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A Principal Purpose: There Can Be Only One

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In this article, Willis explores the confusion created by the different interpretations of the principal purpose of tax avoidance standard.

Introduction

The principal purpose of tax avoidance standard (the standard)[1] was seemingly well understood by all, at least until recently. The historic interpretation of the standard is consistent with the government's long-standing announced policy of eliminating confusing tax rules.[2] Nonetheless, in recent regulations the IRS appears to present paradoxical interpretations of the standard, contrary to the government's stated policies on drafting regulations and common-sense meanings. The principal purpose of this article is to explain why the IRS should adhere to the Supreme Court's conclusion that the term "principal" is synonymous with "of first importance."

Principal Purpose

The Eleventh Circuit recently said the article "a" is "'used as a function word before most singular nouns other than proper and mass nouns when the individual in question is undetermined, unidentified, or unspecified.'"[3] The definite article "the" is commonly used before a specified singular noun (for example, *the* Supreme Court of the United States). The indefinite articles "a," and "an," are more typically reserved for nouns that are unspecified (for example, *a* regulation). As the court said in *In re Dow Corning Corp.*,[4] "'it would be extending liberality to an unwarrantable length to confound the articles "a" and "the." The most unlettered persons understand that "a" is indefinite, but "the" refers to a certain object.' *Black's Law Dictionary* (5th ed. 1979)."

In *Malat v. Riddell*,[5] the Supreme Court held that the term "primarily" as used in section 1221(1) means "of first importance" or "principally." Congress understood this when creating the predecessor to section 269. Addressing the statutory phrase "the principal purpose," the 1943 Senate report said that "the section should be operative only if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose."[6] Consistent with that stated intent, the IRS promulgated reg.

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[1]*See, e.g.*, section 269(a) ("*the* principal purpose"); section 357(b)(1) ("*the* principal purpose"); reg. section 1.304-4 ("*a* principal purpose"); reg. section 1.305-5(b)(2)(ii)(b) ("*a* principal purpose"); and reg. section 1.367(a)-3(c)(4)(ii) ("*a* principal purpose"). (Emphases added.)

[2]In September 1993 President Clinton signed Executive Order 12866 requiring that each agency "draft its regulations to be simple and easy to understand, with the goal of minimizing the potential for uncertainty and litigation arising from such uncertainty." 58 F.R. 51735. The following year Treasury said that "consistent with EO 12866 . . . the goal of the IRS is to make the regulations practical and user-friendly by providing guidance that is as clear and simple as possible." Treasury Department, "Regulatory Plan for Fiscal Year 1995" (Nov. 14, 1994).

[3]*Driscoll v. Commissioner*, 669 F.3d 1309 (11th Cir. 2012), *rev'g and remanding* 135 T.C. 557 (2010) (quoting from *Webster's Third New International Dictionary* (1993)).

[4]237 B.R. 380 (Bankr. E.D. Mich. 1999).

[5]383 U.S. 569 (1966).

[6]S. Rep. No. 78-627, at 59 (1943). *See also VGS Corp. v. Commissioner*, 68 T.C. 563 (1977) ("From the record as a whole we can only conclude that *the primary purpose* of the acquisition of VGS by New Southland and its shareholders was their belief that VGS would become a highly profitable public utility. Accordingly, we hold that *the principal purpose* of the acquisition was not the avoidance or evasion of Federal income tax and, therefore, section 269 does not operate to deny the carryover of the VGS net operating losses and investment credit" (emphasis added)).

section 1.269-3(a), which says: ''If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.''[7]

The Supreme Court requires that when applying principles of statutory construction, it should first be determined whether the language at issue has a plain and unambiguous meaning.[8] The plain meanings of ''a,'' ''the,'' and ''principal'' should be clear. So, can an indefinite article modify the commonsense meaning of principal purpose? Historically, the courts have agreed that the answer is no; however, some recent cases appear to have allowed the indefinite article ''a'' to redefine the standard. The IRS has similarly attempted to change the standard in recent regulations despite *Riddell* and many other decisions.

There Can Be Only One Principal Purpose

Several cases addressing the meaning of the phrase ''a principal purpose'' indicate that it is synonymous with ''the principal purpose.'' In more recent legislation, Congress appears to have used ''one of its'' interchangeably with ''a'' in drafting antiavoidance rules under which the principal purpose standard can apply to a series of transactions.[9] Because the word ''principal'' allows only for a singular item, ''one of its'' principal purposes must be read in its plural form (that is, transactions pursuant to a plan that each have a principal purpose and collectively have principal purposes).[10] Thus, ''one of its'' and ''a'' should be synonymous when used in the context of the standard in a single transaction.

