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From Gregory to Enron: The Too Perfect Theory and Tax Law

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> *Conjuring is the only absolutely honest profession: a conjuror promises to deceive and does.*
>
> *– Karl Germain, lawyer and magician*[1]

I. INTRODUCTION

In the last few years, we have seen a number of financial stories discussing corporate America's trickery, many using magic terms such as "sleight of hand," "hocus-pocus," and "trickery."[2] In one news

[1] STUART CRAMER, GERMAIN THE WIZARD 237 (2002). Germain the Wizard (also known as Karl Germain) (1878–1959), whose real name was Charles W. Mattmueller, Jr., was a prominent magician in the 1910s who gave up the magic profession to become a practicing lawyer. Germain had a magic pupil late in his life and requested that his pupil never divulge the secrets that Germain revealed to him, even making the threatening statement: "If you ever write anything about me after I am gone, I will come back and haunt you." *Id.* at 31. Fortunately for the magic profession, Germain's pupil, Stuart Cramer (1911–2003), did not honor his mentor's wishes. Shortly after Germain's death in 1959, Cramer published several books about Germain, thereby allowing future generations of magicians to realize the brilliance of his mentor. *See, e.g.*, STUART CRAMER, GERMAIN THE WIZARD AND HIS LEGERDEMAIN (1966); STUART CRAMER, THE SECRETS OF KARL GERMAIN (1962).

There has been a resurgence of interest in Germain the Wizard with the publication in 2002 of Cramer's third book on Germain, entitled simply GERMAIN THE WIZARD.

[2] *See, e.g.*, David Henry & Marcia Vickers, *Whipsawed by Wall Street*, BUS. WK., Mar. 10, 2003, at 55 ("Earnings surprises — and consequent lurches in stocks — are likely to become much more common as U.S. and international regulators change accounting rules in an effort to discourage corporate hocus-pocus."); Jonathan Peterson, *Scandals Keep Many Wary of Wall Street; Lingering Distrust in the Financial System Could Hurt Bush in the Presidential Campaign*, L.A. TIMES, Mar. 23, 2004, at A1 ("More than two years after Enron Corp. became an emblem of corporate fraud and trickery, opinion surveys show that throughout the nation the public's faith in the financial system remains shaken. . . ."); James Surowiecki, *Aim High*, THE NEW YORKER, Sept. 22, 2003, at 90 (describing the Air Force's accounting practices as the

story published in the *New York Times*, the author writes that "even David Copperfield could learn a trick or two from some of the true masters of illusion: the financial wizards on Wall Street and in corporate America."[3] Numerous books and financial articles have discussed the trickery at corporate giants, such as Enron, WorldCom, and Global Crossing.[4] For example, in one financial story, the author writes that "[t]he true extent of this dodge [tax avoidance] has not been disclosed, except for sleight of hand like this: Using deductions for stock options, the company [Enron] turned a $112-million tax liability into a $278-million refund."[5]

Although financial writers have been using magic terms in describing tax law (and accounting reporting), do such terms and theories really have a place in the law? This Article will show that there is a connection between magic and tax law.[6] A theory in magic known as the Too Perfect Theory, which has been present in magic circles for many years and has recently had a resurgence in popularity, is applicable to tax law.

The Too Perfect Theory has been interpreted to mean that a magic trick may be too perfect, in that not only does it not fool the audience, but the effect itself may lead the audience to discover how the trick is performed.[7] A number of prominent magicians have

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"kind of sleight of hand that corporate America indulged in during the nineties, to its enduring embarrassment").

[3] Kurt Eichenwald, *Just a Little Abracadabra and How Those Numbers Fall Into Place*, N.Y. TIMES, Aug. 16, 1998, § 3, at 9.

[4] *See, e.g.*, LYNNE W. JETER, DISCONNECTED: DECEIT AND BETRAYAL AT WORLDCOM (2003); BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003); REBECCA SMITH & JOHN R. EMSHWILLER, 24 DAYS (2003); Joshua Chaffin, *Global Crossing Hires Outside Auditor; Telecommunications Bankrupt Carrier Plans Special Committee and Appoints Firm to Review Matters SEC is Investigating*, FIN. TIMES, Feb. 5, 2002, at 28; Daniel Kadlec, *WorldCon; Nailed for the Biggest Bookkeeping Deception in History, a Fallen Telecom Giant Gives Investors One More Reason to Doubt Corporate Integrity*, TIME, July 8, 2002, at 20; Anne Tergesen, *Cash-Flow Hocus-Pocus*, BUS. WK., July 15, 2002, at 130.

[5] John Balzar, *Only Suckers Pay Taxes*, L.A. TIMES, Apr. 14, 2002, at M5.

[6] There have been articles written on the deceptive nature of tax lawyers but they do not involve theories in magic being applied to tax law. *See, e.g.*, Calvin H. Johnson, *Seeking Shelter: Opportunity Lost in Pleasant Summit*, 47 TAX NOTES 1009 (1990); Lee A. Sheppard, *News Analysis — The Fairies, the Magic Circle, and Partnership Options*, 90 TAX NOTES 721 (2001); Steven J. Willis, *Masks, Magic and Games: The Use of Tax Law as a Policy Tool*, 4 AM. J. TAX POL'Y 41 (1985).

[7] *See* Rick Johnsson, *The "Too Perfect" Theory*, HIEROPHANT, Fall 1970–Spring 1971, at 247–50.

written about and debated the Too Perfect Theory, with most agreeing with the theory and a small minority disagreeing with it for various reasons.[8] What is interesting about the Too Perfect Theory is that it seems to be applicable to the law, particularly the practice of transactional law, such as tax law. In other words, is it possible for a transaction to be structured in which the results are too perfect under the tax law? Most judges, law academics, lawyers, and law students would immediately respond, "Absolutely not." They would claim that transactional lawyers strive for perfection and anything less may lead to malpractice claims. But, as this Article will show, a transaction may have results that are too perfect under the tax law, and, as a result, the transaction may be subject to recharacterization by the government and the courts.[9]

The first part of this Article will describe in detail the Too Perfect Theory in the area in which it originated: the field of magic or conjuring.[10] The second part of this Article will apply the theory to an area of transactional law in which perfection has always been seen as the goal of the lawyer: tax law.[11] In the field of tax law, any mistake in structuring a transaction can lead to disastrous tax consequences. This is probably most prevalent in the area of international tax law, in which no less an authority than Professor James Eustice has written, "[T]o be wrong here [international tax] is to court tax disasters on a

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[8] *See, e.g.*, SIMON ARONSON, THE ARONSON APPROACH 172 (1990); MICHAEL CLOSE, WORKERS, NUMBER 3, at 84–88 (1993); PETER LAMONT & RICHARD WISEMAN, MAGIC IN THEORY 97 (1999) (noting that the theory is "controversial"); STEPHEN MINCH, KEN KRENZEL'S INGENUITIES ix (1997) ("Here I am in accord with Juan Tamariz, Tommy Wonder and others who maintain that the goal to be sought is one of absolute, clueless bewilderment."); 2 TOMMY WONDER & STEPHEN MINCH, THE BOOKS OF WONDER 319 (1996) ("This theory has been rather widely accepted, is applied quite a bit by some, and is unfortunately gaining in popularity."); John Carney, *The Flaw in the Diamond*, GENII: THE CONJURORS' MAG., Aug. 2001, at 59–62; Michael Close, *A Worker's Take on "Too Perfect,"* GENII: THE CONJURORS' MAG., Aug. 2001, at 62–64; Martin Lewis, *Find a Better Method*, GENII: THE CONJURORS' MAG., Aug. 2001, at 67; Harry Lorayne, *It's Your Call: On the Too-Perfect Theory*, GENII: THE CONJURORS' MAG., Aug. 2001, at 68–70; Darwin Ortiz, *Striving for Perfection*, GENII: THE CONJURORS' MAG., Aug. 2001, at 64–67; Jon Racherbaumer, *The Too Perfect Theory: Thirty Years Later*, GENII: THE CONJURORS' MAG., Aug. 2001, at 48–57; Jamy Ian Swiss, *The Too Perfect Theory in Action*, GENII: THE CONJURORS' MAG., Aug. 2001, at 57–59; Patrick Watson, *Assenting to the Inexplicable*, GENII: THE CONJURORS' MAG., Aug. 2001, at 67–68.

[9] *See infra* notes 84–109 and accompanying text.

[10] *See infra* notes 16–83 and accompanying text.

[11] *See infra* notes 84–222 and accompanying text.

scale rarely encountered on the home front."[12] In this Article, the conventional wisdom of perfection in structuring transactions for tax purposes will be questioned, with examples from both domestic and international tax law. In the final parts of the Article, the Too Perfect Theory will be analyzed in the context of common transactions.[13] An analysis of current practice will reveal that, while almost all tax advisors are intuitively aware of the Too Perfect Theory, many of them have violated it.

It may seem odd for a law professor to be interested in magic. However, the legal profession's fascination with conjuring goes back hundreds of years, and it appears to be more prevalent today than ever, with such noted judges as Alex Kozinski and Stephen Trott of the United States Court of Appeals for the Ninth Circuit being avid magic enthusiasts.[14] Conjurors are also fascinated by the law; for example, one of the best conjurors in the world, England's Guy Hollingworth, has given up the profession of conjuring to pursue a law degree and become a barrister.[15]

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[12] James S. Eustice, *Foreword to* 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION v (2002).

[13] *See infra* notes 223–281 and accompanying text.

[14] *See* Kevin Livingston, *Attorney Can Pull a Rabbit Out of his Hat – Literally*, THE RECORDER, Feb. 28, 2000, at 5.

Angelo J. Lewis (1839–1919), who wrote under the pen name of Professor Hoffmann, is often considered to be the greatest author of conjuring textbooks. Lewis wrote MODERN MAGIC (1876), MORE MAGIC (1890), and LATER MAGIC (1904), still regarded as three of the greatest magic books ever written. He also wrote two books on law: THE INDIAN PENAL CODE (1870) and THE CODE OF CIVIL PROCEDURE (1871). *See* THOMAS A. SAWYER, PROFESSOR HOFFMANN: A BIBLIOGRAPHY 13 (1983).

Lewis was an amateur magician and an Oxford-educated barrister who used a pen name because "[he] didn't expect that it would do a practising barrister any good to pose as the author of a work on conjuring." J.B. FINDLAY & THOMAS A. SAWYER, PROFESSOR HOFFMANN: A STUDY 7 (1977).

Charles J. Carter (1874–1936), who utilized the stage name of Carter the Great, was one of the most well known stage magicians and illusionists during the 1910s and 1920s. He graduated from law school but went into the magic profession almost immediately after graduation. *See* MIKE CAVENEY, CARTER THE GREAT (1995). There has been a resurgence of interest in Carter the Great with the publication of Glen David Gold's bestselling novel, CARTER BEATS THE DEVIL (2001).

[15] *See* GUY W.R. HOLLINGWORTH, DRAWING ROOM DECEPTIONS OR THE ETIQUETTE OF DECEPTION 9 (1999).

When you have excluded the impossible, whatever remains, however improbable, must be the truth.
– Sir Arthur Conan Doyle[16]

II. TOO PERFECT THEORY

A. *Illustration of the Too Perfect Theory*

Before describing in detail the Too Perfect Theory, it is best to demonstrate its application by way of example. A well-known magic trick is the "Cigarette through Quarter."[17] This trick can be purchased in any magic shop, and David Blaine and David Copperfield have performed it on their television specials.[18] The effect is as follows: a magician borrows a quarter and a cigarette from a spectator. The magician puts one end of the cigarette against the center of the quarter and very slowly and deliberately pushes the cigarette through the middle of the quarter (in fact, part of the cigarette can be seen protruding from the rear of the quarter). The magician, if using a lighted cigarette, may even puff on the cigarette at this stage. After clearly demonstrating the cigarette has penetrated through the middle of the quarter, the magician slowly removes the cigarette from the middle of the quarter with no hole visible in the quarter once the cigarette is removed, i.e., the hole in the quarter has "healed." The magician immediately hands the cigarette and quarter to the spectators for their inspection.

Let me emphasize that the spectators actually see the cigarette penetrating the middle of the quarter.[19] Now, it should be fairly easy

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[16] SIR ARTHUR CONAN DOYLE, *The Adventure of the Beryl Coronet, in* THE COMPLETE SHERLOCK HOLMES 315 (n.d.).

[17] The "Cigarette through Quarter" trick has been described in a number of magic books with various handlings. *See, e.g.*, RICHARD KAUFMAN, THE COLLECTED ALMANAC 392–95 (1992) (Derek Dingle's version of the Cigarette through Quarter); JON RACHERBAUMER, IN A CLASS BY HIMSELF: THE LEGACY OF DON ALAN 27–35 (2000); 1 WONDER & MINCH, *supra* note 8, at 257–60.

[18] Interestingly, Blaine and Copperfield, who are probably the two most well known magicians in the country today, routinely violate the Too Perfect Theory. *See* JAMY IAN SWISS, SHATTERING ILLUSIONS 184–85 (2002). In fact, noted magician Jamy Ian Swiss believes that Copperfield has invented a phenomenon that goes beyond the Too Perfect Theory — what Swiss refers to as the Too Perfect Effect. *Id.* at 185. For example, in one of his television specials, Copperfield made the Statue of Liberty disappear. This is so incredible that almost no spectator would believe this no matter what method is used. *Id.*

[19] For a picture of a cigarette penetrating a gimmicked quarter, see http://www.magictricks.com/coins/cigthru.htm (last visited Feb. 5, 2005).

to figure out the trick. Everyone knows that it is impossible to push a cigarette through the middle of a quarter.[20] So if that is exactly what the magician is doing, then he or she must be using a gimmicked quarter with a hole in it. In fact, that is the case. The center of the gimmicked quarter, about the same circumference as a cigarette, is cut out and separated from the rest of the quarter but is held in place by a spring hinge on the back of the quarter. One side of the quarter looks like a regular quarter, and it is this side (and only this side) that the audience sees. When the cigarette is pressed against the middle of the gimmicked quarter, the center hinges back, allowing the cigarette to penetrate the center of the quarter. When the cigarette is removed, the center of the quarter snaps back into place, leaving no visible hole in the quarter.

The magician switches the gimmicked quarter for the real quarter at the beginning of the trick (when the spectators do not know what to expect) and then switches the quarters back at the end of the trick.[21] The trick is too perfect, and, as a result, it becomes easy for the spectators to figure out the method. In fact, a well-known magician, Jamy Ian Swiss, wrote that after he had performed the Cigarette through Quarter, perfectly in his opinion, the spectator responded, "Neat. Where's that nifty coin with the hole in it?"[22] Swiss very quickly realized that he had violated the Too Perfect Theory.[23]

B. The Origin of the Too Perfect Theory

In 1945, a magician named "Monk" Watson published a small

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[20] In general, solid through solid effects, such as the Cigarette through Quarter, are a difficult sell to audiences. *See* RACHERBAUMER, *supra* note 17, at 35. Some performers have tried to help the sell in the Cigarette through Quarter by using a lighted cigarette and stating that the heat from the lighted cigarette softens the metal in the center of the quarter so as to allow the cigarette to penetrate the quarter. Admittedly, this is a stretch. *Id.*

[21] The most difficult part of the trick is switching quarters, particularly at the end of the trick when the spectators are closely watching the quarter and the cigarette. Magicians, however, have developed methods to switch quarters that are undetectable. *See, e.g.*, HENRY HAY, THE AMATEUR MAGICIAN'S HANDBOOK 143 (1982) (the DeManche change); RICHARD KAUFMAN, COINMAGIC 6–7, 10–12 (1981) (the Palm change and the Shuttle pass); 1 HARRY LORAYNE, APOCALYPSE 87 (2000) (Bob Elliott's Flipswitch).

[22] *See* SWISS, *supra* note 18, at 179.

[23] *Id.* at 180. Another well-known magician, David Ben, who was formerly a practicing tax lawyer, has written that the Cigarette through Quarter is "an effect, that for some strange reason, I have never thought very magical. Perhaps it is 'too perfect.'" DAVID BEN, TRICKS 19 (2003).

pamphlet on magic entitled *The Professional Touch.*[24] One chapter in the pamphlet was entitled, "Can a Trick Be Too Perfect?"[25] In this chapter, Watson described a magic show in which he performed a trick commonly known as the "Bill in the Lemon."[26] Generally, in this trick, the performer borrows a dollar bill from a spectator. A corner is torn off the dollar bill and given to the spectator. The performer also shows a lemon, which is given to a second spectator. The performer places the dollar bill in an envelope and then lights the envelope on fire. The second spectator holding the lemon is then given a knife to cut open the lemon and inside is the rolled-up dollar bill. The missing corner of the dollar bill in the lemon matches the torn-off corner of the dollar bill that is being held by the first spectator. The performer does not come within ten feet of the lemon from the time the second spectator is given the lemon.

