Codifying and Miscodifying Judicial Anti-Abuse Tax Doctrines

Linda Jellum

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CODIFYING AND "MISCODIFYING" JUDICIAL ANTI-ABUSE TAX DOCTRINES

Linda D. Jellum*

As former President George W. Bush said once, "the tax code is a complicated mess . . . [and] a million pages long." The length and complexity of the Internal Revenue Code (Code) is largely the result of the U.S. government’s rule-based approach to curtail tax abuse. Taxpayers, aided by literalism, have long found and used language in the tax laws to avoid or minimize their tax obligations. Although complying with the language of the law, abusive tax transactions are nevertheless at odds with the law’s spirit. Historically, the government, specifically Congress and the Department of the Treasury (Treasury), has responded by crafting new rules to stem the abuse.

Using a rule-based approach to combat tax abuse had its advantages, including certainty in application. With rules, the substance of the law is generally known before an individual acts; hence, rules often work well in the tax arena. Nevertheless, the rule-based approach had its disadvantages. For one thing, it forced the government to be reactive rather than proactive, as innovative taxpayers found new ways to work around the language of each new rule. The government has never been able to craft enough targeted rules to stem all tax abuse. For this reason, both the Treasury and Congress decided to try something new: a standards-based approach. Doctrines meant

* Ellison Capers Palmer, Sr. Professor in Law in Tax, Mercer University School of Law. E-mail: jellum@law.mercer.edu. I would like to thank my research assistant, Dianna Lee, J.D. expected 2014, and librarian James Walsh for their excellent research and editing help. I would also like to thank Dean Gary Simson and Mercer University Law School for research support. Professors Philip Hackney, Leandra Lederman, Gail Richmond, and Dean Richard Gershon, and tax attorneys Ivy Cadle, Ryan Kelly, G. Boone Smith, IV, and Christopher Steele all provided invaluable suggestions, which greatly improved this article. I presented a draft version of this article at the 2013 Administrative Law Discussion Forum held by the University of Louisville’s Louis D. Brandeis School of Law. I would like to thank Professors Russell Weaver, Jack Beermann, Jeff Lubbers, and the other participants of that forum for their helpful suggestions on that draft.

to prevent abuse of the Code may be better designed as standards, which are more difficult than rules to circumvent.

This article examines two standard-based approaches. First, in 1995, the Treasury promulgated a general, anti-abuse regulation applicable to all of subchapter K of the Code. Second, in 2010, Congress codified the economic substance doctrine. In both cases, these governmental entities adopted judicially crafted tax doctrines that required transactions to satisfy the tax code’s language as well as its underlying purpose; however, Congress’s codification and the Treasury’s promulgation differed in significant ways. This article explains why Congress got it right, while the Treasury got it entirely wrong.

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I. **INTRODUCTION**

In 2002, the city of Bochum, Germany sold its sewer system to Wachovia National Bank\(^2\) for approximately $500,000.\(^3\) The German city, 

however, never lost the use of its sewer system, as Wachovia immediately leased the system back to the city. Although Bochum agreed to pay Wachovia the cost of the lease over many years, in reality, Bochum likely never paid a cent. Instead, the city of Bochum earned $20 million from this transaction, commonly referred to as a sale-in/lease-out transaction.

Why would an American bank want to purchase and then lease back sewer pipes in Germany? The answer is simple: to reduce its federal tax burden. The Wachovia/Bochum transaction is just one example of an abusive tax strategy, which can create enormous federal tax breaks for American corporations. As a result of these SILO transactions, foreign
cities earned millions of dollars for serving as accommodation parties by leasing or selling their infrastructural assets to American companies. American companies were then able to claim many times that amount in depreciation, interest deductions, and amortization for federal tax avoidance purposes. For example, when the dust settled in the Wachovia/Bochum situation, Wachovia not only received the majority of its money back from the city, but also claimed a reported $175 million in tax savings. According to one expert, Wachovia paid no federal income taxes in 2002 despite reporting income of $3.6 billion. Much of its tax savings came from transactions like the Bochum sewer deal.

Although the Wachovia/Bochum scheme would not be allowed under tax laws today, abusive tax manipulation continues to occur. For example, in August 2005, KPMG LLP, one of the world’s largest accounting firms, avoided indictment for conspiracy to commit criminal tax fraud after

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10 This practice also occurs in American cities. See Joshua D. Blank & Nancy Staudt, Corporate Shams, 87 N.Y.U. L. Rev. 1641, 1643-44 (2012) (suggesting that corporate taxpayers have claimed more than $35 billion in tax depreciations by taking “their lawyers’ advice to buy city assets — such as buses, light rails, bridges, et cetera — for the sole purpose of obtaining huge depreciation tax deductions.”).

11 Typically, American companies negotiated with foreign governmental entities that were not subject to taxes in their own country (or that would want depreciation deductions), such as a foreign municipality, water authority, or transit authority to lease large, immovable infrastructural assets with long, useful lives, such as streetcars, water lines, air traffic control systems, rail systems, dams, and school buildings. David Evans, The $150 Billion Shell Game, BLOOMBERG MARKETS, Aug. 2004, at 64, available at http://eblm.us/David Evans_offshore.pdf; Tax Shelters, supra note 5

12 William F. Nelson, The Limits of Literalism: The Effect of Substance over Form, Clear Reflection and Business Purpose Considerations on the Proper Interpretation of Subchapter K, 73 TAXES 641, 645 (1995). While these arrangements lack a business purpose and are done routinely for tax avoidance, they are routinely respected. Id.

13 Offshore Tax Issues, supra note 4; Evans, supra note 11; Frontline, supra note 2 (estimating the tax savings at $160 million); Introduction: Tax Me If You Can, supra note 3. In 2002, Wachovia saved $1.2 billion in taxes from these types of leasing agreements. Robert S. McIntyre, Study Shows Big Corporations Benefitted from Bush Tax Breaks, 2004 TNT 185-37 (Sept. 22, 2004).

14 Introduction: Tax Me If You Can, supra note 3. A Wachovia spokesperson indicated that its leasing transaction was in full compliance with tax laws. Rick Rothaker, PBS’s “Frontline” Eyes Wachovia’s Leasing Activity, CHARLOTTE OBSERVER (Feb. 21, 2004).

15 According to the Frontline report, Wachovia saved $3 billion in taxes over three years from leasing. Frontline, supra note 2.

agreeing to pay the Internal Revenue Service (Service) $456 million in fines, restitution, and penalties.\textsuperscript{17} The indictment alleged that KPMG conspired to defraud the Service by using fraudulent tax shelters between 1996 and 2003 to concoct phony tax losses worth at least $11 billion, which equated to $2.5 billion in evaded taxes.\textsuperscript{18}

Similarly, in March 2013, Ernst & Young LLP, another of the world’s biggest accounting firms, agreed to pay the United States $123 million to resolve a criminal fraud investigation into the firm’s alleged use of tax shelters between 1999 and 2004 to evade more than $2 billion in taxes.\textsuperscript{19}

Today, tax avoidance and minimization — whether from tax shelters, loopholes, unprofitability, or for other reasons — continues to be a big business: “[c]orporate giants such as telecom firm Verizon, drugmaker Bristol-Myers Squibb and power management firm Eaton, all reported effective tax rates of 0\% during the past 12 months.”\textsuperscript{20}

Literalism allowed the creation of abusive transactions like the Wachovia/Bochum deal because these transactions were in compliance with the literal language of the applicable tax laws even though they produced results contrary to the law’s spirit.\textsuperscript{21} Legal filings from the defendants in the KPMG case suggest that literalism would have played a role in their defense.\textsuperscript{22} Taxpayers have always been tempted to use the language of the tax laws to produce results the government did not contemplate. To be fair, attempts to minimize or avoid taxes are not wrong per se: “[a]ny 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.”\textsuperscript{23}

\begin{itemize}
\item[]\textsuperscript{17} Press Release, Dep’t of Justice, KPMG to Pay $456 Million for Criminal Violations in Relation to Largest-ever Tax Shelter Fraud Case (Aug. 29, 2005), \textit{available at} http://www.justice.gov/opa/pr/2005/August/05_ag_433.html.
\item[]\textsuperscript{18} \textit{Id.}
\item[]\textsuperscript{20} Matt Krantz, \textit{Companies Just Say No to Paying Taxes; Strategies, Past Losses in Play}, USA TODAY, Oct. 24, 2013, at 2B (noting that “the Government Accountability Office released a report showing that companies in 2010 paid an average effective tax rate of 12.6\%, well below the 35\% federal corporate tax rate.”).
\item[]\textsuperscript{23} Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), \textit{aff’d}, 293 U.S. 465 (1935). Of course, despite this quote the taxpayer in \textit{Gregory} ultimately lost.
\end{itemize}
Transactions that allow a taxpayer to avoid paying taxes that would otherwise be due are often labeled as “tax shelters.” Tax shelters are not inherently bad; indeed, Congress actively encourages tax shelters in some situations. Nevertheless, many are abusive. Although there is no universally accepted definition of an abusive tax shelter, some suggest that abusive tax shelters meet the technical requirements of the law, while simultaneously flouting congressional intent.

While abusive tax shelters are not new, their character has changed with time. Historically, to combat abuse, either Congress would enact a statute or the Treasury would promulgate a new regulation to target the specific behavior. Indeed, that is exactly what happened as a result of the

24 Congress regularly allows taxpayers to avoid paying taxes to encourage specific behaviors. Likely, you have benefited from one of these arrangements. For example, legitimate ways to shelter income from taxation include retirement plans, Roth IRA accounts, deductions for home mortgage interest, the Hope scholarship credit, and deductions for small business research and development. Congress creates these tax programs to encourage certain types of social and economic behavior: the government wants people to save money for retirement, to buy homes, to go to college, and to invest in the research needed to develop new companies. Leandra Lederman, \(W(h)\)ither Economic Substance?, 95 IOWA L. REV. 389, 395–96 (2010) (identifying some tax provisions that are expressly designed to alter taxpayers’ behavior).

25 Alan Gunn, The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations, 54 SMU L. REV. 159, 164 (2001) (“a transaction that tries to use a statutory (or regulatory) provision to achieve a goal that no sensible legislator would have approved of is abusive.”); Lederman, supra note 24 (citing Calvin H. Johnson, What’s a Tax Shelter?, 68 TAX NOTES 879, 879 (Aug. 14, 1995) and Deborah H. Schenk, Foreword, 55 TAX L. REV. 125, 127 (2002)).

26 See Cunningham & Repetti, supra note 21, at 20; Gunn, supra note 25, at 164 (defining abusive transactions). The line between legal and illegal tax shelters is so blurred that the Service characterizes improper shelters as “abusive” rather than “illegal.” See generally DEP’T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS (July 1999), available at http://www.treasury.gov/resource-center/tax-policy/Documents/ctswhite.pdf. There is no one definition in the Internal Revenue Code (Code); rather, there are many. Yet they share a theme: abusive tax shelters are business arrangements wherein “a significant purpose of such . . . arrangement is the avoidance or evasion of Federal income tax.” I.R.C. § 6662(d)(2)(C)(ii) (defining the term “tax shelter” for underpayment penalties). In 1999, the Department of the Treasury (Treasury) identified some common characteristics of illegitimate, corporate tax shelters: (1) lack of economic substance or business purpose; (2) inconsistent financial accounting and tax treatments; (3) participation by tax-exempt entities or entities that receive a substantial fee to enter into the transaction; (4) marketing activity; (5) secrecy; (6) tax savings fee structures; and (7) high transactions costs. See DEP’T OF THE TREASURY, supra.