In *Dittler Bros. Inc. v. Commissioner*,[11] the Tax Court interpreted the former section 367 rule requiring that the parties to an expatriating transfer of property establish to the IRS that the exchange was not ''in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes'':

> Although we have never interpreted the term principal purpose within the context of section 367, nonetheless, we have interpreted the meaning of principal purpose in a somewhat analogous provision under section 269. . . . In contrast to section 269, section 367 speaks in terms of a plan having as one of its principal purposes the avoidance of Federal income taxes. . . . We believe that the term ''principal purpose'' should be construed in accordance with its ordinary meaning. Such a rule of statutory construction has been endorsed by the Supreme Court. *Malat v. Riddell*, 383 U.S. 569, 571 (1966). Webster's New Collegiate Dictionary defines ''principal'' as ''first in rank, authority, importance, or degree.'' Thus, the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its ''first-in-importance'' purposes the avoidance of Federal income taxes.[12] [Emphasis added.]

Therefore, reference to ''one of its principal purposes'' still requires the tested transaction to have a primary purpose of tax avoidance. The Fifth Circuit affirmed the Tax Court's holding in *Dittler*.[13]

Further, in *Pitcher v. Commissioner*,[14] the Tax Court said:

> As we held in *Dittler* . . . the proper test for whether tax avoidance was *a principal purpose*

[7]*See Bobsee Corp. v. United States*, 411 F.2d 231 (5th Cir. 1969) (stating with respect to section 269 that ''our Green Light decision heeded the policy and the actual language of the section rather than the abortive attempt at definition in the Senate committee report. As we view the operation of the statute, there are only two relevant classes of purposes: tax-avoidance and non-tax-avoidance; the statute applies only if the former class exceeds the latter'').

[8]*See Barnhart v. Sigmon Coal Co. Inc.*, 534 U.S. 438 (2002), *citing Robinson v. Shell Oil Co.*, 519 U.S. 337 (1997), *citing United States v. Ron Pair Enterprises Inc.*, 489 U.S. 235 (1998). *See also Connecticut National Bank v. Germain*, 503 U.S. 249, 253-254 (1992) (''We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there'').

[9]*See, e.g.*, section 954(h)(7), which states that ''there shall be disregarded any item of income, gain, loss, or deduction with respect to any transaction or series of transactions *one of the principal purposes* of which is qualifying income or gain for the exclusion under this section, including any transaction or series of transactions *a principal purpose* of which is the acceleration or deferral of any item in order to claim the benefits of such exclusion through the application of this subsection'' (emphasis added); *see also* section 877(f), which provides as ''one of its principal purposes the avoidance of taxes'' and section 306(b)(4), which requires in certain instances that a transaction is ''not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.''

[10]*Supra* note 7.

[11]72 T.C. 896 (1979).

[12]*See also Hershey Food Corp. v. Commissioner*, 76 T.C. 312 (1981); *Kaiser Aluminum & Chemical Corp. v. Commissioner*, 76 T.C. 325 (1981); and *Girli & Co. Inc. v. Commissioner*, 668 F.2d 691 (2d Cir. 1982). For a thorough discussion of *Dittler* and the historic uncertainty of the use of the phrase ''principal purpose'' in section 367, see E.C. Lashbrooke Jr., ''Recapture of Past Foreign Branch Losses on Transfer of Branch Assets to a Foreign Corporation,'' 4 *Nw. J. Int'l L. & Bus*. 359 (1982) (''Congress has not provided any statutory guidance in the Code on what constitutes a plan having the avoidance of federal income taxes as one of its principal purposes, and the IRS and the courts have provided disparate guidelines''). *See also* Steven W. McLeighton, ''Complex Rules Burden Outbound Transfers of Tangibles and Intangibles,'' *The Tax Adviser* (1997).

[13]642 F.2d 1211 (5th Cir. 1981).

[14]84 T.C. 85 (1985).

> is not, as respondent urges, whether a tax-avoidance purpose ''figures prominently as a reason for the plan,'' or whether business reasons are ''so overwhelming as to make tax avoidance a negligible concern,'' but rather whether the transaction had ''as one of its 'first-in-importance' purposes the avoidance of Federal income taxes.'' [Emphasis added.]