Watson noted that the trick was "too perfect."[27] The audience would quickly realize that there were two dollar bills and that the one in the lemon was not the same bill that the performer borrowed from the first spectator. The performer must have previously torn off a corner of a dollar bill before inserting the bill in the lemon and then switched this torn corner for the torn corner from the dollar bill borrowed from the first spectator. Therefore, Watson changed the performance of the trick by first burning the envelope containing the borrowed dollar bill *and then* picking up the lemon, inserting the knife in the lemon, and giving the lemon to the second spectator.[28] The second spectator would then finish cutting open the lemon to reveal the dollar bill. Watson noted that performing the trick in this manner "would give the impression that in some way I [Watson] had put the bill in the lemon," thus giving him credit for great magical skills.[29] Watson is generally credited with coining the term "Too Perfect," but his theory did not make much of an impact in the magic world at the

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[24] MONK WATSON, THE PROFESSIONAL TOUCH (1945).

[25] *Id.* at 14–15.

[26] The "Bill in the Lemon" has been described in a number of magic books with various handlings. *See, e.g.*, DAVID CHARVET, THE BILL IN LEMON BOOK (1990); T. NELSON DOWNS, THE ART OF MAGIC 315–17 (1909); HAY, *supra* note 21, at 382; JOHN NORTHERN HILLIARD, GREATER MAGIC 771–74 (1938); BARRIE RICHARDSON, THEATER OF THE MIND 34–43 (1999); BILL TARR, 101 EASY TO DO MAGIC TRICKS 32 (1992); MARK WILSON, MARK WILSON'S COMPLETE COURSE IN MAGIC 230–34 (1988).

[27] WATSON, *supra* note 24, at 15.

[28] *Id.*

[29] *Id.*

time.[30] However, that would change in about twenty-five years.

Dai Vernon is generally considered to be the greatest close-up magician of the twentieth century.[31] Beginning in the 1930s and continuing until his death, wherever Vernon went quickly became the center of the magic world. For example, Vernon moved from New York to California in 1963 to take up residence at the Magic Castle in Hollywood.[32] Many leading magicians from all over the country traveled to Hollywood to be near him.[33] Late in his career, Vernon was credited with stating that "[a] spectator never or rarely was fooled by what a magician performed for him in the way of tricks."[34] Those magicians who were not fans and supporters of Vernon claimed that the great man had finally lost it. Even avid supporters of Vernon questioned whether he was starting to slip in his mental capacity.

A well-known magician named Rick Johnsson attempted to analyze Vernon's statement from the perspective that maybe Vernon was right. In January 1971, Johnsson published his theory in an article entitled *The "Too Perfect" Theory* in a magazine designed for close-up magicians.[35] Johnsson wrote that it was his belief, and that he also

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30 *See* SWISS, *supra* note 18, at 190 (citing Monk Watson as "likely the man who truly deserves credit for the catchy terminology").

Terminology similar to "Too Perfect" had been used prior to 1945. For example, T. Nelson Downs (1867–1938) sent a letter to Faucett Ross in which he wrote, "It is a mistake to try to do miracles in front of an audience. If a trick is *too wonderful* it will not impress the average spectator." LEWIS GANSON, MAGIC WITH FAUCETT ROSS 189 (1980) (emphasis added). It is possible that Downs was referring to what Swiss called the Too Perfect Effect. *See supra* note 18.

31 The standard biography of Dai Vernon is HE FOOLED HOUDINI: DAI VERNON, A MAGICAL LIFE (Bruce Cervon & Keith Burns eds., 1992) [hereinafter HE FOOLED HOUDINI]. However, tax lawyer-turned-magician David Ben is working on a multivolume biography of Dai Vernon that is expected to be the most comprehensive work yet on Vernon's life.

A number of books have been written describing in detail the magic of Dai Vernon. *See, e.g.*, Lewis Ganson, The Dai Vernon Book of Magic (1957); Lewis Ganson, Dai Vernon's Inner Secrets of Card Magic (1959); Lewis Ganson, Dai Vernon's More Inner Secrets of Card Magic (1960); Lewis Ganson, Dai Vernon's Further Inner Secrets of Card Magic (1961); Stars of Magic (Louis Tannen ed., 1961); Lewis Ganson, Dai Vernon's Ultimate Secrets of Card Magic (1968); Stephen Minch, Dai Vernon: The Lost Inner Secrets (1987); Stephen Minch, Dai Vernon: More Lost Inner Secrets (1988); Stephen Minch, Dai Vernon: Further Lost Inner Secrets (1989).

32 *See* HE FOOLED HOUDINI, *supra* note 31, at 297.

33 *Id.* at xv. Vernon remained as the magician in residence at the Magic Castle until his death in 1992 at the age of 98.

34 Johnsson, *supra* note 7, at 247.

35 *Id.*

thought it to be Dai Vernon's belief, that not only do magicians not fool spectators, but magicians must not fool them.[36] Johnsson wrote that "[i]t is by not fooling the spectator that we magicians are most effective."[37] To believe this principle, Johnsson claimed that one must accept two premises: first, a spectator does not attribute supernatural powers to the magician, and second, the unknown is unacceptable to a rational spectator.[38] Johnsson then broke down the second premise into the following three hypotheses: (1) spectators will find or invent an answer for an effect that baffles them; (2) the answer may not be rational or consistent with the available information; and (3) spectators are flexible in changing their answer upon receiving more complete information.[39]

PREMISES
Spectators do not attribute supernatural powers to the magician.
The unknown is unacceptable to a rational spectator.

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HYPOTHESES
Spectators will find or invent an answer for an effect that baffles them.
The answer may not be rational or consistent with the available information.
Spectators are flexible in changing their answer upon receiving more complete information.

Looking to the first premise and the first two hypotheses of the second premise, Johnsson wrote that magicians should understand why spectators leave a magical performance by concluding that "it went up his sleeve" or "it's done with mirrors" or some other ridiculous explanation that is completely inconsistent with the facts.[40]

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *Id.* at 248. There are times, however, when a trick is accomplished by sleeving

Because the spectator does not attribute supernatural powers to the magician (premise one), and the unknown is unacceptable to the spectator (premise two), the spectator will find or invent an answer (hypothesis one to premise two), and the answer may not be rational (hypothesis two to premise two).[41] *In certain cases, however, if the effect is too perfect, the spectator will eliminate all solutions except one, and that will be the correct one.*

Johnsson recommended that magicians utilize hypothesis three to premise two (spectators are flexible in changing their answers upon receiving more information) by giving the spectator information that will (1) lead the spectator away from the correct solution, (2) be acceptable to the spectator, (3) not detract from the effect, and (4) give the magician credit for great skill.[42] In other words, Johnsson believed that

> [i]t behooves magicians to avoid leaving a spectator one accurate path to follow, leading to the modus operandi; or to leave the onlooker paths that take credit away from the magician himself. It's better to direct the spectator to follow a path of the magician's own choosing, leading him to the conclusion that the magician is some clever devil.[43]

In his article, Johnsson laid out the tenets of The Too Perfect Theory: some tricks, by virtue of their perfection, become imperfect.[44] Conversely, some tricks, by virtue of their imperfection, become perfect.[45] In sum, there are two parts to the Too Perfect Theory: the effect and the method. The more miraculous the effect, the more the performer needs to focus on the method of accomplishing the effect so that the spectators are led away from the actual method.

Johnsson gave several examples of tricks in describing his theory.[46] For example, suppose a spectator is given a deck of cards, goes into the next room, shuffles the deck, removes one card from the

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or through the use of mirrors. *See, e.g.*, ROSS BERTRAM, MAGIC AND METHODS OF ROSS BERTRAM 122–28 (1978) (Bertram, an expert at sleeving, devoted a chapter to that art.); S.H. SHARPE, CONJURORS' OPTICAL SECRETS (1985) (a classic book detailing the use of mirrors to achieve magical effects).

[41] Johnsson, *supra* note 7, at 248.

[42] *Id.*

[43] *Id.* at 250.

[44] *Id.* at 248.

[45] *Id.*

[46] *Id.* at 248–50.

deck, and places that card in her pocket. She returns to the room where the magician is, and the magician immediately ascertains her chosen card. Johnsson wrote that the spectator will eventually deduce that the deck must have been a trick deck (i.e., all the cards are the same).[47] Whether the spectator's solution is the correct one or not (most likely it is), the spectator will claim credit for herself and the entertainment value will be lost. To prevent such a result, Johnsson suggested using the spectator's own deck and then leaving it with her at the end of the trick.[48] However, he immediately dismissed this solution to the Too Perfect Theory as being too difficult to accomplish.[49]

Johnsson then suggested a number of other possibilities for making the trick less perfect.[50] These include having the spectator stay in the same room as the magician, making the trick not quite as impossible; showing an indifferent card(s) in the deck by flashing the face of the deck at the spectator before the trick begins; handling the deck a bit before disclosing the chosen card; switching the trick deck for a regular deck by placing the trick deck in a pocket and then pulling out a regular deck from the same pocket in anticipation of the spectator wanting to see the deck; or handling the deck a bit, then spelling out the name of the chosen card as the magician removes one card at a time from the top of the deck and finally revealing the selected card as the top card of the remainder of the deck.[51]

Johnsson noted that for years magicians have been performing tricks that are too perfect and getting away with it.[52] Johnsson wrote:

> But unless they [the tricks] were done at carefully chosen, psychologically correct times (with an abundant supply of acting ability thrown in for good measure), they could never have fooled anyone. More specifically, in order to be most mystifying, they could only be accomplished after first

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[47] *Id.* at 248. Contrary to what many spectators believe, magicians rarely use trick decks or trick cards. In fact, some magicians insist on using a borrowed deck or leaving the deck with the spectators once the performance is completed.

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.* For example, under the last method, if the spectator stated that she selected the queen of hearts, the magician would spell out q-u-e-e-n-o-f-h-e-a-r-t-s removing one card from the top of the deck for each letter. The card on top of the remaining portion of the deck would then be turned over and it would be the queen of hearts.

[52] *Id.* at 250.

> convincing the spectators by prior miracles; convincing them that you could do the impossible, then moving on rapidly to subsequent miracles of a sounder nature, preventing the spectators from giving the situation much thought. It follows that such effects, for the most part, could not stand alone or could not be used for a one-shot bit, an opening or closing effect. It should be apparent that by applying the "imperfecting" technique, otherwise shaky effects requiring a great deal of skill in placement and performance come close to being completely flexible and can be performed practically whenever the mood moves one.[53]

C. Solutions to the Too Perfect Problem

Since Johnsson's article in 1971, magicians who accept the Too Perfect Theory have generally developed three solutions to a trick that is too perfect.[54] The first is to make the trick less perfect by "reducing the claim" or, as Johnsson would say, imperfecting the trick by weakening the effect.[55] In other words, magicians must reduce the claim or the effect so that the trick does not look too perfect. For example, in the Cigarette through Quarter trick, some magicians will smoke the cigarette while it penetrates the quarter. Reducing the claim would require the magician not to smoke the cigarette and to remove the cigarette quickly from the middle of the quarter.[56] Then the magician may ask the spectator, "What do you think you saw?"[57] The implication is that maybe the cigarette never really penetrated the quarter, but rather was just part of an illusion. In other words, magicians can avoid making the trick look too good. However, a number of magicians have rejected this solution (reducing the claim)

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[53] *Id.*

[54] There is actually a fourth solution that can either stand alone or be used in conjunction with one of the three other solutions. The fourth solution is to perform a trick that is too perfect at a well-chosen time – generally, after having performed a number of other effects, thereby establishing an ability to perform the impossible. *Id.* at 250.

[55] *Id.* at 247–48.

[56] *See* SWISS, *supra* note 18, at 181 (explaining that the most important he change made to Cigarette through Quarter was to perform other effects first, establishing an apparent ability to perform the impossible, and then perform the trick; also noting that he did not puff on the cigarette while inserted through the quarter and did not leave the cigarette inserted in the quarter for very long).

[57] *Id.*

to the Too Perfect Theory and argued that they would never want to lessen the impact of a trick.[58]

A second solution to a trick that is too perfect is to raise the proof.[59] In other words, leave the miraculous effect intact but add facts that support the effect.[60] Returning again to the Cigarette through Quarter trick, one way of raising the proof is to have a spectator mark the coin in some unique way to prove that the cigarette is penetrating the spectator's coin. As a result, the use of a gimmicked coin is ruled out in the spectator's mind. In other words, the magician acknowledges that the spectators will figure out the method and therefore tries to eliminate that method from their thinking.[61] This second solution is in many ways an ideal solution

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[58] *See, e.g.*, SWISS, *supra* note 18, at 189 ("[T]he argument seems to be that to lessen the effect is to 'stop thinking too soon.'"); 2 WONDER & MINCH, *supra* note 8, at 319; Ortiz, *supra* note 8, at 64–67.

[59] *See generally* DARIEL FITZKEE, MAGIC BY MISDIRECTION, 51–60 (1945) (describing a trick in which a borrowed dollar bill is placed in an envelope, which is then burned leaving nothing but ashes, and the dollar bill then reappears in a gift wrapped package that has been in plain view the entire time; stating that the proof must be raised by, for example, having the spectator select among a number of dollar bills and the serial number of the selected bill being carefully written down "because the ultimate effect is so unbelievable that collusion [between the magician and the spectator] is often suspected").

This solution has also been referred to as canceling or preemptive proof. *See* STEPHEN MINCH, SECRETS OF A PUERTO RICAN GAMBLER 11 (1980) ("Each time you do something in a routine, try to figure out what possible method a spectator might surmise for its explanation. Then structure the next portion of the routine to knock over, or *cancel*, this possibility in the audience's mind.").

[60] One of the leading card magicians in the United States, Darwin Ortiz, believes that raising the proof is the proper solution to a trick that is too perfect. *See* Ortiz, *supra* note 8, at 64–65. Ortiz, who dropped out of NYU Law School to pursue a career in magic, writes that in no circumstances would he ever lessen the impact of a trick (i.e., reduce the claim) but would rather eliminate all possible solutions and force the spectator to accept the impossibility. *Id.* at 65.

[61] *See* HENNING NELMS, MAGIC AND SHOWMANSHIP: A HANDBOOK FOR CONJURORS 115 (1969). Nelms (1900–1986), a lawyer and theatrical director, wrote that spectators will accept the wildest explanations rather than admit that they were fooled. *Id.* For example, "It's all done with mirrors," or "It went up his sleeve," are two very common explanations given by spectators even when the trick could in no way be accomplished with mirrors or sleeves. *Id.* As a result, Nelms suggested anticipating solutions that spectators may advance and then eliminating those possibilities from the trick. *Id.*

Juan Tamariz has devoted an entire book to eliminating all possibilities from a trick, THE MAGIC WAY (1988). Tamariz established what is known as the Theory of False Solutions. He does not attempt to lead the spectators to a false and satisfying solution to an effect but rather leads them to a false solution (away from the actual because it leaves the miraculous effect intact. The problem with this second solution, however, is the difficulty in accomplishing it. It is extremely difficult to switch a gimmicked coin for a borrowed marked coin and have the spectators believe that the cigarette is penetrating the borrowed marked coin. In fact, Johnsson acknowledges this solution to the Too Perfect Theory (i.e., eliminating all solutions) but concludes, "I'll leave that to you [to decide]. . . . I'll take the easier path [of imperfecting the trick]."[62]

The late Derek Dingle, one of the greatest close-up magicians of all time, devised a brilliant solution to the Cigarette through Quarter trick by raising the proof.[63] He had *two* gimmicked quarters: one simply had a hole drilled through it (it looked like a bullet had been shot through it) and the second was the standard gimmicked quarter for the trick (with the spring hinge).[64] He then performed the trick for the spectators and asked them if they knew how he did it.[65] He then explained that he switched the borrowed quarter for one with a hole in it and showed the first gimmicked quarter (with the bullet hole) to the spectators.[66] He then brought out a second quarter, which the spectators believed to be the real quarter but in actuality was the second gimmicked quarter (with the spring hinge), and explained how he switched the quarter with the bullet hole for this ostensibly real quarter that he was now holding in his hand.[67]

Dingle then stated, "You know I always thought it would be great if I could do this without using the quarter with the hole in it. If I could really do it with a real quarter with no switching or anything like that, it would make me a real magician."[68] He then slowly pushed the cigarette through the middle of the second gimmicked quarter. Dingle would puff on the cigarette while it penetrated the quarter and would leave the cigarette in the quarter for a short time.[69] When

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method) such that, in the end, the false solution will be unacceptable to the spectators and leave them completely mystified. *See* SWISS, supra note 18, at 191–92.

