taxanalysts viewpoints

Save the Economic Substance Doctrine From Congress

By Dennis J. Ventry Jr.

Dennis J. Ventry Jr. is an assistant professor of law at American University Washington College of Law.

Introduction

Last month the government won the latest in a string of court decisions involving abusive tax avoidance.[1] In a sharp rebuke to the taxpayer's position, the Seventh Circuit found that the transaction in question — which generated a $3.6 million tax loss from an investment in which the taxpayer had $6,000 at risk — lacked economic substance and bestowed unwarranted tax benefits on both the taxpayer and the shelter organizer, ''the sort of thing that the IRS frowns on.''[2] The court with precision and relative disgust described how the organizer, disgraced tax lawyer Paul Daugerdas, issued opinion letters while at Jenkens & Gilchrist that ''led to the firm's demise'' and forced it to pay out more than $75 million in penalties.[3]

Although lacking the scorn of the Seventh Circuit,[4] other federal courts have recently invalidated abusive transactions by relying heavily on the economic substance doctrine. Government victories in 2006 included four appellate court wins[5] and, in 2007, three favorable district court decisions,[6] two victories in the Court of Federal Claims,[7] and two U.S. Supreme Court denials of certiorari.[8] Pro-government decisions from a few years earlier relied just as effectively on the economic substance doctrine to strike down abusive transactions.[9] But the recent decisions explicitly ''reaffirm the vitality of the economic substance doctrine''[10] and underscore that literal compliance with statutory tax provisions is simply not enough to secure tax benefits.[11]

Despite the antishelter success of the judicially created economic substance doctrine, Congress is preparing to straitjacket the doctrine by codifying it under the Internal Revenue Code.[12] Codification is a *terrible* idea. Reducing

---

[1] *Cemco Investors, LLC and Forest Chartered Holdings, Ltd. v. United States*, No. 07-2220, *Doc 2008-2695*, *2008 TNT 27-8* (7th Cir. 2008).

[2] *Id.* at 3.

[3] *Id.* at 1. ''Like many tax shelters it was complex in detail but simple in principle.'' *Id.*

[4] *But see* a 2007 opinion from the Court of Federal Claims in which the court invalidated a tax shelter purchased by H.J. Heinz Co.:

> A Heinz promotion from the late 1950s and early 1960s touted its tomato ketchup by stating, ''It's Red Magic Time!'' But no amount of magic, red or otherwise, can hide the meat of the transactions in question, the connective tissues and gristle of which have been revealed by the multitined substance over form doctrine. *Sans sa sauce*, it becomes plain that plaintiffs' transaction simply was not ''the thing which the statute intended.''

H.J. Heinz Co. v. United States, 76 Fed. Cl. 570, 593, *Doc 2007-12834*, *2007 TNT 103-16* (2007) (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)).

[5] *See Coltec Industries, Inc. v. United States*, 454 F.3d 1340, *Doc 2006-13276*, *2006 TNT 134-10* (Fed. Cir. 2006); *TIFD III-E, Inc. (Castle Harbour) v. United States*, 459 F.3d 220, *Doc 2006-14691*, *2006 TNT 150-8* (2d Cir. 2006); *Black & Decker Corp. v. United States*, 436 F.3d 431, *Doc 2006-2133*, *2006 TNT 23-8* (4th Cir. 2006); *Dow Chemical Co. v. United States*, 435 F.3d 594, *Doc 2006-1308*, *2006 TNT 15-11* (6th Cir. 2006).

[6] *See Cemco Investors, LLC v. United States*, No. 04-C-8211, *Doc 2007-7960*, *2007 TNT 61-13* (N.D. Ill. 2007); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F. Supp.2d 885, *Doc 2007-2603*, *2007 TNT 22-9* (D.C.E.D. Tex. 2007); *BB&T Corp. v. United States*, No. 1:04CV00941, *Doc 2007-446*, *2007 TNT 4-19* (M.D.N.C. 2007).

[7] *See Jade Trading LLC v. United States*, No 03-2164T, *Doc 2007-28072*, *2007 TNT 248-5* (Fed. Cl. 2007); *H.J. Heinz Co., supra* note 4.

[8] *See Dow Chemical Co. v. United States*, 127 Sup. Ct. 1251, *cert. denied* (Feb. 20, 2007); *Coltec Industries Inc. v. United States*, 127 Sup. Ct. 1261, *cert. denied* (Feb. 20, 2007).

[9] *See, e.g.*, *Boca Investerings Partnership v. United States*, 314 F.3d 625, *Doc 2003-1175*, *2003 TNT 8-7* (D.C. Cir. 2003); *ASA Investerings v. Commissioner*, 201 F.3d 505, *Doc 2000-3346*, *2000 TNT 23-11* (D.C. Cir. 2000); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 294, *Doc 1999-33731*, *1999 TNT 202-6* (1999); *Saba Partnership v. Commissioner*, 78 T.C.M. 684, 713-715, *Doc 1999-34675*, *1999 TNT 208-8* (1999), *vacated and remanded in light of ASA Investerings*, *supra*, *Saba Partnership v. Commissioner*, 273 F.3d 1135, *Doc 2001-31675*, *2001 TNT 249-5* (D.C. Cir. 2001), at which point the Tax Court once again invalidated the transaction under the economic substance doctrine, this time using the principles articulated in *ASA Investerings*, *Saba Partnership v. Commissioner*, T.C. Memo. 2003-31, *Doc 2003-3910*, *2003 TNT 29-19* (2003); *ACM Partnership*, T.C. Memo. 1997-115, *aff'd in part, rev'd in part, and remanded*, 157 F.3d 231, *Doc 98-31128*, *98 TNT 202-7* (3d Cir. 1998).

[10] *Jade Trading LLC*, *supra* note 7, at 2.

[11] *See also* Robert Willens, ''Economic Substance' Doctrine Denies Tax Benefits,'' *Tax Notes*, Jan. 28, 2008, p. 537, *Doc 2008-494*, *2008 TNT 19-40* (drawing a similar conclusion from recent economic substance cases).

