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Rationalizing Tax Law by Breaking the Addiction to Economic Substance

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RATIONALIZING TAX LAW BY BREAKING THE ADDICTION TO ECONOMIC SUBSTANCE

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> *[T]ax laws are read particularistically, as rules rather than standards, as specifying required conduct rather than desired end states. The big difference [from antitrust laws] is the nature of delegation: zero power has been delegated to judges in tax cases.*
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> — Judge Frank H. Easterbrook, U.S. Court of Appeals, Seventh Circuit[1]

I. INTRODUCTION

Somewhere between legitimate tax planning and outright tax fraud lies some gray area. A taxpayer who filed a federal income tax return showing that his employer withheld much more than the actual amount withheld—with the intention of tricking the Internal Revenue Service

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1. Frank H. Easterbrook, *Judicial Discretion in Statutory Interpretation*, 57 OKLA. L. REV. 1, 7 (2004).

into sending him a refund he does not deserve—has committed tax fraud. This result is clear. Just as clear on the other end of the spectrum, a taxpayer who chose to own a home rather than rent in order to obtain the tax benefits of the home mortgage interest deduction[2] has engaged in legitimate tax planning. Between these two extremes, it is not so clear where legitimate tax planning crosses the line well short of outright tax fraud but into questionable tax planning.

At times a number of different taxpayers hone in on the same planning strategy to save money on taxes or obtain a tax refund. When the government identifies such a strategy, it has some decisions to make. When it is clear a particular strategy is the strategy Congress intended taxpayers to take, such as the home mortgage interest deduction, the decision is easy: Leave it alone. When a strategy involves fraud, the decision is also easy: Direct enforcement resources at the strategy and hold the taxpayers accountable. When it appears that the law permits a strategy but that it probably should not, the government may change the law.

The government has a number of tools or weapons at its disposal to combat tax planning that it decides is questionable. A number of these tools arose from common taxpayer strategies or anticipate specific tax planning strategies. For example, the government may make an adjustment to the transfer of goods between related companies where there is an opportunity for the related companies to price their goods in such a way as to game the tax system.[3] However, the government cannot always come up with an easy fix for everything. To combat unanticipated or otherwise difficult to prevent strategies the government finds questionable, the government has a few more generalized weapons in its arsenal. One of these weapons is the economic substance doctrine.[4]

This doctrine—developed by the courts—permits a court to disallow tax benefits derived from a transaction that otherwise complies with the substantive provisions of the Internal Revenue Code where the government believes the transaction is questionable.[5] The debates about the

2. *See* 26 U.S.C. § 163(h)(2)(D) (West 2011).

3. *Id.* § 482. Related companies have the opportunity to transfer goods from one entity in a high tax jurisdiction (like the United States) to a low tax jurisdiction (like Bermuda) at a price that exploits the difference in tax rates. For example, if company D were to manufacture a car for $10,000 and sell it to a related company, F, in Bermuda for the same price, D wouldn't earn any profit—and therefore pay no tax—in the United States. If F then were to sell that same car to a distributor in Spain for $15,000 then F would earn $5000 in Bermuda, but, since there is no income tax in Bermuda, neither D nor F would pay any income tax even though D would have paid tax on the $5,000 profit if it had sold the car directly to the distributor in Spain. There is no way to prevent this particular planning strategy without providing the government with a drastic remedy, the authority to make an adjustment in such circumstances.

4. *See id.* § 7701(o). Others include the substance-over-form doctrine and the step transaction doctrine. *See* Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699 (2003).

5. *See* 26 § U.S.C. 7701(o).

doctrine tend to focus on whether it is better in the form of a judicial doctrine or codified into the Internal Revenue Code rather than whether it is a good thing at all. This article takes the minority position that it is bad for tax law in either form and that another solution—one that is more clear, cogent, and certain yet will accomplish the same objective—is warranted. Other commentators have been unable to consider other solutions that would lead to clearer results, as if they are addicted to the economic substance doctrine. The replacement proposed here—a risk requirement—would accomplish the same objective as the economic substance doctrine while restoring certainty and rationality to the system of taxation that has been lacking since the 1930s.

This article examines whether the economic doctrine is appropriate in the first instance. As recognized by those supporting the doctrine, the government and its constituents have a legitimate interest in enforcing the tax laws. Similarly, taxpayers and their elected representatives have a legitimate interest in limiting the government so that it does not overreach. These are competing goals, but in tax law there seems to be little scholarship aimed at preventing the government from overreaching. The literature has leaned toward strengthening the government's position on "tax shelters"[6] and transactions that "abuse" the tax laws. It appears that this inclination stems at least in part from recent publicity of questionable tax planning practices.[7]

Using the economic substance doctrine for this purpose is somewhat like throwing hand grenades at ants that have infiltrated a house. It kills the ants, but it does serious damage to the house and the legitimate inhabitants. This article suggests that we look for a solution to questionable tax planning that is more like a bug spray than a hand grenade. Perhaps a few suggestions may lead to an appropriate bug-spray solution.

This article critiques the economic substance doctrine and recommends an alternative. Specifically, the next section will discuss the background, some illustrative cases, and many problems with the doctrine. In the third section, the article will provide a potential viable al-

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6. "Unfortunately, there is no single definition of what constitutes a tax shelter, in part because tax shelters are difficult to describe generically, and in part because not everyone agrees on what known transactions should be contained within the scope of the term." Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 399 (2010). Professor Karen Burke has stated that "[t]ax shelters are typically designed to comply with the literal words of the statute while circumventing its purpose," while Mr. David Hariton has argued "that the hallmark of a tax shelter is the sheltering of unrelated income." *Id.* at 399 n.29.

7. *See* Janet Novack, *The Hustling of X-Rated Tax Shelters*, FORBES (Dec. 14, 1998), *available at* http://www.forbes.com/forbes/1998/1214/6213198a.html. There has also been a great deal of publicity related to the litigation between the government and KPMG, a large accounting and consulting firm. *See* Susan Clearly Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 FORDHAM L. REV. 961, 993–94 (2006).

ternative to the economic substance doctrine. Finally, the article concludes that a risk requirement of some kind should supplant the economic substance doctrine.

II. THE ECONOMIC SUBSTANCE DOCTRINE

Congress recently enacted § 7701(o), which incorporates with adjustments the judicial version of the economic substance doctrine into the Internal Revenue Code.[8] It provides that where the economic substance doctrine could be applicable, two factors must be satisfied for the transaction to be respected as having economic substance.[9] A transaction will have economic substance only if it:

- "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and . . . "
- the taxpayer that engaged in the transaction "has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[10]

These elements look deceptively rule-based, but they are not. In the classic rules versus standards discourse, rules are laws the content of which one can ascertain before acting.[11] Standards, in contrast, are laws the content of which an adjudicator ascertains after the events at issue have already occurred.[12] Our system of taxation is the quintessential rule-based system.[13] There are countless sources for looking up the tax law that applies to a given fact situation. On the other side of the spectrum, our system for determining liability for negligence is the quintessential standard-based system.[14] The system relies on the duty of care determined on the basis of the reasonable man standard.

One of the characteristics of a law or set of laws that is best expressed in rules instead of standards is a high frequency of events governed by the law.[15] The tax laws apply to millions of transactions occurring on a daily basis. These laws would not be administrable if the government had to determine what the law meant to each transaction on a case-by-case basis.[16] In a system where taxpayers self-assess their own

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8. 26 U.S.C. § 7701(o).

9. *Id.* § 7701(o)(1)(A)–(B).

10. *Id.*

11. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 561–63 (1992); Kathleen M. Sullivan, *The Supreme Court, 1991 Term—Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 58–59 (1992).

12. *See* Kaplow, *supra* note 11, at 561–63; Sullivan, *supra* note 11, at 58–59.

13. *See* Kaplow, *supra* note 11, at 563–622 (using tax as an example of rule-based law).

14. *See id.* at 563–615 (using negligence as an example of standard-based law).

15. *See id.*

16. "Emperor" Joshua Norton of 19th century San Francisco used to negotiate taxes on a case-by-case basis, but it is not clear that what he called a "tax" was really intended to

tax liabilities by filing a tax return, the ability to ascertain the law in advance is paramount.

The Internal Revenue Code, treasury regulations, and volumes of agency guidance provide a system of rules that, in theory, taxpayers may rely on in conducting their affairs and filing their tax returns. The economic substance doctrine comes in after the fact and permits a court to say that a taxpayer was too aggressive, thereby denying any tax benefits.[17] The doctrine is a standard in a clever rule disguise.

A. History

Judge Learned Hand produced the ingredients for the economic substance doctrine in the 1930s in a case called *Helvering v. Gregory*.[18] In that case, the court overrode the taxpayer's tax-planning result even though the achievement of that result complied with the literal terms of the statute.[19] *Gregory* gave rise to multiple doctrines other than the economic substance doctrine as well.[20]

Of the judicial doctrines courts have developed in taxation, the economic substance doctrine has represented the most often invoked weapon to combat modern questionable tax planning behavior. Courts have developed other non-statutory approaches, but they resemble canons of construction rather than substantive rules. Many of these other judicially-developed approaches represent specific principles for viewing specific sets of facts. For example, the assignment of income doctrine does not allow a taxpayer to pretend someone else earned money that the taxpayer actually earned,[21] and the sham entity doctrine permits the IRS to disregard a business entity that carries on no actual business.[22] This article does not criticize these approaches because they appear grounded

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be a tax. His method of imposing taxes "was to walk into the offices of an old business friend and politely announce an imperial assessment of ten million or so dollars, but could quickly be talked down to two or three, or perhaps a cigar, with which he would walk out entirely satisfied." *A Story of Emperor Norton*, EMPEROR NORTON RECORDS (1999), http://www.emperornorton.net/mirror/http/www.emperornorton.com_80/info.html.

17. The after-the-fact orientation of the doctrine can be seen by the D.C. Circuit's language in *ASA Investerings Partnership*:

> Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated-in every respect except for differing investments in tax avoidance.

ASA Investerings P'ship v. Comm'r, 201 F.3d 505, 513 (D.C. Cir. 2000).

18. 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

19. *See id.* at 810–11. For detailed discussions of the facts of *Gregory*, see Madison, *supra* note 4, at 718–22 and Lederman, *supra* note 6, at 402–06.

20. *See generally* Madison, *supra* note 4.

21. Lucas v. Earl, 281 U.S. 111 (1930).

22. Moline Props., Inc. v. Comm'r, 319 U.S. 436 (1943).

in common sense. As discussed in the last part of this section, the economic substance doctrine does not appear so grounded.

Depending on the formulation, the economic substance doctrine, as developed in the courts, could add two elements to any Internal Revenue Code provisions already governing virtually any potentially taxable transaction. The formulations involved the presence or absence of two factors, neither of which has anything to do with the validity of a transaction.

As a judicial doctrine, the economic substance doctrine permitted a court to determine a taxpayer's entitlement to tax benefits with respect to a particular transaction or series of transactions by gauging the presence or absence of (1) business purpose or (2) economic substance.[23] If this is your first experience with the economic substance doctrine, these two terms or factors may seem straightforward. They are far from it.