27 For example, after the Enron scandal, the Service issued a regulation that prohibited partnerships from using an allocation method to achieve tax results inconsistent with the intent of the partnership rules in the Code. See Treas. Reg. § 1.704-3(a)(10) (as amended in
Wachovia/Bochum transaction. In the same way, Congress included provisions in the Tax Reform Act of 1986 to combat the abusive tax shelters of the 1970s and 1980s. These shelters typically involved upper-middle income taxpayers who used mass-marketed, debt-financed arrangements to generate artificial tax losses. These taxpayers sheltered their income from taxation by exploiting specific loopholes in the Code, including, for example, leveraging depreciation, claiming investment tax credits, and amortizing deductions. These tax shelters allowed taxpayers to deduct noneconomic losses from rental activities and other trades or businesses, regardless of whether they actively participated in the venture, against wages and investment income. For example, a profitable lawyer or doctor might become a partner in a farming business to offset legal or medical income. Congress closed these loopholes with section 469 of the 1986 Tax Reform Act, which limited a taxpayer’s ability to deduct losses from businesses in which that taxpayer did not materially participate. Because these abusive tax shelters had common characteristics and

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31. Id. (noting that they involved the creation of artificial losses for passive investors though the combination of tax preferences such as accelerated depreciation and interest expense deductions).

32. Id.

33. Id.

34. § 501, 100 Stat. at 2233; see also I.R.C. § 469 (called “passive loss rules”).
generally involved individual investors, it was “possible to kill them all with a single bullet,” or, to put it more civilly, a specifically targeted rule.\textsuperscript{35}

Using a rule-based approach to combat tax abuse has its advantages, including certainty in application. With rules, the substance of the law is generally known before an individual acts. Rules can work well in the tax arena because of this certainty.\textsuperscript{36} Yet, a rule-based approach has its disadvantages.\textsuperscript{37} It forces Congress and the Treasury to be reactive rather than proactive, as innovative taxpayers find new ways to work around the language of rules. In reality, these governmental entities simply cannot craft enough targeted rules to stem all tax abuse.\textsuperscript{38} In addition, as the government has enacted more and more rules, the tax laws have consequently increased in length, detail, and complexity.\textsuperscript{39} The Treasury and Congress wanted a different way to combat abusive tax shelters.\textsuperscript{40} Doctrines meant to prevent

\begin{itemize}
\item \textsuperscript{35} Chirelstein & Zelenak, supra note 30, at 1951. The Code of 1986 largely eliminated these abuses with the at-risk rules of section 465 and the passive loss rules of section 469.
\item \textsuperscript{36} Cf. Cunningham & Repetti, supra note 21, at 57 (“Many rules under the income tax create bright lines . . . the benefit derived from certainty is considered sufficiently important as long as the rule is applied to a real business transaction.”). When laws conform to societal expectations and define conduct in commonly understood ways, standards work well because most individuals will follow such laws without inducement. When laws do not conform to societal expectation or define conduct in expected ways, however, individuals and their lawyers respond by holding legislatures to the precise words in the statute. For instance, a law prohibiting murder may work sufficiently well as when written as a standard, while a law requiring individuals to pay thirty percent of their income to the federal government likely would not. See Linda D. Jellum, Mastering Statutory Interpretation 6-7 (2d ed. 2013).
\item \textsuperscript{37} See Jensen, supra note 27, at 14–17 (describing the limitations).
\item \textsuperscript{38} John F. Coverdale, Text as Limit: A Plea for a Decent Respect for the Tax Code, 71 Tul. L. Rev. 1501, 1523 (1997) (“Congress cannot possibly contemplate all of the circumstances in which the rules it enacts will come into play.”).
\item \textsuperscript{39} See generally 1 Nat’l Taxpayer Advocate, 2008 Annual Report to Congress § 1, at 1 available at http://www.irs.gov/Advocate/National-Taxpayer-Advocate’s-2008-Annual-Report-to-Congress! (noting that the most serious problem facing taxpayers and the Service is the complexity of the Code).
\item \textsuperscript{40} Cunningham & Repetti, supra note 21, at 33. To be fair, codifying a judicially developed tax standard is not unprecedented. Congress had codified another judicially created tax doctrine in 1969. In 1924, the Board of Tax Appeals originated what is known as the public policy doctrine when that court denied a taxpayer’s request to deduct expenses the taxpayer incurred while successfully defending a perjury indictment. Bacter v. Commissioner, 1 B.T.A. 214 (1924). The court reasoned that expenses related to the commission of illegal acts were not ordinary and necessary. Id. Ultimately, the Supreme Court rejected this holding and held that expenses incurred by a taxpayer when defending a criminal prosecution were deductible as ordinary and necessary business expenses. Commissioner v. Tellier, 383 U.S. 687, 694 (1966). In so holding, the Court very narrowly defined the parameters of the public policy doctrine. Id. Thereafter, Congress codified the
abuse of the tax code are best designed as standards, because rules are easier to circumvent.\textsuperscript{41}

For these reasons, the Treasury and Congress turned to standard-based approaches. Standards are easier and less expensive to adopt than rules,\textsuperscript{42} but they are also more challenging to interpret and apply because the substance of the law often becomes known only after an individual acts.\textsuperscript{43} Hence, they are more uncertain.\textsuperscript{44} To put it in basic terms, rules are generally preferable for regulating common transactions and everyday behavior (for example, speed limits), while standards are preferable for regulating less common transactions that arise in varied factual circumstances (for example, the “reasonable person” standard in negligence).\textsuperscript{45} Typically, rules are the prototype of legislatures, while standards are the province of courts.\textsuperscript{46}

This article explores two standard-based approaches. First, in 1995, the Treasury promulgated a general, anti-abuse regulation applicable to all of

document in the Tax Reform Act of 1969. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of the Code). The relevant section provides, “[n]o deduction shall be allowed under subsection [162](a) for any fine or similar penalty paid to a government for the violation of any law.” § 902(a), 83 Stat. at 710 (codified at I.R.C. § 162(f)). Additionally, the Act disallows deductions for illegal bribes and kickbacks, § 902(b), 83 Stat. at 710 (codified at I.R.C. § 162(e), and for treble damage payments incurred because of antitrust law violations, § 902(a), 83 Stat. at 710 (codified at § 162(g)). For a fuller discussion of this topic, see F. Phillip Manns, Jr., \textit{Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?}, 13 \textit{V. A. Tax Rev.} 271 (1993).

\textsuperscript{41} Assaf Likhovski, \textit{The Duke and The Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication}, 25 \textit{Cardozo L. Rev.} 953, 968 (2004) (“[T]ax avoidance doctrines are meant to regulate behavior which varies greatly (since tax avoiders often can choose among a large number of legal ways to circumvent a particular tax norm).”).


\textsuperscript{43} Cunningham & Repetti, \textit{supra} note 21, at 56. \textit{But see} David A. Weisbach, \textit{Formalism in the Tax Law}, 66 \textit{U. Chi. L. Rev.} 860 (1999) (arguing that rules, although perceived as less, complex are often very complex).

\textsuperscript{44} Nonetheless, some argue that uncertainty can be valuable in the tax field, for it may deter taxpayers from testing the legal limits. Jensen, \textit{supra} note 27, at 39.

\textsuperscript{45} Cunningham & Repetti, \textit{supra} note 21, at 56.

\textsuperscript{46} By interpreting the Code in an anti-textual manner, judges turn rules into standards and violate separation of powers. Coverdale, \textit{supra} note 38, at 1525; Louis Kaplow, \textit{Rules Versus Standards: An Economic Analysis}, 42 \textit{Duke L.J.} 557, 563–64, 573, 577, 621 (1992) (arguing that the initial cost of making rules is high because rules require the lawmaker to determine the law’s content in advance and that the ex post cost of standards is high because their exact scope is more costly to predict or enforce; thus, when a legal norm will be applied frequently, a rule is more efficient).
subchapter K of chapter 1 of the Code, commonly known as the "partnership subchapter." While abusive tax shelters are not unique to partnerships, subchapter K was a good place for the Treasury to start because favorable tax treatment of partnerships is often a principal reason taxpayers choose this particular business entity. Moreover, unique aspects of the partnership tax laws — including its aggregate-entity dichotomy — foster creative tax manipulation. Second, and more recently, Congress codified the common law economic substance doctrine. In both cases, the government codified — to be precise, Congress codified and the Treasury promulgated — judicially crafted tax anti-abuse doctrines that required transactions to satisfy both the tax law's language and its underlying purpose; however, Congress's codification and the Treasury's promulgation differed in significant ways. Spoiler alert: Congress got it mostly right, while the Treasury got it entirely wrong.

I proceed as follows. In Part II, I describe the judicially created common law tax anti-abuse doctrines, including the business purpose doctrine, substance over form, the economic substance doctrine, and the step transaction doctrine. I explain the parameters of these various doctrines and principles, as well as their origination. Importantly, the economic

47 The Code is divided into various chapters and subchapters, including subchapter C (for corporations), subchapter K (for partnerships), subchapter S (for small businesses), and many others.

48 Travis L. Bowen & Rick D. Bailey, Limited Partnerships: Use in Tax, Estate and Business Planning, 32 IDAHO L. REV. 305, 307 (1996) ("The process of selecting the proper entity form requires a balancing of both business law and tax objectives."); Choice of Entity, Tax Mgmt. Portfolios (BNA) No. 700-3d, at A-1 (1993) ("Multiple planning objectives are often applicable . . . to choose that business entity form which provides both (i) the greatest federal and state income tax planning benefits, and (ii) advantages for business law planning (particularly the limitation of any potential liabilities otherwise applicable to the business owners.").

49 See infra Part III.

50 Letter from Peter Faber to Margaret Milner Richardson, Commissioner, Internal Revenue Serv. (Aug. 12, 1994), in Faber Offers Views on Partnership Antiabuse Reg., 1994 TNT 167-9, 1237-38 (Aug. 12, 1994); Lee A. Sheppard, Partnership Antiabuse Rule: Dirty Minds Meet Mrs. Gregory, 64 TAX NOTES 295 (July 18, 1994) (describing a public hearing regarding the proposed regulations).

51 Technically, "[c]ommon law" refers to that body of governing principles, mainly substantive, expounded by the common-law courts of England in deciding cases before them.” William B. Stoebuck, Reception of English Common Law in the American Colonies, 10 WM. & MARY L. REV. 393, 393 (1968). In this article, I use the term more colloquially to simply mean judge-made legal doctrine.