[12] *See* H.R. 2419, Farm, Nutrition, and Bioenergy Act of 2007, section 12521.

the doctrine to an inelastic administrative rule would sap its power and lead to more rather than less abuse, by providing clever tax planners an opportunity to occupy and manipulate the statutory line between permissible and impermissible behavior. The power of the doctrine lies in its ability to adapt to new and unforeseen tax planning strategies. Malleable standards are particularly important in the context of tax law, where the law itself is often ambiguous and where application of fact to law contains countless outcomes, such that determining the ''right'' answer is an inherently uncertain proposition. A rigid rule would provide opportunity rather than certainty, and it would foster overaggressive tax planning. The economic substance doctrine often acts as the last line of defense against abusive tax avoidance, and its facts and circumstances analysis is better left in the hands of judges than legislative drafters.

Rules vs. Standards

A judicious mix of rules and standards is essential to effective tax enforcement. Rules provide certainty of outcome as well as lower compliance costs, and they enhance due process and fair treatment. Standards, for their part, breathe life into rules, adding context, intent, and purpose to text and language. In other words, standards provide coherence to a bunch of otherwise independent rules by giving them overarching purpose. Reliance on rules alone would require that legislators, regulators, and legislative drafters predict all potential uses and abuses of each and every tax provision, both in isolation and in combination with each other.[13] Even if policymakers were somehow equipped with the power to see into the future, reliance on rules alone would yield an unduly complex and distortive regime. Standards by themselves are not the solution either. The flexibility of standards can be a virtue in assisting regulators and courts in responding to unpredictable taxpayer behavior. But that flexibility can also produce increased uncertainty, higher compliance costs, and behavioral distortions. Moreover, standards can easily produce a one-sided system in favor of the government, with tax authorities administering and enforcing the law with wide and arbitrary discretion.

Coordinated use of comprehensible rules and antiabuse standards holds the promise of achieving optimal tax compliance with lower costs for taxpayers, tax regulators, and the tax system.[14] A balanced compliment of rules and standards allows tax authorities to enunciate general principles and goals underlying the rules and to rely on tax professionals and taxpayers to implement and fulfill those goals. In recent cases, courts have scrutinized tax practitioners' alleged compliance with legal rules in light of the underlying standards, examining applicable ethical standards as well as common-law doctrines such as economic substance, business purpose, and substance over form.[15] Complying with the literal terms of a statute or other legal rule was not necessarily enough in those cases; courts required practitioners to show compliance with the purpose of statutory language and respect for the coherence of the system.

Without standards to overlay rules, tax planning would run amok. Bright-line rules encourage literalist interpretations of the law and a myopic focus on form over substance. Faced with a bright-line rule, some tax advisers view it as their job to obscure and expand the line.[16] The ''ultimate question'' in tax practice, law professor James Eustice has noted, is ''where 'the line' is between acceptable tax planning and unacceptable overreaching, and, equally important, how clear that line should be.''[17] Tax shelters, practitioner-scholar Peter Canellos has said, although perhaps on the legal side of the line, ''almost always ignore the underlying purpose of the law.''[18] Standards provide a check on unadulterated tax reduction, and they offer the government, courts, and aggrieved taxpayers powerful weapons to wield against overreaching practitioners.

Antiabuse Rules and Judicial Doctrines

In recent years, the government has implemented a standards-based approach by adopting various antiabuse rules. These ''rules'' operate more like standards. Typically promulgated by regulation but occasionally embedded directly in a statute, they override otherwise applicable legal rules when taxpayers enter into aggressive tax avoidance transactions deemed to violate the purposes of the statute or regulation. A transaction can

---

[13]Indeed, given the infinite transactional permutations for tax planning, relying on rules alone would be futile and even irresponsible. *See* David P. Hariton, ''When and How Should the Economic Substance Doctrine Be Applied?'' 60 *Tax L. Rev*. 29, 33 (2006) (writing that ''no government can foresee, let alone draft, rules that produce the 'right' tax results under every conceivable permutation of facts that can be constructed by taxpayers in an increasingly complex financial world'').

[14]For rules versus standards in tax law, see David A. Weisbach, ''Formalism in the Tax Law,'' 66 *Chi. L. Rev*. 860 (1999); Louis Kaplow, ''Rules Versus Standards: An Economic Analysis,'' 42 *Duke L.J*. 557 (1992).

[15]This scrutiny is evident in the tax shelter cases cited above (*supra* notes 1, 5-9) as well as the tax shelter malpractice cases that flowed from the most recent government attack on abusive tax avoidance. *See, e.g.*, *Swartz v. KPMG LLP*, 476 F.3d 755, *Doc 2007-3660*, *2007 TNT 30-11* (9th Cir. 2007) (examining a legal opinion concluding that a BLIPS transaction was more likely than not valid); *Hoehn Family LLC v. PriceWaterhouseCoopers LLP*, 2007 U.S. Dist. LEXIS 23422, *Doc 2007-8537*, *2007 TNT 65-12* (W.D. Mo. 2007) (examining a legal opinion concluding that a FLIP transaction was more likely than not valid); *Denney v. Jenkens & Gilchrist*, 340 F. Supp.2d 338, *Doc 2004-11523*, *2004 TNT 105-7* (S.D.N.Y. 2004) (examining a legal opinion concluding that a COBRA transaction was more likely than not valid).

[16]*See* Hariton, ''Sorting Out the Tangle of Economic Substance,'' 52 *Tax Law*. 235, 238 (1999) (stating that some lawyers' ''reverence for our objective method of determining tax liabilities approaches something like religious fervor (or more cynically, they recognize that results based to the maximum extent on the unadulterated application of objective rules tend to aggrandize both the power and the pocketbook of the tax practitioner)'').