Despite the choice of words, ''one of its principal purposes'' still requires the tested transaction to have a single primary purpose of tax avoidance, which is why the Tax Court stated ''we think respondent is grasping at straws in an effort to persuade us to hold that tax avoidance was one of the principal purposes of the exchange involved herein.''[15]

Following the holding in *Dittler*, Congress removed the principal purpose of tax avoidance standard from section 367 and adopted statutory rules that provided taxpayers greater certainty and more objective standards (for example, the active trade or business test). The 1984 blue book addressed the Tax Court's interpretation of principal purpose in *Dittler*, stating:

> The prior law provisions in section 367(a) applied only to transfers pursuant to ''a plan having as one of its principal purposes the avoidance of Federal income taxes.'' Interpreting this provision in *Dittler Bros.*, the Tax Court required that a tax avoidance purpose for a transfer be greater in importance than any business purpose before section 367(a) was applied to prevent a tax-free outbound transfer of property.[16]

In *Furstenberg v. Commissioner*,[17] the Tax Court interpreted ''one of its principal purposes'' in section 877,[18] which can affect the taxation of expatriated citizens. Citing *Dittler*, the court said, ''We believe that the term 'principal purpose' should be construed in accordance with its ordinary meaning. Such a rule of statutory construction has been endorsed by the Supreme Court. *Malat v. Riddell*, 383 U.S. 569, 571 (1966).''

The Joint Committee on Taxation has cited both *Dittler* and *Furstenberg* for the proposition that the IRS will have more difficulty in showing tax avoidance was one of a transaction's principal purposes under a ''first-in-importance'' standard.[19] Moreover, the courts continue to rely on the *Riddell* standard. In *Commissioner v. Soliman*,[20] the Supreme Court again explained that ''both the commonsense and dictionary meanings of 'principal' demonstrate that this constitutes the most important or significant.''[21]

In the section 1248 context, the Tax Court has looked to the well-recognized standard applied in sections 269, 367, and 1221, as discussed above, for defining the word ''principally.'' Section 1248(e) applies section 1248(a) to some situations when a domestic corporation was ''formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations.'' In explaining its conclusion, the Tax Court in *Teller v. Commissioner*[22] stated:

> While no cases have specifically addressed the meaning to be afforded to the term ''principally'' within the context of section 1248, that term has been defined in other contexts. The phrase ''principal purpose'' is used in section 269 and explained in section 1.269-3(a), Income Tax Regs., as being a purpose that exceeds, in importance, any other purpose. Additionally, the Supreme Court has defined

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[15]The *Pitcher* court explained that in the section 351 transaction ''YPI clearly needed capital in order to continue profitable operations, and the management of YPI decided that a public offering was the optimal approach. A foreign offering avoided the time and money involved with the SEC registration needed for a domestic offering. Management chose Canada due to prior dealings with Canadian investors, geographic proximity, and a favorable market outlook.''

[16]Joint Committee on Taxation, ''General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,'' JCS-41-84 (Dec. 31, 1984).

[17]83 T.C. 755 (1984).

[18]For a thorough discussion of this case and the historic uncertainty of the use of ''principal purpose'' in section 877, see Emmanuelle Lee, Comment, ''Will the Reunification of U.S. Citizenship Still Be Worth Some Tax Savings — An Analysis of the Recent Reform on the Taxation of Expatriates,'' 37 *Santa Clara L. Rev*. 1063 (1997). *See also* LTR 200403047 (concluding ''that A will not be treated under section 877(a)(2) as having the avoidance of U.S. taxes as *a* principal purpose for her expatriation because the information submitted clearly establishes the lack of a principal purpose to avoid taxes under subtitle A or B of the Code'' (emphasis added)).

(Footnote continued in next column.)

[19]*See also* JCT, ''Issues Presented by Proposals to Modify the Tax Treatment of Expatriation,'' JCS-17-95, Appendix G (June 1, 1995). ''In *Furstenberg v. Comm'r*, 83 T.C. 755 (1984), the Tax Court made it easier for the taxpayer to establish lack of tax avoidance purpose (and, therefore, more difficult for the IRS to establish tax motivation). In 1975, Cecil von Furstenberg saved over $5 million in U.S. taxes by relinquishing her U.S. citizenship. In a 1984 decision, the Tax Court, adopting the principal purpose of tax avoidance standard set forth in *Dittler Bros., Inc. v. Commissioner*, 72 T.C. 896 (1979), found that Ms. Furstenberg was not subject to U.S. tax under section 877 because tax avoidance was not one of her 'first-in-importance' purposes'').

[20]506 U.S. 168 (1993).