Prior to codification, the formulations of the doctrine differed from place to place in how the presence or absence of these factors figured into the result.[24] The majority of the courts applied one of two tests.[25] Some courts held a transaction succeeded—i.e., was entitled to respect—under the economic substance doctrine if either a business purpose was present or economic substance was present (the affirmative test).[26] Other courts held a transaction failed under the economic substance doctrine if either a business purpose was lacking or economic substance was lacking (the disaffirming test).[27] The disaffirming test posed a more difficult hurdle for the taxpayer to overcome because the taxpayer would

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23. *See* Madison, *supra* note 4, at 722–23.

24. *See, e.g.*, Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001) (holding that a transaction fails if it lacks either economic substance or business purpose); Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992) (holding that a transaction succeeds if it possesses economic substance or business purpose).

25. To complicate matters, some courts consider business purpose and economic substance among other factors to determine whether a transaction has economic substance. *See* ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998). Discussion of this formulation, or lack thereof, is beyond the scope of this article.

26. *See Horn*, 968 F.2d at 1229 (holding that a transaction succeeds if it possesses economic substance or business purpose). Using B for Business purpose, E for economic substance, and S for Success, this form of the test can be represented symbolically as follows: $(B \vee E) \rightarrow S$.

27. *Winn-Dixie Stores*, 254 F.3d at 1316 (holding that a transaction fails if it lacks either economic substance or business purpose). Using B for Business purpose, E for economic substance, and S for Success, this form of the test can be represented symbolically as follows: $(\sim B \vee \sim E) \rightarrow \sim S$. The tilde, sometimes referred to as a squiggly line, *see* Wells Fargo & Co. v. Comm'r, 224 F.3d 874, 882 n.3 (8th Cir. 2000), is a "not" symbol. Therefore, "~S" means "it is not the case that S." In literature on economic substance, an author might refer to one as a conjunctive test and the other as a disjunctive test, but that's incorrect. They can both be stated either conjunctively or disjunctively. Above, they are stated disjunctively. The affirmative test can be represented conjunctively as $\sim(\sim B \,\&\, \sim E) \rightarrow S$. The disaffirming test can be represented conjunctively as $\sim(B \,\&\, E) \rightarrow \sim S$. *See* O'Donnabhain v. Comm'r, No. 6402-06, slip op. at 78–80, 2010 WL 364206 at *30 (Feb. 2, 2010) (en banc) (Halpern, J., concurring); *see also* GARY M. HARDEGREE, SYMBOLIC LOGIC 102, 241 (3d ed. 1999) (discussing deMorgan's laws).

lose if it failed to establish the existence of either factor. With the affirmative test, a taxpayer could still prevail if it failed to establish the existence of one of the factors as long as it established the existence of the other factor.

Courts have applied the business purpose test in at least three different ways. First, some courts used the business purpose test as a method of statutory interpretation. This application involved an inquiry into whether the purpose of a transaction contradicted or defeated the purported form of the transaction. This may be referred to as the contradiction test.[28] Second, some courts applied the test as an inquiry into the taxpayer's subjective intent.[29] If a taxpayer entered into the transaction solely for tax purposes and had no real business reason for it, a court applying this test would invalidate the transaction (assuming other requirements to invalidate the transaction, if any, were satisfied). This may be called a subjective purpose test. Third, some courts applied the test as an objective inquiry into whether the transaction at issue had occurred for business reasons.[30] If a transaction occurred for business reasons rather than tax reasons, a court applying this test as a general matter would allow whatever tax benefits followed from the transaction (assuming other requirements to allow the transaction, if any, were satisfied).[31] This may be referred to as the objective purpose test. As between the subjective intent of the taxpayer and the objective appearance of the transaction, the subjective test was more difficult for a taxpayer to deal with because taxpayers, if they are prudent and rational, consider the tax consequences of most transactions.[32] If a transaction "smells" bad,[33] a court might have used evidence of consideration of tax consequences as evidence of a lack business purpose.

With respect to the economic substance factor, a transaction must have had "economic effects other than the creation of tax benefits."[34] Although "economic effects" in the context of the economic substance doctrine included whether genuine enforceable obligations were created,[35] many lower courts appeared to have settled on the idea that it

28. Madison, *supra* note 4, at 728; *see also* Chisholm v. Comm'r, 79 F.2d 14, 15 (2d Cir. 1935); *Horn*, 968 F.2d 1229; Thomas C. Durham et al., *Mrs. Gregory's Great-Grandchildren: The Lost Generation*, 2 J. TAX'N GLOBAL TRANSACTIONS 25 (2002).

29. *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 92 (4th Cir. 1985).

30. *See, e.g.*, United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001).

31. *See id.* at 1018.

32. *See* discussion *infra* Part II.C.

33. *See* ACM P'ship v. Comm'r, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting) (Judge McKee refers to the majority's conclusion that a transaction lacked economic substance as "akin to a 'smell test.' If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to 'put one over.'").

34. *United Parcel Serv. of Am, Inc.*, 254 F.3d at 1018 (quoting Kirchman v. Comm'r, 862 F.2d 1486, 1492 (11th Cir. 1989)).

35. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 582–83 (1978).

means a transaction should have a pre-tax profit.[36] Some of these courts said the pre-tax profit should be significant, and others said it should be nominal.[37] The nominal test was the easier pre-tax profit test because it set a lower threshold for a taxpayer than the significant pre-tax profit test.

The enacted version changes the doctrine somewhat. It changes the terminology (but purportedly not the "substance")[38] of the judicially created doctrine. Instead of "economic substance" and "business purpose," the new provisions use "[meaningful] change[] in . . . economic position" and "substantial [non-tax] purpose" respectively.[39]

The drafters chose the most difficult standards from the historical economic substance doctrine for taxpayers to satisfy. Recall that under the judge-developed economic substance doctrine, taxpayers had more difficulty satisfying a disaffirming test because the taxpayer would fail if neither test is satisfied, while under an affirmative test a taxpayer would still succeed even if it failed to establish one of the factors. The new provisions use this more difficult disaffirming test regarding the relationship between economic position and purpose.

As discussed above, some courts applied the economic substance doctrine using a subjective business purpose inquiry and others with an objective inquiry; the subjective one is a more difficult hurdle for the taxpayer. The new statutory provisions use the more difficult subjective inquiry.[40]

Also recall that under the judge-developed economic substance doctrine, taxpayers have more difficulty satisfying a test for significant pre-tax profit than a test for nominal profit. Congress opted for something more difficult than a nominal test—a "meaningful" change in economic position. "Meaningful" is a more difficult hurdle for a taxpayer to satisfy than "nominal." It is not clear, however, if meaningful means something different than significant.

Congress did, however, attempt to clarify the pre-tax profit test. The profit test is now whether the "present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected."[41] This provision helps clarify that the test has nothing to do with "significant" or "nominal" profit. Rather, it is

36. *See* Madison, *supra* note 4, at 727–28.

37. *See, e.g.*, Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 786 (5th Cir. 2001) (stating that profit of $1.25 million was sufficient for economic substance even though the transactions at issue involved more than $800 million in shares of stock in Royal Dutch Shell); Sheldon v. Comm'r, 94 T.C. 738, 768–69 (1990) (stating that the transaction lacked economic substance even though the taxpayer earned a nominal profit).

38. According to the subparagraph title, the new provisions are merely a "clarification" of the economic substance doctrine. *See* 26 U.S.C. § 7701(o) (West 2011).

39. *Id.*

40. *See id.* § 7701(o)(1)(B) ("[T]he *taxpayer* has a substantial purpose." (emphasis added)).

41. 26 U.S.C. § 7701(o)(2)(A) (West 2011).

necessary to compare the pre-tax profit potential to the discounted net tax benefits in terms of substantiality.

B. Illustrative Cases

The economic substance doctrine, the application of the doctrine, and the transactions to which courts have applied the doctrine are complex. The complexity makes the doctrine difficult to understand in the abstract. An examination of some illustrative cases will make the discussion of economic substance and the approach proposed here more concrete. The transactions underlying the *UPS* and the *Jade Trading* cases, discussed below, are somewhat familiar to many in the tax community.

1. *UPS*

In *UPS v. Commissioner*, a package shipping company made it a practice to reimburse customers up to $100 if a package became damaged or lost.[42] For damages or losses over that level, the taxpayer covered amounts in increments of $100 for a small fee, referred to as "excess-value" coverage.[43] The small fees added up, however, and the taxpayer earned rather large profits on what was essentially an insurance business.[44]

Following the advice of its insurance broker, UPS formed an affiliate in Bermuda by way of a dividend distribution to certain shareholders.[45] Through a third party insurance company, UPS purchased insurance coverage for its customers for the excess-value coverage while continuing to collect the fees.[46] The third-party insurance company reinsured this coverage with UPS's newly formed Bermuda affiliate for the amounts collected by UPS from customers with the insurance company keeping a cut.[47]

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42. 254 F.3d 1014, 1016 (11th Cir. 2001) ("UPS, whose main business is shipping packages, had a practice in the early 1980s of reimbursing customers for lost or damaged parcels up to $100 in declared value.").

43. *Id.* ("UPS would assume liability up to the parcel's declared value if the customer paid 25¢ per additional $100 in declared value, the 'excess-value charge.'").

44. *See id.* ("UPS turned a large profit on excess-value charges because it never came close to paying as much in claims as it collected in charges . . . .").

45. *See id.* ("UPS's insurance broker suggested that UPS could avoid paying taxes on the lucrative excess-value business if it restructured the program as insurance provided by an overseas affiliate. UPS implemented this plan in 1983 by first forming and capitalizing a Bermuda subsidiary, Overseas Partners, Ltd. (OPL), almost all of whose shares were distributed as a taxable dividend to UPS shareholders[,] most of whom were employees . . . .").

46. *See id.* ("UPS then purchased an insurance policy, for the benefit of UPS customers, from National Union Fire Insurance Company.").

47. *See id.* ("OPL [the UPS affiliate] assumed risk commensurate with National Union's [the third party insurance carrier], in exchange for premiums that equal the excess-value payments National Union got from UPS, less commissions, fees, and excise taxes.").

The gaming of the system here is obvious. For the one tax year at issue, the transaction shifted $100 million in income to a jurisdiction that is free from tax.[48] In the majority opinion, the court noted that UPS did it for the purpose of saving money on taxes.[49]

In *UPS*, the taxpayer ultimately prevailed with respect to the application of the economic substance doctrine.[50] The appellate court remanded the case to the Tax Court for further proceedings reviewing the authority of the IRS to adjust transfer prices.[51] There, the parties opted for mediation of the issues, the results of which are not public.[52]

Venue for *UPS* was in the Eleventh Circuit.[53] The Eleventh Circuit uses the disaffirming test for economic substance.[54] A transaction in that circuit fails under the economic substance doctrine if it lacks either a business purpose *or* economic substance.[55]

The *UPS* court applied the business purpose prong of the economic substance inquiry in the objective sense. The court asked whether the transaction "figures in a bona fide, profit-seeking business."[56] In taking this approach, the court respected Supreme Court pronouncements that taxpayers have the right to plan their taxes.[57] The court held that UPS satisfied the business purpose prong because UPS merely changed the form of an ongoing business.[58] The business was a real business providing customers with loss-liability coverage, and UPS lowered its liability exposure with the transaction by shifting its risks to a legally separate entity.