[17]James S. Eustice, ''Abusive Corporate Tax Shelters: Old 'Brine' in New Bottles,'' 55 *Tax L. Rev*. 135, 136 (2002).

[18]Peter C. Canellos, ''A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters,'' 54 *SMU L. Rev*. 47, 52 (2001).

run afoul of an antiabuse rule even if the transaction otherwise complies with statutory language. The use of those rules covers an increasing number of transactions, including the tax treatment of partnerships;[19] consolidated returns;[20] debt instruments;[21] interest-rate, equity, and commodity swaps;[22] and net operating loss limitations.[23] Essentially, the various antiabuse rules reflect the spirit of common-law doctrines that look to the overarching effect and purpose of a transaction rather than to whether a taxpayer complied with a series of unrelated tax provisions. The antiabuse rules for partnerships, for example, provide that if a partnership ''is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K,'' the government ''can recast the transaction for federal tax purposes.''[24] The antiabuse rules reflect the principle that there is a difference between the letter of the law and its spirit. And for the government or a court to validate tax benefits, the taxpayer must comply with both.

Antiabuse rules also reflect explicit application of long-standing judicial doctrines that apply a purposive rather than a literalist interpretation of the tax law. The most commonly known doctrines include economic substance, business purpose, sham transaction, and substance over form. The economic substance doctrine has been a particularly effective tool in the fight against tax shelters, and reflects an amalgam of the other common-law doctrines. It represents a judicial effort ''to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.''[25] We are often reminded that taxpayers possess ''an unquestioned right to decrease or avoid . . . taxes by means which the law permits.''[26] But ''there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is perfectly permissible) and creating a transaction, without a business purpose, in order to create a tax benefit (which is impermissible).''[27]

In applying the economic substance doctrine to a particular transaction or series of transactions, courts have historically used a flexible two-part test to discern whether a transaction contains ''sufficient substance, apart from its tax consequences, to be respected for tax purposes.''[28] The first prong analyzes whether the transaction contains ''objective'' economic substance, an inquiry that evaluates the likelihood of economic profit,[29] exposure to risk,[30] and substance versus form. The second prong is more subjective, and examines the business motivation or purpose behind the transaction in an attempt to determine whether the transaction was ''rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation.''[31]

In recent cases, courts have emphasized the first prong of the test, opining that the '''objective economic reality of the transaction' is paramount.''[32] A transaction that contains objective economic substance will undoubtedly be respected for tax purposes regardless of the taxpayer's subjective motivation for entering into the transaction.[33] Conversely, a transaction that does not contain adequate economic substance will be invalidated for tax purposes without regard to the validity of the taxpayer's business motivation for undertaking the deal.[34] It is also clear,

---

[19]*See* reg. section 1.701-2.
[20]*See* reg. section 1.1502-95.
[21]*See* reg. section 1.1275-2.
[22]*See* reg. section 1.446-3.
[23]*See* reg. section 1.172-3.
[24]Reg. section 1.701-2(b).
[25]*Coltec Industries, Inc.*, *supra* note 5, at 1353-1354.
[26]*Jade Trading LLC*, *supra* note 7, at 55. This sentiment is captured most famously in an oft-quoted line from *Gregory v. Helvering*: ''The 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 permits, cannot be doubted.'' *Gregory*, 293 U.S. at 469. The next line from the opinion is just as famous, although primarily due to its omission by pro-taxpayer courts and commentators: ''But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.'' *Id.*
[27]*Coltec Industries, Inc.*, *supra* note 5, at 1357.
[28]Joseph Bankman, ''The Economic Substance Doctrine,'' 74 *S. Cal. L. Rev.* 5, 9 (2000).
[29]Commentators have rightly argued that profit is an unreliable barometer for determining whether a transaction contains sufficient economic substance. *See* Hariton, *supra* note 13, at 53 (concluding that ''profit motive and profit potential are not useful yardsticks for application of the economic substance doctrine. What matters in deciding whether a transaction has 'economic substance' is not whether the transaction is expected to generate a profit, but rather whether the transaction gives rise to unique economic risk that is significant in relation to the tax benefits claimed.'').
[30]Exposure to risk, according to Hariton, is the most important factor in determining the legitimacy of a transaction. ''If taxpayers are at least required to take on unique economic risk that is substantial in relation to the tax benefits they claim, we shall see relatively few shelters, for no one seems willing to lose real money just to claim questionable tax benefits. When one gets to the bottom of the facts in one of these shelter cases, one invariably discovers that all of the significant economic risks have been hedged away.'' Hariton, *supra* note 13, at 54.
[31]*Compaq Computer Corp. v. Commissioner*, 113 T.C. 214, 224, *Doc 1999-22959*, *1999 TNT 128-10* (1999) (*citing ACM Partnership*, *supra* note 9).
[32]*Jade Trading LLC*, *supra* note 7 (*citing Coltec Industries, supra* note 5, at 1356 n.16).
[33]This threshold can result in courts validating ''even the most egregious tax benefits if they arise from transactions with meaningful economic consequences.'' Hariton, *supra* note 16, at 235.
[34]As others have observed, the business purpose test is simply too subjective to be dispositive of validity, because it involves evaluating the self-serving testimony of the very actors who signed off on the transaction or transactions in question. *See* Bankman, *supra* note 28, at 27-28 (stating that the ''primary criticism of the business purpose test is that it leads to the creation of false or misleading documents''); reg. section 1.183.2(a) (''In determining whether an activity is engaged in for

(Footnote continued on next page.)

however, that a transaction ''clearly supported by the text, intent, and purpose (or whatever combination that comports with the judge's interpretive stance) will withstand judicial scrutiny'' independent of whether it otherwise meets either, neither, or both prongs of the economic substance test.[35] The fact of the matter is that judicially invalidated transactions usually fail both the objective economic reality prong and the subjective business purpose prong if only because excessive risk exposure (associated with economic substance) almost never fulfills a ''useful nontax purpose'' (associated with business purpose).[36]

