Daniel N. Shaviro, Professor of Law, NYU Law School, *The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance.*

Abstract:

This paper presents the story of *Knetsch v. United States*, 364 U.S. 361 (1960), perhaps the leading case defining impermissible tax avoidance. In *Knetsch*, the taxpayer had purported to borrow $4 million at a 3.5 percent interest rate so he could "invest" this money, with the same counter-party, in deferred annuity bonds that offered only a 2.5 percent return. The rationale for thus losing $40,000 per year before tax ($140,000 incurred minus $100,000 earned) was that, under black-letter tax law at the time of the deal, Knetsch apparently could deduct the interest expense while not currently including the interest earned. With marginal tax rates at the time reaching 90 percent, he figured to save more than $110,000 per year in taxes if the deductions were allowed.

The Supreme Court in *Knetsch* held, however (affirming the courts below), that the transaction was a sham, not involving true indebtedness. Accordingly, not even Knetsch's out-of-pocket cost of $40,000 per year was deductible. While the Court, echoing earlier decisions, agreed that a taxpayer's "legal right … to decrease" his taxes "cannot be doubted," it emphasized the need to ascertain whether "what was done, apart from the tax motive, was the thing which the statute intended." Here, there had only been a "fiction … For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."

Knetsch is an important case even though, by the time it was decided, the specific tax planning ploy at issue had been barred prospectively for six years (since 1954). Part of the case's importance is merely apparent. As Professor Walter Blum predicted at the time, it made "the term 'sham' … more popular than ever in opinion writing … [where] it will be

widely employed … to signify that the taxpayer loses." *Knetsch*'s importance is real as well as apparent, however. It decisively established (in a more broadly applicable and straightforward setting than prior cases, such as the renowned Gregory v. Helvering, 293 U.S. 465 (1935)) that a transaction must meet some minimum standard of economic substance, business purpose, and/or potential for pre-tax profit if it is to be respected for tax purposes. This set of related requirements has come over time to play an ever greater role in tax planning, in tax audit and litigation controversy, and in tax policy debates. For example, it has been at center stage in the ongoing judicial and policy disputes concerning corporate tax shelters.

The paper has two main emphases. First, it explores in detail the actual history of the *Knetsch* transaction and litigation. Second, it examines the evolution of anti-tax avoidance doctrine, starting with *Gregory* and proceeding through the present, with accompanying discussion of the rationale for anti-tax avoidance doctrine.

Simply as a story, *Knetsch* has much to offer. The transactional background provides a glimpse of the forgotten world of aggressive tax planning just at the point when, in the aftermath of World War II, the income tax had newly morphed from a "class tax" into a "mass tax." The effective democratization of the income tax meant that ever more people without direct access to sophisticated counsel would be eager to find ways to reduce their tax liabilities (especially given the era's whopping marginal rates). It is instructive to see how, at least in this instance, the shelter entrepreneurs operated, by obtaining and then disseminating their own favorable IRS private letter rulings (at the time unpublished). Unfortunately for the life expectancy of their business, however, they could not reach a mass audience without alerting the IRS to what they were doing.

Nor is the history of the *Knetsch* litigation devoid of what Gilbert and Sullivan termed "innocent merriment." The outcome may have been influenced by what seem (admittedly with hindsight) to have been dubious tactical choices on the taxpayer's side. Knetsch's lawyers emphasized one main argument: that Congress, by deciding to bar the ploy only as to post-effective date contracts, had affirmatively legislated that the deductions were allowable indefinitely as to pre-effective date contracts, wholly without regard to the actual pre-effective date state of the law. In other words, prior law had been amended (if necessary) in the taxpayer's favor despite the total absence of supporting evidence for this proposition apart from the effective date itself. Opposing counsel and judges kept misunderstanding this argument as the more conventional one that enactment of the bar on interest deductions supported an inference about the state of prior law, only to be corrected each time by Knetsch's counsel.

The principal Supreme Court amicus brief filed in Knetsch's favor (by prominent attorneys who represented other taxpayers in parallel litigation) was scarcely less eccentric. It denounced the IRS for determining that taxpayers who had personally received favorable private letter rulings on the deals – but no others – could deduct their out-of-pocket transaction costs. (The rulings were otherwise revoked.) The amicus brief argued that this "discrimination" between taxpayers who happened to "have letters with their names at the top" and all other taxpayers was "monstrous," and indeed morally equivalent to racism.

In reviewing the broader history of anti-tax avoidance doctrine, the article mainly examines *Gregory* and two subsequent leading cases: Goldstein v. Commissioner, 364 F.2d (2d Cir. 1966, *cert. denied*, 385 U.S. 1005 (1967), and Frank Lyon Co. v. United States, 435 U.S. 561 (1978)). It then traces the doctrine forward to the present day, and briefly considers the apparent fork in the road that is suggested by recent courts' divergent approaches in deciding corporate tax shelter cases.

The paper also sheds light on the rationale (in the author's view) for anti-tax avoidance doctrine, by noting that Knetsch clearly would have won had he simply accepted a risky rather than a fixed return. For example, had the deferred annuity bonds paid double or nothing ($200,000 or zero a year with equal probability, rather than a certain $100,000), he would have been able to show that the transaction was no mere fiction and offered something of substance beyond a tax deduction. This raises the question of why taxpayers should be treated more favorably when they accept downside economic risks than when they do not, given that the government (and all other taxpayers) derive absolutely no benefit from inducing them to accept these risks. The answer, the paper suggests, is that the risk requirement, along with other aspects of the economic substance doctrine, is simply an arbitrary friction (albeit one well worth imposing) that fortuitously serves to discourage aggressive tax planning. Similarly, if a kindergarten teacher puts the cookie jar on a high shelf, she probably does not mean to encourage her five-year olds to start stacking up boxes and standing on chairs. Rather, she may simply have figured that this way fewer of them will reach the cookies when she is not looking.