52 The Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 24 Stat. 1029, 1067 (to be codified at I.R.C. § 7701(o)).

53 For this article, I use the term “codify” in its colloquial sense to simplify.
Codifying and "Miscodifying" Anti-abuse Doctrines

II: JUDICIALLY CREATED TAX ANTI-ABUSE DOCTRINES

The Code is a highly comprehensive, rule-based collection of statutes. Subsection 1.701-2, commonly known as the "anti-abuse regulation." In Part IV, I examine the Treasury's adoption of the judicially created anti-abuse doctrines and conclude that the Treasury significantly altered and augmented the doctrines despite claiming not to. Similarly, in Parts V and VI, I first explain Congress's codification of the economic substance doctrine and then conclude that, unlike the Treasury, Congress made significantly fewer changes. Part VII concludes.

54 Currently, the Code has almost 10,000 provisions. I.R.C. §§ 1-9834; see also Allen D. Madison, The Tension Between Textualism and Substance-over-form Doctrines in Tax Law, 43 SANTA CLARA L. REV. 699, 716 (2003) (noting that as of early 2003, "[t]he Internal Revenue Code [took] up two volumes of statutory provisions, with six volumes of accompanying regulations . . . .").

55 Remarks in Colorado Springs, Colorado, supra note 1. While President Bush may have been exaggerating, the Code is indeed long and complex. The Code is published separately as title 26 of the United States Code and is the only volume that is published separately in its own code. Title 26 contains most, but not all, of the federal tax statutes. Some tax statutes are located in other sections of the United States Code, such as those related to bankruptcy, which are found in title 11, and those related to the judiciary, which are found in title 29.

56 Tax exceptionalism means that tax statutes should be interpreted differently from other statutes due to their unique characteristics. Kristin E. Hickman, The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference, 90 MINN. L. REV. 1537, 1542, 1559–63 (2006) (defining tax exceptionalism and disagreeing with those scholars who argue that tax interpretation is unique).


58 See, e.g., David P. Hariton, Tax Benefits, Tax Administration, and Legislative Intent, 53 TAX LAW. 579 (2000); Hickman, supra note 56; Steve R. Johnson, Auer/Seminole Rock Deference in the Tax Court, 11 PITT. TAX REV. 1 (2013); Steve R. Johnson, Preserving Fairness in Tax Administration in the Mayo Era, 32 VA. TAX REV. 269 (2012); Madison,
literalists wish to hold Congress and the Treasury strictly to the words of the tax laws. They argue that if a transaction complies literally with the law, then that transaction should be valid despite any inconsistency with the law’s spirit or Congress’s intent. They see no reason for the judicial common law doctrines — tax anti-abuse doctrines — that allow the Service to reconfigure transactions based on their economic impact, rather than the transaction’s literal form. In contrast, nontextualists believe that textualism, particularly in its literalist form, fosters sham transactions that undermine the legitimacy of the tax code as a whole. These theorists blame textualism, at least in part, for “[t]he recent proliferation of tax shelters,” claiming that textualism gives these shelters legitimacy.

Using nontextualist approaches, the Court long ago crafted common law rules of interpretation, or doctrines, which require a transaction to satisfy both the statute’s language and its underlying purpose; satisfying the literal words of the statute is not sufficient. These anti-abuse doctrines collectively permit the Service to reject a taxpayer’s characterization of a business transaction arguably meeting the precise terms of a tax statute, but simultaneously seeking tax benefits Congress did not intend. Regardless of whether they are legitimate common law exceptions to the Code, these doctrines play a starring role in the government’s standard-based response.


59 See, e.g., Garrett, supra note 57, at 199 ("[T]he language of the statute is the law, and if it is clear, in most cases it should be applied by the Service and by the courts.").
60 Letter from Peter Faber, supra note 50, at 1237.
61 See Cunningham & Repetti, supra note 21, at 26 (suggesting that courts would not have developed the economic substance doctrine if they had been using the textualist method of statutory interpretation).
62 Id. at 20.
63 Id. at 2; see also id. at 20 ("The ascendancy of textualism has had its greatest impact by facilitating the promotion and sale of ‘abusive’ tax shelters.").
64 Id. at 20.
65 Id.
66 Id. at 25–26; Gallee, supra note 22, at 362; William H. Caudill, ABA Tax Section Members Say Antiabuse Rule Is Not a Valid Exercise of IRS Authority, 1994 TNT 146-50, 11 (July 28, 1994) ("Transparent devices totally devoid of any non-tax significance to the parties cannot pass muster even though a literal reading of the statutory language might suggest otherwise.").
Thus, we need to understand them.

The general principle underlying all of these judicially created, anti-abuse doctrines is that the Service should give effect to the substance of a transaction rather than its form. These doctrines include business purpose and substance over form. Substance over form serves as a background principle, supporting a group of related doctrines: the step transaction doctrine, the "sham entity" doctrine, and the economic substance doctrine, which is alternatively, and confusingly, called the sham transaction doctrine. A word of caution, however: the doctrines' boundaries are nondistinct and their terminology is inconsistent. Below, I explain each.

67 Philip Sancilio, Note, Clarifying (or Is It Codifying) The "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code, 113 COLUM. L. REV. 138, 141, 141 n.11 (2013) (citing Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961) for the proposition that "[t]he principle of looking through form to substance... is the cornerstone of sound taxation... ").

68 True v. United States, 190 F.3d 1165, 1176 n.11 (10th Cir. 1999) ("[B]oth the step transaction and sham transaction doctrines are corollaries of the basic substance over form principle... "); Yoram Keinan, Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification, 22 AKRON TAX J. 45, 47-48 (2007) ("Generally, the doctrines that have emerged can be divided into two subtests under the substance-over-form doctrine: (i) the economic substance/sham transaction doctrines (with the business purpose doctrine included as the subjective prong), and (ii) the step transaction doctrine.").

69 Professor Madison coined the term "sham entity doctrine" to characterize those cases in which "the court disregards the participation of an entity that acts as a mere conduit." Madison, supra note 54, at 732 (citing as an example Aiken Indus., Inc. v. Commissioner, 56 T.C. 925 (1971)). In Aiken Industries, "the [tax] court disregarded the participation of a corporation created for the sole purpose of borrowing money from one related corporation and then loaning the same money to another related corporation on the same terms." Id. Because the sham entity doctrine is "[a] close cousin" to the step transaction doctrine, I will assume the latter doctrine includes the former. See id.

70 See generally Blank & Staudt, supra note 10, at 1650–51 (describing these doctrines in slightly different terms); Madison, supra note 54, at 718 (discussing the beginnings of these common law doctrines).

71 United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001) (explaining the function of the "economic-substance doctrine, also called the sham-transaction doctrine... "); Madison, supra note 54, at 718 (noting the overlap: "the jurisprudence of sham entities overlaps with factual substance-over-form principles. In addition, the sham transaction doctrine is often called the economic substance doctrine, and transactions discussed in the context of either the sham transaction doctrine or the economic substance doctrine are often called economic or substantive shams... "). Note that this latter terminology confusingly includes both "shams in fact," which are transactions that never took place, and "shams in substance," which are transactions that took place but that lacked economic substance. Lederman, supra note 24, at 391 n.1.
A. Business Purpose

In 1935, the Supreme Court decided *Gregory v. Helvering.* While all of the common law anti-abuse doctrines can trace their roots to *Gregory,* this case is perhaps best known for birthing the business purpose doctrine. In *Gregory,* the taxpayer, a wealthy businesswoman, was the sole shareholder of a corporation that owned stock in a second corporation. Mrs. Gregory wanted to sell the second corporation's block of stock; however, she did not want to pay the higher ordinary income tax rate on the dividend distributions. To avoid doing so, Mrs. Gregory took the following steps: (1) formed a third corporation; (2) exchanged the block of stock in the second corporation for shares in the newly formed third corporation; (3) liquidated the third corporation; and (4) claimed that the dividend resulted from a reorganization, thus entitling her to substantially reduce her tax liability under reorganization tax laws. The Service refused to recognize the transaction as a valid reorganization because the taxpayer's sole motive was tax avoidance. Literally interpreting the term

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72 293 U.S. 465 (1935). "This case is often seen as a milestone in the adoption of a substantive anti-taxpayer approach to tax avoidance in American law and is one of the most cited tax cases ever." Likhovski, *supra* note 41, at 957–58.

73 See generally Madison, *supra* note 54, at 718 (discussing the beginnings of these common law doctrines).

74 For an interesting discussion of the political climate leading to *Gregory,* see Likhovski, *supra* note 41 (arguing that tax avoidance by the wealthy, including Andrew Mellon, former Secretary of the Treasury, influenced Judge Learned Hand to decide the case against the taxpayer).

75 *Gregory,* 293 U.S. at 467.

76 Id.

77 Id.

78 Under the Revenue Act of 1928, reorganizations were tax-free: "[i]f there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized." Revenue Act of 1928, Pub. L. No. 562, § 112(g), 45 Stat. 791, 818 (1928). Further, the statute defined a "reorganization" as, amongst other possibilities, "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred . . . ." § 112(h)(i)(1)(B), 45 Stat. at 818.

79 Despite the taxpayer's motivation, the tax court upheld the reorganization on appeal because it complied literally with the law. *Gregory v. Commissioner,* 27 B.T.A. 223 (1932), rev'd, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).
"reorganization" in the Revenue Act of 1928, the Board of Tax Appeals agreed with Mrs. Gregory. 80

Rejecting literalism, the Supreme Court 81 agreed with the Service. After noting that tax avoidance and minimization are indeed legitimate, the Court criticized Mrs. Gregory's reorganization as an:

[O]peration having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business . . . . 82

Although acknowledging that the transaction was conducted in accordance with the literal terms of the Code, the Court nevertheless refused to recognize the transaction as a legitimate tax-free reorganization under the statute. 83 "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." 84 Asking "whether what was done, apart from the tax motive, was the thing which the statute intended," 85 the Court used a purposivist approach to craft the business purpose doctrine. 86 "Gregory was an aggressive judicial opinion. Neither the statute nor the legislative history directly imposed a 'business purpose requirement.' Nevertheless, the Court used the legislative history to create one, and the debate continues today as to whether the Supreme Court properly decided this case." 87

The business purpose doctrine provides that a transaction must serve a bona fide business purpose other than tax avoidance to qualify for

80 Id. at 225 ("A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration.").

81 Judge Learned Hand wrote the opinion for the Second Circuit. 69 F.2d 809 (2d Cir. 1934). One year later, the Supreme Court adopted Judge Hand's opinion, noting that "[t]he reasoning of the court below . . . leaves little to be said." 293 U.S. 465, 469 (1935).

82 Gregory, 293 U.S. at 469.

83 Id.

84 Id. at 470.

85 Id. at 469.

86 Id. at 469–70 ("The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."). The Treasury later added the business purpose requirement to the reorganization regulations. Treas. Reg. § 1.368-1(c) (2001).