Keeping Economic Substance in the Courts

As described above,[37] judges have become quite comfortable using the economic substance doctrine to invalidate abusive transactions. Given the government's impressive record of late in front of these judges, it would be tempting to conclude that the economic substance doctrine is now firmly entrenched as the protector of the revenue, the government's trump card in the tax avoidance game. Fortunately, important elements of the government recognize the contingent nature of tax shelter litigation and of using standards to police abusive behavior. Asked for comment after one of the more decisive wins, for example, IRS Chief Counsel Donald Korb was appropriately subdued, observing a trend but not a definitive victory: ''Courts are increasingly recognizing that abusive transactions often lack economic substance.''[38] As Korb knows, relying on economic substance as the last line of defense in the tax shelter battle has produced episodic results.[39] In the not-so-distant past, on the heels of seemingly momentous victories, courts dealt the government a series of tax shelter losses.[40] Moreover, although we now point to *Coltec*, *Black & Decker*, *Castle Harbour*, and *Dow Chemical* as seminal victories in the application of the economic substance doctrine to invalidate abusive tax avoidance transactions, it is important to remember that the government lost each of those cases at the district court level,[41] losses that to observers at the time signaled the death knell of the economic substance doctrine.[42] Courts can inadvertently misapply the doctrine,[43] they can purposefully misapply the doctrine,[44]

---

profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.''). More importantly, as Hariton notes, injecting a transaction with ''business purpose'' ''does not require the taxpayer to take on any economic risk,'' the most important factor separating legitimate from illegitimate transactions. Hariton, *supra* note 13, at 53.

[35]Bankman, *supra* note 28, at 12. *See also* Hariton, *supra* note 13, at 31 (arguing that ''a court's inquiry is not finished when it concludes that a transaction lacks business purpose and economic substance. The tax benefits arising from such a transaction should not be disallowed unless they are clearly inconsistent with tax policy and congressional intent''); Hariton, *supra* note 16, at 246 (stating that ''the mere fact that the transaction lacked economic substance does not mean that [the transaction's tax benefits] will be disallowed. The question is whether the tax benefits arising from the transaction were arguably contemplated, or at least condoned, by Congress.'').

[36]*See* Hariton, ''How to Fix Economic Substance,'' *Tax Notes*, Apr. 28, 2003, p. 539, *Doc 2003-10599*, *2003 TNT 82-83* (noting that ''few taxpayers are willing to incur real economic risk merely to put themselves in a position to claim unwarranted tax benefits''). Most economic substance cases either explicitly or implicitly recognize that the two prongs of the test are inextricably interrelated. *See e.g.*, *Saba Partnership*, *supra* note 9; *UPS of Am. Inc. v. Commissioner*, 78 T.C.M. 262, 270, *Doc 1999-26528*, *1999 TNT 153-11* (1999). *ACM Partnership v. Commissioner*, 157 F.3d 231, 247, *Doc 98-31128*, *98 TNT 202-7* (3d Cir. 1998).

[37]*See supra* notes 1-11 and accompanying text.

[38]Crystal Tandon, ''IRS Wins *Coltec* Appeal on Economic Substance Grounds,'' *Tax Notes*, July 17, 2006, p. 207, *Doc 2006-13316, 2006 TNT 134-1*.

[39]David A. Weisbach has described the episodic outcomes of tax shelter litigation as a game of chance:

> Recent taxpayer wins show that the series of government wins was a mere coincidence, much like baseball teams on a streak that is merely a property of statistics rather than a change in ball playing skills. Although not literally independent like a coin flip, the analogy is close enough: If we flip enough coins, we are likely eventually to get 10 heads in a row. It may seem like the heads are on a streak, but the odds on each flip have not changed. The apparent advantage for heads and for the government is a result of selective vision.

Weisbach, ''Ten Truths About Tax Shelters,'' 55 *Tax L. Rev.* 215, 228-229 (2002).

[40]*See, e.g.*, *IES Industries, Inc. v. United States*, 253 F. 3d 350, *Doc 2001-16769*, *2001 TNT 116-12* (8th Cir. 2001) (reversing the district court and finding as valid a listed transaction generating a foreign tax credit and capital loss); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, *Doc 2002-184*, *2002 TNT 1-5* (5th Cir. 2001) (applying *IES Industries* in overturning the Tax Court's disallowance of an identical transaction); *UPS of America v. Commissioner*, 251 F.3d 1014, *Doc 2001-17453*, *2001 TNT 122-5* (11th Cir. 2001) (reversing the Tax Court's determination that the restructuring of customer loss claims lacked economic substance and business purpose and amounted to a sham).

[41]*Black & Decker Corp. v. United States*, 340 F. Supp.2d 621, *Doc 2004-3752*, *2004 TNT 36-9* (D. Md. 2004); *Coltec Industries v. United States*, 62 Fed. Cl. 716, *Doc 2004-21316*, *2004 TNT 214-16* (2004); *TIFD III-E, Inc. (Castle Harbour) v. United States*, 342 F. Supp.2d 94, *Doc 2004-21384*, *2004 TNT 214-17* (D. Conn. 2004); *Dow Chemical Co. v. United States*, 250 F. Supp.2d 748, *Doc 2003-8335*, *2003 TNT 64-7* (E.D. Mich. 2003).

[42]*See* Kenneth A. Gary and Sheryl Stratton, ''Economic Substance: Will Congress Have to Intercede?'' *Tax Notes*, Nov. 15, 2004, p. 907, *Doc 2004-21864*, *2004 TNT 220-2*; Julie Brienza and Karla L. Miller, ''Economic Substance Trips Up IRS in *Coltec*, *Castle Harbour* Cases,'' *Tax Notes*, Nov. 8, 2004, p. 780, *Doc 2004-21395*, *2004 TNT 214-4*.