[62] Johnsson, *supra* note 7, at 248.

[63] *See* KAUFMAN, *supra* note 17, at 392–95. Two of the best books on close-up magic are devoted to the magic of Derek Dingle, HARRY LORAYNE, DINGLE'S DECEPTIONS (n.d.) and RICHARD KAUFMAN, THE COMPLETE WORKS OF DEREK DINGLE (1982).

[64] KAUFMAN, *supra* note 17, at 391–92.

[65] *Id.* at 394.

[66] *Id.*

[67] *Id.*

[68] *Id.*

[69] *Id.* at 394–95.

Dingle removed the cigarette, no hole was visible in the quarter because of the spring hinge, and he quickly switched the second gimmicked quarter for the real quarter before handing it back to the spectator.[70]

Dingle's solution attempted to remove from the spectators' minds the possibility that he switched quarters for the second penetration.[71] He acknowledged switching quarters the first time he did the penetration, but the second penetration looked like real magic because the hinged quarter left behind no hole when he removed the cigarette.

A third solution to the Too Perfect Theory is to provide a false solution to the trick.[72] In other words, lead the spectators down the wrong path in determining the solution so that the magician receives credit for great skill or ingenuity.[73] John Cornelius is one of the most creative magicians today.[74] He utilizes two quarters for the Cigarette

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[70] *Id.* Dingle performs this trick on a video that was released in 1985. No matter how hard one looks, it is impossible to see Dingle switching quarters. *See* Videotape: Stars of Magic: Derek Dingle (Louis Tannen, Inc. 1985).

[71] KAUFMAN, *supra* note 17, at 394–95. The routine is effective because of the psychology involved. Admitting switching coins the first time confirms what the spectators believe all along, mentally disarming the spectators; switching coins a second time will not occur to the spectators, and they will be convinced that the second coin is the real one. *Id.* at 395.

[72] *See* Johnsson, *supra* note 7, at 248 (explaining it would be wise to provide the spectator with a solution of the magician's choosing so as to lead the spectator away from the actual method).

[73] Watson recognizes this solution and advocates it even though it weakens the effect. *See* WATSON, *supra* note 24, at 15. Johnsson also recognizes this solution. *See* Johnsson, *supra* note 7, at 248–49. Johnsson believes:

> [T]he imperfections, while weakening the effect from a strength standpoint, actually strengthen the effect from the standpoint that the spectator is led away from the actual method by being shown and pushed down numerous blind alleys — all of which should bring him to the conclusion, "I didn't see that sly, old fox do a darned thing, but he had ample opportunity to do something sneaky. Gee! What a clever guy!"

Id. at 249. In his conclusion, Johnsson writes:

> It behooves magicians to avoid leaving a spectator one accurate path to follow, leading to the modus operandi; or to leave the onlooker paths that take credit away from the magician himself. It's better to direct the spectator to follow a path of the magician's own choosing, leading him to the conclusion that the magician is "some clever devil."

Id. at 250.

[74] For an entire book devoted to the magic of John Cornelius, see LANCE

through Quarter.[75] The first quarter is a regular quarter with a small hole drilled through the middle. The second quarter is the gimmicked quarter (with the spring hinge) and also has a small hole drilled through it. Cornelius shows the gimmicked quarter with the small hole in it (i.e., he does not borrow a quarter from a spectator). He pushes the cigarette through the middle of the quarter. He removes the cigarette from the quarter and then switches quarters, handing the regular quarter with the small hole drilled in it to the spectators for their inspection.

The spectators try to determine how Cornelius pushed a cigarette through a hole clearly smaller than the circumference of the cigarette. The effect of the trick is probably lessened somewhat, but more importantly the spectators are led away from the correct method (switching quarters) to incorrect methods, such as whether the hole expands in some way, whether the cigarette shrinks, or other explanations along those lines.[76]

There are numerous other examples in magic in which the performer should consider the Too Perfect Theory. For example, a very common magic trick is the "Floating Dollar Bill."[77] The magician borrows a dollar bill and places it on the table. The dollar bill floats off the table and then returns to the table. If the magician floats the dollar bill too high off the table and leaves it floating in the air for too long a period of time, the spectators will guess that a very fine thread that cannot be seen is being used, and they will be correct. As a result, a very creative magician named John Kennedy reduces the claim.[78] He only floats the dollar bill a few inches off the table and for only a few seconds.[79] Accordingly, the spectators are not sure exactly what they saw and will either rule out or pass over the possibility of a very fine thread being used.[80]

A final example is the "Torn and Restored Card" trick.[81] The

PIERCE, THE AWARD WINNING MAGIC OF JOHN CORNELIUS (2001).

[75] *See* STEPHEN MINCH, CARNEYCOPIA xxviii (1991).

[76] *Id.*

[77] The "Floating Dollar Bill" has been described in a number of magic books and pamphlets under various names. *See, e.g.*, NICHOLAS EINHORN, THE PRACTICAL ENCYCLOPEDIA OF MAGIC 219 (2002); JON LECLAIR, THE ART OF INVISIBLE THREAD 65–74 (1997); MINCH, *supra* note 75, at xxviii–xxix; GENO MUNARI & MARK BLAIS, ULTRA FLOATING OBJECT 14–15 (1997); SWISS, *supra* note 18, at 166–67.

[78] *See* MINCH, *supra* note 75, at xxviii.

[79] *Id.*

[80] *Id.* at xxxix.

[81] The "Torn and Restored Card" has been described in a number of magic

magician has a spectator select a playing card from a deck of cards and then proceeds to tear the selected card into four pieces. The magician then restores the playing card, piece by piece. Putting aside the illogical aspect of the trick (why tear the playing card to begin with if the magician wants a restored playing card at the end?), most spectators will guess correctly that there are two playing cards — one of the two cards is torn into four pieces and these pieces are then switched for the duplicate card. Magician-turned-barrister Guy Hollingworth solves the problem by raising the proof.[82] When the spectator selects the playing card, he has the spectator sign across the face of the card.[83] He then restores the playing card, piece by piece, with the signature in full view the entire time. It is an incredibly difficult trick to do well, but properly performed, the spectators will either rule out or not suspect the possibility of a duplicate card.

In sum, there are certain magic tricks that are simply too perfect when performed. As a result, the trick may not fool the audience, and even worse, the effect itself may lead the audience to discover how the trick is performed. Magicians have developed three solutions to a trick that is too perfect: (1) reduce the claim, thereby making the trick less miraculous; (2) raise the proof by adding in convincers to support or justify the miraculous effect; or (3) lead the spectators down a false path so as to give the magician credit for great skill or ingenuity (or eliminate all possible solutions to the trick, thereby completely fooling the spectators).

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books and pamphlets with various handlings. *See, e.g.*, JOHN CARNEY, TORN AND RESTORED (1995); HOLLINGWORTH, *supra* note 15, at 275–311; KAUFMAN, *supra* note 63, at 187–89; HARRY LORAYNE, STAR QUALITY: THE MAGIC OF DAVID REGAL 153–59 (1987); JOHN LOVICK, THE REPARATION (2d ed. 1998); J.C. WAGNER, 7 SECRETS 1–27 (1978).

[82] *See* HOLLINGWORTH, *supra* note 15, at 275–311. Hollingworth's version of the Torn and Restored Card is generally considered to be the best. He performed his version on television in 1996, and it immediately created a huge sensation in the magic world. Hollingworth's version is extremely difficult to perform well, which probably explains why very few magicians utilize it in their performances.

[83] *Id.* at 278–80.

> *Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.*
>
> — *Judge Learned Hand*[84]

III. APPLICATION OF THE TOO PERFECT THEORY IN TAX LAW

Tax law is an extremely demanding area of law. One small mistake in structuring a transaction can lead to disastrous tax consequences.[85] As a result, tax practitioners strive to structure a transaction as perfectly as possible.[86] But it is possible for a transaction to be structured so as to reach a tax result that is too perfect. If the transaction is too perfect, the government and the courts may determine that the sole purpose of the transaction was tax avoidance and, as a result, may recharacterize the transaction to produce different tax results or may simply deny the taxpayer the desired tax consequences.

One of the most well-known and important U.S. Supreme Court tax cases is *Gregory v. Helvering*.[87] In this case, Evelyn Gregory

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[84] Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). There has been a resurgence of interest in the *Gregory* case due, in large part, to the publicity surrounding corporate tax shelters. *See, e.g.*, Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters*, 54 SMU L. REV. 3 (2001); *Symposium on Corporate Tax Shelters* (pts. I & II) 55 TAX L. REV. 125, 289 (2002).

[85] Professor James Eustice once stated in an ABA Tax Section interview:

> It's very tough to practice. That's one of the joys of academia — you can raise questions that you don't have to answer. When you are on the line you have to give an answer. I would guess it's not only not fun to practice [tax law], I would guess it's scary. What little I've done of it, I know it is. Because you're not sure what little thing is tucked down there some place.

Interview with James S. Eustice, Gerald L. Wallace Professor of Law, NYU School of Law, *in* 1992 A.B.A. SEC. TAXATION, at 38, 42.

[86] In fact, leading academics and practitioners have written numerous form books designed to help tax practitioners avoid making any mistakes in structuring transactions. *See, e.g.*, BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS: FORMS (4th ed. 1995); MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS (June 2004); ROBERT L. WHITMIRE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS: STRUCTURING AND DRAFTING AGREEMENTS (2d ed. Supp. 2002).

[87] 293 U.S. 465 (1935). One leading academic has described the *Gregory* case as "[p]erhaps the most famous tax case in history. . . ." *See* George K. Yin, *The Story of* Crane*: How a Widow's Misfortune Led to Tax Shelters*, *in* TAX STORIES 207, 228 n.49 (Paul L. Caron ed., 2003).

owned all of the stock of United Mortgage Corporation (UMC). UMC in turn owned 1000 shares of Monitor Securities Corporation (Monitor). Gregory wanted to dispose of the Monitor stock and at the same time minimize the amount of taxes she would owe. Consequently, she formed Averill Corporation on September 18, 1928. Three days later, UMC transferred its Monitor stock to Averill Corporation for which all of the shares of Averill were issued to Gregory. On September 24, 1928, Gregory liquidated Averill Corporation and received the 1000 shares of Monitor stock. Averill Corporation did not conduct any business, nor was it intended to conduct any business (apart from holding the Monitor stock for three days). Gregory immediately sold the Monitor stock for $133,333.33, reporting a capital gain of $76,007.88.[88]

Gregory maintained that the transfer of Monitor stock from UMC to Averill was a reorganization followed by a liquidation of Averill.[89]

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[88] According to the Board of Tax Appeals, the liquidation of Averill, whereby Gregory received the Monitor shares, resulted in gain of $76,007.88, the difference between the undisputed basis of $57,325.45 attributed to the Averill shares and $133,333.33, the undisputed value of the Monitor shares so received. The immediate sale by Gregory of the Monitor shares for no more than their value resulted in the realization by her of no further gain. *See* Gregory v. Commissioner, 27 B.T.A. 223, 226 (1932), *rev'd sub nom.* Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[89] Gregory argued that the transaction fell within the definition of reorganization of section 112(i)(l)(B) of the Revenue Act of 1928. That provision provided that "(l) The term 'reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. . . ." *See* I.R.C. § 112(i)(1)(B); *Gregory v. Helvering*, 293 U.S. at 468. This provision is very similar to section 368(a)(1)(D) of present law.

Because the transaction was a reorganization, Gregory argued that she came within section 112(g) of the Revenue Act of 1928. That provision provided:

> If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. . . .

I.R.C. § 112(g); 293 U.S. at 468. No provision under present law is exactly the same as section 112(g), but section 355 does permit some tax-free spin-offs. *See* BERNARD WOLFMAN, FEDERAL INCOME TAXATION OF CORPORATE ENTERPRISE 543 (3d ed. 1990). A spin-off is a pro rata distribution by a parent corporation of the stock of a subsidiary corporation. *See* 1 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.01[1][e] (7th ed.

The Internal Revenue Service (Service) argued that the reorganization had no substance and therefore should be disregarded. The Board of Tax Appeals upheld Gregory's view and rejected the view of the Service.[90] The Court of Appeals for the Second Circuit, in a famous opinion written by Judge Learned Hand, reversed the Board of Tax Appeals and held that no reorganization had taken place.[91] As a result, Ms. Gregory realized dividend income on the distribution of the Averill stock.[92]

Justice Sutherland delivered the opinion of the Supreme Court, affirming the decision of the Second Circuit.[93] He wrote that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law

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2000).

[90] *Gregory v. Commissioner*, 27 B.T.A. at 225 (1932).

[91] *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934). In the Second Circuit opinion, Judge Hand wrote:

> We agree with the Board [of Tax Appeals] and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

Id. at 810. In holding against the taxpayer, Judge Hand continued:

> Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board [of Tax Appeals] has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.

Id. at 810–11.

[92] The Commissioner, according to the Second Circuit Court of Appeals, argued that "the whole transaction was merely the declaration of a dividend by the United Mortgage Corporation consisting of the Monitor shares in specie . . . ." 69 F.2d at 810. Justice Sutherland, writing for the Supreme Court, thought, however, that the Commissioner claimed the transaction should be taxed "as though the United corporation had paid [Ms. Gregory] a dividend consisting of the amount realized from the sale of the Monitor shares." 293 U.S. at 467. Judge Hand, writing for the Second Circuit Court of Appeals, wrote that "the result is the same whether the tax be calculated as the Commissioner calculated it, or upon the value of the Averill shares as a dividend. . . ." 69 F.2d at 811. *See also* WOLFMAN, *supra* note 89, at 548.

[93] *See Gregory v. Helvering*, 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

permits, cannot be doubted."[94] He then wrote that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[95]

Justice Sutherland concluded that the transaction entered into by Gregory was

> [s]imply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described.[96]

In the final part of the opinion, Justice Sutherland wrote, *"In these circumstances, the facts speak for themselves and are susceptible of but one interpretation."*[97] The transaction "was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."[98] The transaction was outside the plain intent of the reorganization statute and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision . . . of all serious purpose."[99]

What is fascinating about Justice Sutherland's opinion is that he applied the Too Perfect Theory to a transaction involving tax law. The Too Perfect Theory generally provides that a trick that is too perfect will fool no one and, in fact, will actually allow the spectators to determine how the trick is accomplished because only one solution is possible. Justice Sutherland wrote that the transaction Gregory entered into was "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."[100] This was easy to see because Gregory formed Averill on September 18, had UMC transfer the Monitor stock to Averill on September 21,

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[94] 293 U.S. at 469.

[95] *Id.*

[96] *Id.*

[97] *Id.* at 470 (emphasis added).

[98] *Id.*

[99] *Id.*

[100] *Id.*

and then liquidated Averill on September 24. Justice Sutherland noted that there is only "one interpretation" of the transaction — it was done simply to reduce taxes with no business or corporate purpose.[101] In other words, Gregory's transaction was too perfect, and it thereby became easy for Justice Sutherland to figure out that the sole motive for the transaction was tax avoidance. Justice Sutherland then recharacterized the transaction because a transaction done solely for tax avoidance was unacceptable.[102]

Let us examine another well-known tax case, *Kronenberg v. Commissioner.*[103] Kronenberg, a U.S. citizen, maintained his legal residence in Lucerne, Switzerland. He was born in Switzerland in 1922 and immigrated to the United States in 1949. He became a naturalized U.S. citizen in 1955 but also retained his Swiss citizenship. Kronenberg was the president of a mica importing business, Polymica & Insulation Co., Inc. (PIC) and also owned slightly over 95% of the stock of PIC. In 1966, Kronenberg decided to sell the business, and on January 26, 1966, he entered into an executory contract to sell substantially all of its assets. He also intended to return to Switzerland after April 30, 1967, in accordance with an employment agreement he had with the purchaser of those assets.

On February 26, 1966, the PIC shareholders voted to adopt a plan of complete liquidation, which was to be completed by February 25, 1967.[104] A timely election to liquidate PIC was filed with the Service.

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[101] *Id.*

[102] As a result, it is possible to view Justice Sutherland's opinion as employing a three-step process. Under the first step, he determined that the transaction in *Gregory* was, in essence, too perfect. 293 U.S. at 469–70. Under the second step, as a result of the transaction being too perfect, Justice Sutherland concluded that there was "but one interpretation" of its goal — tax avoidance. *Id.* at 470. These two steps are the two aspects of the Too Perfect Theory — result and method. *See supra* notes 44–46 and accompanying text. Under step three, Justice Sutherland recharacterized the transaction because of the absence of a "business or corporate purpose," i.e., the transaction was done simply for tax avoidance. *Id.* at 469–70.