With respect to the economic substance factor, the court examined whether the transaction had real economic effects other than tax bene-

48. *See id.* at 1022 (Ryskamp, J., dissenting) ("UPS failed to show any legitimate business reason for giving up nearly $100 million in EVC income in 1984.").

49. *See id.* at 1017 (noting that "according to the [tax] court . . . contemporary memoranda and documents show that UPS's sole motivation was tax avoidance").

50. *Id.* at 1020.

51. *See id.* (remanding to the Tax Court for consideration of issues related to §§ 482 and 845(a)); *see also* 26 U.S.C. §§ 482 & 845(a) (West 2011).

52. *See* Docket Sheet at entry 287, United Parcel Serv. of Am., Inc. v. Comm'r, No. 15993-95, (T.C. Mar. 26, 2002), *available at* https://www.ustaxcourt.gov/UstcDockInq/DocketDisplay.aspx?DocketNo=95015993 (granting joint motion for mediation).

53. *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1014.

54. *See* Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001).

55. *See id.* (holding that a transaction fails if it lacks either economic substance or business purpose, which is the same as saying that to succeed a transaction must possess both business purpose and economic substance).

56. *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1019.

57. *See id.* at 1019 (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("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.")).

58. *Id.* at 1020 ("The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive.").

fits.[59] The court held that the taxpayer satisfied this prong of the doctrine because each of the resulting obligations was a genuine and enforceable legal obligation.[60] Even though UPS shifted the income to an offshore affiliate, a third party insurance company assumed actual risk in the process. Also, UPS did not control the offshore affiliate—it was a separate legal entity.[61]

The court held that UPS had established that the transaction had both business purpose and economic substance.[62] Therefore, since neither business purpose nor economic substance was lacking, the court held in favor of UPS.[63]

2. *Compaq*

In *Compaq Computer Corporation v. Commissioner*, one of the largest personal computer manufacturers[64] had incurred tax liability on the sale of stock in another company for a capital gain of $232 million.[65] Twenty-First Securities Corporation learned of the gain and approached Compaq with some strategies to offset the tax owed on gain from the sale of stock.[66] One of the strategies involved the purchase and sale of stock in a foreign company through American Depository Receipts (ADRs).[67] Eventually, Compaq decided to go forward with the transactions in ADRs.[68]

Compaq made 23 purchases of ADRs in Royal Dutch Petroleum Corporation (Shell) right before the dividend record date of the stock.[69] The approximate $10 million Shell ADRs had an aggregate price of approximately $888 million.[70] Right after the dividend record date, Compaq sold all 23 blocks of ADRs for an aggregate price of $869 million.[71] The pre-record-date purchases and post-record-date sales all occurred

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59. *Id.* at 1018 ("The kind of 'economic effects' required to entitle a transaction to respect in taxation include the creation of genuine obligations enforceable by an unrelated party.").

60. *Id.* ("The restructuring of UPS's excess-value business generated just such obligations. There was a real insurance policy between UPS and National Union that gave National Union the right to receive the excess-value charges that UPS collected.").

61. *Id.* at 1019 ("OPL is an independently taxable entity that is not under UPS's control.").

62. *Id.* at 1020 ("We therefore conclude that UPS's restructuring of its excess-value business had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation.").

63. *Id.*

64. 78 T.C.M. (CCH) 20 (1999).

65. *See* Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 215 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

66. *Id.*

67. *Id.* at 216.

68. *Id.*

69. *Id.* at 217.

70. *Id.*

71. *Id.*

over the course of about an hour.[72] The difference between the purchase price and the sale price reflected an approximate $19 million loss for Compaq.[73] Holding the ADRs on the dividend record date entitled Compaq to an approximate dividend of $19 million after taxes.[74] In other words, the $19 million dividend was almost a complete offset to the $19 million loss on the transactions.

The dividend enabled Compaq to offset the loss without taking into account that Shell withheld a 15% tax on the dividend payment imposed by the Netherlands government.[75] The pre-tax dividend was an approximate $22.5 million, and that tax was an approximate $3.4 million and entitled Compaq to a foreign tax credit of the same amount.[76] The Shell game here, then, is that because the dividend appeared to provide a complete offset to the loss even after the withholding tax payment, Compaq received a near costless $3.4 million foreign tax credit. Compaq paid a fee of $1.5 million so the net tax benefit was an approximate $1.9 million.[77]

Neither the IRS's brief nor the Tax Court's opinion identified how Compaq could have been gaming the system. There was a $19 million inclusion in income offset by a $19 million capital loss, so no gaming there. The $3.4 million tax credit was offset by the payment of the tax that generated the credit, so no gaming there either. Neither the Tax Court's opinion nor the IRS's brief identified how the income from the dividend and the loss that resulted offset each other after the imposition of the Dutch tax on the dividend. In its appellate brief, the IRS was adamant that the multiple transactions were subject to the economic substance doctrine, but it was not persuasive in proving that Compaq received a tax benefit.[78] The brief identified the foreign tax credit as the tax benefit—and repeated this assertion over and over—but did not explain how it was a tax benefit when Compaq had to pay a foreign tax that gave rise to it.[79] The Tax Court and the IRS attempted to exclude the payment of the foreign tax from the calculations without much of an explanation.[80]

The reasoning of the Tax Court and the IRS raise the question of whether Compaq obtained a tax benefit at all. It stands to reason that if a taxpayer does not receive a tax benefit, perhaps the economic substance doctrine or any other anti-abuse rule should not apply. Compaq did, however, obtain a tax benefit. When the value of the Shell stock

72. *Id.* at 218.
73. *Id.*
74. *Id.*
75. *Id.* at 221.
76. *Id.*
77. *Id.*
78. *See generally* Brief for the Appellee, Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001) (No. 00-60648), 2001 WL 34094592.
79. *See id.*
80. *See generally id.*; *Compaq*, 113 T.C. at 221–22.

dropped after taking into account the payment of the dividend, it went down by the amount of dividend less the withholding tax because the seller of the stock could not take advantage of the foreign tax credit.[81] Because the seller could not take advantage of the foreign tax credit, it valued the shares less the withholding tax. Accordingly, Compaq was able to acquire stock with a value to Compaq of $22.5 million (because it could claim a foreign tax credit) by paying only $19.1 million.[82] Although this argument did not appear in the Tax Court opinion or the IRS's brief, it looks like the IRS raised it in oral argument. The Fifth Circuit dismissed it, however.[83]

Like *UPS*, Compaq prevailed on appeal.[84] The Fifth Circuit found that the transaction had both economic substance and a business purpose. The transactions had economic substance, according to the court, because they had both pre-tax profit and after-tax profit.[85]

With respect to business purpose, the court first suggested a lack of business purpose would not invalidate the transaction.[86] It appears from this comment that the Fifth Circuit applies a taxpayer friendly affirming test because the taxpayer could prevail by showing it satisfied one of the factors in contrast to the disaffirming test where a taxpayer must satisfy both factors. The court also appeared to reject a subjective test for business purpose. The court refused to find that Compaq's large capital gain was grounds for holding that the transaction lacked a business purpose.[87] Regardless, the court held the transactions had a business purpose because the court found that Compaq sought a pre-tax profit from the Shell dividend.[88]

The transactions having both economic substance and business purpose, the court held in favor of Compaq.

3. *Jade Trading*

Jade Trading, LLC v. United States[89] involved a listed transaction[90] known as Son of BOSS.[91] The transaction—entered into by three brothers, the Ervins—involved multiple stages with interim transactions.[92]

81. See Michael S. Knoll, *Compaq Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 26 VA. TAX REV. 821, 829 (2007).

82. *See id.*

83. *See Compaq*, 277 F.3d at 787 n.8.

84. *See id.* at 788.

85. *Id.* at 787.

86. *Id.* at 786.

87. *Id.* at 787 n.8.

88. *Id.* at 787.

89. 80 Fed. Cl. 11 (2007), *aff'd in part, vacated in part, rev'd in part*, 598 F.3d 1372 (2010), *reconsideration denied*, 81 Fed. Cl. 173 (2008).

90. The IRS maintains a "list" of transactions it deems questionable. *See* 26 U.S.C. § 6707A(c)(2) (West 2011); 26 C.F.R. § 1.6011-4(b)(2) (2009).

91. *Jade Trading LLC*, 80 Fed. Cl. at 57.

92. *See generally id.* at 29–35.

The Ervins each acted identically in the process, so they will be referred to collectively for purposes of simplicity. The brothers had just sold their cable business for approximately a $40 million profit and entered into the Son of BOSS transaction to offset that gain.[93] There were four stages: the spread transaction,[94] the contribution to the partnership,[95] the withdrawal from the partnership,[96] and the sale of the asset with built-in losses.[97] All stages occurred in the year of the sale of the cable business.[98]

In the spread-transaction stage, the Ervins formed LLCs. Each of the LLCs purchased currency option contracts and wrote (sold) currency option contracts.[99] The premium the Ervins paid for the purchase of the options was $45,000,060.[100] The premium to be received by the Ervins on the sale of the options was $44,550,054.[101] To enter these two transactions, the Ervins paid around $450,000, the approximate difference between the premiums on the two option contracts.[102] The purchase and sale of the option contracts were essentially offsetting positions.

The contribution to the partnership occurred the next month.[103] Each brother's LLC contributed the spread on the option contracts (rather than each individual contract) to Jade Trading, a partnership created by a hedge fund manager and a bank. The organizers set up Jade Trading ostensibly as a vehicle to engage in short to medium-term gains on derivatives trading.[104] When the underlying currencies started falling, the Ervins "decided" to have their LLCs withdraw from Jade.[105]

The withdrawal from the partnership occurred two months after the contribution.[106] The Ervins' LLCs received around $125,000 in cash and Xerox stock for their interest in Jade.[107] During that same month, the LLCs sold most of the stock in Xerox.[108]

The sleight of hand was that the Ervins were able to make a $45 million investment in Jade Trading without shelling out even close to

93. *See id.* at 15 (noting that the Ervins earned about $40 million selling their cable business); *id.* at 52 (noting the transaction was entered into in order to "generate a grossly inflated basis").

94. *See id.* at 31.

95. *See id.* at 34.

96. *See id.* at 35.

97. *See id.* at 36.

98. *See id.* at 15 (the business was sold in March of 1999); *id.* at 36 (the stock to which the loss attached was sold before December 31, 1999).

99. *See id.* at 31.

100. *See id.* ($15,000,020 x 3).

101. *See id.* ($14,850,018 x 3).

102. *See id.* at 13.

103. *See id.* at 31 (noting the Ervins entered the spread transaction in September 1999); *id.* at 34 (noting the Ervin's joined the Jade partnership in October 1999).

104. *See id.* at 30–31.

105. *Id.* at 35.

106. *Id.* (noting that the Ervins exited Jade in December 1999).

107. *Id.* at 36.