87 Cunningham & Repetti, supra note 21, at 54 n.290.
beneficial tax treatment. In theory, when a transaction has no substantial business purpose other than the avoidance or reduction of federal tax liability, the Service can disregard the transaction. This standard is a pretty low burden, however, and is easy for taxpayers to meet. Generally, the Code "operates without regard to the significance of business purpose as weighed against tax avoidance purpose, as long as the transaction at issue has at least some business purpose, economic reality or profit potential." For example, in Cottage Savings Ass'n v. Commissioner, the taxpayer swapped the participation interests of one mortgage portfolio for another, solely to realize a tax loss. The Sixth Circuit denied the tax benefits, noting, "[w]hat is done for the purpose of tax avoidance must, however, have some business purpose and not be an economic transaction in form only. The courts will not 'exalt artifice above reality.'" The Supreme Court reversed, finding the exchange to be bona fide because it was an arm's length transaction. In upholding the transaction, the Court ignored the taxpayer's tax avoidance motive and required very little in the way of a business purpose. Similarly, in Rice's Toyota World v. Commissioner, the Fourth Circuit stated, "[t]o treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction . . . ." In sum, the level of business purpose that courts require pursuant to this doctrine is not exacting.

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88 Id. at 21.
89 Peter L. Faber, Business Purpose and Section 355, 43 TAX LAW. 855, 874 (1990).
90 Interestingly, one recent article argues that "notwithstanding the nearly obsessive attention paid by scholars and policymakers to the underlying business purpose of a transaction, [Blank and Staudt's] study shows that this factor does not play the key role in the judicial decisionmaking process that might be expected." Blank & Staudt, supra note 10, at 1647.
91 Nelson, supra note 12, at 644.
93 Id. at 853 (quoting Gregory v. Helvering, 293 U.S. 465, 370 (1935)).
95 Id.
96 Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (describing the business purpose prong of the economic substance doctrine).
97 See also In re CM Holdings, Inc., 301 F.3d 96, 102 n.4 (3d Cir. 2002) (asking "whether the taxpayer had a business reason, aside from tax avoidance, for engaging in the transaction."); United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014, 1019 (11th Cir. 2001) ("[A] transaction has a 'business purpose,' when . . . it figures in a bona fide, profit-seeking business."); IES Indus., Inc. v. United States, 253 F.3d 350, 355 (8th Cir. 2001) (confusingly suggesting that "the business purpose test is a subjective economic substance test.").
One last point: this doctrine depends largely on the taxpayer's motivation for conducting the transaction and is a corollary to the economic substance principle, discussed below. Together, the business purpose doctrine and economic substance principle form the economic substance doctrine.

B. Substance Over Form

Like the business purpose doctrine, the substance over form doctrine (or principle) is also a judicially created interpretive tool that allows the Service and courts to require more than literal compliance with the tax laws. Substance over form is more amorphous than business purpose because "it applies differently in different contexts and is sometimes known by different names." Thus, it might be more apt to say that substance over form serves as a background principle, supporting a group of related

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98 See Joseph Bankman, The Economic Substance Doctrine, 74 S. CAL. L. REV. 5, 10-11 (2000) (providing an overview of the economic substance doctrine); Lederman, supra note 24, at 416 (describing the two prongs of the economic substance doctrine as including a "subjective business purpose" requirement and an "objective economic substance" requirement); Charlene D. Luke, The Relevance Games: Congress's Choices for Economic Substance Gamemakers, 66 TAX L. 551, 558-59 (2013) (describing the objective and subjective prongs of economic substance); see also Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 171 (D. Conn. 2004) ('"The terminology used . . . is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance . . . ."'), aff'd, 150 F. App'x 40 (2d Cir. 2005).

99 See infra text accompanying note 132 (explaining the difference between the economic substance principle and doctrine).


101 Cunningham & Repetti, supra note 21, at 23.
doctrines, each of which allows the Service to tax a transaction’s substance rather than the formal steps the taxpayer took to complete it. Like the business purpose requirement, the substance requirement is not exacting: “while it is often averred that in matters of tax, substance governs form, the fact is that for most of the Code a very little substance carries a whole lot of form.”

Although referenced in early case law, the substance over form similarly had its start in Gregory. When denying Mrs. Gregory the tax benefits she claimed, the Court criticized her transaction as “a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character.” Two later cases built on this idea. In Higgins v. Smith, the Supreme Court stated that “[t]he Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction . . . .” In Commissioner v. Court Holding Co., the Court refused to “permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities,” because “[t]he incidence of taxation depends on the substance of a transaction.”

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102 See sources cited supra note 68.
103 See Lederman, supra note 24, at 391.
104 Nelson, supra note 12, at 644.
105 See, e.g., United States v. Phellis, 257 U.S. 156, 168 (1921) (“We recognize the importance of regarding matters of substance and disregarding forms in applying [tax laws] . . . .”); S. Pac. Co. v. Lowe, 247 U.S. 330, 337 (1918) (recognizing that dividends paid out of corporate surplus, “in mere form only, bore the appearance of income accruing after [the date the dividends were distributed], while in truth and in substance it accrued before . . . .”). But see United States v. Isham, 84 U.S. 496, 505 (1873) (considering the form of an instrument, regardless of the effect of the instrument in conducting business).
108 308 U.S. 473 (1940).
109 Id. at 477.
110 324 U.S. 331 (1945).
111 Id. at 334.
From this substance over form concept, at least two different, but related, doctrines emerged. First, and most importantly for this article, the "economic substance" doctrine, also confusingly called the sham transaction doctrine, allows the Service to deny tax benefits if the purported pretax economic profit is significantly less than the value of the expected tax benefits from the transaction. Likewise, the "step transaction" doctrine permits the Service to disregard steps in a transaction when those steps lack independent significance. Both doctrines are based on the idea that if two transactions have the same economic outcome, they should have the same tax outcome. Let us look at each in more detail.

1. Economic Substance

The requirement that a transaction have economic substance originated from Gregory's substance over form language. In Gregory, the taxpayer had an independent business purpose for conducting the transaction (she wanted to sell her stock); thus, only the form of the transaction (a reorganization) was tax-motivated. In contrast, in Knetsch v. United States, the taxpayer did not have an independent business purpose for conducting the transaction; the taxpayer was only seeking tax benefits. Thus, both the purpose for the transaction (its existence) and the form of the

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113 "'Sham transaction' terminology is confusing, however, because it encompasses 'shams in fact,' which are transactions that never occurred, as well as 'shams in substance,' which lack economic substance. The substantive sham cases typically apply the same or similar analysis as that used in economic substance cases." Lederman, supra note 24, at 391 n.1 (citing United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001) (explaining the function of the "economic-substance doctrine, also called the sham-transaction doctrine . . . .") and Yoram Keinan, The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine, 111 TAX NOTES 327, 330–31 (2006) (discussing the relationship between the economic substance and sham transaction doctrines)).

114 Daniel N. Shaviro, Economic Substance, Corporate Tax Shelters, and the Compaq Case, 88 TAX NOTES 221 (July 10, 2000).

115 Cunningham & Repetti, supra note 21, at 23.

116 Lederman, supra note 24, at 435; see also Cunningham & Repetti, supra note 21, at 23.

117 Bankman, supra note 98 (providing an overview of the economic substance doctrine).


119 Lederman, supra note 24, at 408.

120 364 U.S. 361 (1960) (discussing the doctrine).

121 Id. at 366.
transaction were tax-motivated.\textsuperscript{122} Hence, in \textit{Knetsch}, the Court's analysis focused on the economic effect of the transaction (the form) rather than the taxpayer's motivation or purpose.

The facts of \textit{Knetsch} are not relevant here.\textsuperscript{123} It is sufficient to know that \textit{Knetsch} involved tax arbitrage — "whereby [a taxpayer] profit[s] after-tax from both paying and receiving a dollar because the dollar . . . paid is treated more favorably than the dollar . . . received."\textsuperscript{124} In \textit{Knetsch}, the taxpayers paid $91,570 to reduce their tax obligation by $233,297.68.\textsuperscript{125} The taxpayer was able to reduce the tax obligation by accelerating deductions, postponing income, and converting ordinary income into capital gain.\textsuperscript{126} Had the tax benefits been allowed, the taxpayer would have profited by $141,727.68.\textsuperscript{127} Referencing \textit{Gregory}, and again acknowledging that tax avoidance was indeed legitimate, the Court nevertheless called the taxpayer's transaction a "fiction," a "sham," and a "facade."\textsuperscript{128} The Court noted that the transaction did "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax." For it is patent that there was nothing of substance to be realized by [the taxpayer] from this transaction beyond a tax deduction."\textsuperscript{129} Accordingly, the Court denied the tax benefits.\textsuperscript{130}

In doing so, the Court focused on the economic impact of the transaction;\textsuperscript{131} I will call this the "economic substance principle" to distinguish it from the economic substance doctrine described below.\textsuperscript{132} Pursuant to the economic substance principle, a court examines whether the purported economic activity would have occurred absent any tax benefits the taxpayer now claims; stated differently, the court asks whether there was a prospect of profit before taxes (pretax profit).\textsuperscript{133} A transaction must

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\item\textsuperscript{122} Lederman, \textit{supra} note 24, at 408.
\item\textsuperscript{123} For an excellent explanation of the case, see \textit{id.} at 406–09.
\item\textsuperscript{124} \textit{Id.} at 408 (quoting Daniel N. Shaviro, \textit{The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance, in Tax Stories} 313, 323 (Paul L. Caron ed., 2003)).
\item\textsuperscript{125} \textit{Knetsch}, 364 U.S. at 366.
\item\textsuperscript{126} \textit{Id.} at 365–66; Lederman, \textit{supra} note 24, at 408 (citing Joshua D. Rosenberg, \textit{Tax Avoidance and Income Measurement}, 87 \textit{Mich. L. Rev.} 365, 409 n.126 (1988)).
\item\textsuperscript{127} Lederman, \textit{supra} note 24, at 407.
\item\textsuperscript{128} \textit{Knetsch}, 364 U.S. at 366.
\item\textsuperscript{129} \textit{Id.} at 366 (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957)).
\item\textsuperscript{130} \textit{Id.} at 365–66.
\item\textsuperscript{131} \textit{Id.}
\item\textsuperscript{132} \textit{See infra} text accompanying notes 146–168.
\item\textsuperscript{133} Bankman, \textit{supra} note 98, at 10 (citing Saba P'ship v. Commissioner, T.C.M. (CCH) 684, 720–21 (1999)); Lederman, \textit{supra} note 24, at 391 (arguing that the modern economic substance doctrine should be replaced with an examination of congressional intent).
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have a meaningful economic purpose or investor risk to be legitimate; the Service can invalidate a transaction if it lacks economic substance independent of tax considerations. Simply put, "the transaction [must have] practical economic effects other than the creation of income tax losses."\textsuperscript{134}

Ultimately, the Court combined the business purpose doctrine and the economic substance principle into one test in a subsequent case, \textit{Frank Lyon Co. v. United States}.\textsuperscript{135} \textit{Frank Lyon} involved a sale/lease-back transaction of a building. Again, the complex facts are irrelevant for purposes of this article.\textsuperscript{136} In sum, the issue for the Court was whether the taxpayer, Frank Lyon, was entitled to claim depreciation and other deductions on a building when it acted more like a lender than a lessor.\textsuperscript{137} Frank Lyon had entered into an arrangement at below market value to finance a building.\textsuperscript{138} While it faced possible financial loss if its business partner went bankrupt, Frank Lyon could realize up to $1.5 million in tax benefits if all went well.\textsuperscript{139} The transaction in its essence was simple: the business partner effectively sold depreciation deductions, which are nontransferable, to the highest bidder, which in this case was Frank Lyon.\textsuperscript{140}