Three recent court decisions have called into question the application and viability of the business purpose doctrine or economic substance doctrine. *See, e.g.*, Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 2004) (holding for the taxpayer in a contingent liability tax shelter transaction); TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004) (holding for the taxpayer in a lease stripping transaction); Coltec Indus. v. United States, 62 Fed. Cl. 716 (2004) (holding for the taxpayer in a contingent liability tax shelter transaction). *But see* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004) (holding for the government in a lease stripping transaction that lacked economic substance).

[103] 64 T.C. 428 (1975).

[104] Under section 337, as in effect from 1954 to 1986, if a corporation adopted a

In December 1966, Kronenberg's accountants told him that if he received his liquidating distributions from PIC after he lost U.S. citizenship, he would not be subject to U.S. tax on those distributions. In January 1967, Kronenberg decided definitively to move to Switzerland and participated in a flurry of activities in preparation for departure. He sold the family home, purchased airline tickets, made arrangements for transporting the family possessions, and engaged attorneys to prepare papers to formally liquidate PIC.

On February 20, 1967, the PIC shareholders adopted a certificate of dissolution. The next day, Kronenberg and his family left the United States, arriving in Switzerland on February 22, 1967. Kronenberg renounced his U.S. citizenship on February 23. On February 24, the PIC assets were transferred to Kronenberg's personal account (pursuant to his instructions to his attorneys to arrange for the transfer of the PIC assets at the latest possible time). Kronenberg did not report the distributions in liquidation of PIC in his U.S. income tax returns. The Service argued that section 877 applied, requiring Kronenberg to include the PIC liquidating distributions in income and pay U.S. taxes on that amount.

The Tax Court agreed with the Service that section 877 applied, and, as a result, Kronenberg was required to pay U.S. taxes on the PIC liquidating distributions.[105] The court recognized that section 877 applies to a former U.S. citizen if that individual renounced U.S. citizenship within the last ten years, unless such loss of citizenship did not have as one of its principal purposes the avoidance of taxes.[106]

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plan of complete liquidation and distributed all of its assets in complete liquidation within the twelve-month period beginning on the date of adoption of the plan of liquidation, it did not recognize gain or loss from the sale or exchange of property within the twelve-month period. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.61 (5th ed. 1987). Congress repealed section 337 as part of the Tax Reform Act of 1986 and replaced it with a completely different type of provision applicable to the liquidation of a subsidiary into its parent. *See* Pub. L. No. 99-514, § 631(a), 100 Stat. 2085, 2269–75 (1986).

[105] 64 T.C. at 432–37.

[106] *Id.* at 434. Congress enacted section 877 in 1966 and substantially amended it in 1996. *See* Foreign Investors Tax Act of 1966 and Presidential Election Campaign Fund Act of 1966, Pub. L. No. 89-809, § 103(f)(1), 80 Stat. 1539, 1551–55; Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, § 511, 110 Stat. 1936, 2093–100. The purpose of the section is to impose an alternative taxing regime for ten years on former U.S. citizens (and certain former U.S. residents) who renounced U.S. citizenship, unless the loss of U.S. citizenship did not have for one of its principal purposes the avoidance of federal income, estate, gift, or generation skipping transfer taxes. *See, e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, 108TH

The court concluded that at least one of the principal purposes for expatriation was to secure the tax advantages of which Kronenberg learned from his accountants in December 1966, and therefore section 877 applied to Kronenberg.[107] In support of its conclusion, the court wrote, "The timing of Mr. Kronenberg's activities in January and February 1967 is *too perfect* to be unplanned."[108]

The Tax Court, then, not only applied the Too Perfect Theory but actually used the words "too perfect" in its opinion. Again, the Too Perfect Theory has two parts: the result and the method to reach that result. Kronenberg argued for the best possible result for him: no U.S. taxes on the PIC liquidating distributions. The court then looked at the method to reach that perfect result and concluded that the method was "too perfect."[109] In other words, the filing of the PIC dissolution certificate on February 20 and Kronenberg's activities

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CONG., REVIEW OF THE PRESENT LAW TAX AND IMMIGRATION TREATMENT OF RELINQUISHMENT OF CITIZENSHIP AND TERMINATION OF LONG-TERM RESIDENCY (Joint Comm. Print 2003); 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 66.1 (2d ed. 2001); Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863 (2004).

Congress has again substantially amended section 877 as part of the American Jobs Creation Act of 2004, adopting objective rules to replace the subjective determination of tax avoidance. *See* Pub. L. No. 108-357, § 804, 118 Stat. 1418, 1569–73.

[107] 64 T.C. at 435.

[108] *Id.* (emphasis added).

[109] *Id.* The *Kronenberg* case should be contrasted with *Furstenberg v. Commissioner*, 83 T.C. 755 (1984). In *Furstenberg*, the taxpayer, a U.S. citizen who renounced her U.S. citizenship to become an Austrian citizen, was not subject to section 877. After discussing the *Kronenberg* case, the Tax Court concluded that the taxpayer's activities in *Furstenberg* were "too imperfect from a tax standpoint to have been planned." 83 T.C. at 780. The Tax Court came to this conclusion upon noting that the taxpayer did not engage in activities connected to expatriation, decided to expatriate before knowing the tax consequences, lived in Europe for more than seven years, knew only of negative tax consequences at the time of expatriation, and did no planning with respect to trust distributions until after her expatriation. *Id.*

There are numerous classic (and not so classic) examples in the tax laws in which a transaction has been respected while a similar but too perfect transaction has been recharacterized. *Compare* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (recharacterizing liquidating distribution followed by sale) *with* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950) (respecting liquidating distribution followed by sale) *and compare* Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970) (recharacterizing distribution from subsidiary followed by sale of the subsidiary) *with* Litton Indus., Inc. v. Commissioner, 89 T.C. 1086 (1987) (respecting distribution from subsidiary followed by sale of the subsidiary).

thereafter — leaving the United States on February 21, arriving in Switzerland on February 22, renouncing U.S. citizenship on February 23, and finally receiving the funds from PIC on February 24 — were too perfectly planned, reaching a too perfect result, thereby easily allowing the Tax Court to conclude that this transaction was done for tax avoidance purposes under section 877.

> *It [watching a skillful lawyer] was like close-up magic. You know — how it doesn't really matter whether the balls are disappearing, because it truly is magic that human skill can make it look that way.*
>
> — *Scott Turow, lawyer and author*[110]

IV. REFLECTIONS ON THE TOO PERFECT THEORY

The courts have utilized the Too Perfect Theory in recharacterizing a transaction for tax purposes for many years, going back at least as far as the leading case of *Gregory* in 1935.[111] Even though Justice Sutherland, writing for the Court in *Gregory*, did not use the term Too Perfect, he applied the theory to Gregory's transaction in recharacterizing it.[112] There is, however, one significant difference between what a conjuror does and what a tax lawyer does in applying the Too Perfect Theory. The conjuror tells his audience that he is going to fool them with sleight of hand.[113] As a result, the audience is prepared to be fooled and some, if not most, of the members of the audience may afterwards attempt to figure out how the tricks were done.[114] The audience knows there is no such thing as actual or real magic and realizes it is about to be deceived with sleight of hand or maybe mechanical trickery (such as sawing a woman in half).[115] Some magicians will attempt to eliminate all possible methods that a spectator may consider in trying to determine how a trick is

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[110] SCOTT TUROW, THE BURDEN OF PROOF 327 (1990).

[111] *See supra* notes 87–102 and accompanying text.

[112] *See supra* notes 93–102 and accompanying text.

[113] *See supra* note 1 and accompanying text.

[114] *See* SWISS, *supra* note 18, at 186–87.

[115] The Too Perfect Theory has been most often applied to close-up magic. However, the theory can also be applied to stage magic and large-scale illusions, such as sawing a woman in half. *See* Richard Kaufman, *Genii Speaks*, GENII: THE CONJURORS' MAG., Aug. 2001, at 10–11 ("The discussion [of the Too Perfect Theory] is generally limited to close-up magic (though it shouldn't be). . . .").

done.[116] As a result, however, one prominent magician has noted that the magician is hoisting the spectator on the horns of a dilemma: "There is no such thing as magic/There is no other possible explanation."[117]

There is one category of conjuror that attempts to convince his audience that what he is doing is actual magic and not sleight of hand: the so-called psychics or mystics.[118] For example, during the early 1900s, a number of psychics represented themselves as performing real magic, and, as a result, Harry Houdini spent the latter part of his life exposing psychics as performing nothing more than trickery or sleight of hand.[119] More recently, Uri Geller became famous during the 1970s for bending keys and spoons with just the power of thought, fixing broken watches by merely holding the watches in his hands for a few moments, and reading the thoughts of others. Geller represented himself as performing real magic, not sleight of hand, and many people believed that he was the real thing.[120] In other words, the tricks that he was performing were not magicians' tricks but rather reflected real magic, i.e., he could really bend spoons and fix broken watches with just his magical powers. Magicians, however, were not so easily fooled.[121] In the mid-1970s, a well-known magician named James Randi (also known as the Amazing Randi) demonstrated that

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[116] *See supra* notes 60–62.

[117] WHIT HAYDN, NOTES ON THREE CARD MONTE 112 (2001).

[118] Johnsson, who popularized the Too Perfect Theory, wrote that the need to consider the Too Perfect Theory is lessened for psychics or mystics because most people believe in, or would like to believe in, the possibility of extrasensory perception. *See* Johnsson, *supra* note 7, at 250. *See also* JOHN BANNON, SMOKE AND MIRRORS 11 (1991) ("Some forms of deception — those used by con men, politicians, card sharps, and some mentalists — are not meant to be revealed. The means of deception, and even the *fact* of deception, are kept secret. In a magic trick, the fact of deception is presumed — one cannot really do the impossible.").

For a recent discussion by a conjuror of psychics and mystics, see MARTIN GARDNER, ARE UNIVERSES THICKER THAN BLACKBERRIES? 225–72 (2003).

[119] Houdini published a book, two years before his death, exposing spiritualists, mediums, and psychics. *See* HARRY HOUDINI, A MAGICIAN AMONG THE SPIRITS (1924). *See also* J.C. CANNELL, THE SECRETS OF HOUDINI (1973); HOUDINI ON MAGIC (Walter B. Gibson & Morris N. Young eds., 1953).

[120] *See generally* GARDNER, *supra* note 118, at 203–04, 244–45.

[121] Martin Gardner, who wrote the Mathematical Games column for *Scientific American* for over twenty-five years, has written that "[b]ecause magicians are the world's experts on the art of deception, it is one of the scandals of psychic research that investigators, except on rare occasions, will not seek the aid of knowledgeable conjurors when they test psychics who perform feats unexplainable by natural laws." *See* GARDNER, *supra* note 118, at 244.

all of Geller's routines could be accomplished by sleight of hand. Randi even published several books in which he explained the workings behind many of Geller's routines.[122] Geller soon disappeared from the public eye with only occasional appearances in more recent times.

The tax lawyer, however, is bound by ethical obligations in performing her duties.[123] For example, she cannot deceive or try to deceive the government or the courts (as by creating evidence that is false or misleading).[124] Consequently, the government and the courts are generally not on alert for intentional deception, but rather simply analyze the transaction in question and apply the tax laws to that particular transaction in reaching a result.

If a tax lawyer structures a transaction in such a way as to achieve a result that is too perfect, the government and the courts may become wary and attempt to recharacterize the transaction. The tax lawyer in such cases may be viewed as a conjuror by the government and the courts who is trying to deceive them with a transaction that is

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[122] *See* JAMES RANDI, THE MAGIC OF URI GELLER (1975); JAMES RANDI, THE TRUTH ABOUT URI GELLER (1982).

Randi's foundation, the James Randi Educational Foundation, offers a $1 million prize to "anyone who can show, under proper observing conditions, evidence of any paranormal, supernatural, or occult power or event." *See* James Randi Educational Foundation, *One Million Dollar Paranormal Challenge*, *at* http://www.randi.org/research/index.html (last visited Feb. 5, 2005). To date, no one has passed even the preliminary tests necessary to qualify for the prize.

[123] *See, e.g.*, MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 833–48 (Revised 4th ed. 2002); BERNARD WOLFMAN ET AL., ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE (1995); BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE (5th ed. 1999).

[124] *See, e.g.*, Treas. Reg. § 10.51 (2004) ("Incompetence and disreputable conduct" includes "giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading."); MODEL RULES OF PROF'L CONDUCT R. 4.1(a) (2003) ("In the course of representing a client a lawyer shall not knowingly: make a false statement of material fact or law to a third person."); *id.* R. 3.3(a) ("A lawyer shall not knowingly: make a false statement of material fact or law to a tribunal . . . or offer evidence that the lawyer knows to be false."); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 314 (1965) (stating that "the lawyer is under a duty not to mislead the Service, either by misstatement, silence, or through his client"); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985) (stating that "the lawyer is under a duty not to mislead the Internal Revenue Service deliberately, either by misstatements or by silence or by permitting the client to mislead").

too perfect.[125] As a result, tax lawyers, like conjurors, have devised several methods to attempt to prevent a court from recharacterizing a transaction that is too perfect, namely, reducing the claim, raising the proof, or providing a false (or alternative) theory.

> *Confusing details, if not overdone, help to obscure trails leading to [the] solution.*
>
> *— Dariel Fitzkee*[126]

V. STRUCTURING TRANSACTIONS TO AVOID THE APPLICATION OF THE TOO PERFECT THEORY

As is discussed above, in the field of conjuring, there are generally three methods for avoiding the application of the Too Perfect Theory: reducing the claim, raising the proof, and providing a false (or alternative) solution.[127] These three solutions are as applicable in structuring transactions as they are in magic. Each of these three solutions has been utilized by tax lawyers to prevent a court from recharacterizing a transaction.[128]

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[125] If the tax lawyer convinces the government and the courts that what she is doing is legitimate and no deception is involved, then she may be analogized to the psychics or mystics. As a result, if the government or courts attempt to expose her as deceiving or misleading them, then they may be acting in the role of a James Randi exposing a Uri Geller. However, tax lawyers in general may be viewed by the government and the courts as conjurors performing the trick of tax savings or tax avoidance.

[126] FITZKEE, *supra* note 59, at 58. Fitzkee was an acoustical engineer who spent a large part of his life involved in theater. He wrote three of the finest books ever written on the presentation of magic: SHOWMANSHIP FOR MAGICIANS (1943), THE TRICK BRAIN (1944), and MAGIC BY MISDIRECTION (1945).

[127] *See supra* notes 54–83 and accompanying text.

[128] *See supra* note 54 for a fourth possible solution. The fourth possible solution does not seem relevant in the context of a tax lawyer structuring transactions. It may be possible, however, in that a tax lawyer may structure a number of transactions that are not recharacterized by the government or the courts. Once the government has become accustomed to the tax lawyer structuring transactions in a manner that may be slightly aggressive, then the tax lawyer may attempt to structure a transaction that reaches a result that is too perfect and which, in isolation, would be recharacterized by the government. But the tax lawyer who has convinced the government of the legitimacy of the earlier transactions may be able to get away with a transaction that is too perfect.

A. Reducing the Claim

Aiken Industries, Inc. v. Commissioner[129] is probably the leading tax case involving treaty shopping. In this case, Ecuadorian Corp., Ltd. (ECL), a Bahamian corporation, owned 99.997% of the stock of Aiken Industries, Inc., a Delaware corporation. Aiken Industries owned all of the outstanding stock of Mechanical Products, Inc. (MPI), also a Delaware corporation. ECL also owned all of the outstanding stock of Compania de Cervezas Nacionales (CCN), an Ecuadorian corporation.

On April 1, 1963, MPI borrowed $2.25 million from ECL. In return, MPI issued to ECL a twenty-year 4% sinking fund promissory note. The following year, ECL assigned the note to Industrias Hondurenas S.A. de C.V. (Industrias), a newly formed, wholly owned subsidiary of CCN. Industrias was incorporated under the laws of the Republic of Honduras. As consideration for the assignment, ECL received nine promissory notes of Industrias payable on demand, each in the principal amount of $250,000, and each bearing interest at the rate of 4% per annum.

During the years in question, the United States had an income tax treaty with the Republic of Honduras (the treaty terminated on December 31, 1966). The treaty provided for a zero withholding tax on interest received by a resident of a treaty country from sources within the other treaty country. As a result, MPI (a U.S. corporation) did not withhold any tax when it made interest payments on the 4% sinking fund promissory note held by Industrias (a Republic of Honduras corporation). If MPI had made the interest payments to ECL (a Bahamian corporation), then it would have been subject to a 30% withholding tax because the United States did not have an income tax treaty with the Bahamas.[130]

The Tax Court noted that ECL transferred the 4% $2.25 million

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[129] 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1.