[21]The Court was interpreting the reference to ''principal place of business'' in section 280A(c)(1)(A). Citing *Riddell*, the Court said it ''looks to words' 'ordinary, everyday senses' in interpreting a revenue statute's meaning.'' *Id.*

[22]T.C. Memo. 1992-402.

> the term ''primarily'' in connection with section 1221 as ''principally'' or ''of first importance.'' *Malat v. Riddell*, 383 U.S. 569 (1966). Although the term ''principally'' is used in *Malat v. Riddell*, *supra*, in a manner that is correlative or reciprocal to its use in section 1248, it may be considered as an equivalency in this setting. On numerous occasions we have interpreted statutory language by reference to the meaning of a word in its ordinary everyday sense. We accord the everyday meaning to the term ''principally'' as being of first importance. One may reasonably deduce from other usages of the term ''principal'' that it is not equivalent to the term ''substantial.''[23]

The IRS has at times respected the Supreme Court's conclusion in *Riddell* when interpreting ''a principal purpose.'' For example, when contemplating the design of section 954 regulations, the IRS opted to use ''a significant purpose'' instead of ''a principal purpose.'' In making that decision, the IRS said: ''Thus, in line with the decision in [*Riddell*], a distinction is drawn between *a significant* purpose and *a* principal purpose (or purpose of first importance). The former is clearly a lesser standard''[24] (emphasis added).

More Than One Principal Purpose?

In apparent contrast to the decisions discussed above is the Seventh Circuit's interpretation of ''a principal purpose'' under 29 U.S.C. section 1392(c) in *Santa Fe Pacific Corp. v. Central States, Southeast and Southwest Areas Pension Fund*,[25] a labor law case governed by ERISA rules:

> The imposition of withdrawal liability in a sale of business situation requires only that a principal purpose of the sale be to escape withdrawal liability. It needn't be the only purpose; *it need only have been one of the factors that weighed heavily in the seller's thinking*. We can find no decisions discussing situations in which there is more than one principal (major, weighty, salient, important) purpose, but we would be doing violence to the language and the purpose of the statute if we read ''a principal'' as ''the principal.'' [Emphasis added.]

Therefore, according to the Seventh Circuit, taxpayers must demonstrate in the context of 29 U.S.C. section 1392(c) that avoidance of a withdrawal liability was not a major, salient, or important factor for undertaking the transaction. The IRS has attempted to rely on the *Santa Fe* standard when interpreting ''a principal purpose'' as used in a tax regulation,[26] contrary to its prior interpretation, which was based on a Supreme Court decision.[27]

In *Teamsters Joint Council v. Empire Beef Co.*,[28] on remand from the Fourth Circuit, the district court similarly examined ''a principal purpose'' under 29 U.S.C. section 1392. It observed:

> Section 1392(c) requires only that ''*a* principal purpose'' (as opposed to ''*the* principal purpose'') of the transaction be to evade or avoid withdrawal liability. Plaintiffs read the word ''principal'' out of the statute altogether. ''The clear import of 'a principal' is to let the employer off the hook *even if one of his purposes was to beat withdrawal liability*, provided however that it was a minor, subordinate purpose.'' *Santa Fe Pac. Corp. v. Cent. States Se. & Sw. Areas Pension Fund*, 22 F.3d 725, 727 (7th Cir. 1994) (emphasis added). . . . Section 1392(c) does not apply unless evading withdrawal liability was ''one of the factors that *weighed heavily* in the [employer's] thinking.'' *Id.* [Emphasis added.]

The court went on to determine that ''a principal purpose'' of the agreement in question was not to avoid the withdrawal liability but was ''merely a collateral purpose.''[29]

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[23]*See also Jefferson v. Commissioner*, 50 T.C. 963, 968 (1968) (citing *Riddell* for the conclusion that individuals may take losses for transactions entered into ''primarily'' for profit under section 165 because of its ''ordinary and everyday meaning, viz, 'of first importance'").

[24]Notice of Proposed Rulemaking (Mar. 8, 1972). *But see* 53 F.R. 27489 (providing, in direct conflict with the U.S. Supreme Court's decision in *Riddell* that ''a principal purpose need not be the purpose of first importance'').

[25]22 F.3d 725 (7th Cir. 1994).

[26]*See also* LTR 9509035, relying on *Santa Fe*, in which the IRS states:

> Section 1.148-10(e) provides that if an issuer enters into a transaction for *a principal purpose* of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148. . . . Although the City represents that it prepaid the City Liability and issued the BANs because of the savings available from the prepayment of the City Liability, *the issue is* not *whether the City had* compelling *reasons independent of the opportunity to earn arbitrage; it is whether the opportunity to earn arbitrage is one of the principal purposes* of issuing the Proposed Bonds . . . [i.e.,] one of the factors that weighed heavily in the seller's thinking. [Emphasis added.]