Like the taxpayer in \textit{Knetsch}, the taxpayer in \textit{Frank Lyon} did not have a business purpose for the transaction,\textsuperscript{141} thus, both the existence and the form of the transaction were tax-motivated. For this reason, both business purpose and economic substance were at issue. Unlike in \textit{Knetsch}, however, Frank Lyon had a business partner, and that partner had a legitimate business reason for entering into and structuring the transaction as the parties did.\textsuperscript{142} Although Frank Lyon had neither a business purpose nor the possibility of economic gain absent tax considerations, the Court nevertheless concluded that because the taxpayer had undertaken a transaction with a "genuine economic risk," the deductions were allowable.\textsuperscript{143} In crafting the economic substance doctrine, the Court stated:

\textsuperscript{134} ACM P'ship v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998).
\textsuperscript{136} For an excellent explanation of the case, see Lederman, \textit{supra} note 24, at 409–16.
\textsuperscript{137} \textit{Frank Lyon}, 435 U.S. at 568–69.
\textsuperscript{138} \textit{Id.} at 565–66.
\textsuperscript{139} \textit{Id.} at 571–72.
\textsuperscript{140} Lederman, \textit{supra} note 24, at 414.
\textsuperscript{141} \textit{Id.} at 409–13.
\textsuperscript{142} \textit{Id.} at 409.
\textsuperscript{143} \textit{Frank Lyon}, 435 U.S. at 583.
[W]here, as here, there is a genuine multiple-party transaction with \textit{economic substance} which is compelled or encouraged by \textit{business} or \textit{regulatory realities}, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.\footnote{144}

Thus was born the economic substance doctrine.\footnote{145} The economic substance doctrine combines the business purpose doctrine and the economic substance principle into a single two-pronged test.\footnote{146} Under the business purpose prong, a court assesses the underlying motivation for the transaction.\footnote{147} Under the economic substance prong, a court determines whether the purported economic activity would have occurred absent the tax benefits.\footnote{148} While the business purpose prong focuses on the taxpayer's intent, the economic substance prong focuses on the transaction's effect.\footnote{149}

Unfortunately, the Court never clearly delineated the doctrine. Moreover, because the Court framed the doctrine in the negative in \textit{Frank Lyon}, lower courts were confused about how to apply the two prongs.\footnote{150} Hence, multiple versions of the doctrine emerged\footnote{151}: a conjunctive test,\footnote{152} a

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\item[144] Id. at 583–84 (emphasis added).
\item[145] Fid. Int'l Currency Advisor A Fund, LLC \textit{v.} United States, 747 F. Supp. 2d 49, 226 (D. Mass. 2010) (stating that "even the name of the [economic substance] doctrine — which is sometimes called the sham transaction doctrine — has never been settled."), \textit{aff'd on other grounds}, 661 F.3d 667 (1st Cir. 2011); \textit{see also} Dow Chem. Co. \textit{v.} United States, 435 F.3d 594, 598–605 (6th Cir. 2006) (applying economic substance analysis but using sham transaction terminology).
\item[146] Madison, \textit{supra} note 54, at 718.
\item[147] Lederman, \textit{supra} note 24, at 417.
\item[148] Id.
\item[152] See, \textit{e.g.}, Coltec Indus., Inc. \textit{v.} United States, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("[A] lack of economic substance is sufficient to disqualify the transaction . . . ."); Pasternak \textit{v.} Commissioner, 990 F.2d 893, 902 (6th Cir. 1993) (disallowing tax credits because transactions were "devoid of economic substance consonant with their intended tax effects.").
\end{enumerate}
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disjunctive test, and a third, less common, factor-based test. Pursuant to the conjunctive test, courts allowed tax benefits only when a transaction had both a business purpose and economic substance. Pursuant to the disjunctive test, courts allowed tax benefits when a transaction had either a business purpose or economic substance.

2. Step Transaction

Another substance over form principle, the step transaction doctrine, allows the Service to treat “a series of formally independent steps . . . as a single, integrated transaction” for tax purposes and ignore the tax effects of the transaction’s intermediate steps. The step transaction doctrine first

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153 See, e.g., Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes . . . and that the transaction has no economic substance . . . .” (quoting Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985))).

154 See, e.g., Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990) (explaining that “the Court’s holding in Frank Lyon was not intended to outline a rigid two-step analysis . . . [rather] business purpose and economic substance are simply more precise factors to consider in the application of this court’s traditional sham analysis . . . .” (quoting Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988))).

155 See, e.g., Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 544 (5th Cir. 2009) (“If a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations.”); Coltec Indus., Inc., 454 F.3d at 1355 (“[E]ven if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction . . . .”); Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006) (“If the transaction has economic substance, ‘the question becomes whether the taxpayer was motivated by profit’ . . . [but] ‘[i]f . . . the transaction is a sham, . . . the [subjective] inquiry is never made.’” (quoting Illes v. Commissioner, 982 F.2d 163, 165 (6th Cir. 1992))); Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992) (suggesting that the transaction is a sham if it lacks both economic substance and business purpose).

156 “In other words, the presence of either a business purpose or profit motive will suffice to respect the transaction. Consistent with this suggestion, many courts apply the economic substance doctrine only after concluding that the transaction does not serve a nontax business purpose other than generating a profit.” Cunningham & Repetti, supra note 21, at 25–26 (internal citations omitted); see also, e.g., Black & Decker Corp., 436 F.3d at 441 (holding that when the taxpayer was motivated by no business purposes and the transaction had no economic substance it is a sham); United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001) (suggesting that the transaction is a sham if it lacks either economic substance or business purpose); Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985) (suggesting that the transaction is a sham if it lacks both economic substance and business purpose).

157 Madison, supra note 54, at 730 (identifying three different tests courts use to implement this doctrine).
came into play in *Minnesota Tea Co. v. Helvering.*\(^{158}\) In that case, the taxpayer sold some of its assets for stock in another company and the remainder of its assets for cash in pursuance of a plan of reorganization.\(^{159}\) Under the relevant statute at the time, the sale of the assets would result in a taxable gain unless the proceeds were "distributed" to the taxpayer’s shareholders.\(^{160}\) Instead of using the cash to directly pay creditors, the taxpayer disseminated the cash to its shareholders in return for their agreement to assume the taxpayer’s debts.\(^{161}\) The Court ignored the steps of the transaction and held that there was no "distribution" within the meaning of the statute, finding that the dissemination was, instead, the taxpayer’s payment to its creditors.\(^{162}\) Therefore, the Court allowed the Service to tax the gain from the sale of the assets.\(^{163}\) In doing so, the Court noted that:

A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution . . . was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands.\(^{164}\)

Later, in *Commissioner v. Court Holding Co.*, a corporation with two shareholders orally agreed to sell an apartment building to a third party.\(^{165}\) Following the advice of legal counsel, the taxpayer-corporation first liquidated the property to its shareholders, who subsequently sold the building to the true buyer.\(^{166}\) Affirming the Tax Court’s finding against the taxpayer-corporation, the Supreme Court ignored the shareholders’ participation in the transaction, stating that a “transaction must be viewed as

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\(^{158}\) 302 U.S. 609, 613 (1938); see also Commissioner v. Clark, 489 U.S. 726, 738 (1989) (noting that the step transaction doctrine was “well-established” and was understood to mean that “interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.”); Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) (“[T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant [to the whole].”).

\(^{159}\) *Minnesota Tea Co.*, 302 U.S. at 610.

\(^{160}\) *Id.* at 612.

\(^{161}\) *Id.* at 611–12.

\(^{162}\) *Id.* at 612.

\(^{163}\) *Id.* at 613.

\(^{164}\) *Id.*

\(^{165}\) Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

\(^{166}\) *Id.* at 333.
a whole, and each step, from the commencement of negotiations to the
consummation of the sale, is relevant [to the whole]."\(^{167}\)

To determine whether the Service may collapse the steps of a
transaction for tax purposes under various circumstances, lower courts
developed three different tests: the binding commitment test, the
interdependence test, and the end result tests.\(^{168}\) Pursuant to the "binding
commitment" test, established in *Commissioner v. Gordon*, a court will
combine a series of separate steps when a taxpayer formally binds itself to
complete each step.\(^{169}\) For this test, the taxpayer’s intent is irrelevant.\(^{170}\)
Pursuant to the "interdependence," or "mutual interdependence," test, a
court will combine a series of separate steps when the steps are so
interrelated that "each step in the transaction[] le[ads] inexorably to the
next."\(^{171}\) "To describe this test another way, a taxpayer may see a series of
her transactions integrated if one of the transactions would have been
pointless without the completion of the entire series of transactions."\(^{172}\)
Finally, pursuant to the third test, the "end result" or "intent" test, a court
will combine a series of separate steps when the taxpayer intended the final
result at the time of entering into the series of prearranged transactions.\(^{173}\)
Unlike the binding commitment test, the taxpayer’s actual, subjective intent
is critical under this test.\(^{174}\) Importantly, the Court has yet to adopt any of
these formulations.\(^{175}\)

Although the lower courts may agree on the rhetoric for each test, their
application of the tests differs. "While one may say, half seriously, that the
step transaction doctrine is the most finely etched of judicial tax doctrines,
the truth of this assertion lies more in the clarity of the doctrine’s

\(^{167}\) *Id.* at 334.

\(^{168}\) For a review of these tests, see Sancilio, *supra* note 67, at 150 (describing the
doctrinal messiness and distinguishing the various formulations).

\(^{169}\) *Commissioner v. Gordon*, 391 U.S. 83, 96–97 (1968) (refusing to collapse a two-
step sale into a single transaction because the taxpayer had made "no promise to sell any
particular amount of stock, at any particular time, at any particular price.").

\(^{170}\) *Madison, supra* note 54, at 730.

\(^{171}\) *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1247 (5th Cir. 1983).

\(^{172}\) *Madison, supra* note 54, at 730.

\(^{173}\) *See, e.g.*, Russell v. *Commissioner*, 832 F.2d 349, 352 (6th Cir. 1987); *Brown v.
United States*, 782 F.2d 559, 564 (6th Cir. 1986); *Davis v. Commissioner*, 746 F.2d 357 (6th
Cir. 1984); *Sec. Indus. Ins. Co.*, 702 F.2d at 1246 ("[L]egal maneuvers . . . . [cannot] disguise
the fact that the intended result of each series of transactions was the acquisition of [another
company’s] assets . . . ."). For a more recent case, see *Long Term Capital Holdings v. United

\(^{174}\) *Brown*, 782 F.2d at 564 ("This [end result] test clearly makes intent a necessary
element for application of the doctrine.").

\(^{175}\) *Madison, supra* note 54, at 737.
articulation than in its application." Regardless, these formulations are neither mutually exclusive nor mutually dependent. It is not essential to understand their permutations in detail; it is enough to know that the step transaction doctrine was inexact.

It is important to understand that in 1995, when the Treasury promulgated regulation 1.701-2, the anti-abuse regulation, these judicially created anti-abuse doctrines existed, although their boundaries were not well defined. Regardless, the Treasury turned to these doctrines in fashioning its anti-abuse regulation to address the abusive tax shelter problem. In doing so, however, the Treasury significantly altered them, as I explain next.