108. *Id.*

that amount in cash—as mentioned, they paid their broker only about $450,000. They received only around $380,000 back from their investment.[109] Accordingly, their cash loss was approximately $70,000, but they claimed a paper loss for tax purposes in excess of $44 million that offset the gain on the sale of their cable business in full. In other words, absent the Son of BOSS transaction, the Ervins would have reported $14 million in taxes on the sale of the cable business (assuming a 35% tax rate), and instead reported no tax due related to the sale.

How did they manage this savings on their tax returns? The contribution of assets and liabilities to a partnership, such as the purchased option contracts, is in general not a taxable event.[110] However, such a contribution affects the contributor's tax basis in that partnership—the partner's tax basis in the interest in the partnership is the value of the contribution.[111] For example, if I contribute $100 to a partnership, neither the partnership nor I get taxed. My basis in my interest in the partnership, however, would be $100. Common sense suggests that the initial contribution of the offsetting positions entered into by the Ervin LLCs would create a near zero basis in the Ervin's partnership interest in Jade Trading under the partnership rules because one would expect the assets (the purchased options) to be netted with the liabilities (the sold options). In other words, if I contribute an asset worth $100 along with an asset subject to a $100 liability, one would not expect an effect on my basis in the partnership because the contributions offset each other.

The Ervins argued, however, that while the purchased options increased the basis of the LLCs in Jade Trading, the sold options did not decrease the basis.[112] Their argument that the sold options did not decrease the basis rested on authority existing at the time permitting a taxpayer to treat the contract to sell an option as a contingent liability (which did not decrease the basis) rather than an actual liability (that would have decreased the basis).[113] On the basis of the facts of the case,

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109. *Id.* ($126,122 x 3).

110. *Id.* at 44 n.63; *see also* 26 U.S.C. § 721(a) (West 2011) ("No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.").

111. *Jade Trading*, 80 Fed. Cl. at 44; *see also* 26 U.S.C. § 722 ("The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution. . . .").

112. *Jade Trading*, 80 Fed. Cl. at 44 ("Plaintiffs claim that their bases in their Jade partnership interests increased by the value of the purchased option but did not decrease by the value of the sold option assumed by the partnership.").

113. *Id.* ("Plaintiffs argue that the sold options assumed by Jade were contingent obligations, not liabilities for purposes of lowering the basis in the Ervin LLCs' partnership interests under section 752(b). In so arguing, Plaintiffs seize upon the construction of section 752 by the Tax Court in *Helmer v. Comm'r*, [T.C. Memo 1975-160,] 34 T.C.M. (CCH) 727 (1975), which at the time of their transactions was good law.").

it appears that by design, the Ervins' LLCs entered into the option contracts with the intent of artificially boosting the LLCs' basis in Jade Trading. Administrative regulations no longer permit this strategy.[114]

In *Jade Trading*, it is not clear whether the court applied the affirmative or the disaffirming economic substance test. The court examined whether the transaction was "capable of making a profit and altering [the Ervins'] financial positions."[115] At trial, experts had testified that the investment in Jade could not turn a profit.[116] For the roughly $450,000 the Ervin LLCs put in Jade, the most they could have gotten back was $420,000.[117] Also, the LLCs each paid about $1 million in fees,[118] which made it even harder to profit. These two amounts led the court to conclude that a reasonable investor would not have expected a profit from the transaction.[119] Noting that the Ervins had invested in Jade Trading and then exited sixty days later, the court concluded that the purpose was not to make money speculating in currency markets but rather to generate inflated basis.[120] Accordingly, the taxpayers lost because their transactions lacked profit potential and business purpose.[121]

4. The Malleability of the Outcomes

What would the results have been if these cases had arisen in different circuits? *Jade Trading* would probably have come out the same regardless because the series of transactions lacked both economic sub-

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114. *See id.* at 44 n.64.

> On August 13, 2000, the IRS issued Notice 2000-44 announcing its intention to challenge transactions similar to the spread transaction at issue here. On June 24, 2003, the IRS issued new Temporary Regulations under § 752 with a retroactive effective date of October 18, 1999—after the Ervin LLCs' contributed the spread to Jade. Treas. Reg. § 1.752-6T (2003). Under those regulations, the sold short option would be treated as a liability. The preamble to this regulation states: "The definition of a liability contained in these proposed regulations does not follow *Helmer v. Comm'r*, T.C. Memo 1975-160. 68 Fed. Reg. 37434 (June 24, 2003)."

Id.

115. *Id.* at 48.

116. *Id.* at 49 ("Plaintiffs' and Defendant's experts, Mr. Shoji and Dr. DeRosa, agreed the maximum profit potential on the spread at expiration, on its face, was roughly $140,000, no matter how high the euro climbed.").

117. *See id.* (140,000 x 3).

118. *Id.* (explaining that $934,100 in fees was spent in forming Ervin LLCs).

119. *Id.* at 49–50 ("The fact that the Ervins had to spend over $934,000 to obtain an investment return of $140,000, establishes that no reasonable investor would engage in such a transaction to earn a profit.").

120. *Id.* at 52 ("Just as in *Gregory*, the Ervins' transfer of the spread transaction to Jade and their exit from Jade some 60 days later lacked economic substance because this machination was 'the consummation of a preconceived plan,' not to earn profits speculating on a new currency, but to enter and exit the partnership, using one leg of the spread to generate grossly inflated basis.").

121. *See id.*

stance and business purpose. On the same findings of fact, *Compaq* probably would have come out the same as well because the transactions had both economic substance and business purpose. *UPS*, however, might not have. In a circuit where business purpose was subjective,[122] UPS would have failed that part of the test—the court did not reject the finding below that UPS entered into the transaction to save money on taxes.[123] However, those circuits usually applied the taxpayer-friendly affirmative test.[124] Thus, the question in such a circuit would have been whether UPS would have satisfied the economic substance factor. Satisfying this factor would have been doubtful because UPS was likely going to continue earning the same amount of pretax profit after the restructuring as before or earn less because it interposed a third party into the structure.[125]

How would these cases come out under the version in § 7701(o)? Again, *Jade Trading* would probably arrive at the same result. UPS's failure to prevail would be more certain here. The statutory version uses the taxpayer-unfriendly disaffirming test and is more stringent with the factors.[126] As in the Eleventh Circuit, under a disaffirming test the taxpayer loses upon the failure to establish the presence of either of the factors. Also, the business purpose test in the statutory version is subjective. Thus, the finding that the transaction was entered into in order to save money on taxes would be dispositive.

C. Analysis of the Doctrine's Flaws

Are the results achieved applying the economic substance doctrine to the sample transactions or any other questionable transaction "good"? The literature on the economic substance doctrine is unrevealing. The view set forth here—that the economic substance doctrine, whether it is in statutory or precedential form, is an inappropriate tool for addressing questionable tax planning—is a minority one. The positions of commentators fall into three categories: (1) those who favor codification over the judicial doctrine; (2) those who favor the judicial doctrine over codification; and (3) the few who oppose the economic substance doctrine generally. Some commentators on the doctrine do not fit into any of these categories because they raise issues about the doctrine without taking a

122. *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 92 (4th Cir. 1985).

123. *See* United Parcel Serv. Of Am., Inc., 254 F.3d 1014, 1017 (11th Cir. 2001) ("[A]ccording to the [tax] court . . . contemporary memoranda and documents show that UPS's sole motivation was tax avoidance.").

124. *See, e.g.*, Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316 (11th Cir. 2001) (applying the taxpayer-unfriendly disaffirming test where a transaction fails if it lacks either economic substance or business purpose, which is the same as saying that to succeed a transaction must possess both business purpose and economic substance).

125. *See United Parcel Serv. of Am., Inc.*, 254 F.3d at 1016–17.

126. *See* 26 U.S.C. § 7701(o)(1) (West 2011).

position. Some of these commentators bear mentioning because of the significance of the issues they raise.

Proponents of codification pointed to aspects of the judicially developed version of the doctrine that codification would fix. First, it would fix the lack of uniformity arising from some courts applying an affirmative test, others applying a disaffirming test, and still others looking at the economic component and the purpose component as but two factors among many.[127] The new provisions set forth in the statute use a disaffirming test, meaning that a transaction fails if it lacks either the economic component or the purpose component. It is difficult to dispute that uniformity is an important aspect of tax law.

Second, proponents of codification suggested that codification would give the judicially developed doctrine more legitimacy.[128] One case, until it was reversed, created an uproar in the tax bar because the court refused to apply the judicial version of the economic substance doctrine on the basis that to do so would violate the Constitution's separation of powers.[129] The basic reasoning was that courts developed the doctrine, not Congress, yet Congress writes our laws, and the court is not bound by precedent conflicting with the laws Congress has written.[130] It is surprising that the court took such a bold move. Perhaps there are other judges that have refused to apply the doctrine *sub rosa* by deciding the case on technical grounds instead, but this judge took the doctrine head on. Perhaps it was necessary for Congress to codify it for the doctrine to remain viable. The Supreme Court continues to become more textualist, an approach that finds its grounding in the separation of powers.[131] Some prominent textualists have affirmed the application of the economic substance doctrine, though without giving it an explicit endorsement.[132]

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127. *See* Samuel C. Thompson, Jr., *Despite Widespread Opposition, Congress Should Codify the ESD*, 110 TAX NOTES 781, 782 (2006) ("Rather than increasing complexity and uncertainty, codification of the [economic substance doctrine] would lead to a uniform application of the doctrine.").

128. *See* Jeff Rector, Note, *A Review of the Economic Substance Doctrine*, 10 STAN. J.L. BUS. & FIN. 173, 189 (2004).

129. *See* Coltec Indus. v. United States, 62 Fed. Cl. 716, 740–41 (2004), *rev'd*, 454 F.3d 1340 (2006).

130. *See generally id.*

131. *See* Madison, *supra* note 4, at 703.

132. Even Judge Easterbrook, the source of this article's opening quotation, has authored an opinion affirming a lower court decision applying the economic substance doctrine. *See generally* Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008). It should also be noted that Justice Samuel Alito, thought to be a textualist, sat on the majority of the divided Third Circuit panel that affirmed the Tax Court's application of the economic substance doctrine in *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998), when he was a federal appellate judge. *See* Elliot M. Davis, Note, *The Newer Textualism: Justice Alito's Statutory Interpretation*, 30 HARV. J.L. & PUB. POL'Y 983, 984 (2007) ("[A]t least in simple cases, Justice Alito exhibits textualist behavior.").