[43]Some of the government losses, for instance, can be attributed to courts learning how to apply the economic substance doctrine to complex corporate tax shelters rather than to the primitive individual tax shelters of the 1970s and 1980s. The earlier cases involved relatively straightforward overvaluations, unenforceable nonrecourse debt, and even fraud. Also, they had ''horrible facts, and they produced a lot of sloppy, lenient standards of decision.'' Lee A. Sheppard, ''Drafting Economic Substance,'' *Tax Notes*, Sept. 3, 2001, p. 1258, *Doc 2001-23054*, *2001 TNT 171-4*.

[44]According to Sheppard, ''The economic substance doctrine is like a mechanical watch — it works best when it is in the hands of a technician who understands it.'' In a 2008 decision, Sheppard reports that Tax Court Judge James Halpern ''knowingly misapplied [the doctrine] in granting a taxpayer's motion

(Footnote continued on next page.)

they can apply it restrictively,[45] and they sometimes have no choice but to decide for the taxpayer when government lawyers put on a bad case.[46] The bottom line is that when courts apply standards, we have to be ready to take the bad with the good, knowing that the doctrine can deliver losses in addition to victories. ''Economic substance cases are very fact-intensive,'' Korb has observed, ''and the results of a particular case often turn on a variety of factors'' such that ''a loss in one particular tax shelter case in which it is asserted does not undermine our confidence to use the doctrine, when appropriate, to attack tax shelters in other cases.''[47]

Congress believes that it can control these contingencies by codifying the economic substance doctrine. Politicians first considered the idea of codification in the early 2000s after several government losses in tax shelter cases.[48] A handful of judges encouraged congressional intervention, writing in pro-taxpayer opinions that it was not the job of courts to scrutinize the economic reality and business purpose of transactions that otherwise complied with the letter of the law. ''Under our time-tested system of separation of powers,'' Judge Braden opined in *Coltec*, ''it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare.''[49] Members of Congress were listening[50] and introduced at least one piece of legislation codifying the economic substance doctrine every year between 2001 and 2007.[51] The most recent effort is reflected in the 2007 farm bill, which as of this writing had passed the House and Senate and awaits reconciliation.[52] The bill contains a provision to codify a ''clarification'' of the economic substance doctrine,[53] and it further provides statutory penalties for understatements of tax attributable to transactions found lacking in economic substance.[54] The provision is estimated to generate approximately $10 billion in additional revenue over 10 years, a feature that according to some observers almost guarantees codification in 2008.[55]

But codifying the economic substance doctrine is ''an incredibly bad idea.''[56] The complexity of the doctrine and its numerous interpretive nuances defy statutory definition. The doctrine by its very nature ''poses open-ended and unanswerable questions,'' law professor Joseph Bankman has said, that must be applied on a case-by-case, transaction-by-transaction basis.[57] Moreover, courts apply it ''to a near-infinite variety of economic activities and transactions,'' particularly those involving the treatment of capital, which itself is ''inconsistent and to some extent incoherent.''[58] Taxpayers and their advisers view this incoherence as an opportunity to structure transactions ''that produce tax benefits out of thin air,'' exploiting conflicting rules to obscure the ''right'' tax treatment of a particular transaction as well as

---

for summary judgment in *Countryside Limited Partnership v. Commissioner*, T.C. Memo. 2008-3.'' ''Judge Halpern's opinion,'' Sheppard writes, ''is sophistry, parsing where parsing is inappropriate.'' The deal fell squarely within the partnership anti-abuse rules and judicial precedent (in particular, *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965)), but Judge Halpern brushed aside both otherwise binding authorities in finding for the taxpayer. Sheppard, ''Erroneous Application of the Economic Substance Doctrine,'' *Tax Notes*, Jan. 14, 2008, p. 259, *Doc 2008-629*, *2008 TNT 10-4*.

[45]*See* Sheppard, ''Drafting Economic Substance, Part 3,'' *Tax Notes*, Feb. 28, 2005, p. 1020, *Doc 2005-3638*, *2005 TNT 39-6* (writing in the wake of *Coltec*, *Black & Decker*, and *Castle Harbour*, ''Federal judges have been sending the message that the economic substance doctrine is not a free-standing, all-purpose answer to everything that the IRS does not like'').

[46]*See* Sheppard, *supra* note 44, at 267 (taking government lawyers to task in *Countrywide* for failing to get tax shelter materials into evidence, a failure that resulted in the court treating ''the whole mess as though it were a business deal with favorable tax planning rather than a tax-sheltered sale'').

[47]Brienza and Miller, *supra* note 42, at 781.

[48]*See* Gary and Stratton, *supra* note 42, at 907 (Korb expressing concern that losses in the district courts in *Coltec*, *Black & Decker*, and *Castle Harbour* might rejuvenate efforts in Congress for codifying the economic substance doctrine). Some academics have also argued for codification on the grounds that it would reduce taxpayer victories by providing courts with a single, precise definition of ''abusive transaction.'' *See, e.g.*, Stratton, ''Shelter Disclosure, Doctrine Codification Debated,'' *Tax Notes*, Apr. 7, 2003, p. 25, *Doc 2003-8113*, *2003 TNT 61-3* (summarizing comments from Prof. Larry Zelenak).

[49]*Coltec Industries, Inc.*, *supra* note 5, at 756.

[50]Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, for one, has stated regarding codification, ''I consider that doing what the courts told us that we ought to do because Congress ought to define the tax code as

(Footnote continued in next column.)

opposed to the courts, in particular when you get four different courts defining economic substance.'' Heather M. Rothman, ''Grassley Defends Farm Bill's Language on Economic Substance as Loophole-Closer,'' 19 *Daily Tax Rep*. at G-4 (BNA) (Jan. 30, 2008).