III: TREASURY REGULATION 1.701-2

Congress did not enact subchapter K to encourage taxpayers to minimize their tax obligations or to encourage the proliferation of tax shelters. Rather, Congress enacted subchapter K as part of the 1954 revisions to the Code to permit businesses organized for joint profit to be conducted with "simplicity, flexibility, and equity as between the partners." Nevertheless, subchapter K became a preferred vehicle for abusive tax schemes, in part because it is highly technical and has a number of features that aid tax avoidance. First, partnerships are generally treated as pass-through, or flow-through, entities, such that the partnership pays no taxes. Instead, individual partners pay taxes on their distributive share of

177 See Sancilio, supra note 67, at 150 (describing the doctrinal messiness and distinguishing the various formulations).
178 See generally Gunn, supra note 25, at 160 (calling the step transaction doctrine "ubiquitous if obscure"); Rosenberg, supra note 126, at 400–17 (describing, explaining, and critiquing the various step transaction formulations); Schneider, supra note 176, at 48; Sancilio, supra note 67, at 151–52 (describing the three tests).
181 Cunningham & Repetti, supra note 21, at 4.
182 JOHN A. MILLER & JEFFREY A. MAINE, THE FUNDAMENTALS OF FEDERAL TAXATION: PROBLEMS AND MATERIALS 530 (3d ed. 2013). Congress allowed businesses flexibility in choosing between aggregate and entity concepts, depending on which was more appropriate when applying other provisions of the Code. H.R. REP. NO. 83-2543, at 58 (1954) (Conf. Rep.). Under the aggregate concept, a partnership is a conduit passing income to its partners, who then report that income on their personal income tax returns. This is the approach used.
the partnership’s taxable income regardless of whether any funds are actually distributed to the partners. Yet in some cases, the Code allows the partners to treat a partnership as an entity. The Code “takes a schizophrenic view of partnerships: it treats partnerships as entities for certain purposes and as an aggregate of its members for other purposes.” Because there is little guidance for taxpayers to choose between the two, taxpayers, not surprisingly, choose the more tax favorable. Second, partnerships are immensely flexible, although the tax laws do require allocations under the partnership agreement to have substantial economic effect. Third, because partnership formation is a nontaxable event, formation has no immediate tax impact, although this is also true for corporate formation. Fourth, when a partner contributes property to a partnership in exchange for a partnership interest, that partner recognizes no gain or loss. Fifth, and finally, the Code “[c]ontains a number of very specific rules that dictate tax consequences that do not adequately follow economic consequences.” For example, an income-stripping partnership transaction by which income is allocated to a nontaxable partner (such as a foreign entity) can be used to generate artificial losses, which are then allocated to a taxable partner.

Id. H.R. REP. NO. 83-2543, at 58. While the partners can decide how to allocate partnership income, that allocation must reflect the economic reality of their business arrangement.

See I.R.C. § 761(a) (defining partnerships and allowing the partners to opt out of subchapter K); Treas. Reg. § 301.7701-3(a) (2006) (“An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701–2(b)(2)) or a partnership . . . .”).

Cunningham & Repetti, supra note 21, at 36.

“Some tax rules favor certain investment vehicles rather than investments. Partnerships and S corporations are taxed more favorably than C corporations. Taxpayers who qualify for all three forms of business organization can choose one form over another solely for tax reasons.” Bankman, supra note 98, at 13.

See I.R.C. § 704(b); Treas. Reg. § 1.704-1(b) (2013).

Miller & Maine, supra note 182, at 530.

Pursuant to section 721 of the Code. Id. at 531. This can also hold true in the corporate context.

Cunningham & Repetti, supra note 21, at 35. This may be true for closely held corporations as well.

The Treasury promulgated regulation 1.701-2 on December 29, 1994 after a contentious notice and comment process. The regulation provides that if taxpayers form a partnership or use a partnership in a transaction or series of transactions that violate "the intent of subchapter K," the Commissioner can recast the transaction. Unfortunately, the Treasury did not use terminology precisely or consistently. The regulation refers to "the intent of subchapter K" in some sections, and refers to "the intended purpose of a provision of the Code" and "the purposes of other provisions of the code" in other sections. The "intent" language is confusing because a collection of statutes cannot form an intent; rather, legislators, who are individuals, may form an intent regarding a statute they are enacting. Statutes, which are inanimate things incapable of thinking, can have a purpose or purposes but cannot form intent. While related, purpose and intent are not interchangeable, and this language caused, and continues to cause, confusion and controversy.

192 Treas. Reg. § 1.701-2 (as amended by T.D. 8588, 1995-1 C.B. 109); INTERNAL REVENUE SERV., supra note 179; Herman J. Marino, The Final Partnership Anti-abuse Regulation: The Treasury Redefines the "Intent of Subchapter K", 73 TAXES 171, 171 (1995); Nelson, supra note 12, at 641, 651 (noting that the regulation "provoked unusual, if not unprecedented, opposition from tax professionals" and was "no less than astonishing"); see also Sheldon I. Banoff, Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2, 66 TAX NOTES 1859, 1859 (Mar. 20, 1995) (mentioning "the vociferous response in letters and at tax conferences and professional associations pro and con (largely con); the contentious public hearing; the seemingly well-founded allegations of procedural violations in issuing and finalizing the regulation; the reaction to and criticisms of the final regulation . . . ."); Letter from Robert D. Comfort, Chairman, Tax Section of the Phila. Bar Assoc., to the Internal Revenue Service (June 30, 1994), in Philadelphia Bar Tax Section Calls for Partnership Rule's Withdrawal, 1994 TNT 140-31 (June 30, 1994) (noting concern that "very few partnership transactions [would be] clearly safe from challenge under the anti-abuse rule").

193 Treas. Reg. § 1.701-2(b).

194 Id. § 1.701-2(a), (b) (emphasis added).


196 See JELLUM, supra note 36, at 33–34; Gunn, supra note 25, at 163 n.21 ("Purpose‘ would probably have been a better word. No one doubts that statutes are enacted to achieve some purpose, while references to ‘intent’ may invite speculations about the mental states of legislators, almost none of whom have even read the legislation they have enacted, let alone thought enough about it to have formed an ‘intent’ about how particular cases should be resolved.").

197 See JELLUM, supra note 36, at 33–34.

198 See, e.g., Garrett, supra note 57, at 199 (arguing that legislative intent does not exist). Critics pounced on the imprecise terminology, in part, because the idea of legislative intent is highly controversial. As one tax professional challenged, "[o]ne cannot discern a legislative intent for even one provision of the partnership tax laws; moreover, one cannot
The anti-abuse regulation authorizes the Commissioner of the Service to disregard and recast a partnership transaction if: (1) a principal purpose of the transaction is to reduce substantially the partners' aggregate federal tax liability; and (2) the manner in which the liability is reduced is inconsistent with "the intent of subchapter K." To be consistent with "the intent of subchapter K," the transaction must meet the following three-pronged test (two of the prongs were borrowed from the judicially created anti-abuse doctrines described above):

- **The business purpose prong**: The partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose.

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**Application of subchapter K rules.** The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (intent of subchapter K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K.


Because the Treasury subdivided the section into three subsections, most commentators identify only three factors. See, e.g., Marino, *supra* note 192, at 175 (calling the factors "a three-fold requirement"). Two of the subsections contain two factors, however, making for a total of five factors. See Lipton, *supra* note 199, at 68–69 (identifying five factors). Following the regulation's structure, I also use the term "three" rather than "five."
• The substance over form prong: The partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose.

• The clear reflection of income prong: The tax consequences to each partner of partnership operations and of transactions between the partner and the partnership accurately must reflect the partners' economic agreement and the tax consequences must clearly reflect income.201

The Treasury identified these three factors as reflecting “the intent of subchapter K” because when Congress enacted subchapter K, lawmakers wanted to allow taxpayers to conduct joint business activities using flexible economic arrangements while not incurring a tax simply for forming the entity.202

Pursuant to the regulation, generally speaking, if a transaction fails to meet any one of these three prongs, the Service may recast the transaction; however, the clear reflection of income prong contains an exception. Because some provisions of subchapter K and its regulations were enacted to promote administrative convenience and for other policy reasons, a particular provision may produce tax results that do not clearly reflect income.203 For this reason, the regulation states that if the business purpose prong and the substance over form prong are both met, then the clear reflection of income prong is also deemed to be satisfied so long as “the tax results . . . are clearly contemplated by that [tax] provision.”204

201 Treasury Regulation section 1.701-2(a) provides in full:

Intent of subchapter K. Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements — (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose. (2) The form of each partnership transaction must be respected under substance over form principles. (3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income . . . .

202 Treas. Reg. § 1.701-2(a) (as amended by T.D. 8588, 1995-1 C.B. 109); see also Internal Revenue Serv., supra note 179.

203 Lipton, supra note 199, at 68–69. The clearest examples are basis adjustments under sections 732 and 754. Marino, supra note 192, at 174.

204 Treas. Reg. § 1.701-2(a)(3). Treasury Regulation section 1.701-2(a)(3) provides in
Rejecting literalism, the Treasury was very clear that "[e]ven though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can" recast the transaction. In sum, pursuant to the regulation, the Service may re-characterize a partnership transaction as it deems appropriate to achieve tax results that are consistent with the intent of subchapter K when: (1) a principal purpose of the transaction was to substantially reduce the partners' aggregate federal income tax liability; and (2) the transaction fails the three prong test.

While there are often multiple reasons for structuring a transaction in a particular way, including reducing tax liability, the Treasury was concerned with whether the tax reduction purpose was "a principal purpose." If so, then the regulation will apply and the Service may recast the transaction, although the Service is not required to do so. Thus, if the claimed tax benefits are too favorable, despite the fact that a transaction served a legitimate business purpose, the Service need not respect the transaction.

Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

_id. § 1.701-2(b); see also Lipton, supra note 199, at 68 ("[t]he scope of the Service's authority to recast a transaction is breathtaking."); Samuel C. Thompson, Jr., Ex-governement Officials Challenge Partnership Anti-abuse Reg: An Analysis, 1995 TNT 242-47 (Dec. 11, 1995) (noting that the recasting can include "adjusting the claimed tax treatment.").

These pertinent facts and circumstances are identified in Treasury Regulation section 1.701-2(c).

INTERNAL REVENUE SERV., SETTLEMENT GUIDELINE: SUBCHAPTER K ANTI-ABUSE REGULATION § 1.701-2 (Sept. 23, 1998) (discussing the factors to be considered when negotiating a settlement in this area).

Cunningham & Repetti, supra note 21, at 38; Lipton, supra note 199, at 68-69 ("Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal income tax liability in a manner inconsistent with the intent of Subchapter K is determined on the basis of all of the facts and circumstances. The anti-abuse Regulations contain a nonexclusive list of factors
IV: EVALUATING THE TREASURY'S PROMULGATION

When the Treasury promulgated the anti-abuse regulation, the U.S. legal landscape was somewhat opaque. The judiciary had developed the anti-abuse doctrines identified earlier,\textsuperscript{209} including the business purpose, the substance over form, and the economic substance doctrines.\textsuperscript{210} Their exact parameters were unclear, however, especially in the mid-1990s. Nevertheless, there is little doubt that the Treasury intended to adopt these doctrines, as it claimed that “the fundamental principles reflected in the regulation [were] consistent with the established legal doctrines . . . .”\textsuperscript{211} As we will see, the Treasury was simply wrong.