Third, proponents suggested codifying the doctrine in order to strengthen it.[133] Some of the suggestions are general, but a few are very specific. For example, Professor James Delaney suggested that the doctrine be codified to shore up the profit requirement.[134] Indeed, Congress did clarify the profit aspect of the doctrine.[135]

Opponents of codification argued that it would weaken the judicially-developed version of the doctrine.[136] This category of commentators suggested that the judicially-developed doctrine is flexible, and that codification would take away this flexibility.[137] It appears that the drafters took this criticism into account. The statute attempts to preserve the flexibility of the common law version by providing that "the determination of whether the economic substance doctrine is relevant" will remain the same as before the enactment.[138]

The positions for and against codification assume without much discussion that the economic substance doctrine in some form is good for our tax system. Commentators appear to either presume that protection of the fisc outweighs any other concerns with the tax system or remain unaware of alternatives. Although the position of this article is that the

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133. *See, e.g.*, James M. Delaney, *Where Ethics Merge With Substantive Law—An Analysis of Tax Motivated Transactions*, 38 IND. L. REV. 295, 341–42 (2005) (suggesting that the economic substance doctrine should be enacted into law to strengthen the requirement of profit); James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 165 (2002) ("[T]he time may well be at hand when the creation of uncertainty (rather than merely "frictions" or impediments) for excessively tax-driven transactions is the only way to stop them."); David B. McGinty, *Economic Substance, Business Purpose, and Tax Avoidance in Section 351 Contingent Liability Transactions After* Black & Decker, Coltec, *and* Hercules, 36 CUMB. L. REV. 1 (2005) (suggesting that judicial doctrines are not applied at times because of lack of codification); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325 (2002) (suggesting that codification of the economic substance doctrine would permit Congress to resolve whether it applies to separate aspects of a larger transaction).

134. *See* Delaney, *supra* note 133, at 341–42.

135. *See* 26 U.S.C. § 7701(o)(2)(A) (West 2011) (providing that the profit requirement is satisfied "only if the present value of the reasonably expected pre-tax profit . . . is substantial" with respect to the "tax benefits . . . .").

136. *See generally* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77 (2006). The NYSBA Tax Section "did not think it possible . . . to devise a sequence of abstract words that distinguishes abusive tax-motivated transactions from other transactions." *Id.* at 110. "Over the years, the organized tax bar has engaged in a sustained attack on codification [of the economic substance doctrine]." *Id.* at 113; *see also* Dennis J. Ventry, Jr., *Save the Economic Substance Doctrine from Congress*, 118 TAX NOTES 1405 (2008).

137. *See* Edward L. Froelich & John W. Westmoreland, *Common Law vs. Rule of Law*, 106 TAX NOTES 723 (2005); Ventry, *supra* note 136, at 1405–06 ("Codification is a *terrible* idea. Reducing 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.").

138. 26 U.S.C. § 7701(o)(5)(C).

fisc is important as well, the suggestion below is that there are additional concerns and other ways to protect it.

There are clear benefits to having an economic substance doctrine or some other identifiable "anti-abuse" rule. Like any other explicit "anti-abuse" rule, the judge-developed doctrine provides an appearance of fairness. When it appears that one taxpayer has abused the tax laws, other taxpayers do not want to feel like chumps. Sanctioned transactions that appear abusive might make the tax laws seem unfair. Thus, perhaps a court's willingness to unravel questionable tax benefits sets everything right with the rest of the taxpaying public.

Perhaps incorporating the doctrine into the Internal Revenue Code has given the doctrine legitimacy. As discussed above, a recent lower court decision refused to apply the economic substance doctrine.[139] Although the appellate court reversed the decision, the lower court opinion lays persuasive groundwork for courts to refuse to apply the pre-statute version of the doctrine developed in the courts—the separation of powers in the U.S. Constitution.[140]

Regardless of whether these issues have been addressed by replacing the judicial doctrine with Internal Revenue Code provisions, the economic substance doctrine remains an inappropriate tool to deal with questionable tax planning because it makes the law vague, uncertain, and fallacious. The vagueness of the law and the fallaciousness in its application make the law uncertain, but these concepts are independent problems that merit separate discussion.

1. Vagueness

The most salient problem with the economic substance doctrine is that it is vague. It is vague because the two crucial terms of the doctrine are vague.[141] The terms have meant different things to different people at different times. It appears that Judge Hand's factual analysis morphed into substantive legal standards that overlay and override the text of the Internal Revenue Code.[142] The economic substance doctrine has not proved a useful tool for Congress to demarcate exactly what it wants to tax and exactly what it does not want to tax. These terms in the enacted provisions are no less vague than the judicial doctrine.

As discussed above, the courts had found three different ways to apply the business purpose test.[143] The fact that courts had developed

139. *See* Coltec Indus. v. United States, 62 Fed. Cl. 716, 740–41 (2004), *rev'd*, 454 F.3d 1340 (Fed. Cir. 2006).

140. *See generally id.*

141. *See* Joseph Bankman, *Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs*, 31 OHIO N.U. L. REV. 1, 5 (2005); Madison, *supra* note 4, at 722–29 (discussing the sham transaction doctrine, which is another term for the economic substance doctrine).

142. *See* Lederman, *supra* note 6, at 398, 402–09.

143. *See* discussion *supra* Part II.A.

three ways to apply the test is itself evidence that the term "business purpose" was vague. The new provision resolved this aspect of vagueness by making the business purpose test a subjective test, eschewing the objective and statutory interpretation applications.[144] Another point of vagueness resulted in part by the use of the word "business purpose" in the doctrine. In *UPS*, the court of appeals noted that the Tax Court's opinion in the case took the term literally despite the fact that the Supreme Court has held that taxpayers may engage in tax planning.[145] Given that tax-planning is permissible,[146] it is strange that a court determining whether a transaction had a business purpose would consider that the materials a taxpayer may have read happened to emphasize tax benefits.[147] In the new provisions, it appears that the purpose requirement is a full narrative that is more specific. This change means that the requirement can probably be taken more literally. However, it is not clear whether Congress still expects courts to credit Judge Hand's and Justice Holmes's proclamations that taxpayers are entitled to minimize their taxes.[148] There is no mention of these proclamations in the legislative history.[149]

While clearing up some of the vagueness, the statutory version of the doctrine includes a modifier to the purpose requirement: the taxpayer's non-tax purpose must be "substantial."[150] This modifier adds some vagueness that was not present before. A substantial non-tax purpose is about as clear as a substantial pregnancy.

The term economic substance makes the law vague because profit has little bearing on the validity of a transaction. Consider loss leaders. A loss leader is a product that a retail store sells below cost to attract

144. 26 U.S.C. § 7701(o) (West 2011).

145. United Parcel Serv. Of Am., Inc., 254 F.3d 1014, 1019 (11th Cir. 2001) ("[T]he tax court's narrow notion of 'business purpose'—which is admittedly implied by the phrase's plain language—stretches the economic-substance doctrine farther than it has been stretched . . . . This concept of 'business purpose' is a necessary corollary to the venerable axiom that tax-planning is permissible."); *see also* Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("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."); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395–96 (1930) ("The fact that [the taxpayer] desired to [escape taxation] is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it.").

146. *See* Madison, *supra* note 4, at 720–21 & n.152 (citing Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935)).

147. *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 93 (4th Cir. 1985).

148. *See Superior Oil*, 280 U.S. at 395–96; Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) ("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.").

149. *See* Health Care and Education Reconciliation Act of 2010, H.R. 4276, 111th Cong. § 1409 (2010).

150. 26 U.S.C. § 7701(o) (West 2011).

customers with heavily discounted prices.[151] Under the disaffirming economic substance test where a transaction must have a business purpose (which a loss leader does) and a reasonable expectation of profit (i.e., economic substance), a retail store would be theoretically prohibited from including the cost of the product in cost of goods sold on a federal tax return because by definition there is no possibility of profit.

In addition, the possibility of profit has little to do with the validity of deductions on interest corporations pay. Corporate taxpayers are entitled to deduct amounts paid on indebtedness.[152] This is a benefit for taxpayers that finance with debt rather than equity.[153] Consider an investor that contributes $100 to a business and expects $10 a year from the business. The investor will receive the yearly income as a dividend or as interest depending on whether the investment contribution was to capital (*i.e.*, an equity investment) or a loan (*i.e.*, a debt investment).[154] For the business which obtained the financing, the payment of interest is deductible but the payment of a dividend is not. The deductibility of the interest paid to the investor is a tax benefit for which the business incurs only a cost and cannot reasonably expect a profit. Accordingly, where profit potential is relevant, interest deductions are theoretically not allowed.

Regardless, the Supreme Court has never found that the term economic substance means profit or that it means anything else. In addition, commentators have made the case that a pre-tax profit requirement to ferret out questionable tax planning lacks a coherent basis.[155]

The Supreme Court used the word "substance" in *Gregory* and in *Knetsch*.[156] In neither case was the word used to refer to profit. Rather, in both cases the term substance appears to have meant: not a sham.[157] In *Gregory*, the Court was setting forth the Commissioner's position rather than defining the term itself.[158] In the end, the Court's holding was

151. *See* Stephen A. Butscher & Michael Laker, *Market-Driven Product Development*, MARKETING MGMT., Summer 2000, at 48, 48–53.

152. 26 U.S.C. § 163 (West 2011).

153. *See* MICHAEL A. LIVINGSTON ET AL., TAXATION LAW, PLANNING, AND POLICY 659–61 (2010).

154. The dividend is the economic equivalent of the interest payment. *See id.* at 737.

155. *See* David P. Hariton, *The* Compaq *Case*, Notice 98-5, *and Tax Shelters: The Theory is All Wrong*, 94 TAX NOTES 501, 508 (2002); Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985, 987 (1981); George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405, 420 (2002).

156. *See* Knetsch v. United States, 364 U.S. 361, 366 (1960) ("There may well be single premium annuity arrangements with nontax substance which create an 'indebtedness' for the purposes of § 23(b) of the 1939 Code and § 163(a) of the 1954 Code. But this one is a sham."); Gregory v. Helvering, 293 U.S. 465, 467 (1935) ("The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded . . . .").

157. *Knetsch*, 364 U.S. at 366; *Gregory*, 293 U.S. at 467.

158. *See Gregory*, 293 U.S. at 467 ("The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance . . . .").

that the transaction labeled a reorganization was not—despite having met all of the statutory requirements—a reorganization under the Code.

Similarly, the Supreme Court used the term "substance" in *Court Holding*.[159] In *Court Holding*, the Supreme Court held that substance rather than form controls in tax cases.[160] The Court was basically saying that we look at what really happened rather than taking for granted what a taxpayer labeled a transaction. This interpretation is consistent with *Gregory* and *Knetsch*, but there is still no mention of profit.

Perhaps it is irrelevant how the courts went down this road of equating profit potential to economic substance. The statute now contemplates profit potential as a manner of satisfying the economic prong of the doctrine.[161] It is still not clear, however, how one shows a meaningful economic effect without demonstrating profit potential.

The requirement of a meaningful change in economic position has a slight advantage in that the factor does not bear the same name as the doctrine.

2. Uncertainty

Tax policy discussions tend to focus on efficiency and fairness.[162] An often ignored policy consideration is uncertainty, which is one of the most troubling problems with the economic substance doctrine. It makes the tax law uncertain. Adam Smith set forth a maxim regarding certainty in 1776 that tax law should be certain and not arbitrary.[163] Although no commentators have made a direct challenge to Adam Smith's maxim regarding certainty, some suggest that other considerations deserve pri-

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159. *See* Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945) ("The incidence of taxation depends upon the substance of a transaction.").

160. *See id.*

161. 26 U.S.C. § 7701(o)(2) (West 2011).

162. *See* LAURIE L. MALMAN ET AL., THE INDIVIDUAL TAX BASE 8–14 (2002).

163. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 536 (Harriman House 2007) (1776); *see also* Paul J. Donahue, *The Rule of* Sheldon v. Commissioner*: Is it an Economically Efficient Evolution of the Sham Transaction Doctrine?* 13 VA. TAX. REV. 165 (1993) ("The goal of certainty has been universally acknowledged as a sign of sound tax policy since Adam Smith's *The Wealth of Nations*."). Mr. Donahue is one of the few commentators to bring up Adam Smith's maxim in the context of questionable tax planning. Although he acknowledges the maxim, he believed in 1993 that the economic substance doctrine (referred to as the sham transaction doctrine at the time) created uncertainty but not so much uncertainty as to violate the maxim. *Id.* at 183. Most importantly, he agrees with Adam Smith that taxes should be certain. Professor John Coverdale has also suggested that certainty takes precedence over judicial text avoidance. John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1507 (1997) ("A decision rule that prohibits courts from adopting antitextual interpretations reflects the proper roles of the legislature and the courts under our democratic constitutional system, it respects the distinctive characteristics of the Code, and it promotes the values of certainty and predictability that are very important when dealing with tax statutes.").

ority.[164] In choosing a solution for addressing questionable tax planning, it would seem that, all else being equal, it is safe to assume even these commentators would prefer a solution that causes less uncertainty than the other options.

The uncertainty arises in part from the vagueness inherent in the terms discussed above, but other factors contribute as well. This section discusses the lack of a definable target and overbreadth. The next section discusses another factor that creates uncertainty, which is the fallaciousness in the application of the business or non-tax business purpose prong of the doctrine.

The doctrine is uncertain in part because the target—questionable tax planning behavior—is difficult to define. This target is difficult to define because it is subjective, situational, and dynamic. It is not clear what should be accomplished with the economic substance doctrine. For example, it is hard to tell if supporters of the doctrine believe it should deter all potentially questionable tax planning or if it should merely take away the incentive to devise questionable devices.

It is also not clear what behaviors one should deem questionable in the context of taxation because the idea of what constitutes questionable tax-planning behavior is somewhat subjective.[165] An authoritative "White Paper" provides a list of characteristics associated with questionable tax planning behavior.[166] It gives little guidance, however, as to what is questionable about most of the characteristics listed.[167] According to the White Paper it was the level of tax avoidance that was unacceptable at the time, but it acknowledged that questionable tax planning behavior was difficult to define.[168]

The White Paper identified the following characteristics of questionable tax planning:

(1) Lack of economic substance;

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164. *See* Eustice, *supra* note 133, at 165 ("[T]he time may well be at hand when the creation of uncertainty (rather than merely 'frictions' or impediments) for excessively tax-driven transactions is the only way to stop them."); Donahue, *supra* note 163, at 183.

165. *See* Calvin H. Johnson, *What's a Tax Shelter?* 68 TAX NOTES 879, 879 (1995) ("There is no consensus definition of a 'tax shelter' in the law or legal literature. The most authoritative definitions, alas, also make the least sense."); Deborah H. Schenk, *Foreword*, 55 TAX L. REV. 125, 127 (2002) ("The difficulty with defining shelters is that, like Justice Potter Stewart, we know them when we see them, but we apparently cannot agree either on what we are seeing or how to describe what we see."); Schler, *supra* note 133, at 328–29 (noting "that there is no established definition of the term [tax shelter]. . . . Any number of definitions . . . are possible"); *see also* Borris I. Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 MICH. L. REV. 1099, 1100–20 (1973) (noting that different commentators often use the same language to criticize very different aspects of the tax system).

166. U.S. TREASURY DEP'T, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 14 (1999), *available at* http://www.quatloos.com/whiteppr.pdf [hereinafter TREASURY WHITE PAPER].

167. *See id.* at 13–18. The White Paper asserted that it was the level of tax avoidance that was unacceptable at the time. *Id.* at 1.

168. *See id.* at 1.

(2) Inconsistent financial and accounting treatment;

(3) Presence of tax-indifferent parties;

(4) Complexity;

(5) Unnecessary steps or novel investments;

(6) Promotion or marketing;

(7) Confidentiality;

(8) High transaction costs; and

(9) Risk reduction arrangements.[169]

Most of these characteristics are not inherently questionable on their own. Most observers would agree, for example, that some complex transactions with high transaction costs are beyond question. High transaction costs in light of other factors, however, may raise questions about tax planning. In *Jade Trading*, the transaction costs were only recoverable with a rate of return investors could have reasonably expected.[170]

Another notable point regarding the subjective nature of determining the characteristics of questionable tax planning behavior is the suggestion that in some cases the planning behavior might not appear questionable if done in the formation of an entity rather than as a restructuring.[171] Professor George Yin raised the issue in scrutinizing the transaction in *UPS*. Although he ultimately concluded that the transaction is questionable, he queried whether the UPS transaction would have received much criticism if UPS had already had an existing entity offshore. It is a good point. If a taxpayer is involved in a business, and a competitor enters the market with a tax-efficient structure already in place,[172] should the taxpayer remain disadvantaged?

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169. *Id.* at 14–18.

170. *See* Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 49 (2007), *aff'd in part, vacated in part, rev'd in part by* 598 F.3d 1372 (Fed. 2010), *reconsideration denied*, 81 Fed. Cl. 173 (2008) ("[J]ust breaking even on this investment, that is, exiting Jade with the $225,002 invested and enough to cover the over $934,100 in fees, would have required at least an annualized 420 percent rate of return on that $225,002 investment.").

171. *See* Yin, *supra* note 155, at 423–24 ("One wonders whether the plan [in United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001)] would have encountered the same scrutiny had the taxpayer initiated the excess-value activity with the restructured steps in place. If not, should there be a different result if, for whatever reason, the 'tax' steps are not taken until a later time?").

172. Using UPS as an example, one could imagine a competitor entering the package delivery business already having an excess value reimbursement structure sitting in Bermuda.

A common test for whether a transaction is questionable is whether the results are "too good to be true."[173] This test is subjective on its face. There is some irony here, and this irony helps illustrate the subjective nature of the economic substance doctrine. The economic substance doctrine can serve as a tool to override a tax result the government does not like even though the transaction achieving the result complied with the technical requirements of the Internal Revenue Code, related regulations, and other administrative rulings. The situation in which the doctrine gets used in theory arises when a taxpayer takes a "too good to be true" position on a tax return which is denied on audit. The taxpayer generally either sues the government to stop collection of the deficiency amount or pays the government the amount of the tax liability and eventually sues for a refund.[174] In defending the denial of the claimed tax benefits, the government's argument sounds plausibly legalistic: "*Your Honor, we denied the tax benefit by application of the economic substance doctrine.*" In essence, however, the government is a defendant saying, "*Your Honor, we want you to just ignore the fact that the taxpayer complied with the relevant Code provisions, regulations, and rulings.*" This argument is nothing short of incredible for a defendant. Imagine a criminal defendant making the same argument: "*Your Honor, just ignore the fact that there is a law against robbing a bank.*" The suggestion here is that the government's argument that the economic substance doctrine should apply in a court of law, which can render any provisions in the Internal Revenue Code inapplicable, is in itself too good to be true and therefore makes a significant contribution to the uncertainty in the tax laws.

In addition, the prevailing wisdom of what constitutes questionable tax planning behavior is subject to change. An example of a change that occurred in the courts is the concept of a double tax benefit. For a number of years, courts had shown some reluctance to permit taxpayers to gain more than one benefit from a transaction.[175] In 2001, however, the Supreme Court decided a case where it backed off of this proposition.[176]

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173. Evidence that the term is often used to determine whether tax planning is questionable is the fact that the concept is incorporated into the Treasury regulations addressing penalties. *See* 26 C.F.R. § 1.6662-3(b)(1)(iii) (2009). It is incorporated into IRS guidance as well. A Google search on the IRS web site for the phrase "too good to be true" returned 427 hits [search run Jan. 18, 2010].

174. *See generally* Thomas D. Greenaway, *Choice of Forum in Federal Civil Tax Litigation*, 62 TAX LAW. 311 (2009).

175. *See, e.g.*, United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969) ("[T]he Code should not be interpreted to allow [the taxpayer] 'the practical equivalent of double deduction' . . . ." (quoting Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934)); United States v. Ludey, 274 U.S. 295, 301 (1927) ("Any other construction would permit a double deduction for the loss of the same capital assets."); S/V Drilling Partners v. Comm'r, 114 T.C. 83, 89 (2000) ("The denial of double credits under section 29 is consistent with the long-standing judicial preference for interpreting tax statutes, absent a clear declaration of congressional intent, not to allow double credits.")).

176. *See* Gitlitz v. Comm'r, 531 U.S. 206, 219–20 (2001) ("[C]ourts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of in-

Another characteristic of the economic substance doctrine that makes the tax law uncertain is that it is overbroad. It pervades every provision of the Internal Revenue Code.[177] The staff of the Joint Committee on Taxation suggested that this far-reaching facet of the doctrine interfered with Congress's ability to get previous proposals for codification passed.[178] The Staff addressed the overbreadth problem in a proposal to Congress by limiting the application of its suggested economic substance doctrine formulation to known tax shelter problem areas of the Internal Revenue Code.[179]

The scope of the doctrine is all-encompassing. The economic substance doctrine can apply to virtually any transaction.[180] If a transaction does not meet the terms accorded to the doctrine by a particular judge then the judge may deny the tax benefits despite a clear provision in the Internal Revenue Code providing them. Government guidance has provided support to this understanding of the economic substance doctrine by suggesting the doctrine applies to almost any transaction where the anticipated pre-tax profit is not significant in relation to the anticipated tax benefits.[181] As Professor Leandra Lederman has pointed out, the economic substance doctrine does not distinguish between measuring provisions and incentivizing provisions.[182] It is as if the tax system did not have the bug spray to kill ants that infested the house so it threw a hand grenade at them.

An example of a provision that provides an intentional tax benefit is the home mortgage interest deduction. Taxpayers may deduct interest paid on a home mortgage.[183] However, such a deduction is available only for a personal residence.[184] In theory, using business purpose as a factor,

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debtedness before reducing any tax attributes, the shareholders would wrongly experience a 'double windfall' . . . . Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern.").

177. *See generally* David P. Hariton, *Economic Substance Complaint No. 1: 'Too Vague and Too Broad,'* 96 TAX NOTES 1893 (2002).

178. *See* STAFF OF THE JOINT COMM. ON TAXATION, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 1 (2005) ("Prior proposals to restrain such activity by codifying the 'economic substance' doctrine have been criticized as either removing too much flexibility from the courts or potentially applying too broadly to many non-tax-shelter transactions.").

179. *See id.* at 19–20 (setting forth "applicable transactions").

180. *See* Madison, *supra* note 4, at 716 n.131; *see also* Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 864 (1982) (reviewing BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (1981)) ("The effect of these doctrines is the existence alongside the Internal Revenue Code of an additional (and somewhat autonomous) set of principles for deciding tax disputes."); *see also* Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 695 (1978).

181. *See* Rev. Rul. 99-14, 1999-1 C.B. 835 (referring to the economic substance doctrine as the sham transaction doctrine).

182. Lederman, *supra* note 6, at 392–93.

183. *See* 26 U.S.C. § 163(h) (West 2011).