[51]*See* H.R. 2520, Abusive Tax Shelter Shutdown Act of 2001; H.R. 5095, American Competitiveness and Corporate Accountability Act of 2002; H.R. 1555, Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003; S. 476, CARE (Charity Aid, Recovery, and Empowerment) Act of 2003; S. 2, Jobs and Growth Reconciliation Tax Act of 2003; S. 1637, American Jobs Creation Act of 2004; S. 1937, Tax Shelter Transparency and Enforcement Act of 2004; S. 2020, Tax Relief Act of 2005; S. 1321, Telephone Excise Tax Repeal Act of 2005; S. 3738, Nonitemizer Real Property Tax Deduction Act of 2006; S. 681, H.R. 2136, Stop Tax Haven Abuse Act of 2007.

[52]*See supra* note 12.

[53]Presumably, use of the word ''clarification'' is meant to suggest that codification will unify the varying judicial definitions of the economic substance doctrine rather than supplant them with an entirely new, legislatively crafted standard. Either way, codification defuses the doctrine's flexibility, which this article identifies as its overwhelming virtue.

[54]*Id.* at section 12522.

[55]*See* Jeremiah Coder and Sheppard, ''Officials Predict Economic Substance Codification in 2008,'' *Tax Notes*, Jan. 28, 2008, p. 468, *Doc 2008-1239*, *2008 TNT 15-5* (Odintz and Desmond betting that Congress will pass the farm bill and codify the economic substance doctrine).

[56]Stratton, *supra* note 48, at 25 (quoting Greg Jenner, deputy assistant secretary for tax policy).

[57]Bankman, *supra* note 28, at 25. By transaction-by-transaction, I mean transactions in their entirety rather than merely individual transactional steps.

[58]*Id.*

the underlying purpose of relevant code provisions.[59] Codifying the economic substance doctrine would allow tax advisers to further exploit the interpretive and practical difficulties of determining the legitimacy of tax transactions because courts would be stuck applying a rigid rule to elusive transactions.

Money talks, however. And the estimated $10 billion in revenue expected to flow from codification is manna for a cash-strapped Congress, the ''major offset'' to recent legislative spending bills.[60] Supporters of codification have attempted to link the proposal to reform rather than revenue. ''I'm not doing this to raise taxes,'' but rather to clarify the definition for taxpayers and courts, proponent Chuck Grassley, R-Iowa, Senate Finance Committee ranking minority member, has stated.[61] It is a loophole closer rather than a revenue raiser.[62] Other observers rightly see revenue driving the codification movement. ''Whether economic substance codification is good policy or not,'' Joshua Odintz, tax counsel to the Finance Committee, has written, ''it's money on the table.''[63] Treasury Tax Legislative Counsel Michael Desmond has been even more forthcoming. Codification is popular among lawmakers, says Desmond, because it would bring in ''a lot of money.''[64]

Potential revenue is not a good enough reason to codify the economic substance doctrine. Treasury, leading practitioners, academics, and tax policy commentators oppose codifying the doctrine. Government officials and practitioners are ''unanimous in their opposition to codification.''[65] The White House believes that defining the economic substance doctrine ''is best left for the courts,''[66] while Treasury officials believe a judicially controlled doctrine provides judges the tools they need to protect the revenue.[67] Further, the American Bar Association Section of Taxation,[68] the New York State Bar Association Tax Section,[69] the American Institute of Certified Public Accountants,[70] and the Tax Executives Institute[71] oppose codification. Reducing the doctrine to a statute may have been appropriate 10 years ago, when courts were applying it haphazardly, such that it did not provide a sufficient deterrent to abusive behavior.[72] But changes in substantive law — expanded and stricter tax penalties, heightened reporting and disclosure standards, and increased transparency in tax and accounting[73] — make the argument for codification considerably less salient.[74] Moreover, the streak of government tax shelter

---

[59]*Id.*

[60]Chuck O'Toole, ''Administration Threatens Veto of Farm Bill,'' *Tax Notes*, Nov. 12, 2007, p. 645, *Doc 2007-24714*, *2007 TNT 216-5*.

[61]Meg Shreve, ''Grassley Doubtful on Energy, Confident on Economic Substance,'' *Tax Notes*, Oct. 15, 2007, p. 199.

[62]Rothman, *supra* note 50.

[63]Sheppard, ''Beyond the Economic Substance Codification Provision,'' *Tax Notes*, Oct. 15, 2007, p. 205.

[64]Coder, ''Desmond Says Legislative Outlook Driven by Pay-Go,'' *Tax Notes*, June 11, 2007, p. 989, *Doc 2007-13303*, *2007 TNT 107-2*. *See also* Sheppard, ''Economic Substance Update,'' *Tax Notes*, Mar. 13, 2006, p. 1137, *Doc 2006-4365*, *2006 TNT 49-4* (explaining the popularity of codification by noting that ''it has a revenue estimate attached to it'').

[65]Heidi Glenn, ''IRS Official, Practitioners Pan Economic Substance Codification,'' *Tax Notes*, June 4, 2007, p. 888, *Doc 2007-13194, 2007 TNT 106-1*.

[66]White House, ''Statement of Administration Policy, H.R. 2419 — Food and Energy Security Act of 2007'' (Nov. 6, 2007), *Doc 2007-24718*, *2007 TNT 216-41*. President Bush, nothing if not consistent, has said he opposes codification because it would raise taxes. *See* Federal Tax and Accounting, ''Schafer Says Senate Conferees' Farm Bill Still Unacceptable, Supports House Version,'' 32 *Daily Tax Rep.* (BNA) at G-4 (Feb. 19, 2008).

[67]*See* Patrice Gay and Coder, ''Claims Courts Rules for Gov't on Economic Substance,'' *Tax Notes*, Jan. 7, 2008, p. 112; Stratton, ''IRS, Tax Bar Urge Congress to Leave Economic Substance

(Footnote continued in next column.)

Alone,'' *Tax Notes*, Feb. 26, 2007, p. 814, *Doc 2007-4474*, *2007 TNT 36-2* (IRS Chief Counsel Donald Korb saying that codification ''would not add anything'').