[130] In general, the United States imposes a 30% tax on U.S. source interest payments. I.R.C. §§ 871(a)(1), 881(a). The tax is generally collected by a withholding requirement imposed on the payer. I.R.C. §§ 1441, 1442. There are two important statutory exceptions to the imposition of the 30% withholding tax on U.S. source interest income: the bank deposit interest and the portfolio interest provisions. I.R.C. §§ 871(h), 871(i)(2)(A), 881(c), 881(d). Neither of the two statutory exceptions was applicable in *Aiken Industries* because the U.S. source interest was not interest on a bank deposit and the portfolio interest rules were not enacted until 1984. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a)(1), 98 Stat. 494, 648. As a result, the taxpayer in *Aiken Industries* had to rely on an income tax treaty to reduce the 30% withholding tax on U.S. source interest income.

sinking fund promissory note of MPI to Industrias in exchange for nine promissory notes of Industrias with the same total principal amount of $2.25 million and with the same 4% interest rate.[131] More specifically, Industrias received exactly what it gave up in a dollar-for-dollar exchange. As a result, Industrias paid out exactly what it collected and therefore made no profit on the exchange of notes.[132] Because Industrias had the same inflow and outflow of funds and MPI, ECL, and Industrias were all members of the same corporate group, the Tax Court concluded that the transaction did not have a valid economic or business purpose.[133] The transaction's only purpose was tax avoidance.[134] As a result, the court found that the interest payments were not exempt from taxation under the treaty.

Aiken Industries is a classic case in the area of international tax.[135] Because the tax results were so perfect, it was easy for a court to determine that the sole purpose of the transaction was tax avoidance and that there was no economic or business purpose for the transaction.

A number of years later, the Tax Court had another opportunity to decide a case involving treaty shopping, *Northern Indiana Public Service Co. v. Commissioner.*[136] In this case, Northern Indiana Public Service Co. (NIPSCO), a U.S. corporation, had a wholly owned foreign subsidiary, Northern Indiana Public Service Finance N.V. (Finance). In early 1981, NIPSCO formed Finance in Curacao under the Commercial Code of the Netherlands Antilles. Finance was to issue bonds in the Eurobond market and then loan the proceeds to NIPSCO so that it could use the funds to construct additions to its utility properties.

In October 1981, Finance issued seven-year notes in the Eurobond market in the amount of $70 million at an interest rate of 17.25%. Finance then immediately loaned the proceeds to NIPSCO in exchange for a seven-year note in the amount of $70 million at an

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131 56 T.C. at 934.

132 *Id.*

133 *Id.*

134 *Id.* The Tax Court noted that a tax avoidance motive is not inherently fatal to a transaction; however, a tax avoidance motive standing by itself is not a business purpose sufficient to support the transaction. *Id.*

135 *Aiken Industries* is generally considered to be the classic example of a taxpayer involved in treaty shopping. *See, e.g.*, BITTKER & LOKKEN, *supra* note 106, ¶ 67.3.2; JOSEPH ISENBERGH, INTERNATIONAL TAXATION 31, 237–40 (2000); CHARLES KINGSON, INTERNATIONAL TAXATION 62–85 (1998).

136 105 T.C. 341 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).

interest rate of 18.25%. As a result, Finance earned income on the one percentage point spread of approximately $700,000 each year (1% times $70 million) for four years until October 1985, when NIPSCO paid off the $70 million note to Finance and Finance then redeemed the $70 million notes it had issued in the Eurobond market. As a result, Finance's aggregate income over the four years on the spread between the Eurobond notes and NIPSCO's note was $2.8 million. Finance also earned interest income on its investments (exclusive of interest received from NIPSCO).

During the years in question, the United States had an income tax treaty with the Netherlands Antilles.[137] The treaty provided for a zero withholding tax on interest received by a resident of a treaty country from sources within the other treaty country. As a result, NIPSCO (a U.S. corporation) did not withhold any tax when it made interest payments on the $70 million note to Finance (a Netherlands Antilles corporation). In addition, Finance did not withhold any tax when it made interest payments on the $70 million Eurobond notes. The government argued that Finance was a mere conduit or agent and that it should be ignored.[138] According to the government, NIPSCO should be viewed as having paid interest directly to the Eurobond holders and should have withheld taxes on the interest payments.[139]

The Tax Court stated that "a choice to transact business in corporate form will be recognized for tax purposes so long as there is a business purpose or the corporation engages in business activity."[140] The Tax Court noted that Finance engaged in the business activity of lending and borrowing money at a profit and that activity was sufficient to recognize its existence.[141] The Tax Court distinguished

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[137] In a note dated June 29, 1987, the U.S. government notified the Netherlands Antilles (and Aruba) that it was terminating its income tax treaty with the Netherlands Antilles (and Aruba) effective January 1, 1988. On July 10, 1987, the U.S. government modified its June 29 note to provide that Article VIII of both treaties would continue in force after December 31, 1987. Article VIII exempts from U.S. tax interest payments from U.S. persons to corporations and residents of the Netherlands Antilles (and Aruba). A protocol between the United States and the Netherlands Antilles became effective on December 30, 1996, limiting the U.S. tax exemption for interest payments. *See* John Venuti et al., *Current Status of U.S. Tax Treaties and International Tax Agreements*, 33 TAX MGMT. INT'L J. 260, 261 n.3 (2004).

[138] 105 T.C. at 347.

[139] *Id.*

[140] *Id.*

[141] *Id.* at 348.

Northern Indiana from *Aiken Industries*.[142] In *Aiken Industries*, the transaction was entirely between related parties.[143] In contrast, Finance borrowed funds from unrelated third parties, the Eurobond holders.[144] In addition, and probably more importantly, Finance's borrowing and lending activity was a business activity that resulted in $2.8 million of income for Finance over a four-year period.[145] In *Aiken Industries*, Industrias paid out exactly what it collected and therefore made no profit on the transaction.

The taxpayer in *Aiken Industries* lost while the taxpayer in *Northern Indiana* won. The primary difference is that in the former case, the transaction was structured so as to reach a result that was too perfect.[146] More specifically, MPI made interest payments to Industrias, which in turn made *identical* interest payments to ECL. It was easy for the Tax Court to, in essence, ignore the existence of Industrias and treat the interest payments as made directly from MPI to ECL. In *Northern Indiana*, however, NIPSCO made interest payments to Finance, which in turn made *non-identical* interest payments to the Eurobond holders. As a result, approximately $700,000 of income was built into the transaction each year for Finance. Finance would then owe taxes each year to Netherlands Antilles on this income. The result was something less than perfection (i.e., taxes owed to the Netherlands Antilles), but it would pass muster in court. However, if the transaction in *Northern Indiana* were structured to reach a result that was too perfect (i.e., no taxes owed to the Netherlands Antilles), the Tax Court would, in all likelihood, have recharacterized the transaction as it did in *Aiken Industries*. As a result, the tax planners in *Northern Indiana* lowered the claim by making the result less perfect.[147]

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[142] *Id.* at 353–55.

[143] *Id.* at 354–55 ("The fact that the transaction [in *Aiken Industries*] was entirely between related parties was important to our conclusion that it was void of any 'economic or business purpose.'").

[144] *Id.* at 354.

[145] *Id.* at 355.

[146] In addition, in *Northern Indiana*, the Tax Court seemed to lower the proof from the taxpayer to prevent recharacterization because the parties were unrelated. In *Aiken Industries*, however, the Tax Court required higher proof from the taxpayer to prevent recharacterization because the parties were related.

[147] The government appealed the Tax Court's decision in *Northern Indiana*. On appeal, the Seventh Circuit Court of Appeals affirmed the decision of the Tax Court writing that "[l]ooking at the record as a whole, we find that the Tax Court did not clearly err by determining that Finance carried on sufficient business activity so as to require recognition of its interest transactions with Taxpayer for tax purposes."

B. Raising the Proof

A second method to avoid inviting a court to apply the Too Perfect Theory to recharacterize a transaction is to raise the proof in support of the perfect claim. A well-known series of cases in the 1950s and 1960s involving prepaid service income of accrual method taxpayers illustrates this method.[148] In 1957, the Supreme Court decided *Automobile Club of Michigan v. Commissioner.*[149] In this case, Automobile Club of Michigan, an accrual method taxpayer, received annual membership dues at the beginning of the membership year. It allocated the dues pro rata over the membership year (one-twelfth to each month) thereby deferring their inclusion in income. The government argued that Automobile Club of Michigan had to include the dues in income at the time of receipt because it had a claim of right without restriction as to their disposition.[150] The Supreme Court held that Automobile Club of Michigan's method of allocating the dues over the membership year on a pro rata basis was "purely artificial and bears no relation to the services which petitioner [Automobile Club of Michigan] may in fact be called upon to render for the member."[151] The Court further held that the government's authority under section 446(b), requiring use of an accounting method that clearly reflects income, did not exceed permissible limits.[152] As a result, Automobile Club of Michigan had to include the dues in income upon receipt.

Four years later, the Supreme Court decided *American*

Northern Indiana Pub. Serv. Co. v. Commissioner, 155 F.3d 506, 514 (1997).

[148] The literature on the taxation of prepaid income is quite voluminous. *See, e.g.*, CHRISTOPHER H. HANNA, COMPARATIVE INCOME TAX DEFERRAL: THE UNITED STATES AND JAPAN 41–45, 107–11 (2000); Jeffrey P. Cantrell et al., *Notice 89-21 Crashes the Interest Rate Swap Party*, 45 TAX NOTES 337 (Oct. 6, 1989); Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984); Calvin H. Johnson, *The Illegitimate "Earned" Requirement in Tax and Nontax Accounting*, 50 TAX L. REV. 373 (1995); Laurie L. Malman, *Treatment of Prepaid Income – Clear Reflection of Income or Muddied Waters*, 37 TAX L. REV. 103 (1981); Robert H. Scarborough, *Payments in Advance of Performance*, 69 TAXES 798 (1991); Steven J. Willis, *It's Time for* Schlude *to Go*, 93 TAX NOTES 127 (Oct. 1, 2001).

[149] 353 U.S. 180 (1957).

[150] *Id.* at 188–89.

[151] *Id.* at 189.

[152] *Id.* at 189–90. Section 446(b) provides, that "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." I.R.C. § 446(b).

Automobile Ass'n v. United States.[153] In this case, involving another automobile club on the accrual method of accounting, the taxpayer, American Automobile Association, attempted to justify its pro rata monthly allocation and inclusion of prepaid dues through statistical evidence. American Automobile Association did not deny that its accounting system was substantially identical to that of Automobile Club of Michigan.[154] But, as the Court put it, American Automobile Association argued:

> [*Automobile Club of*] *Michigan does not control this case because of a difference in proof*, i.e., that in this case the record contains expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed; and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience.[155]

The Supreme Court held, however, that a finding by the trial court that the method employed by American Automobile Association was in accord with generally accepted accounting principles did not mean "that for income tax purposes it so clearly reflects income as to be binding on the Treasury."[156] The Court further held:

> Likewise, other findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinate significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit. Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the *pro rata* method of allocating each year's membership dues in equal monthly installments not in fact related to the expenses incurred.[157]

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[153] 367 U.S. 687 (1961).

[154] *Id.* at 691.

[155] *Id.* (emphasis added).

[156] *Id.* at 693.

[157] *Id.* The Supreme Court also noted that Congress enacted a provision in 1954, section 452, that permitted deferral of prepaid income but repealed the provision the very next year, in 1955, because of revenue concerns. *Id.* at 695. The Court wrote:

As a result, even though American Automobile Association raised the proof in support of its claim for deferral, it was unsuccessful and therefore had to include the prepaid dues in income upon receipt.[158]

In 1963, two years after *American Automobile Ass'n*, the Supreme Court decided *Schlude v. Commissioner*.[159] In *Schlude*, the taxpayer, a dance studio on the accrual method of accounting, received advance payments from customers for future dance lessons. A customer had to take the lessons within a designated period, but there was no schedule of specific dates for the lessons. The dance studio included the advance payments in income as a customer took lessons and credited any remaining balance in income when the customer's right to remaining lessons terminated upon the expiration of the time period for taking the lessons. As a result, it appeared that the taxpayer had overcome the difficulties identified by the Supreme

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> To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted § 452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound." Instead of constituting a merely duplicative creation, the fact is that § 452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue, was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy.

Id. at 695–96.

[158] About a month after the Supreme Court's decision in *American Automobile Ass'n*, Congress enacted section 456, permitting deferral of prepaid dues income for certain membership organizations. Pub. L. No. 87-109, § 1(a), 75 Stat. 152, 222 (1961). Congress's action may have been in direct response to the Supreme Court's statement in *American Automobile Ass'n*:

> We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case.

367 U.S. at 697. *See also* BITTKER & LOKKEN, *supra* note 106, ¶ 105.5.3.

[159] 372 U.S. 128 (1963).

Court in *Automobile Club of Michigan* and *American Automobile Ass'n* by keeping records on the lessons given to its customers and thereby accurately measuring the amount of services rendered.[160]

The Supreme Court held, however, that the dance studio had to include the advance payments in income upon receipt because the taxpayer's allocation method suffered from the same defect as the taxpayers in *Automobile Club of Michigan* and *American Automobile Ass'n*.[161] The Court wrote:

> The system employed here suffers from the very same vice, for the studio sought to defer its cash receipts on the basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse. But even though the student did not demand the remaining lessons, the contracts permitted the studio to insist upon payment in accordance with the obligations undertaken and to retain whatever prepayments were made without restriction as to use and without obligation of refund. At the end of each period, while the number of lessons taught had been meticulously reflected, the studio was uncertain whether none, some or all of the remaining lessons would be rendered. Clearly, services were rendered solely on demand in the fashion of the *American Automobile Association* and *Automobile Club of Michigan* cases.[162]

Looking at the three Supreme Court cases, commonly referred to as the Trilogy, it is fairly clear that the taxpayers in *American Automobile Ass'n* and *Schlude* tried to raise the proof in support of the claim of deferral to avoid the fate of the taxpayer in *Automobile Club of Michigan*. They certainly did not lower the claim, as the taxpayers continued to strive for deferral of advance payments for services. Unfortunately for the taxpayers, the proof was not sufficient for the Court to permit deferral.

In 1968, an accrual method taxpayer was able to raise the proof high enough to convince a court that deferral of income was

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[160] *See id.* at 141 (Stewart, J., dissenting).

[161] *Id.* at 135.

[162] *Id.* at 135–36.

permissible for advance payments for services. In *Artnell Co. v. Commissioner*,[163] the taxpayer, the Chicago White Sox baseball team, sold season tickets and single game tickets for future baseball games. It also received revenues for broadcasting and televising future games and from selling parking tickets. The taxpayer was on the accrual method and its taxable year ended on May 31, 1962. As of May 31, the taxpayer showed as deferred unearned income that portion of the amount received for season tickets, single tickets, radio, television, and parking tickets, allocable to games played after May 31.[164] As the games were played, the taxpayer included in income the amounts of deferred unearned income allocated to each game.[165] The government argued that the taxpayer must include the advance payments in income upon receipt and "that deferral of income is a matter for Congress to permit and, until Congress acts, deferral must be disallowed."[166] The Tax Court agreed with the government.[167]

The Seventh Circuit reversed the Tax Court, holding that there must be situations in which deferral of income (from advance payments for services) will so clearly reflect income that the Supreme Court would find an abuse of discretion if the government rejected the taxpayer's method of accounting.[168] The Seventh Circuit noted that in the Trilogy, the government did not abuse its discretion in rejecting deferral of income "where the time and extent of performance of future services were uncertain."[169] But the uncertainty in the Trilogy was not present in *Artnell*.[170] The baseball games were to be played on a fixed schedule and, except for rain dates, there was certainty as to the time and extent of performance.[171] As a result, the Seventh Circuit remanded to the Tax Court to determine whether the Chicago White Sox's method of accounting clearly reflected its income.[172]

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163 48 T.C. 411 (1967), *rev'd and rem'd*, 400 F.2d 981 (7th Cir. 1968), *acq.*, 1968-2 C.B. 1.

164 48 T.C. 413–14.

165 *Id.* at 413. The Seventh Circuit stated that requiring the business to include the entire amount of payment in income on receipt "tends to reflect an illusory or partially illusory gain for the period of receipt." 400 F.2d at 983.

166 400 F.2d at 983.

167 48 T.C. at 419.

168 400 F.2d at 985.

169 *Id.* at 983–84.

170 *Id.* at 984.

171 *Id.* ("We would have no difficulty distinguishing the instant case in this respect.").

172 *Id.* at 985.