184. *See id.*

such a deduction would not be allowable because the loan is not entered into for business purposes. Many taxpayers own rather than rent in order to take advantage of the incentive, meaning they do not even have a non-tax purpose. The new statutory version of the economic substance doctrine discussed above provides an exception for individuals, reducing some of the potential overbreadth.[185] It also reduces the breadth by limiting the doctrine to federal income taxes.[186]

It appears that the government has attempted to address the uncertainty problem through internal administration. It is the author's understanding that there is a group of attorneys within the IRS Chief Counsel Office that deal exclusively with economic substance. It is the author's further understanding that the point of such attorneys dealing solely with the doctrine is to make sure it is applied uniformly at the agency level. Although the installation of such a group is commendable and deserving of the highest recognition, it does not overcome the myriad problems discussed here. It does not make sense to give the government such a destructive weapon to use against taxpayers, even if they restrain themselves from using it without extensive review. Restraining an exterminator from using hand grenades to rid a house of ants is inferior to arming the exterminator with an appropriate bug spray.

3. Fallaciousness

Another problem with the economic substance doctrine is that it is fallacious. A fallacy is a deceptive error in reasoning.[187] One of the factors—business purpose—suffers from a motive fallacy in its application. This motive fallacy pervades everyday life.[188] The person who invokes this fallacy is essentially making a point—one that deceptively sounds reasonable—that is not necessary to support his conclusion.[189]

Consider a pharmaceutical company's assertion that its medication will alleviate depression. One who asserts that the pharmaceutical company is not being truthful on the basis that it is just trying to make money has committed the motive fallacy. Whether it is true that the medication will alleviate symptoms of depression does not depend on the pharmaceutical company's motive. Rather, the truth of the assertion depends on whether people who take the medication find their depression alleviated by it. Philosopher Jamie Whyte suggests that the motive fallacy is pervasive because it is much easier to rely on the motive falla-

185. *See id.* § 7701(o)(5)(B).

186. *See id.* § 7701(o)(1)(A)&(B).

187. HARRY J. GENSLER, INTRODUCTION TO LOGIC § 15.2, at 331 (2002) ("A fallacy is a deceptive error of thinking.").

188. JAMIE WHYTE, CRIMES AGAINST LOGIC: EXPOSING THE BOGUS ARGUMENTS OF POLITICIANS, PRIESTS, JOURNALISTS, AND OTHER SERIAL OFFENDERS 16–17 (2004) ("The difficulty with the Motive Fallacy is not so much seeing that it is a fallacy, but spotting its instances in everyday life. It is so common that we have become desensitized . . . ." Once you "attune yourself to it . . . you will see that the Motive Fallacy is . . . universal.").

189. *See generally id.*

cy than to actually go through all the work of verifying the truth of a particular assertion.[190] In our example, it is much easier and cheaper to question the pharmaceutical company's motives than to go through the hassle of actually conducting drug trials of the product to see if it works.[191]

As in the pharmaceutical company example, when the government raises the economic substance doctrine, implicit (perhaps sometimes explicit) in the invocation of the business purpose factor is an attack on the motives of taxpayers. The argument is that the taxpayer is just trying to save money on taxes. Stated in this way, the violation of the motive fallacy becomes apparent. If Congress replaces the term "business purpose" with "non-tax purpose" in codifying the doctrine, the underlying attack on the taxpayer's motive is still there. Whether the term is business purpose or non-tax purpose, an essential element of the government's argument is that the taxpayer's motives are questionable. This argument is a fallacy.

The fallacy is salient when the tables turn as well. There are practitioners, taxpayers, and perhaps others that find fault with the government because it just wants to collect more taxes. This assertion is as fallacious when questioning the government's motives as it is when questioning a taxpayer's motives. An important difference, however, is that there is no doctrine that permits taxpayers to invalidate the actions of the government on the basis of its motives. The positions the author's clients have taken in accomplishing the objectives advised upon—whether that be complying with the tax laws, collecting taxes, or presiding over disputes between taxpayers and the government—were within the bounds of the law. Questioning the positions of any of these clients on the basis of their motives is a violation of the motive fallacy. The statutory version of the doctrine adopts this fallacy into the Internal Revenue Code by imposing a subjective purpose requirement on the taxpayer.[192]

4. Consequences of the Above Flaws

Because the doctrine makes the tax law vague, uncertain, and fallacious, it creates a colossal waste of time, money, and government resources. Taxpayers spend a great deal of time litigating cases involving the economic substance doctrine. The *UPS* case came out in UPS's favor

190. *Id.* at 17 (using an example where a news organization reports the findings of a think tank and then refers to it as "right-leaning" instead of refuting the think tank's conclusions with actual support because "that would require reading the [think tank's] paper, and perhaps other works cited in support of the case . . . [a]nd who has the time or energy for all that?").

191. *See generally id.*

192. 26 U.S.C. § 7701(o) (West 2011).

nearly two decades after the company filed returns for the years litigated.[193]

In terms of wasting money, the litigation costs are patent. Because the case took almost two decades to resolve, the attorneys for UPS did not come cheap. But that is only one taxpayer that went to litigation. Sophisticated taxpayers—even if they never litigate a case involving the economic substance doctrine—must take it into account in their business planning. This expense should be unnecessary because an ideal system of taxation is a rule-based system where the law, for the most part, gets its content prior to a taxpayer entering into any transactions. It is important for the law to have clarity prior to filing a return. The economic substance doctrine, despite taking on the appearance of a rule, creates tremendous expense because it is a disguised standard.

Taxpayers are not the only ones that waste time and money as a result of the economic substance doctrine. The government does so as well. With clearer rules, it might not have been necessary for the government to litigate any of the sample cases above.

III. A RISK REQUIREMENT ALTERNATIVE

For the above reasons, the economic substance doctrine should perish. Taking this as a given, how does one evaluate alternatives? First and foremost, the best alternative would not suffer from the same maladies as the economic substance doctrine. Rather than make the tax law vague, uncertain, and fallacious,[194] the alternative should clarify the tax law, while at the same time making it more certain and cogent. In addition, the alternative should be broad enough to cover as many questionable transactions as possible, narrow enough that it does not delegate Congress's taxing power to the IRS and the courts, and balanced enough that it does not chill legitimate transactions.

Let us consider some (hopefully) hypothetical situations. In this first hypothetical, assume that you are considering entering into a transaction to "shelter" some of your earnings or gains. Your tax advisor—be it an attorney, accountant, or tax return preparer—says to you, "The IRS will probably disallow the tax benefits of that transaction because it doesn't have economic substance." Before reading this article, or becoming a tax attorney, would you have known what economic substance meant? You could have tried to look up the terms "economic" and "substance," but that would not have provided you much of an answer. Delving into "meaningful economic effect" and "substantial [non-tax] purpose" would not have served as much of a guide either.

In this second hypothetical, assume the same facts as above except that the advisor says, "The IRS will probably disallow the tax benefits of

193. *See* United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1016 (11th Cir. 2001).

194. *See* discussion *supra* Part II.C.

that transaction because the other party (or you) doesn't take any risk." The chances are that you have a much better idea of what your advisor is talking about. Risk is a term a taxpayer can understand and apply without much assistance. Such is not the case with the terms "economic substance," "meaningful economic effects," "business purpose," and "non-tax purpose."

Creative taxpayers and their advisors have succeeded at creating artificial losses, artificial profits, and artificial purposes, as well as generating artificial foreign tax credits to obtain tax benefits. It is doubtful, however, that a taxpayer would be able to create artificial risk to meet a risk requirement without committing outright fraud. The essence of what is questionable about a transaction that many might reasonably find objectionable is that one of the parties has not taken on any risk. Conversely, the author is not aware of a transaction where all the parties take appropriate risks that would reasonably be questionable.

As risk is the essence of what is questionable, the target of the risk requirement is very specific—transactions without risk or parties to a transaction who have not taken on any risk. There may be some choices to make regarding which formulation of the risk requirement strikes the optimal balance between the legitimate objectives of the taxpayers and the objectives of the government. Once the choice is made, however, the risk requirement will not have the flaw that the economic substance doctrine has—an undefined target. Accordingly, a risk requirement would bring more certainty to the application of the tax laws.

Although the term "risk" may have different meanings in different professions—insurance, financial, legal, and medical, to name a few—a fact-finder asked to determine whether a transaction took on appropriate risks will have no trouble understanding the job. An attorney representing a taxpayer required to demonstrate that a transaction carried appropriate risks will have no difficulty determining what types of witnesses to call. With the economic substance doctrine, there is no telling what types of witnesses might be necessary. The doctrine is a "smell test."[195] It is difficult to decide what type of witness will make a transaction smell nice. When an economist or other witness testifies, it is easy for the court to dismiss the testimony by concluding that the witness focused on the wrong economic effects or the wrong kinds of profit.[196]

A risk requirement may, in some cases, be harder on the taxpayer; in other cases, it might be harder on the government. But, in either case, for both parties, it would be clearer what each has to do. To prove a party to a transaction incurred risk, a taxpayer could present its own

195. *See* ACM P'ship v. Comm'r, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting) (suggesting that the majority's application of the economic substance doctrine is "something akin to a 'smell test'").

196. *See, e.g.*, Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 782 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999) (noting the trial court used a "curious method of calculation" in assessing whether the taxpayer had a reasonable possibility of profiting).

employees, or it could present risk analysts for a particular industry, a particular type of transaction, a particular type of taxpayer, or a particular type of risk. The government would have a better idea what it needs or who it needs to present to disprove the taxpayer's witnesses. Although it is less likely to be necessary to call expert witnesses to determine whether a transaction involved the appropriate amount of risk, there is an entire profession—actuarial science—that can assist both parties. Actuaries evaluate risk on a daily basis.[197] Whereas satisfying the economic substance doctrine is somewhat of an art—and an abstract one at that—the application of a risk requirement would be more like a science.

Moreover, the risk requirement will be easier to understand. Taxpayers, the government, and fact-finders would have little difficulty determining whether a transaction carries the appropriate risk. The codification of the economic substance doctrine replaces existing confusing and vague terms with new confusing and vague terms. The economic substance doctrine has a history that would become meaningless if new terms strayed too far from the historical terms. A statutory risk requirement would not bring with it any excess baggage that the new statutory economic substance doctrine brings.

Many have acknowledged the importance of risk in determining whether transactions may be questionable for tax purposes. For example, several Supreme Court cases involving transactions that the government thought were questionable involved the taking of risk resulted in decisions in favor of the taxpayer. First, in *Frank Lyon* the Supreme Court noted a number of reasons to sustain the tax benefits of the transaction, and appeared to emphasize risk.[198] Second, in *Cottage Savings* the Supreme Court sustained transactions where the taxpayer swapped economically equivalent portfolios of mortgages and claimed deductions for the tax losses.[199] The economic equivalence, however, was theoretical. The taxpayer took the risk that the portfolio it received in exchange for the one it gave up was economically inferior. Third, in *Eisner v. Macomber* the taxpayer was permitted to defer payment of tax because his investment "remain[ed] the property of the company, and subject to business risks which may [have] result[ed] in wiping out the entire investment."[200]

It is apparent that Congress recognized a relationship between risk and questionable tax planning in 1984 when it enacted section 7701(f).[201] This section required the Treasury to prescribe regulations "necessary or appropriate to prevent the avoidance of those provisions of this title

197. *See What Is an Actuary?*, SOCIETY OF ACTUARIES, http://www.soa.org/about/about-what-is-an-actuary.aspx (last visited May 2, 2011).

198. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

199. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554 (1991).

200. 252 U.S. 189, 211 (1920).

201. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 53, 98 Stat. 494, 565 (codified as amended 26 U.S.C. § 7701 (2006)).

which deal with . . . diminishing risks."[202] The IRS has not yet issued final regulations pursuant to this provision.[203] Congress has also used the concept of risk to determine when tax consequences occur. A stock option is taxable under § 83 when it becomes transferrable or is no longer subject to a substantial risk of forfeiture.[204] Although the provision does not relate risk directly to questionable tax planning, it is significant that risk is used as a proxy for determining when the taxable aspect of a transaction takes place.

Some literature suggests that the proper focus of an inquiry into a transaction is on the risks taken. A risk requirement as suggested here aligns with this literature.[205] To some extent the Treasury Department has also identified risk as an important factor. The idea, however, may have gotten lost in the concept of economic substance.[206] The economic substance doctrine does not serve as an appropriate gauge of questionable tax-planning behavior. A risk requirement could serve as a viable replacement of the economic substance doctrine. Such a requirement was proven to be an effective means of curbing tax shelter problems when the "at-risk" requirement in section 465 was extended to real estate transactions in 1986, reducing in part the real estate tax shelter problem of the 1970s and 1980s.[207]

Moreover, the outcomes of the illustrative transactions discussed above in Part II demonstrate the importance of the presence or absence of risk. In *UPS*, where the court deemed the transaction worthy of respect, the presence of risk was quite literal because it involved the shifting of insurance risk from one party to another. In *Jade Trading*, where the court unraveled the tax benefit, the taxpayers did not risk any more than $450,000 to get a tax benefit of approximately $14 million. In addition, entering into the offsetting options was a nearly risk-free transaction.[208]

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202. 26 U.S.C. § 7701(f) (West 2011).

203. RONALD W. BLASI, MASTER BANK TAX GUIDE 413 (1999).

204. *See generally* 26 U.S.C. § 83.

205. *See generally* Lee A. Sheppard, *News Analysis: Drafting Economic Substance, Part 3*, 106 TAX NOTES 1020 (2005) (referring to Judge Richard Posner's opinion in Yosha v. Comm'r, 861 F.2d 494 (7th Cir. 1988) and work by Charles Kingson); Charles I. Kingson, *The Confusion Over Tax Ownership*, 93 TAX NOTES 409 (2001).

206. TREASURY WHITE PAPER, *supra* note 166, at 12 (describing a corporate tax shelter as "the lack of significant pre-tax economic substance or risk to the participating parties.").

207. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 13.02, at 313–19 (11th ed. 2009) (describing the passive activity loss rules); Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1951 (2005); Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499, 554–88 (1989).

208. *See* Jade Trading, LLC v. U.S., 80 Fed. Cl. 11, 32 (2007) (noting that the option dealer, AIG, did not need any margin (credit) from the Ervin LLCs for the options transactions because they did not involve any risk).

This article does not provide a final recommendation as to the correct way to impose a risk requirement. The reason is that there is a range of options to choose from with respect to a risk requirement. There are some considerations that any risk requirement should cover in order for it to have the effect endorsed in this article. First, it is important that any risk requirement regime supplant the economic substance doctrine. Second, the range of risk should not be so expansive to include the risk of falling down in the street, but not so narrow as to exclude legal risks. Third, the definition of risk would also have to exclude tax risk, meaning the risk that the government would disallow tax benefits flowing from a particular transaction. Failing to exclude this tax risk would make the rule inoperative. A transaction that includes no other risks other than tax risks would be questionable (the target of the risk requirement), and taking into account the tax risk would make this otherwise questionable transaction valid under the provision.

Two potential risk formulations include extension of the "at risk" requirement to corporate and financial transactions and a modification to a formulation commenter Mr. David Hariton has recommended.[209] The at-risk rule makes it so that a taxpayer may not take a deduction for a loss that exceeds its economic investment, *i.e.*, the amount the taxpayer has "at risk."[210] In addition, only the taxpayer's own funds are considered "at risk." Invested funds obtained from a loan are at risk only if the taxpayer is personally liable or the funds are secured by the taxpayer's own assets.[211] Although it is difficult to have sympathy for the government with respect to the Ervins' transaction in *Jade Trading*,[212] this rule would have provided clear guidance to the Ervins that they would not be entitled to tax benefits if it had applied. The amount they put at risk was no more than $450,000, yet they received a $14 million tax benefit.

Extending this at-risk rule would not have helped the government in *Compaq*.[213] In that case, the taxpayer purchased foreign shares in controlled, after-market trading right before the dividend payment and

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209. *See* David P. Hariton, *How to Fix Economic Substance*, 99 TAX NOTES 539, 543 (2003).

210. 26 U.S.C. § 465 (West 2011); *see also* CHIRELSTEIN, *supra* note 207, at 314–15.

211. CHIRELSTEIN, *supra* note 207, at 315.

212. The taxpayer relied on *Helmer v. Comm'r*, 34 T.C.M. (CCH) 727 (1975), for the proposition that the sold options were contingent obligations rather than liabilities and therefore did not decrease their basis in the partnership while a purchase option for approximately the same amount increased their basis in the partnership. *See* Jade Trading, LLC v. United States, 80 Fed. Cl. 11, 58–59 (2007). If such contingent obligations are not liabilities under *Helmer*, then the Ervins were correct that they had a huge loss. The government apparently did not challenge this and relied solely on the economic substance doctrine to override the law. However, it is likely that the IRS did not challenge it because they benefit from leaving the law contradictory. In other cases, the government argues that options do create a liability or a cost. *See generally* Xilinx, Inc. v. Comm'r, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

213. Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 786 (5th Cir. 2001).

then sold the foreign shares right after the dividend payment, generating a capital loss and a foreign tax credit.[214] Compaq was able to use the credit to offset gain in unrelated transactions.[215]

Mr. Hariton has recommended a statutory provision that would define economic substance as follows: "A transaction has economic substance if the risk of economic loss from participating in the transaction is substantial in relation to the tax benefits arising from the transaction."[216] This provision would augment the other factors of the economic substance doctrine.[217]

Because of the problems with the economic substance doctrine, however, Mr. Hariton's provision could be stripped down to a risk of loss requirement with which to supplant the economic substance doctrine. With the risk requirement, economic substance and business purpose factors are unnecessary. With some tweaking regarding parties to a transaction, a provision derived from Mr. Hariton's proposed economic substance definition could appear as follows: "The tax benefits of any party to a transaction will be respected if the risk of economic loss by any party participating in the transaction is appropriate in relation to the tax benefits arising for any party to the transaction." This provision would change the result in Compaq's tax benefit. Recall that Compaq obtained a foreign tax credit that it did not have to pay for. The counterparty in the transaction, however, incurred no risk in the transaction. The counter-party received a guarantee from the promoter, Twenty-First Securities, that it would reimburse the counter-party for any losses.

The at-risk rule extension would be a narrow risk requirement and may not extend to as broad a range of questionable tax planning that a broader risk requirement would, such as either of the other two. Perhaps it is narrow enough that Congress would not need to worry that courts or the government would use it to invalidate transactions Congress intended to sanction. For the Hariton derivation, however, such extension or overbreadth could be a valid concern. There are two ways a risk-requirement regime could address this overbreadth. First, the regime could limit the risk requirement to historically problematic types of transactions. The staff of the Joint Committee on Taxation took this approach in a 2005 proposed codification of the economic substance doctrine.[218] Their proposal limited the application to six categories—

214. *Id.* at 779–81.

215. *See* David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1, 25 (2003). The loss, however, was offset by taxable dividend income, but that was paid for in part by a foreign tax credit Compaq received in the transaction as well. *Id.*

216. Hariton, *supra* note 209, at 543.

217. *Id.*

218. STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 178, at 19–20 (setting forth "applicable transactions").

transactions involving issues of: tax ownership, income stripping, basis shifts, special allocations, holding periods, and book/tax differentials.[219]

Another way to address the overbreadth would be to provide the government or the staff of Congress's Joint Committee on Taxation the authority to create exemptions to a risk requirement. Professors Marvin Chirelstein and Lawrence Zelenak have included a mechanism for the government to exempt transactions from rules they have proposed. The mechanism could be used with a risk requirement as well. The Chirelstein/Zelenak proposal involves the provision of formal authority to the government for such exemptions, but it could be done less formally by the government as well. It is within the government's discretion to issue guidance stating that it will not challenge a particular type of transaction. Authorizing the staff of the Joint Committee to get involved would be more complicated, but is likely feasible. The Joint Committee already reviews certain large refunds before the government may issue them.[220]

If we were going to pick only one among these risk-requirement options, it would appear that the Hariton derivation would be the most appropriate. The at-risk extension might be too weak on its own. If the Hariton derivative rule is too strong, it can be tempered by limiting it to problematic areas or permitting the government or Congress's nonpartisan committee staff to create exceptions where appropriate. This strikes a balance between limiting both the government's power and taxpayers' ability to game the system. The at-risk rule extension could accompany the Hariton derivation, but it could also stand on its own if Congress decides it is willing to accept the result in *Compaq* that the Hariton derivation addresses.

Perhaps one could allege that a risk requirement might be used as a smell test just as has the economic substance doctrine. However, the potential risk requirement rules are less likely to be used as smell tests because of the more scientific application of the rules. Moreover, the potential risk requirement rules have terms that are not so malleable that the government can bend them to its will.

IV. CONCLUSION

Although the economic substance doctrine has a noble purpose, it is not an appropriate weapon against questionable tax planning.[221] Rather, it operates like a hand grenade where a bug spray will do. The doctrine makes the tax law vague, uncertain, and fallacious. The operative terms, relating to purpose and economic effects, are vague.[222] The vagueness causes uncertainty, but there are other factors that add to

219. *See* Sheppard, *supra* note 205 (describing the applicable transaction categories in the Joint Tax Committee staff proposal).

220. 26 U.S.C. § 6405 (West 2011).

221. *See* discussion *supra* Part II.C.

222. *See* discussion *supra* Part II.C.1.

the uncertainty from the application of the doctrine.[223] Uncertainty also results because commentators have not come to an agreement on what tax planning the doctrine should target and the scope of the doctrine has no theoretical limit. Finally, the focus on the motives of the taxpayer with the purpose prong of the doctrine commits the motive fallacy.[224] Clarity, certainty, and cogency are paramount to our system of taxation, and the economic substance doctrine fails on all three counts. A better alternative must exist.[225] A risk requirement could be made clear, certain, and cogent.[226] Our system would benefit by supplanting the economic substance doctrine with such a requirement.

223. *See* discussion *supra* Part II.C.2.
224. *See* discussion *supra* Part II.C.3.
225. *See* discussion *supra* Part II.C.
226. *See* discussion *supra* Part III.