[68]*See* Susan P. Serota, chair, ABA Section of Taxation, to Senate Finance Committee Chair Max Baucus, D-Mont., and Grassley, ''Supplemental Comments on the Proposed Codification of the Economic Substance Doctrine'' (Apr. 12, 2007), *reproduced in Tax Notes*, Apr. 23, 2007, p. 389, *Doc 2007-9497*, *2007 TNT 72-22* (stating that it ''continue[s] to have substantial reservations about recent versions of legislation codifying the economic substance doctrine'').

[69]*See* New York State Bar Association Tax Section, ''Clarification of Economic Substance'' (May 21, 2003), *reproduced in Tax Notes*, June 23, 2003, p. 1829, *Doc 2003-12678*, *2003 TNT 102-19* (calling codification ''not an effective means of combating abusive tax shelters'').

[70]*See* Thomas J. Purcell III, chair, Tax Executive Committee, (hereinafter AICPA letter) AICPA to William M. Thomas, Grassley, Charles B. Rangel, D-N.Y., and Baucus (Dec. 23, 2005) (see note 80), *Doc 2006-277*, *2006 TNT 3-19* (calling codification ''counterproductive'' and stating that the AICPA ''strongly oppose[s] it'').

[71]Tax Executives Institute, ''TEI Recommends Removal of Economic Substance Provisions from AMT Relief Act'' (Dec. 17, 2007), *available at* 242 *TaxCore* (BNA) (Dec. 18, 2007) (stating that codification ''would do nothing to curb illegitimate transactions because there are no illegitimate transactions currently beyond the doctrine's reach and scope'').

[72]For a cogent argument for codification along these lines, see Ellen P. Aprill, ''Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines,'' 54 *SMU L. Rev.* 9 (2001) (arguing that codification would make the doctrine more salient to courts and administrators as well as to lawyers, accountants, tax directors, and taxpayers in general).

[73]These changes in substantive law include the antishelter provisions in the American Jobs Creation Act of 2004, the written opinion standards in Circular 230 (31 C.F.R. section 10.35), the disclosure rules and internal controls under the Sarbanes-Oxley Act of 2002 (sections 406 and 407 and section 404, respectively), and Financial Accounting Standards Board rules regarding the treatment of unrealized income tax benefits and liabilities on financial statements (FASB Interpretation No. 48, ''Accounting for Uncertainty in Income Taxes, An Interpretation of FASB Statement No. 109'' (2006)).

[74]*See* Susan Simmonds, ''ABA Tax Section Criticizes Revenue Raisers in Highway Bill,'' *Tax Notes*, June 27, 2005, p. 1661 (quoting Kenneth W. Gideon, chair of the ABA tax section, as saying that codification is unnecessary due to the effectiveness of tax shelter legislation); Sam Young, ''Treasury Focuses on Economic Substance, Competitiveness,'' *Tax Notes*, Oct. 15, 2007, p. 207 (quoting Karen Gilbreath Sowell, Treasury deputy assistant secretary for tax policy, as saying that because there is ''a lot more transparency in the tax system, the government has been

(Footnote continued on next page.)

victories in the courts provides evidence that the judicially defined standard is working effectively.[75] Also, if Congress were to codify the doctrine, it would have to define the statute broadly to capture the known universe of tax avoidance. But in so doing, it would necessarily deter legitimate transactions[76] and subject congressionally mandated tax planning to penalty.[77]

The strongest argument against codification is that it would impinge on the key virtue of the judicial doctrine: its flexibility. Indeed, according to Korb, codification would ''take away IRS's ability to go after tax shelters by replacing a flexible judicial rule with an inflexible statutory rule.''[78] Moreover, it is simply impossible to reduce a judicial doctrine to a statute that would cover all potentially abusive transactions without also capturing plain vanilla tax advice.[79] Codification would also provide aggressive tax planners an opportunity to occupy and broaden the statutory line between permissible and impermissible behavior.[80] In this way, codification could ''plant the seeds of the next tax shelter problem'' and, according to Korb, produce ''a bountiful harvest of serious tax noncompliance.''[81] Far better to provide courts a flexible doctrine, malleable to various and unforeseen circumstances. In the hands of courts, the economic substance doctrine has evolved over the years to keep pace with increasingly sophisticated and imaginative tax planning.[82]

Conclusion

Codification would restrict judicial oversight and weaken the power of the economic substance doctrine.[83] Over the years, the doctrine has protected both taxpayers and the government by ensuring that neither the government nor practitioners interpret the nation's tax laws too literally and that neither fail to read the laws as ''part of a statutory scheme through which Congress seeks to accomplish a goal that has breadth and durability.''[84] Codification could never accomplish this task. Interpretive analysis that appreciates a ''statutory scheme'' and weaves together individual tax provisions requires courts ''to ask, and ask in every case,'' whether a transaction or reporting position ''fits the language and the purpose of the statutory provisions in question.''[85] It requires courts to assure that tax advisers do more than conform to

---

winning economic substance cases, there are repercussions when someone behaves badly. There's a lot of very negative publicity for taxpayers and their advisers who don't behave appropriately.''); Coder and Sheppard, *supra* note 55, at 469) (quoting Desmond as saying that codification is unnecessary given changes in financial accounting).

[75]*See* Coder and Sheppard, *supra* note 55, at 469 (quoting Desmond as saying that codifying the doctrine is unnecessary given the government's litigation successes over the last 10 years); Stratton, *supra* note 67, at 814 (Korb saying that keeping economic substance the province of the courts rather than the legislature has resulted in tax shelter victories for the government).

[76]*See* Coder and Sheppard, *supra* note 55, at 469 (codification would deter legitimate business transactions); Glenn, *supra* note 65, at 888 (codification would ''inhibit'' legitimate transactions); Simmonds, *supra* note 74, at 1661 (codification would have a ''negative effect'' on legitimate transactions).