On remand, the Tax Court held that while the Chicago White Sox's method of accounting did not perfectly match income and expenses, the government's method did not either.[173] In fact, the government's method did not match income and expenses nearly as well as the Chicago White Sox's method. Therefore, the Tax Court held that the Chicago White Sox acted properly in deferring its income.[174]

C. *False (or Alternative) Solution*

A third method in avoiding the application of the Too Perfect Theory is to provide a false (or alternative) solution so that a court will uphold the claimed tax consequences of the transaction for a wrong reason. *United Parcel Services of America, Inc. v. Commissioner*[175] addressed the practice of UPS, a parcel delivery company, of reimbursing customers up to $100 of declared value for lost or damaged packages. For any loss in excess of a declared value of $100, UPS would assume liability only if the customer paid twenty-five cents per additional $100 of declared value (the "excess value charge"). UPS made a large profit on the excess value charges because "it never came close to paying as much in claims as it collected in charges, in part because of efforts it made to safeguard and track excess-value shipments."[176]

In 1983, UPS restructured its excess value charges plan to avoid paying taxes on the profits. UPS formed a Bermuda subsidiary, Overseas Partners, Ltd. (OPL) and then distributed the stock of OPL

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[173] 29 T.C.M. 403, 406 (1970). The Tax Court noted that the neither the Chicago White Sox nor the government offered "any expert testimony as to how sound accounting principles should be applied in this case." *Id.* at 405. As a result, the Chicago White Sox could have done a better job in raising the proof by presenting expert testimony.

[174] *Id.* at 406. More recently, another baseball team successfully argued before the Tax Court that it should be permitted to defer its prepaid service income (advances for season tickets and private suite reservations but not sponsor income). *See* Tampa Bay Devil Rays, Ltd. v. Commissioner, 84 T.C.M. 394 (2002).

The government has permitted a very limited amount of deferral for prepaid service income. *See* Rev. Proc. 2004-34, 2004-22 I.R.B. 991 (generally providing for a one year deferral period). *See also* I.R.C. § 455 (prepaid subscription income); I.R.C. § 456 (prepaid dues income); Treas. Reg. § 1.446-3 (as amended in 1994) (notional principal contracts); Treas. Reg. § 1.451-5 (as amended in 2001) (prepaid goods income); Rev. Proc. 97-38, 1997-2 C.B. 479 (advance payment for multiyear service warranty contract).

[175] 78 T.C.M. 262 (1999), *rev'd and rem'd*, 254 F.3d 1014 (11th Cir. 2001).

[176] 254 F.3d at 1016.

to the UPS shareholders as a taxable dividend. UPS also purchased an insurance policy from National Union Fire Insurance Company (National Union). Under this policy, UPS would pay premiums equal to the excess value charges it collected from its customers, and National Union assumed the liability for damage or loss of the excess-value shipments. UPS, however, was responsible for administering the customer claims under the policy.

National Union entered into a reinsurance agreement with OPL. Under the agreement, OPL assumed National Union's liability with respect to the excess-value shipments and in return received premiums from National Union equal to the excess value payments that National Union received from UPS (less commissions, fees, and excise taxes).

As a result of the restructuring, UPS remitted monthly the excess value charges it received, less claims paid, to National Union, which in turn remitted the payments (less its commissions, fees, and excise taxes) to OPL. In its 1984 tax return, UPS did not include income or expenses from the excess value charges but merely deducted the fees and commissions that National Union charged. The Service argued that the excess value payments ultimately remitted to OPL had to be included in UPS's gross income.[177] In a lengthy opinion, the Tax Court agreed with the Service and also imposed penalties on UPS.[178]

The Eleventh Circuit reversed the Tax Court and remanded the action for further proceedings.[179] The Eleventh Circuit applied the two-prong economic substance doctrine in upholding UPS's excess value plan.[180] Under the first prong, the court concluded that the UPS excess value plan had real economic effect because there was a real insurance policy between UPS and National Union, and OPL was an independent taxable entity not under UPS's control.[181]

Under the second prong of the economic substance doctrine, UPS had to show a business purpose for the excess value plan.[182] The court wrote that "a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business."[183] The court found an adequate

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[177] *See* 78 T.C.M. 262 (1999).

[178] *See id.*

[179] *See* 254 F.3d 1014 (11th Cir. 2001).

[180] *Id.* at 1018–20.

[181] *Id.* at 1018–19.

[182] *Id.* at 1019–20.

[183] *Id.* at 1019. The Eleventh Circuit stated that "[t]his concept of 'business purpose' is a necessary corollary to the venerable axiom that tax-planning is

business purpose because the transaction simply altered the form of an existing, bona fide business.[184] More specifically, there was a real business that gave the customers loss coverage and allowed UPS to lower its liability exposure.[185] The court remanded to the Tax Court to consider the government's alternative arguments under the reallocation provisions of sections 482 and 845.[186]

Judge Kenneth Ryskamp dissented from the Eleventh Circuit's opinion.[187] He wrote that the excess value plan was done solely with tax avoidance in mind and with no legitimate, substantive business reason.[188] He noted that UPS advanced a number of explanations for its plan to show a business purpose and that every one was rejected by the Tax Court.[189] UPS claimed that the plan was meant to avoid application of state insurance laws; however, the evidence showed that this was not a real concern and even if it was, federal preemption of

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permissible." *Id.*

[184] *Id.* at 1020.

[185] *Id.*

[186] *Id.* Section 482 provides:

> In any case of two or more organizations, trades, or businesses, (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

I.R.C. § 482.

Section 845 operates in a similar manner to section 482 although it is limited to reinsurance agreements or contracts. In general, under section 845, the Secretary may allocate between or among two or more related persons who are parties to a reinsurance agreement, income, deductions, assets, reserves, credits, and other items related to such agreement, recharacterize any such items, or make any other adjustment, if the Secretary determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper amount, source, or character of the taxable income of each such person. *See* I.R.C. § 845(a).

[187] United Parcel Serv. of America, Inc. v. Commissioner, 254 F.3d 1014, 1020–22 (11th Cir. 2001) (Ryskamp, J., dissenting).

[188] *Id.* at 1021.

[189] *Id.* ("As the tax court articulated in great detail in its well-reasoned 114-page opinion, the evidence in this case overwhelmingly demonstrates that UPS's reinsurance arrangement with NUF [National Union] and OPL had no economic significance or business purpose outside of UPS's desire to avoid federal income tax, and was therefore a sham transaction.").

state laws made the old plan legal.[190] UPS argued that it intended for OPL to become a full-line insurer. It was unnecessary, however, to use EVC income to achieve that goal.[191] UPS also claimed that OPL was a legitimate insurance company even though OPL charged a "substantially inflated rate for EVCs."[192] In an arm's length transaction with a legitimate insurance company, the rates would have been about half those charged by UPS and in turn passed on to OPL.[193] Judge Ryskamp concluded that the Tax Court was correct in holding that no business purpose existed for the excess value plan. It was done solely for tax avoidance purposes.

Judge Ryskamp implies that the majority of the Eleventh Circuit was led down the wrong path by accepting the argument that UPS had a business purpose for the excess value plan. More specifically, the majority seemed to believe that the plan was implemented to avoid state insurance laws, that OPL was to become a full-line insurer, and that OPL was a legitimate insurance company. In other words, Judge Ryskamp implies that the majority believed the false solution(s) that UPS gave for the excess value plan. He and the Tax Court saw the excess value plan for exactly what it was: a too perfect result done solely for tax avoidance purposes.

D. *Combining Theories – Raising the Proof and False Solution*

It is possible to combine two (or three) of the solutions to the problem created by the Too Perfect Theory to avoid a recharacterization. In *IES Industries, Inc. v. United States*,[194] IES, an electric utility company in Iowa, purchased American Depository Receipts (ADRs) with dividend rights attached.[195] These transactions were brought to IES's attention by Twenty-First Securities Corporation, a securities broker in New York. After "some initial investigation," IES signed on to the transactions.[196]

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[190] *Id.*

[191] *Id.*

[192] *Id.*

[193] *Id.* at 1021–22.

[194] No. C97-206, 1999 U.S. Dist. LEXIS 22610 (N.D. Iowa Sept. 22,1999), *aff'd in part and rev'd in part*, 253 F.3d 350 (8th Cir. 2001).

[195] ADRs are publicly traded securities that represent shares of a foreign corporation held in trust by a U.S. bank. 253 F.3d at 351. They are fully negotiable in U.S. dollars with the owner of the ADR entitled to all dividends and capital gains associated with the ADR. *Id.*

[196] *Id.* at 352.

Twenty-First Securities identified ADRs in which companies had announced dividends. IES purchased these ADRs with a settlement date before the record date for the dividend, so that IES would be entitled to the dividend.[197] IES then promptly sold the ADRs with a settlement date after the record date. As the court noted, "The purchase and sale generally took place within hours of each other, and sometimes in Amsterdam when the U.S. and European markets were closed."[198]

IES purchased the ADRs through a counterparty from tax-exempt entities (such as pension funds). These entities were exempt from U.S. tax but were subject to a 15% foreign withholding tax on the dividends they received on the ADRs. Generally, a U.S. taxpayer can credit any foreign tax against its U.S. tax liability;[199] however, a tax-exempt entity cannot benefit from a foreign tax credit because it has no U.S. tax liability. As a result, IES bought the ADRs from the tax-exempt entities so that it could utilize the foreign tax credits that would otherwise go unused.

IES paid the market price plus 85% of the expected gross dividends for the ADRs. After the record date, IES sold the ADRs back to the counterparty at market price. As a result, IES sold the ADRs for less than what it paid for them because the purchase price included the rights to the dividend ("cum-dividend") and the subsequent sales price reflected the market price of the ADRs without the dividend rights ("ex-dividend"). IES thus incurred capital losses, which it carried back to its previous tax years (1989 and 1990) to offset capital gains and sought to obtain a refund of taxes from those years.[200]

In 1991 and 1992, IES reported gross dividend income on its ADR transactions of almost $90.8 million, claimed a foreign tax credit for the foreign taxes withheld on the dividends of over $13.5 million ($90.8 million times 15%), and recognized capital losses of almost $82.8 million (which included commissions).

The Service denied IES's claim for a $26 million refund, and IES sued in district court for the Northern District of Iowa. The district court granted summary judgment for the government. The court

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[197] Dividends are paid on the payment date to those who own the stock on the record date. BLACK'S LAW DICTIONARY 400 (7th ed. 1999).

[198] 253 F.3d at 352.

[199] I.R.C. §§ 901–08.

[200] I.R.C. § 1212(a)(1) (noting that, generally, a corporation may carry a net capital loss back three years and forward five years).

wrote:

> Having reviewed the nature of the ADR transactions in light of the applicable law, it is clear the transactions did not change IES's economic position except for the transactions having resulted in the transfer of the claim to the foreign tax credit to IES. The court is satisfied that the ADR transactions in this matter were shaped solely by tax avoidance considerations, had no other practical economic effect, and are properly disregarded for tax purposes.[201]

The district court easily recognized what IES was trying to do. There is a reason why it was obvious: the ADR transactions were too perfect. IES wanted the foreign tax credits from the tax-exempt entities, and, as a result, the transaction was done solely for tax avoidance purposes. There was no other reason why IES would engage in such a transaction.[202] In fact, it was so obvious that the district court granted summary judgment for the government.

IES appealed to the Eighth Circuit Court of Appeals, which reversed the judgment of the district court.[203] The Eighth Circuit determined that the ADR transactions resulted in a profit or economic benefit to IES and therefore had economic substance.[204] The court reached this result by computing the profit using the gross dividend income before the foreign taxes were withheld and not the net dividend income (gross dividend income less foreign taxes withheld).[205] If the court had used the net dividend income in determining whether IES made a profit on the transaction, then the transaction would in essence be a wash, as the net dividend income almost exactly equaled the capital loss on the sale of the ADRs. By using the gross dividend income, however, IES made a profit approximately equal to the foreign taxes withheld on the gross dividend income. As a result, the court concluded that the ADR

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[201] No. C97-206, 1999 U.S. Dist. LEXIS 22610, at *4–5 (N.D. Iowa Sept. 22, 1999), *aff'd in part and rev'd in part*, 253 F.3d 350 (8th Cir. 2001).

[202] *See, e.g.*, David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong*, 94 TAX NOTES 501 (Jan. 28, 2002); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 94 TAX NOTES 511 (Jan. 28, 2002). *But see* William A. Klein & Kirk J. Stark, Compaq v. Commissioner – *Where is the Tax Arbitrage?*, 94 TAX NOTES 1335 (Mar. 11, 2002).

[203] *See* 253 F.3d 350.

[204] *Id.* at 353–54.

[205] *Id.* at 354 (noting that "the economic benefit to IES was the amount of the *gross* dividend, before the foreign taxes were paid").

transactions had economic substance.[206]

The court also addressed whether IES met the business purpose test with respect to the ADR transactions.[207] Both IES and the Service discussed the risk of loss inherent in the transactions and the court focused on this aspect in determining whether there was a business purpose for the transactions.[208] The court noted that the risk of loss may have been minimal, but that was because IES "did its homework before engaging in the transactions."[209] IES officials met with Twenty-First representatives on two separate occasions and studied the materials that Twenty-First provided.[210] IES also consulted with its outside accountants and its securities counsel before entering into the ADR transactions.[211]

The court also compared IES's behavior with that of Compaq Computer Corporation.[212] In *Compaq Computer Corp. v. Commissioner*,[213] the Tax Court held that Compaq Computer had no business purpose for the ADR transactions into which it entered. The Compaq Computer ADR transactions were almost identical to the ADR transactions entered into by IES. The Eighth Circuit noted Compaq Computer's "evaluation of the proposed transaction was less than businesslike with [taxpayer's assistant treasurer] committing [taxpayer] to this multimillion-dollar transaction based on one meeting with Twenty-First and on his call to a Twenty-First reference."[214] IES, however, exercised good business judgment by doing its own investigation and minimizing risk. In fact, IES rejected some of the ADR transactions brought to it by Twenty-First and made some trades when the U.S. markets were closed to minimize risk. In contrast, Compaq Computer did no investigation or analysis of risks before entering into its ADR transactions. As a result of IES's analysis and investigation of the ADR transactions prior to entering into them, the Eighth Circuit concluded that it exercised good business judgment and therefore met the business purpose

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206 *Id.*

207 *Id.* at 354–56.

208 *Id.* at 355. The government argued that the transactions were shams because there was no risk of loss. *Id.*

209 *Id.*

210 *Id.*

211 *Id.*

212 *Id.*

213 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

214 *IES Indus., Inc. v. United States*, 253 F.3d at 355.

test.[215]

IES argued that it was entitled to its claimed tax benefits from the ADR transactions even though the tax benefits were, in a sense, too perfect. The ADR transactions were economically a wash — the net dividend income, which was the actual amount of dividends received by IES, was almost exactly offset by the loss on the sale of the ADRs. IES claimed the foreign tax credits with respect to the dividend income, which would make the transactions very beneficial for tax purposes although a wash for economic purposes.

IES succeeded in the Eighth Circuit, arguably, by having the court buy into one (and possibly two) false solutions and by also raising the proof with regard to the second (false) solution. First, the court determined that IES made a profit on the transaction by including the gross amount of the dividend in income and ignoring the foreign income taxes. Because of some profit, the court concluded that the transaction had economic substance. A number of commentators believe that this line of analysis is simply wrong.[216] Creating some profit in a transaction is easy — simply add in equity.[217] In addition, foreign income taxes are not the same as U.S. income taxes in certain situations, because of economic incidence as well as the revenue effect on the U.S. government.[218] Therefore, ignoring U.S. income taxes in computing profit does not mean that foreign income taxes should also be ignored.

The court then focused on risk to determine whether IES met the

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[215] *Id.* at 355–56.

[216] *See, e.g.*, Hariton, *supra* note 202, at 502 ("The first holding [requiring profit as measured before the imposition of foreign income taxes] is undeniably correct, but it is a complete nonsequitur."); Shaviro & Weisbach, *supra* note 202, at 515 ("Discussions of pre-tax profit, in some ways, are always surreal. The only meaningful number is after-tax profits. Perhaps this is why the courts got so confused.").

In I.R.S. Notice 98-5, 1998-1 C.B. 334, the government announced that it intended to issue regulations "that would apply an economic profit test to address abusive tax-motivated transactions that generate foreign tax credits that can be used to reduce residual U.S. tax on other foreign source income." Six years later, in early 2004, the government announced that it was abandoning the economic profit test. *See* I.R.S. Notice 2004-19, 2004-11 I.R.B. 606.

[217] *See* Hariton, *supra* note 202, at 509 ("And even if there wasn't any profit in these transactions, you can be sure that there *will* be in the next 30 transactions that come before the courts, because adding in profit is like taking candy from a baby. All it requires is that the taxpayer add some net equity to the transaction so that it is effectively investing capital for a period of time.") (emphasis added).