The Treasury could have adopted a regulation stating:

Notwithstanding anything in this chapter to the contrary, the Commissioner shall be permitted to assert and rely upon applicable judicial principles and authorities, e.g., lack of proper business purpose, substance over form, step transaction and sham transaction doctrines, to challenge and set aside, in whole or in part, abusive transactions involving partnerships.\textsuperscript{212}

Because such a regulation would have merely restated existing law, it would have been “consistent with [the Treasury’s] authority to issue interpretive regulations pursuant to Code section 7805.”\textsuperscript{213} The Treasury did not issue such a regulation.\textsuperscript{214} Instead, as I explain below, the Treasury

\textsuperscript{209}See supra Part II.

\textsuperscript{210}See generally Madison, supra note 54, at 749 (explaining all the doctrines).

\textsuperscript{211}T.D. 8588, 1995-1 C.B. 112.

\textsuperscript{212}Alan H. Daniels, Florida Bar Committee Call for Antiabuse Rule’s Overhaul, 1994 TNT 142-41 (June 22, 1994) (noting that the proposed regulation was “beyond the scope of the Service’s authority” only because it included a standard not embodied in existing law).

\textsuperscript{213}Letter from Robert D. Comfort, supra note 192; Daniels, supra note 212.

\textsuperscript{214}When the Treasury proposed the anti-abuse regulation, some supporters suggested that it offered a matrix for interpreting partnership rules that simply mirrored existing common law doctrines and Code provisions. See, e.g., Letter from Leslie B. Samuels, Assistant Secretary of the Treasury for Tax Policy, to the Honorable Robert Packwood, Chairman, Senate Finance Committee (Dec. 29, 1994), reprinted in Samuels Addresses New Tax Committee Chairs’ Concerns About Antiabuse Reg., 1994 TNT 255-18 (Dec. 30, 1994) (arguing that the regulation merely confirms that the traditional common law doctrines of
altered the existing legal landscape in a number of significant ways. First, the Treasury expanded the common law business purpose doctrine. Second, it conjunctively joined all of the judicially crafted anti-abuse doctrines in one new, supersized test. Finally, and most surprisingly, the Treasury added a new anti-abuse standard — the proper reflection of income prong — which did not exist in common law and only existed in a narrower form in other parts of the Code.\footnote{215} I have already described the judicially crafted anti-abuse doctrines in some detail.\footnote{216} Below, I explain how the Treasury incorporated but nevertheless significantly altered these common law doctrines.

When it promulgated the anti-abuse regulation, the Treasury did not simply intend to adopt the judicially created economic substance doctrine. Nevertheless, the Treasury's regulation resembles the economic substance doctrine both in substance and in organization: the judicially created economic substance doctrine combined the business purpose doctrine and the economic substance principle into a two-pronged test.\footnote{217} Likewise, the Treasury combined the business purpose and substance over form “principles” into one test. The similarities end there; however, the Treasury's test is more comprehensive. Specifically, the Treasury crafted a three-pronged, conjunctive test: (1) a \textit{required} business purpose element; (2) a \textit{required} substance over form element; and (3) an \textit{optional} proper reflection of income prong. Each element and prong differs from its common law counterpart.

Let us explore the differences, beginning with the business purpose doctrine. The Treasury changed the common law business purpose doctrine by raising the standard taxpayers needed to meet to reduce their tax liability. The Treasury incorporated and altered business purpose in two different subsections of the anti-abuse regulation: subsections (a) and (b). Subsection (a) provides that “[t]he partnership must be bona fide and each

\footnote{215} Cunningham & Repetti, \textit{supra} note 21, at 39 n.196 (“critics assert that the proper reflection-of-income standard finds 'no support in the statute, the legislative history, or the case law.'” (quoting William S. McKee & Mark A. Kuller, \textit{Issues Relating to Choice of Entity, Entity Characterization and Partnership Anti-Abuse Rules}, in \textit{TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES AND OTHER STRATEGIC ALLIANCES} 17 (2000))).

\footnote{216} \textit{See supra} Part II.

\footnote{217} \textit{See supra} Part II.B.1.
partnership transaction or series of related transactions must be entered into for *a substantial business purpose.* Subsection (b) permits the Commissioner to recast a partnership if it was "formed or availed of in connection with a transaction a principal purpose of which [was] to reduce substantially the . . . partners' . . . tax liability . . . ." A principal purpose is not the same as the principal purpose. As noted earlier, common law accepts tax avoidance as a legitimate goal of tax planning. "For the past sixty years, at least, taxpayers have been generally free to engage in transactions with a principal purpose of avoiding tax, in recognition of the fact that *there is nothing inherently wrong or bad with engaging in tax planning.*" "[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation." The common law business purpose doctrine allowed recasting only when bad motive was the principal purpose of the transaction. Thus, common law had required only that a taxpayer have some business purpose; in contrast, the Treasury's anti-abuse regulation requires not just that there be "a" or "some" business purpose, but it requires that that purpose be *substantial.* Because the anti-abuse regulation allows

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219 Id. § 1.701-2(b) (emphasis added).
220 Santa Fe Pac. Corp. v. Cent. States, Se. & Sw. Areas Pension Fund, 22 F.3d 725, 727 (7th Cir. 1994); see also Ralph Weiland, *TEI Urges Withdrawal of Partnership Antiabuse Rule,* 1994 TNT 140-21 (July 18, 1994) (arguing that the new standard conflicts with case and statutory law); cf., I.R.C. § 269(a) (using "the principal purpose" language for a corporate tax anti-abuse provision).
223 Letter from Robert D. Comfort, *supra* note 192 (noting that this provision "go[es] far beyond even the most extreme formulations of the business purpose doctrine under existing law."); Cuff, *supra* note 211 (stating, "[t]he proposed regulation changes current law by establishing a general requirement that taxpayers not engage in partnership transactions with 'a principal purpose' of avoiding tax" when taxpayers have been generally free to engage in transactions with a principal purpose of avoiding tax); Thompson, *supra* note 205, at 1396 (acknowledging the change, but suggesting that the choice seemed sensible).
224 Admittedly, other sections of the Code did allow the Service to consider whether a transaction had as "one of its principal purposes the avoidance of Federal income tax." *See,* e.g., I.R.C. §§ 453(e)(7) (relating to income from an installment sale), 1031(f)(2)(C) (relating to the exchange of property held for productive use or investment).
225 Cunningham & Repetti, *supra* note 21, at 51 ("With apparently no statutory authority, the abuse-of-subchapter-K rule not only requires that there be a business purpose, but also that it be 'substantial.'").
recasting when tax avoidance is a principal purpose for the transaction, the
regulation strengthened the Treasury’s ability to challenge taxpayer
motivation should the Treasury choose to apply it.\textsuperscript{226}

The Treasury’s decision to strengthen the common law business
purpose standard was intentional and thought to be crucial to the
regulation’s success. Indeed, Congress had codified the weaker common
law standard in a statute addressing corporate acquisitions, but apparently
the standard was ineffective.\textsuperscript{227} Moreover, while adoption of the weaker
common law standard might have reassured taxpayers that the Service
would not challenge their transactions easily, “adoption of [the common
law standard] would substantially undermine the effectiveness of the
Proposed Regulation in reducing the level of abusive transactions.”\textsuperscript{228} In
sum, the Treasury incorporated business purpose into subsection (b) of the
regulation, but toughened that standard.

In its second required prong, the Treasury specifically incorporated all
of the common law substance-over-form principles in a single, conjunctive
test. The regulation provides: “[t]he form of the transaction must be
respected under substance over form principles.”\textsuperscript{229} Which principles are
specifically included in this prong is unclear. While the anti-abuse
regulation does not separately refer to the step transaction doctrine (let
alone specify which form) or the economic substance principle, these
doctrines developed from substance over form.\textsuperscript{230} Presumably, the Treasury
intended to include them, but the agency could certainly have been clearer.
Additionally, no common law doctrine included all of the judicially created
anti-abuse doctrines and principles in a conjunctive test. The closest

\textsuperscript{226} See James B. Sowell, The Partnership Anti-abuse Rules: Where Have We Been and
Where Are We Going?, 89 TAXES 69 (2011) (describing transactions to which the Treasury
claimed the anti-abuse regulation applied).

\textsuperscript{227} The statute contains a standard similar to the common law standard. I.R.C. §
269(a)(2) (referring to “the principal purpose”). But see Michael L. Schler, NYSBA Submits
Report on Partnership Antiabuse Regulation, 1994 TNT 130-34 (July 1, 1994) (supporting
the regulation’s broadening of the standard by noting that the corporate anti-abuse standard
demonstrates the weakness of the common law test). The courts have also interpreted a few
sections of the Code to require more than just “some” business purpose. See, e.g.,
activity to rise to the level of a “trade or business” under section 162(a) of the Code); United
States v. Gilmore, 372 U.S. 39 (1963) (interpreting sections 162, 165(c)(2), 183 and 212 of
the Code to require that the “primary” purpose of a transaction be to make a profit);
Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965) (interpreting section 355 of the Code
to require spin-offs to have a substantial business purpose).

\textsuperscript{228} Schler, supra note 227.


\textsuperscript{230} See supra Part II.B.
doctrine, the economic substance doctrine, included only two such doctrines, business purpose and economic substance, joined conjunctively, disjunctively, or holistically.231 The Treasury adopted the least taxpayer friendly combination by combining all of the doctrines into one: a supersized economic substance doctrine, if you will.

Finally, the optional “proper reflection of income” prong: pursuant to this prong, “the tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners’ economic agreement and clearly reflect the partner’s income . . . .”232 This prong was never part of the common law landscape and certainly not part of any of the judicially crafted anti-abuse doctrines.233 Although there was some support for this requirement within subchapter K, the existing statutes were not quite this broadly applicable.234 Specifically, section 446 of the Code allows the Treasury to require taxpayers to use accounting methods that clearly reflect income.235 While this section is broad, it does not apply to every partnership transaction, because not all transactions involve accounting procedures.236 Similarly, section 482 allows the Treasury to override Code provisions to clearly reflect income; however, it is normally used “to over-ride a non-arm’s-length arrangement among related parties so that other

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231 See supra Part II.B.


233 See supra Part II. One scholar has argued that after the anti-abuse regulation was promulgated, courts expanded the economic substance doctrine. They avoided applying the anti-abuse regulation, choosing instead to apply the economic substance doctrine to recast the transaction. Sowell, supra note 226, at 75.

234 “[T]here is no generally applicable, Code-wide rule or doctrine under which a normal interpretation of a Code provision is trumped by an overarching concept of clear reflection of income.” Nelson, supra note 12, at 646.

235 Section 446(b) of the Code provides, “[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.” Section 482 of the Code provides:

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

236 Nelson, supra note 12, at 646 (describing the Code sections to which section 446 does not apply).
Code provisions can operate.”