[77]*See* Coder and Sheppard, *supra* note 55, at 469 (codification would extend the doctrine to areas outside traditional common-law concerns and focus instead on the business purpose of, for example, the code's tax-free reorganization provisions or general antiabuse rules); Mark J. Silverman, Philip R. West, and Aaron P. Nocjar, ''The Case Against Economic Substance Codification,'' *Tax Notes*, July 19, 2004, p. 314, *Doc 2004-14344*, *2004 TNT 139-43* (codification would sweep in transactions with no tax avoidance objective as well as those explicitly authorized by Congress such as tax-free reorganizations or tax losses associated with low-income housing credits). *See also* Hariton, ''Economic Substance Complaint No. 1: 'Too Vague and Too Broad,''' *Tax Notes*, Sept. 30, 2002, p. 1893, *Doc 2002-22048*, *2002 TNT 190-30*.

[78]Coder, ''Korb Continues PR Battle Against Economic Substance Codification,'' *Tax Notes*, Nov. 5, 2007, p. 578.

[79]*See* Young, *supra* note 74, at 207 (quoting Sowell as saying, ''It's very difficult to write a piece of legislation that would cover all scenarios''); Hariton, *supra* note 77, at 1894 (arguing that ''we should stop trying to draft a provision to describe every transaction that could ever conceivably be used or viewed as a tax shelter'').

[80]*See* Alison Bennett, ''Economic Substance Could Create Tax Shelter Problem, Korb Warns,'' 31 *Daily Tax Rep.* (BNA) at G-8 (Feb. 15, 2008) (stating that with codification, ''taxpayers will go right up to the edge and structure right around any statutory language''); AICPA letter, *supra* note 70 (stating that ''codifying

(Footnote continued in next column.)

economic substance would deprive the tax system of the flexibility needed to keep pace with the changing economic environment. As past experience with abusive tax shelters shows, fixed rules are often easy to avoid and can lead to new abuses.'').

[81]Bennett, *supra* note 80.

[82]*See* Glenn, *supra* note 65, at 888 (quoting William C. Sabin Jr., senior legal counsel in the IRS Large and Midsize Business Division, saying, ''Given the imagination and energy with which tax shelters seem to be evolving, I think it's useful to let the organic nature of the economic substance doctrine also evolve''); Hariton, *supra* note 16, at 237 (noting the impossibility to ''foresee, let alone draft, rules to govern coherently every conceivable permutation of facts and circumstances in an increasingly complex business world'').

[83]Kathleen David, ''Codification of Economic Substance Remains on Agenda Despite Government's Opposition,'' 16 *Daily Tax Rep.* at G-5 (BNA) (Jan. 25, 2008) (paraphrasing Desmond, saying that codification would ''straitjacket the courts since they are now free to consider different factors and be flexible in their approach''); Bernard Wolfman, ''Why Economic Substance Is Better Left Uncodified,'' *Tax Notes*, July 26, 2004, p. 445, *Doc 2004-14963*, *2004 TNT 144-36*. (''The words, the holding, and the breadth of *Gregory v. Helvering* . . . which courts, practitioners, and the government seek to capture in that doctrine, would lose their strength and much of their purpose if they were reduced to a rigid or formulaic legislative Rx.'')

[84]Wolfman, *supra* note 83, at 465. *See also* Silverman et al., *supra* note 77, at 315. (''The doctrine may be thought of as a principle of equity, enabling a court to do justice in circumstances in which, because of the inflexibility of technically drawn statutes, the court otherwise would be unable to adapt its judgment to the special facts and circumstances of a particular case.'')

[85]Wolfman, *supra* note 83, at 465. *See also* Silverman et al., *supra* note 77, at 316. (''The longstanding application of the doctrine to an almost unending array of different circumstances confirms its strength and flexibility. . . . Although flexibility can be frustrating at times, to both taxpayers and the government, a

(Footnote continued on next page.)

black-letter law in crafting tax avoidance strategies, and to respect what Prof. Daniel Shaviro has called ''frictional impediments to optimal tax planning.''[86] This oversight requires a flexible, holistic approach to statutory interpretation, not a rigid definition of abusive tax shelter activity.[87] Ultimately, it requires that the economic substance doctrine remain in the hands of judges rather than legislators.

---

doctrine of equity such as the economic substance doctrine should remain flexible to respond to current issues.'')

[86]*See* Daniel N. Shaviro, ''Economic Substance, Corporate Tax Shelters, and the *Compaq* Case,'' *Tax Notes*, July 10, 2000, p. 221, *Doc 2000-18568*, *2000 TNT 132-80*. Under normal circumstances, these frictional impediments — adding downside risk to transactions, for instance, or demonstrating genuine business purposes — can yield inefficiencies and dead-weight loss. In the tax planning context, however, these impediments result in increased rather than decreased aggregate social welfare as the welfare saved (associated with reduced wasteful tax planning, resource-intensive investigations, litigation, and revenue losses) outweigh the welfare lost (tax savings).

[87]*See* Willens, *supra* note 11, at 540 (observing, ''one wonders why the flexibility the courts have shown in applying [the doctrine] should be sacrificed for the rigidity that a legislative effort to 'codify' the doctrine would almost certainly entail''); Hariton, ''Stop Calling It Economic Substance,'' *Tax Notes*, June 9, 2003, p. 1543, *Doc 2003-13889*, *2003 TNT 111-51* (concluding that ''if we enact statutory language that is described as a clarification of a common-law antiabuse doctrine, mightn't the statutory language serve to limit the scope and flexibility of that doctrine and the willingness of courts to apply it?''). *Contrast* Samuel C. Thompson Jr. and Robert Allen Clary II, ''Coming In From the 'Cold': The Case for ESD Codification,'' *Tax Notes*, May 26, 2003, p. 1270, *Doc 2003-12944*, *2003 TNT 102-33* (arguing that a judicial doctrine provides too much flexibility and ''gives sophisticated taxpayers too much wiggle room, that is, too many opportunities to convince a court that a purely tax-motivated transaction should be recognized,'' and that a ''rigid'' or ''wooden'' statute would be preferable to the flexible doctrine).