Oil Co. v. Burnet	287 U.S. 299	1932
Bankers' Pocahontas Coal Co. v. Burnet	287 U.S. 308	1932
Burnet v. Aluminum Goods Mfg. Co.	287 U.S. 544	1933
Pinellas Ice & Cold Storage Co. v. C.I.R.	287 U.S. 462	1933
Atlantic City Electric Co. v. Commissioner	288 U.S. 152	1933
Charles Iffeld Co. v. Hernandez	292 U.S. 62	1934
Rockford Life Ins. Co. v. Commissioner	292 U.S. 382	1934
McLaughlin v. Pacific Lumber Co.	293 U.S. 351	1934
Helvering v. Inter-Mountain Life Ins. Co.	294 U.S. 686	1935
Raybestos-Manhattan v. U.S.	296 U.S. 60	1935
General Utilities & Operating Co. v. Helvering	296 U.S. 200	1935
Helvering v. Combs	296 U.S. 365	1935
Morrissey v. Commissioner of Internal Revenue	296 U.S. 344	1935
John A. Nelson Co. v. Helvering	296 U.S. 374	1935
Helvering v. Coleman-Gilbert Associates	296 U.S. 369	1935
Bus & Transport Securities Corp. v. Helvering	296 U.S. 391	1935
G. & K. Mfg. Co. v. Helvering	296 U.S. 389	1935
Helvering v. Minnesota Tea Co.	296 U.S. 378	1935
Swanson v. Commissioner of Internal Revenue	296 U.S. 362	1935
Great Western Power Co. of Cal. v. Commissioner	297 U.S. 543	1936
Helvering v. Illinois Life Ins. Co.	299 U.S. 88	1936
Helvering v. Midland Mut. Life Ins. Co.	300 U.S. 216	1937
U.S. v. A.B. Leach & Co.	300 U.S. 268	1937
Helvering v. Tex-Penn Oil Co.	300 U.S. 481	1937
A.A. Lewis & Co. v. Commissioner	301 U.S. 385	1937
Minnesota Tea Co. v. Helvering	302 U.S. 609	1938
Helvering v. Mountain Producers Corporation	303 U.S. 376	1938
U.S. v. Hendler	303 U.S. 564	1938
Helvering v. National Grocery Co.	304 U.S. 282	1938
M.E. Blatt Co. v. U.S.	305 U.S. 267	1938
First Chrold Corporation v. Commissioner	306 U.S. 117	1939
Helvering v. R.J. Reynolds Tobacco Co.	306 U.S. 110	1939
Helvering v. Pennsylvania Water & Power Co.	306 U.S. 522	1939
Helvering v. F. & R. Lazarus & Co.	308 U.S. 252	1939
Real Estate-Land Title & Trust Co. v. U.S.	309 U.S. 13	1940
U.S. v. Kerider Co.	313 U.S. 443	1941

## CORPORATE SHAMS

71

U.S. v. Joliet & C. R. Co.	315 U.S. 44	1942
Helvering v. Southwest Consol. Corp.	315 U.S. 194	1942
Palm Springs Holding Corp. v. Commissioner	315 U.S. 185	1942
Bondholders Committee v. Commissioner	315 U.S. 189	1942
Helvering v. Alabama Asphaltic Limestone Co.	315 U.S. 179	1942
Magruder v. Wash. Balt. & Annapolis Realty Corp.	316 U.S. 69	1942
Helvering v. Credit Alliance Corporation	316 U.S. 107	1942
Helvering v. James Newton Trust	316 U.S. 527	1942
Helvering v. Sabine Transp. Co.	318 U.S. 306	1943
Helvering v. Chicago Stock Yards Co.	318 U.S. 693	1943
Detroit Edison Co. v. C.I.R.	319 U.S. 98	1943
Virginia Hotel v. Helvering	319 U.S. 523	1943
Security Flour Mills Co. v. Commissioner	321 U.S. 281	1944
United States v. Seattle-First Nat'l Bank	321 U.S. 583	1944
Equitable Life Assur. Soc. of U.S. v. Commissioner	321 U.S. 560	1944
Wisconsin Gas & Electric v. U.S.	322 U.S. 526	1944
Commissioner v. Court Holding Co.	324 U.S. 331	1945
John Kelley Co. v. C.I.R.	326 U.S. 521	1946
Commissioner v. Crawford	326 U.S. 599	1946
Burton-Sutton Oil Co. v. C.I.R.	328 U.S. 25	1946
United States v. Ogilvie Hardware Co.	330 U.S. 709	1947
Commissioner v. S. Tex. Lumber Co.	333 U.S. 496	1948
National Carbide Corp. v. C.I.R.	336 U.S. 422	1949
United States v. Cumberland Pub. Serv. Co.	338 U.S. 451	1950
Brown Shoe Co. v. Commissioner	339 U.S. 583	1950
U.S. v. Anderson, Clayton & Co.	350 U.S. 55	1955
U.S. v. Huntington Beach Co.	350 U.S. 308	1956
U.S. v. Leslie Salt Co.	350 U.S. 383	1956
Millinery Ctr. Bldg. Corp. v. C.I.R.	350 U.S. 456	1956
Libson Shops, Inc. v. Koehler	353 U.S. 382	1957
Commissioner v. P. G. Lake, Inc.	356 U.S. 260	1958
U.S. v. Cannelton Sewer Pipe Co.	364 U.S. 76	1960
Massey Motors, Inc. v. United States	364 U.S. 92	1960
Hertz Corp. v. U.S.	364 U.S. 122	1960
American Auto. Ass'n v. U.S.	367 U.S. 687	1961
Riddell v. Monolith Portland Cement Co.	371 U.S. 537	1963
Paragon Jewel Coal Co. v. C.I.R.	380 U.S. 624	1965
U.S. v. Midland-Ross Corp.	381 U.S. 54	1965
Fribourg Nav. Co. v. C. I. R.	383 U.S. 272	1966
U.S. v. Donruss Co.	393 U.S. 297	1969
U.S. v. Hilton Hotels Corp.	397 U.S. 580	1970



## CORPORATE SHAMS

Commissioner v. First Sec. Bank	405 U.S. 394	1972
C. I. R. v. National Alfalfa Dehydrating & Milling	417 U.S. 134	1974
Central Tablet Mfg. Co. v. U. S.	417 U.S. 673	1974
C. I. R. v. Idaho Power Co.	418 U.S. 1	1974
Ivan Allen Co. v. U. S.	422 U.S. 617	1975
Don E. Williams Co. v. C. I. R.	429 U.S. 569	1977
United States v. Penn Security Life Insurance Co.	430 U.S. 725	1977
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U.S. v. Centennial Sav. Bank FSB	499 U.S. 573	1991
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