[27]*Supra* note 24.

[28]No. 3:08-cv-340 (E.D. Va. 2011).

[29]*See also City of Columbus, Ohio v. Commissioner*, 106 T.C. 325 (1996), *vacated and remanded on other grounds*, 112 F.3d 1201 (D.C. Cir. 1997), in which the Tax Court relied on *Santa Fe* in examining reg. section 1.148-1(b). The regulation provides that investment-type property includes ''a prepayment for property or services . . . if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made

(Footnote continued on next page.)

Santa Fe and *Teamsters* are not tax cases and do not interpret provisions of the IRC or any tax regulations. Further, the logic of their conclusions has been rejected in favor of the reasoning found in *Riddell*. In *Sun Capital Partners v. New England Teamsters*, No. 1:10-cv-10921-DPW, 2012 WL 5197117 (D. Mass. Oct. 18, 2012), the federal district court in Massachusetts explained, with respect to 29 U.S.C section 1392(c), that:

> The adjective ''principal'' means ''most important, consequential, or influential.'' *Webster's Third New Int'l Dictionary* 1802 (1986). The noun ''purpose'' means ''an object, effect, or result aimed at, intended, or attained.'' *Id.* at 1847. The noun ''transaction'' means ''an act, process, or instance of transacting,'' and the verb ''transact'' means ''to prosecute negotiations'' or ''carry on business.'' *Id.* at 2425. The verb ''evade'' means ''to manage to avoid the performance of (an obligation)'' or ''to get around (an intellectual obstacle).'' *Id.* at 786. The verb ''avoid'' means ''to keep away from'' or ''to prevent the occurrence or effectiveness of.'' *Id.* at 151. Thus, under the plain meaning of the text, a person or entity violates section 1392(c) when it carries out a business transaction whose *most important goal* is getting around or preventing withdrawal liability.'' [Emphasis added.]

Conclusion

The Supreme Court's holding in *Riddell* suggests that any standard using ''principal purpose'' is met only when the purpose to evade tax exceeds any other purpose. Relying on *Riddell*, courts have held in the section 269, 367, 1248, and 877 contexts that a principal purpose of tax avoidance standard is satisfied only when the avoidance of tax outranks any other purpose. Conversely, there are 29 U.S.C. section 1392(c) ERISA authorities that support the proposition that a principal purpose need only have been one of the factors that weighed heavily in the taxpayer's thinking. In the end, we are left with the opposing logic of *Dittler* and *Santa Fe* — the former being based on the plain meaning of the word ''principal'' while the latter is based on the meaning of ''a,'' an indefinite article that effectively means nothing.

I believe a plain and common-sense reading of the principal purpose of the tax avoidance standard is clear and requires no further scrutiny regardless of the article preceding it. The courts weighed in and there can be only one principal purpose for any given transaction examined under the standard. Consistent with its stated policy, Treasury should recognize that sound administration requires clear, understandable regulations. If a principal purpose of tax avoidance standard does not suffice, the IRS should use a different standard, for example ''a substantial purpose,''[30] if that standard is consistent with the congressional intent reflected in the statute. The application of either standard in tax penalty provisions is generally construed in favor of taxpayers, as we'll soon discuss.

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until the time payment otherwise would be made.'' One of the city's principal purposes for the 1994 transaction was to ''receive an investment return,'' and there was no question that the city's purpose in prepaying the city obligation was to profit. However, the Tax Court said:

> The fact that [the city] would profit from the discount if the interest on the proposed bonds were taxable does not negate the fact that such profit would be greater if such interest was exempt from tax under section 103(a). Nor does the fact that the issuance of taxable bonds would also be advantageous turn the purpose of the proposed issue on a nontaxable basis from a principal to a subsidiary purpose. Such a view would emasculate the arbitrage restrictions of section 148 whenever a financial advantage of a bond issue could be obtained whether the interest on the bonds was taxable or nontaxable. *In this connection, we think it significant that the regulation speaks in terms of "a" and not "the" principal purpose. Santa Fe Pac. Corp. v. Cent. States, Se. & Sw. Areas Pension Fund*, 22 F.3d 725, 729-30 (7th Cir. 1994). [Emphasis added.]

[30] *See* section 7701(o)(1)(B) (requiring ''a substantial purpose'' other than tax in some instances).