[218] *See* Shaviro & Weisbach, *supra* note 202, at 515.

business purpose test. IES convinced the court that any risk was minimal because it did its "homework" before entering into the ADR transaction (unlike Compaq Computer). More specifically, IES showed enough proof for its claim to the foreign tax credits by detailing its analysis and investigation of the ADR transactions. To the extent that risk is relevant, the court appears to be saying that risk is evidence of a business purpose, but doing research to substantially minimize or eliminate risk (as IES did) is also evidence of a business purpose. That makes no sense.[219] Are we to understand that risk is evidence of a business purpose, but so is the absence of risk?

In its appeal to the Fifth Circuit, Compaq Computer also won with respect to its ADR transactions.[220] Compaq Computer, however, did not raise the proof in support of its claim. Rather, the Fifth Circuit utilized a similar profit analysis and risk analysis, which are arguably false solutions, that the Eighth Circuit utilized in *IES Industries*.

In 1997, Congress enacted section 901(k), effectively ending *IES Industries* and *Compaq* types of transactions involving dividend stripping and foreign tax credits.[221] Congress utilized an entirely different analysis than the Fifth and Eight Circuits. It focused on ownership of the stock (or ADRs) and required the taxpayer to raise the proof to satisfy its ownership by holding the stock at least sixteen days within a thirty-one day period that includes the dividend record date to qualify for the foreign tax credit.[222]

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[219] *See id.* at 516 ("What the courts in *Compaq* and *IES* had to say about economic risk was no less misguided than their discussion of pre-tax profit.").

[220] *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999). The Tax Court had upheld the notice of deficiency sent by the Commissioner to Compaq and had also imposed an accuracy-related penalty for negligence under section 6662.

[221] *See IES Indus., Inc. v. United States*, 253 F.3d at 356 n.5. Congress has recently expanded the principles of section 901(k) to include credits for gross basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the item of income or gain has not held the property for at least sixteen days within a thirty-one day period. Pub. L. No. 108-357, § 832, 118 Stat. 1418 (2004).

[222] *See IES Indus*, 253 F.3d at 356, n.5; Pub. L. No. 105-34, § 1053(a), 111 Stat. 788 (1997). When Congress originally enacted section 901(k) in 1997, it required the taxpayer to hold the stock at least 16 days within a thirty day period that included the dividend record date. Congress recently amended section 901(k) to change the thirty day period to a thirty-one day period. Pub. L. No. 108-311, § 406(g)(1), 118 Stat. 1166 (2004).

The first thing that is learned is that deception depends entirely upon doing things in such a manner that it seems there is no attempt at deception.

— Dariel Fitzkee[223]

VI. THE TOO PERFECT THEORY IN TAX PRACTICE TODAY

Almost all tax practitioners are familiar with the Too Perfect Theory, although they may not realize it. In general, tax practitioners know not to make a transaction too perfect or the government may attempt to recharacterize the transaction. Three well-known examples illustrate the Too Perfect Theory in tax practice today and how some tax practitioners have violated it at their peril.

A. *Reasonable Compensation in an S Corporation*

A very common issue for tax practitioners arises with respect to compensation for services of a shareholder/employee of an S corporation.[224] For income tax purposes, the income of an S corporation generally flows through the entity to each of its shareholders.[225] Each shareholder will pay income taxes on his pro rata share of the S corporation's income;[226] however, this pro rata

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[223] *See* FITZKEE, *supra* note 59, at 224–25.

[224] *See, e.g.*, JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 11.02[5] (4th ed. 2001); A. Bruce Clements & Paul J. Streer, *How Low Can Owner-Employee Compensation Be Set to Save on Employment Taxes?*, 2 J. S CORP. TAX'N 37 (1990); Kirsten Harrington, *Employment Taxes: What Can the Small Businessman Do?*, 10 AKRON TAX J. 61 (1993); Stephen R. Looney & Richard B. Comiter, *Reasonable Compensation: Dividends vs. Wages – A Reverse in Positions*, 7 J. PARTNERSHIP TAX'N 364 (1991); Burgess J.W. Raby & William L. Raby, *When is Compensation Unreasonably Low?*, 86 TAX NOTES 1255 (Feb. 28, 2000).

In 2002, the Treasury Inspector General for Tax Administration (TIGTA) issued an audit report examining whether the Service was effectively identifying taxpayers that were not reporting S corporation officer compensation. *See* TIGTA, *The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations*, TAX NOTES TODAY (July 5, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 182-25). According to the report, eighty-four S corporation cases were reviewed, of which fifty-eight had officer distributions. The issue was not addressed in thirteen of the fifty-eight cases that had officer distributions. In cases reviewed, shareholders reported an average of only $5300 of wages, while reporting an average distribution of $349,323.

[225] I.R.C. § 1363.

[226] I.R.C. § 1366.

share of income is not subject to self-employment taxes.[227] As a result, it is generally very beneficial for the shareholder/employee of an S corporation to avoid receiving compensation for services in the form of wages from the S corporation because it will be subject to both income taxes and employment taxes. The shareholder prefers receiving distributions of money or property with respect to his stock. An important issue arises as to how little compensation an S corporation has to pay its shareholder/employee for services rendered.

If the S corporation pays no wages to its shareholder/employee and simply distributes its earnings as dividends (in the corporate law sense), it will provide an ideal result. But it is too perfect and may be subject to recharacterization.[228] In fact, one judge has described this ploy as "a subterfuge for reality."[229] Tax advisors appear to have developed at least three possibilities to avoid a recharactization. The first possibility is to have the S corporation pay a reasonable salary to the shareholder/employee. Of course, "reasonable salary" implies a wide range of salaries and, as a result, the salary is generally low but reasonable and hopefully supportable. This would be an example of reducing the claim. A second possibility is to argue that the shareholder/employee performed no services or only minor services to the corporation, providing supporting documentation, and that therefore no (or very little) compensation for services is justified.[230] This would be an example of raising the proof. A third possibility is to argue that the shareholder/employee is not really an employee but rather an independent contractor (possibly done for retirement plan

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[227] *See* I.R.C. § 1402; Ding v. Commissioner, 200 F.3d 587 (9th Cir. 1999) (holding that an S corporation shareholder must include a pro rata share of S corporation's income in calculating gross income but not in calculating net income from self-employment); Durando v. United States, 70 F.3d 548 (9th Cir. 1995) (holding that a pro rata share of income from an S corporation was not net earnings from self-employment for purposes of Keogh plan deductions); Rev. Rul. 59-221, 1959-1 C.B. 225.

[228] *See, e.g.*, Dunn & Clark, P.A. v. Commissioner, No. 94-35562, 1995 U.S. App. LEXIS 14334 (9th Cir. June 8, 1995); Radtke v. United States, 895 F.2d 1196 (7th Cir. 1990); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); Veterinary Surgical Consultants, P.C. v. Commissioner, 117 T.C. 141 (2001), *aff'd sub nom. Yeagle Drywall Co. v. Commissioner, No. 02-1132, 2002 U.S. App. LEXIS 27368 (3d Cir. Dec. 18, 2002)*; Rev. Rul. 74-44, 1974-1 C.B. 287; I.R.S. News Release IR-2004-47, 2004 IRB LEXIS 148 (Apr. 5, 2004).

[229] *Veterinary Surgical Consultants*, 117 T.C. at 145.

[230] *See* Davis v. United States, No. 93-C-1173, 1994 U.S. Dist. LEXIS 10725 (D. Colo. July 15, 1994) (accepting taxpayer demonstration that her husband was not an employee of the S corporation and also presentation of evidence as to the extent and value of her services).

purposes and also to have the S corporation avoid paying employment taxes).[231] This would be an example of a false (or alternative) solution.

B. Contingent Liability Tax Shelters

In more recent years, it appears that many tax advisors are ignoring the Too Perfect Theory and structuring transactions with tax results that are too perfect. A common transaction in the mid- and late 1990s was the contingent liability tax shelter.[232] Generally, in this transaction, a high basis asset is transferred to a corporation in exchange for stock of the transferee corporation, and the transferee corporation's assumption of a contingent liability (such as an environmental liability or liability for deferred compensation or other deferred employee benefits).[233] The transferor may remain liable on

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[231] Taxpayers that have made the independent contractor argument have been largely unsuccessful. *See, e.g.*, Nu-Look Design, Inc. v. Commissioner, 356 F.3d 290 (3d Cir. 2004); Dunn & Clark, P.A. v. Commissioner, No. 94-35562, 1995 U.S. App. LEXIS 14334 (9th Cir. June 8, 1995); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); Veterinary Surgical Consultants P.C. v. Commissioner, 85 T.C.M. (CCH) 901 (2003), *aff'd*, No. 03-2733, 2004 U.S. App. LEXIS 4566 (3d Cir. Mar. 10, 2004); Joseph M. Grey Pub. Accountant, P.C. v. Commissioner, 119 T.C. 121 (2002), *aff'd*, No. 02-4417, 2004 U.S. App. LEXIS 6662 (3d Cir. Apr. 7, 2004); Rev. Rul. 82-83, 1982-1 C.B. 151.

In addition, the deduction under section 1402(a)(12) used in computing net earnings from self-employment appears to be overstated, thereby treating independent contractors slightly more favorably than employees. In computing net earnings from self-employment for net earnings at or below the FICA wage base, the net earnings from self-employment should be multiplied by 0.9289 (1/1.0765) rather than by 0.9235 as provided in the statute. In computing net earnings from self-employment for net earnings above the FICA wage base, the net earnings from self-employment should be multiplied by 0.9857 (1/1.0145) rather than by 0.9235 as provided in the statute. *See* I.R.C. § 1401; I.R.C. § 164(f).

[232] The popularity of the contingent liability tax shelter may have been due, in large part, to the issuance of Rev. Rul. 95-74, 1995-2 C.B. 36, in November 1995. In the ruling, the Service stated that, in a section 351 exchange, certain contingent liabilities (i.e., environmental liabilities) assumed by the transferee from the transferor would not be treated as liabilities for purposes of sections 357(c)(1) (defining liabilities) and 358(d) (determining the transferor's basis in the stock received in the section 351 exchange). *See* Rev. Rul. 95-74, 1995-2 C.B. 36. In addition, the contingent liabilities assumed by the transferee were deductible as business expenses under section 162 or were capital expenditures under section 263, as appropriate, under the transferee's method of accounting. *Id.*

[233] *See* I.R.S. Notice 2001-17, 2001-1 C.B. 730 (describing a contingent liability tax shelter, alerting taxpayers that losses generated by such a tax shelter will be disallowed, and identifying it as a listed transaction). *See also* Rev. Proc. 2002-67,

the underlying obligation. The basis and fair market value of the transferred asset is generally only slightly greater than the contingent liability. As a result, the stock received in the transaction will have minimal value.

The transferor reports the exchange as a section 351 nonrecognition transaction.[234] The transferor's basis in the stock received in the transaction is a high exchanged basis unreduced by the contingent liability.[235] The transferor then sells the transferee corporation stock for its fair market value (usually within a relatively short period of time after the exchange) and claims a tax loss in an amount approximately equal to the contingent liability assumed by the transferee corporation. In addition to the transferor's purported

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2002-2 C.B. 733 (describing procedures for taxpayers who elect to participate in a settlement initiative aimed at resolving contingent liability tax shelters similar to those described in I.R.S. Notice 2001-17).

[234] Section 351 generally provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of the corporation and, immediately after the exchange, the transferors are in control of the corporation. I.R.C. § 351(a). "Control" means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368(c). The Service has ruled that if nonvoting stock is outstanding, the transferors must own at least 80% of the total number of shares of each class of nonvoting stock. *See* Rev. Rul. 59-259, 1959-2 C.B. 115.

[235] Liabilities assumed by the transferee corporation are treated as money received by the transferor. I.R.C. § 358(d)(1). Under certain circumstances, however, liabilities assumed by a transferee corporation in a section 351 exchange are not treated as money received by the transferor and thus do not reduce the basis of the stock received in the exchange. I.R.C. §§ 358(d)(2), 357(c)(3). Liabilities that fall within this exception are those the payment of which would give rise to a deduction. I.R.C. § 357(c)(3)(A). However, the exception does not apply to liabilities that resulted in the creation of, or an increase in, the basis of any property. I.R.C. § 357(c)(3)(B).

In 2000, Congress enacted section 358(h), which requires that the basis of property received in a nonrecognition exchange, such as a section 351 exchange, be reduced (but not below its fair market value) by liabilities assumed by another person as part of the exchange and not taken into account under section 358(d). *See* Pub. L. No. 106-554, § 309(a), 114 Stat. 2763 (2000). Exceptions were provided for a liability if "the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange." I.R.C. § 358(h)(2). The term "liability" is defined to "include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account" under the tax laws. I.R.C. § 358(h)(3). Section 358(h) is effective for assumptions of liability after October 18, 1999.

loss on the stock sale, the transferee corporation may claim a deduction with respect to payments on the contingent liability.[236] The Service has identified the contingent liability tax shelter as a listed transaction.[237]

There are at least two aspects of the contingent liability tax shelter that can lead an observer to conclude that the transaction is too perfect. First, the closer the amount of the contingent liability is to the fair market value of the transferred asset, the more perfect the transaction becomes. Second, the more quickly the transferor sells the transferee stock, the more perfect the transaction becomes, because one of the main reasons for entering into a contingent liability tax shelter is for the transferor to accelerate a loss or deduction (as well as to duplicate a loss or deduction).

One of many corporations that entered into contingent liability tax shelters in the mid-1990s was Enron.[238] As is now well known,

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[236] Rev. Rul. 95-74, 1995-2 C.B. 36.

[237] *See* I.R.S. Notice 2001-17, 2001-1 C.B. 730; I.R.S. Notice 2004-67, 2004-41 I.R.B. 600. A listed transaction means that taxpayers may need to disclose their participation in these transactions as prescribed in Treas. Reg. § 1.6011-4, promoters (or other persons responsible for registering tax shelter transactions) may need to register these transactions under Treas. Reg. § 301.6111-2, and material advisors must maintain lists of investors and other information with respect to these listed transactions pursuant to Treas. Reg. § 301.6112-1. *See* I.R.S. Notice 2004-67, 2004-41 I.R.B. 600. After the issuance of IRS Notice 2004-67, Congress enacted a number of provisions, including enhanced penalties, applicable to taxpayers and material advisors with respect to listed and reportable transactions. *See* Pub. L. No. 108-357, §§ 811–22, 118 Stat. 1418 (2004).

[238] *See* STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., 1 REPORT OF INVESTIGATION OF ENRON CORP. AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 118–35 (Joint Comm. Print 2003) [hereinafter JCT ENRON REPORT]. *See also* SECOND INTERIM REPORT OF NEAL BATSON, COURT APPOINTED EXAMINER, at 87-94, Appendix J, In re Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003).

On February 15, 2002, the U.S. Senate Finance Committee, represented by Senators Max Baucus (then chair) and Charles Grassley (ranking member), directed that the staff of the U.S. Joint Committee on Taxation investigate Enron and its related entities on issues relating to federal income tax laws. *See* JCT ENRON REPORT at 1. Almost exactly one year after the directive from the Senate Finance Committee, the Joint Committee released its Enron report on February 13, 2003. The report is over 2700 pages and is contained in three volumes.

Another well-known company, Black & Decker Corporation (B & D), also entered into a contingent liability tax shelter in the 1990s. In 1998, B & D sold three of its businesses, generating a large amount of capital gains. That same year, B & D created Black & Decker Healthcare Management, Inc. (BDHMI), transferring $561 million along with $560 million in contingent employee healthcare claims in exchange

Enron is a Houston-based energy and commodities trading company, which in 2001 was the seventh largest U.S. company, according to Fortune magazine.[239] Enron filed for bankruptcy on December 2, 2001, which, at that time, was the largest bankruptcy in U.S. history.[240]

From 1995 to 2001, Enron planned twelve structured or tax-motivated transactions.[241] Eleven of them were actually implemented during this time, while the twelfth was planned but was never carried out due to the bankruptcy filing in early December 2001.[242] The first

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for newly issued stock of BDHMI. Later that year, B & D sold the BDHMI stock to a third party for $1 million, reporting a capital loss of $560 million ($561 million basis less $1 million amount realized).

B & D used the large capital loss to offset the large amount of capital gains for the year, carrying the excess losses back and then forward. B & D sued for a refund of federal taxes in U.S. District Court for the District of Maryland in the amount of $57,358,030 relating to the contingent liability tax shelter it entered into in 1998. The government moved for summary judgment, arguing that the contingent liabilities are not deductible to BDHMI but rather to B & D. As a result, B & D should have reduced its basis in BDHMI stock by $560 million to $1 million. The District Court denied the government's motion for summary judgment. *See* Black & Decker Corp. v. United States, No. WDQ-02-2070, 2004 U.S. Dist. LEXIS 17351 (D. Md. Aug. 3, 2004). In an opinion dated October 22, 2004 (modifying an opinion dated October 20, 2004), the District Court granted summary judgment to B & D, holding that the transaction had economic substance despite B & D's concession that "tax avoidance was its sole motivation." *See* Black & Decker Corp. v. United States, 340 F. Supp. 2d 621, 623 (D. Md. 2004).

See also Coltec Indus., Inc. v. United States, 62 Fed. Cl. 716 (2004) (holding for the taxpayer in its use of a contingent liability tax shelter).

[239] *See* JCT ENRON REPORT, *supra* note 238, at 58.

[240] *Id.* (Enron's bankruptcy was eclipsed as the largest bankruptcy in U.S. history by WorldCom's bankruptcy on July 21, 2002).

[241] These twelve tax-motivated transactions came to the attention of the staff of the Joint Committee on Taxation through an article in the *Washington Post* dated May 22, 2002. *See* JCT ENRON REPORT, *supra* note 238, at 50 n.42 (referencing April Witt & Peter Behr, *Enron's Other Strategy: Taxes; Internal Papers Reveal How Complex Deals Boosted Profits by $1 Billion*, WASH. POST, May 22, 2002, at A1).

Robert Hermann, who was former general tax counsel (head of taxes) at Enron, gave an interview to the *Washington Post* in which he discussed the twelve tax motivated transactions. As a result, the Joint Committee interviewed Mr. Hermann, as well as requesting documents from Enron and discussing tax issues with a number of current and former Enron employees regarding these twelve transactions.

Within Enron's tax group was a subgroup referred to as the Structured Transactions Group. *See* JCT ENRON REPORT, *supra* note 238, at 102–07. It planned and structured most of the tax-motivated transactions, and named many of them after hurricanes or golf courses.

[242] *See* JCT ENRON REPORT, *supra* note 238, at 104.

of the twelve tax-motivated transactions was named Project Tanya.[243] Arthur Andersen brought Project Tanya to Enron in August 1995.[244] Enron had a large capital gain during 1995 (from the sale of stock of Enron Oil & Gas) and wanted to avoid paying tax on that gain.[245] Arthur Andersen devised a transaction to create a large capital loss to offset the capital gain.[246]

Enron entered into Project Tanya in December 1995 by transferring two intercompany promissory notes to Enron Management, Inc., a wholly owned Enron subsidiary.[247] Enron had a basis in the first note (a twenty-year promissory note) of $120.84 million and a basis in the second note (a ten-year promissory note) of $67.7 million.[248] Enron Management, Inc. also assumed certain contingent liabilities of Enron: deferred compensation obligations of $67.7 million and post-retirement medical, life insurance, and executive death benefit obligations of $120.8 million.[249] In return, Enron received twenty shares of a newly created class of voting preferred stock, which represented $40,000 of Enron Management Inc.'s net equity.[250] Enron's basis in the twenty shares was $188.555 million.[251]

Several weeks later, Enron sold the twenty shares of voting preferred stock to two of its employees, who were officers in Enron's Human Resources Department, for $40,000, recognizing a capital loss of $188.515 million.[252] It was anticipated that in 2002 Enron Management, Inc. would be liquidated into Enron and therefore the

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243 *Id.* at 118–23.

244 *Id.* at 119.

245 *Id.*

246 *Id.* A corporation's capital losses may only be used to offset its capital gains. I.R.C. § 1211(a). Any excess loss may be carried back three years and forward five years. I.R.C. § 1212(a).

247 *See* JCT ENRON REPORT, *supra* note 238, at 120.

248 *Id.*

249 *Id.*

250 *Id.* The preferred stock provided for a 9% annual dividend and "was entitled to three percent of any increase in Enron Management, Inc.'s net equity up to a maximum redemption value of $340,000." *Id.*

251 This was equal to the sum of the tax bases of the two notes that Enron contributed to Enron Management, Inc. ($120.84 million plus $67.7 million). *Id.*

252 The shares were offered to the officers in Enron's Human Resources Department because of their "cost-management knowledge and expertise regarding the various pension and deferred compensation liabilities contributed to Enron Management, Inc." *Id.* at 120 n.254.

contingent liabilities would return to Enron.[253] Enron paid Arthur Andersen approximately $500,000 for this transaction.[254]

Project Tanya took place in December, which was the end of Enron's taxable year. It had to be done by the end of the year so as to offset the large capital gain that Enron had for the year.[255] Focusing on two factors that lead to perfection (the amount of the contingent liability approximating the fair market value of the transferred asset and the timing of the sale of the transferee corporation stock), Enron appears to have made the transaction almost perfect. The contingent liabilities totaled $188.515 million and the transferred assets had a value (and basis) of $188.555 million, a difference of only $40,000. This difference is 2/100ths of 1% (.0002) of the total value of the transferred assets ($40,000/$188,555,000). In addition, Enron only held the preferred stock for several weeks before selling it for a $188.515 million capital loss.[256]

Project Tanya is a fairly straightforward example of a transaction that was done for tax avoidance reasons with no business purpose. In fact, according to an Arthur Andersen memo, "the biggest issue to be resolved [is the] business purpose for [Enron Management, Inc.] managing these [contingent liabilities] items."[257] The original transaction contemplated Enron transferring contingent environmental liabilities, but Enron did not have such liabilities.[258] Instead, Enron transferred contingent deferred compensation and post-retirement benefit obligations with the purported business purpose "to provide an incentive for human resource personnel to manage the deferred compensation and post-retirement benefit obligations by allowing the employees to share in the successes that may result from their management efforts."[259]

One way of viewing Enron's purported business purpose is that it was simply providing an alternative or false solution as to the purpose of the transaction. The real purpose was nothing more than tax avoidance, yet Enron claimed incentives for human resource

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[253] *Id.* at 121.

[254] *Id.* at 123. Arthur Anderson promoted the transaction to Enron and also provided a "more likely than not" tax opinion letter. *Id.*

[255] *Id.* at 119.

[256] The Service reviewed Project Tanya in its audit of Enron's 1995 consolidated tax return and allowed the $188.515 million short-term capital loss. *Id.* at 123.

[257] *Id.* at 120 (first alteration in original) (quoting a memo from Robert P. Palmquist of Arthur Andersen to Robert J. Hermann, dated October 27, 1995).

[258] *Id.* at 119.

[259] *Id.* at 120.

personnel to be more efficient. Enron certainly did not try to reduce the claim by making the transaction less perfect. In fact, the next year Enron entered into Project Valor, which was essentially the same type of transaction as Project Tanya.[260] In Project Valor, Enron created a capital loss of $235 million in December 1996, which it again used to offset a large capital gain it had for the year.[261] As a result, rather than reducing the claim, Enron increased the stakes (utilizing the same claim) from a $188 million capital loss in 1995 to a $235 million capital loss in 1996.[262]

C. SC2 Transactions

Another tax-motivated transaction has recently come to light and drawn significant attention: the SC2 transaction.[263] KPMG marketed the SC2 transaction for about eighteen months from March 2000 to September 2001.[264] Generally, in such a transaction, an individual who owns 100% of a profitable S corporation donates shares of the S-corporation stock to a qualifying charity to shelter income and also to take a charitable contribution deduction.[265] The first step of the transaction is to have the S corporation issue non-voting shares of stock to the individual-shareholder that may typically equal nine times the total number of outstanding shares of stock.[266] Thus, if the S corporation has 100 shares of voting stock outstanding, it will issue 900 shares of non-voting stock.[267] The S corporation also issues warrants to the individual-shareholder to purchase a substantial

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[260] *Id.* at 124–28. Arthur Andersen provided a "more likely than not" tax opinion letter and was paid a fee of approximately $100,000. *Id.* at 127.

[261] *Id.* at 124.

[262] At the time of the release of the Joint Committee on Taxation Enron report in February 2003, the Service was still in the process of auditing Enron's 1996 consolidated tax return. *Id.* at 128.

[263] *See* MINORITY STAFF OF THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, U.S. SENATE, U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS, S. Prt. No. 108-34, at 122–25 (2003) [hereinafter PSI REPORT].

SC2 stands for S-Corporation Charitable Contribution Strategy. *See id.* at 6 n.8.

[264] *Id.* at 122.

[265] *Id.* at 122–25.

[266] *Id.* at 122. An S corporation is only permitted to have one class of stock. I.R.C. § 1361(b)(1)(D). A difference in voting rights among the shares of common stock is not treated as a second class of stock. I.R.C. § 1361(c)(4).

[267] *See* PSI REPORT, *supra* note 263, at 122.

number of shares of the S corporation.[268] The S corporation also passes a resolution limiting or suspending distributions of money (or property) for a period of time generally equal to the time that the charity will own the S corporation stock.[269]

The individual-shareholder donates the non-voting shares of stock to a charitable organization that is not taxed on unrelated business income.[270] As a result, the charity owns 90% of stock of the S corporation, and therefore 90% of the taxable income of the S corporation flows through to the charity.[271] The individual-shareholder takes a charitable deduction equal to the fair market value of the non-voting shares, which generally have a low fair market value because of the existence of the warrants and the lack of voting power.[272] At the time of the donation, the S corporation and charity enter into a redemption agreement allowing the charity to require the S corporation to buy back the non-voting shares at fair market value after a specified period of time (for example, two or three years).[273]

During the two or three years that the charity owns the non-voting shares, the S corporation makes no distributions of money.[274] As a result, the charity is allocated 90% of the taxable income of the S corporation, which goes untaxed, even though it receives no distributions of money. After the period specified in the redemption agreement, the charity sells the non-voting shares back to the S corporation for fair market value.[275] The individual-shareholder now owns 100% of the S corporation's outstanding shares. The S corporation then distributes money to the individual-shareholder.[276]

The end result is that 90% of the income of the S corporation is untaxed each year that the charity owns the non-voting shares. The

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[268] *Id.* (giving an example of 7000 warrants).

[269] *Id.*

[270] *Id.* at 122–23. In the report, PSI identified two charitable organizations that had participated in SC2 transactions: Los Angeles Department of Fire and Police Pension System and the Austin Fire Relief and Retirement Fund. *Id.* at 65 & n.206.

[271] I.R.C. § 1377(a)(1).

[272] I.R.C. § 170.

[273] *See* PSI REPORT, *supra* note 263, at 123. The individual-shareholder also pledges to donate an additional amount to the charity in the event that the shares' value decreases. *Id.*

[274] *Id.*

[275] *Id.* If the charity does not want to sell the non-voting shares back to the S corporation, then the individual-shareholder exercises the warrants, substantially diluting the value of the non-voting shares held by the charity. *Id.*

[276] *Id.*

individual-shareholder is taxed at long-term capital gains rate when receiving distributions from the S corporation, thereby deferring and reducing the rate of taxes paid on the income of the S corporation.[277] In addition, the individual-shareholder claims a charitable deduction for the donation of the non-voting shares to the charity in the year the donation was made.

There are several aspects to this transaction that can lead an observer to conclude that it is too perfect. First, the allocation of income between the charity and the individual-shareholder is important to analyze. KPMG allocated 90% of the income of the S corporation to the charity and only 10% of the income to the individual-shareholder. The larger the percentage of taxable income (with no corresponding economic income) allocated to the charity, the more the transaction looks too perfect. A second factor to analyze is the amount of distributions made during the time that the charity is a shareholder. KPMG structured the transaction so that no distributions were made by the S corporation to the charity owning the shares – this is as perfect as it gets. An additional factor is the type of charity that owns the non-voting shares. KPMG singled out specific types of charities in which the individual-shareholder would receive a charitable contribution deduction and the charity would not be taxed on its share of the S corporation's income. This third factor is a perfect result.

SC2 appears to be a straightforward example of a transaction that was done solely for tax avoidance reasons with no business purpose. In fact, KPMG tax professionals were apparently concerned about the lack of a business purpose for the transaction.[278] They asked why an individual-shareholder, who wanted to make a cash donation to a charity, would donate stock to the charity and then have the S corporation buy the stock back instead of simply donating cash to the charity.[279] One commentator who prepared a written statement for the PSI tax shelter hearing also questioned the business purpose for the SC2 transaction, concluding that no business purpose (or economic substance) existed for the transaction and that it was done solely for tax avoidance purposes.[280] The Service has recently issued a

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[277] I.R.C. § 1368 (stating that the distribution of money first reduces the individual-shareholder's basis in the S corporation stock and any excess is treated as gain from the sale or exchange of property).

[278] *See* PSI REPORT, *supra* note 263, at 43–44.

[279] *Id.*

[280] *See* Reuven S. Avi-Yonah, *Michigan Law Professor Submits Testimony to Senate Subpanel Hearing on Tax Shelters*, TAX NOTES TODAY (Nov. 18, 2003)

notice naming the SC2 transaction as a listed transaction.[281]

VII. CONCLUSION

It is not uncommon for clients to tell tax lawyers that they are magicians when it comes to the tax laws. And, in a sense, tax lawyers are magicians in that they are able to structure transactions in a manner to minimize taxes, in many cases, to the complete bewilderment of their clients. Tax lawyers are constantly striving to structure transactions in ways that will withstand scrutiny from both the government and the courts. Experienced and well-informed tax lawyers know, however, not to make a transaction too perfect. If the results are too perfect, then the transaction may be recharacterized by the government or the courts. In fact, for many years continuing until the present day, tax lawyers have interpreted the Supreme Court's decision in *Gregory* as creating or utilizing a business purpose doctrine, an economic substance doctrine, a step transaction doctrine, or even possibly a substance over form doctrine.[282] But perhaps

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(LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 223-47) ("[T]he [SC2] transaction lacks any non-tax economic substance.").

See also George K. Yin, *Thoughts on Tax Shelters*, 102 TAX NOTES 931, 932 (Feb. 9, 2004) ("[C]ompounding the troublesome nature of these [SC2] shelters is their manufactured quality"; in comparing the SC2 transaction to the *Gregory* case, at least there was an underlying economic objective in *Gregory*, implying that no such objective existed in the SC2 transaction); Calvin H. Johnson, *Law Professor Says Government 'Losing the War Against Tax Shelters,'* TAX NOTES TODAY (Nov. 18, 2003) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 224-27) ("Full litigation should show that as a matter of substance over form, the tax exempt shareholder is not the real owner of the 90–99% [of the S corporation] or the income allocated to it and is not the economic owner of the shares.").

[281] *See* I.R.S. Notice 2004-30, 2004-17 I.R.B. 828 (stating that the Service intends to challenge the purported tax benefits of the SC2 transaction based on various theories, including the judicial doctrine of substance over form, as well arguing that the warrants create a second class of stock thereby terminating the corporation's status as an S corporation); *see also* I.R.S. Notice 2004-67, 2004-41 I.R.B. 600 (including the SC2 transaction within the current listed transactions).

[282] *See, e.g.*, BITTKER & EUSTICE, *supra* note 89, ¶ 1.05[2][c], at 1–21 ("The leading case in this area [business purpose doctrine] is *Gregory v. Helvering*, involving a corporate reorganization. . . ."); BITTKER & LOKKEN, *supra* note 106, ¶ 4.3.5, at 4–52 ("The *Gregory* case, for example, is often cited in support of the business purpose and substance-over-form doctrines, but it could be equally validly viewed as a step transaction case; indeed, it is cited in *Minnesota Tea* in support of the 'devious path' formula [of the step transaction doctrine]."); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 241 (1999) ("The economic substance doctrine was, if not formulated, then at least popularized by Learned Hand in the

another doctrine or theory was created in *Gregory* — the Too Perfect Theory. Gregory's transaction was too perfect, thereby leading the Supreme Court to closely scrutinize her transaction and ultimately conclude that only one interpretation explained the transaction: tax avoidance, which was unacceptable to the Supreme Court.

A transaction that achieves results that are less than perfect will generally have a greater chance of surviving government and judicial scrutiny. As a result, Johnsson's advice for magicians to "imperfect" certain tricks that are too perfect, thereby actually perfecting the trick, is equally applicable to tax lawyers in structuring transactions.[283] Some transactions need to be "imperfected" because they are too perfect. Making the transaction less perfect will, in many cases, actually strengthen the transaction so as to survive scrutiny from the government and the courts. In fact, the government and the courts should scrutinize transactions to determine if the results are too perfect. In such instances, the government and the courts should apply the various doctrines (e.g., business purpose, economic substance, or sham transaction doctrines) to determine whether the transaction should be recharacterized.

Second Circuit's 1934 decision of *Gregory v. Helvering*."); Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 866 (1982) (book review) ("One of the cases that opened this path for the Treasury, and also perhaps the case most widely invoked as a source of first principles on form and substance, is *Helvering v. Gregory*.").

[283] *See supra* notes 35–62 and accompanying text. Of course, the client often wants to avoid the expense of making a transaction more "imperfect," thereby leading to tension, at times, between the tax lawyer and the client.