In sum, while some have suggested that the clear reflection and allocation of income factor made this prong of the anti-abuse regulation superfluous, the prong expanded existing law. Consequently, with the anti-abuse regulation, the Treasury altered existing law, both statutory and common, in a number of ways. First, the Treasury strengthened the common law’s requirement of business purpose by allowing the Commissioner to recast a transaction when “a” principal purpose was tax avoidance and the taxpayer did not otherwise have a “substantial” business purpose for the transaction. Second, the Treasury crafted a “super-sized anti-abuse” test, which, while incorporating the common law anti-abuse doctrines, combined them in new ways. The super-sized test includes a tougher business purpose element and all of the substance over form principles in one conjunctive test. Moreover, the super-sized test includes an optional third prong, the proper reflection of income prong, which did not exist in this form in the common law or the Code. In sum, the Treasury significantly increased the standard taxpayers had to meet to receive tax benefits under subchapter K. Because altering existing common and statutory law is beyond the executive’s constitutional competence, the Treasury’s construction of subchapter K is unreasonable. Although regulations are entitled to considerable weight,

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237 Id.

238 Marino, supra note 192, at 174; see also I.R.C. § 482 (allowing the Secretary to allocate income among businesses to “clearly . . . reflect the income of any such . . . business[].”)

239 Nelson, supra note 12, at 646–47 (“In sum, neither Section 446, 482 nor any other provision grants the IRS or the courts Code-wide authority to override the normal operation of statutory provisions in order to clearly reflect income.”)

240 Daniels, supra note 212; see also Coverdale, supra note 38, at 1517 (“[C]ourts should not adopt a policy that falls outside the range of plausible interpretations of the enacted language of the statute in which Congress announced its choice.”). Although taxpayers have challenged the validity of the regulation in court, this issue has not yet been judicially resolved. In one case, the Treasury strategically removed the issue from the court’s consideration by claiming it had not yet decided whether it would rely on the regulation. Jade Trading, LLC v. United States, 60 Fed. Cl. 558 (2004), motion granted by, 63 Fed. Cl. 143 (2004), and, 65 Fed. Cl. 487 (2005), and, 67 Fed. Cl. 608 (2005), motion granted in part by, 64 Fed. Cl. 85 (2005), motion granted in part, denied in part by, 65 Fed. Cl. 641 (2005), aff’d, in part, vacated, in part, rev’d in part, remanded, vacated in part as moot by, 598 F.3d 1372 (Fed. Cir. 2010). In other cases, courts ruled in favor of the government on other grounds. See, e.g., Kornman & Assoc., Inc. v. United States, 527 F.3d 443 (5th Cir. 2008) (noting that the taxpayer raised invalidity of Treasury regulation 1.701-2 and deciding the case on other grounds); Southgate Master Fund, LLC v. United States, 651 F. Supp. 2d 596 (N.D. Tex. 2009) (same); Klamath Strategic Inv. Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 2006), finding of facts and conclusions of law at, 472 F. Supp. 2d 885 (E.D. Tex. 2007), aff’d, in part, vacated, in part, remanded by, 568 F.3d 537 (5th Cir. 2009);
'[the Treasury] may not usurp the authority of Congress by adding restrictions to a statute which are not there.'"241

V: SECTION 7701(o) OF THE CODE

After more than ten years of debate,242 Congress finally codified the economic substance doctrine in 2010 as part of "Obamacare."243 As if the new health care law were not controversial enough, "codification of the economic substance doctrine was among the most controversial tax items

Santa Monica Pictures, LLC v. Commissioner, 89 T.C.M. (CCH) 1157 (2005) (noting that the taxpayer raised invalidity of Treasury regulation 1.701-2 and deciding the case on other grounds); Jade Trading, 65 Fed. Cl. 487 (discussing privilege relating to deliberative documents in promulgation of Treasury regulation 1.701-2). In two cases, the courts applied the anti-abuse regulation to allow a transaction to be recast; however, the validity of the rules was not addressed. Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d 49 (D. Mass. 2010), amending on reconsideration, Civ. Nos. 05-40151–FDS, 06-40130–FDS, 06–40243–FDS, 06–40244–FDS, 2010 WL 3942533 (D. Mass. Oct. 6, 2010); Nevada Partners Fund, LLC v. United States, 714 F. Supp. 2d 598 (S.D. Miss. 2010). 241 Edward L. Stephenson Trust v. Commissioner, 81 T.C. 283, 288 (1983) (quoting Estate of Boeshore v. Commissioner, 78 T.C. 523, 527 (1982)); see also id. at 291 ("[C]ourts should be wary of broad-scale incorporation of the doctrine of "tax avoidance," or "business purpose," or "sham" in an area so fraught with its own particular problems and nuances. At the very least, we are required to limit those judicially developed doctrines to the situations which they were intended to cover.").


243 Congress codified the doctrine through section 1409 of the Health Care and Education Reconciliation Act of 2010. Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067 (2010) (codified at I.R.C. § 7701(o)). The Health Care and Education Reconciliation Act of 2010 and the Student Aid and Fiscal Responsibility Act were signed into law along with the Patient Protection and Affordable Care Act, known pejoratively as "Obamacare." Thus, Obamacare, or the Affordable Care Act, includes parts of the following: the Affordable Health Care for America Act, the Patient Protection Act, the Health Care and Education Reconciliation Act of 2010, and the Student Aid and Fiscal Responsibility Act.
contained in the health care legislation."⁴⁴ Instead of codifying the doctrine separately as a part of tax reform legislation (like several of the earlier draft bills had proposed), Congress instead buried the doctrine in one of "the most expansive, and contentious, legislative packages in recent memory."⁴⁵

As with the Treasury's promulgation of the anti-abuse regulation, controversy enfolded Congress's many codification attempts.⁴⁶ For different reasons, the George W. Bush administration, tax professionals, the Service, and the Treasury all opposed codification at one time or another.⁴⁷ The Bush administration claimed codification was unnecessary and would be redundant.⁴⁸ Tax professionals feared that codification would lead to uncertain application of an ambiguous doctrine by an overzealous agency.⁴⁹ Others feared that codifying the doctrine would make it too rule-like, subject to manipulation, and less flexible.⁵⁰ In any event, Congress codified the doctrine for multiple reasons: to address abusive tax shelters, to remedy the lack of uniformity in the lower courts, and to raise revenue.⁵¹ In addition to its revenue potential, however, the primary reason Congress codified the doctrine was to address the lower courts' inconsistent application.⁵²

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⁴⁴ Luke, supra note 98, at 552.
⁴⁵ Id. at 553.
⁴⁶ Id.
⁴⁷ Sancilio, supra note 67, at 162.
⁴⁸ See Jensen, supra note 27, at 24.
⁵¹ Joint Comm. on Taxation, Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872, the "Reconciliation Act of 2010," As Amended, in Combination with the Revenue Effects of H.R. 3590, the "Patient Protection and Affordable Care Act ('PPACA')," as Passed by the Senate, and Scheduled for Consideration by the House Committee on Rules on March 20, 2010, at 3 (Comm. Print 2010) (estimating revenue increases of $1.8 billion in the ensuring five years and $4.5 billion in the ensuing ten); see also Jensen, supra note 27, at 22 ("Codification was scored as a revenue-raiser, albeit a small one, and supporters of health care legislation were looking for revenue wherever it might be found."); Luke, supra note 98, at 554; Del Wright, Jr., Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (and How the IRS Helps Them), 45 Ariz. St. L.J. 611, 659-61 (2013).
⁵² Blank & Staudt, supra note 10, at 1656; Jensen, supra note 27, at 24 ("With federal courts of appeals applying the doctrine in varying ways, taxpayers in different parts of the United States were effectively subject to different standards in applying what was, after all,
Congress codified the economic substance doctrine by amending two sections of the Code. First, Congress amended the definitions contained in the income tax section of the Code (subchapter A) to include a section titled “Carification of Economic Substance Doctrine.” This section now defines “the economic substance doctrine” as “the common law doctrine under which [income] tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.” “Transaction” is broadly defined to include “a series of transactions.” While at least one person has questioned whether the economic substance definition includes the other substance over form principles, it seems unlikely. Admittedly, the other substance over form principles are “common law doctrines under which [income] tax benefits . . . with respect to a transaction are not allowable;” however, they are not allowable for reasons other than that “the transaction does not have economic substance or lacks . . . business purpose.” Hence, the definition seems sufficiently narrow to cover only the common law economic substance doctrine with its business purpose and economic substance prongs.

After defining the economic substance doctrine as described, the definition section provides:

In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if —

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position [the economic substance prong], and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction [the business purpose prong].

With this language, Congress adopted the two-prong, conjunctive test, including both the subjective business purpose prong and the objective

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253 I.R.C. § 7701(o).
254 Id. § 7701(o)(5)(A).
255 Id. § 7701(o)(5)(D).
256 Sancilio, supra note 67, at 165.
258 Id.
259 Id. § 7701(o)(1) (emphasis added).
economic substance prong. The subjective business purpose prong requires that a taxpayer have a substantial purpose for entering into a transaction other than to obtain tax benefits and that that purpose be distinct from any effects on federal income tax (subparagraph (B)). The objective economic substance prong requires that a transaction meaningfully change the taxpayer's economic position and that that change be distinct from any federal income tax effects (subparagraph (A)). In other words, the transaction must have some nontax effect. A transaction has economic substance when both prongs are met; thus, Congress elected to codify the stricter, conjunctive form of the common law economic substance doctrine.

While the components of the codified version of the doctrine vary little from the judicially created economic substance doctrine, Congress departed significantly from the common law doctrine in another section of the statute. Congress opted to impose a significant, strict liability penalty for anyone violating the doctrine. In addition to amending the definition section of subtitle A, Congress also amended section 6662, which imposes penalties for underpayments. This amendment levies a penalty equal to twenty percent of the underpayments attributable to a transaction lacking economic substance if the transaction was disclosed in a tax return or in a statement attached to a return; otherwise, the penalty is a whopping forty percent. Importantly, the penalty is a strict liability penalty; if a court determines that the transaction lacked economic substance, the penalty applies regardless of the surrounding facts and circumstances. Unlike other underpayment penalties, taxpayers whose tax benefits are disallowed under section 7701(o) cannot claim an exception based on reasonable cause.

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260 Bankman, supra note 98, at 12.

261 Congress also added other subsections that are not relevant to this article. For example, one provides a "[s]pecial rule where taxpayer relies on profit potential," another notes that state and local tax benefits should be "treated in the same manner as a federal income tax effect," and a third provides that financial accounting benefits shall not be considered as a purpose for entering into a transaction when the origin of the benefits is a reduction of federal income tax. I.R.C. §§ 7701(o)(2)-(4).

262 Id. § 6662(b)(6) ("Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.").

263 Id. § 6662(b)(6). A corresponding amendment to section 6676 provides that the strict liability penalty also applies to refund claims, although in that case the penalty is limited to twenty percent. Id. § 6676(a).

264 See, e.g., id. § 6664(c)(1) ("No penalty shall be imposed . . . with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.").
or good faith. Under the reasonable cause/good faith exception, taxpayers could avoid penalties by claiming they relied on expert legal opinions.

Further, the new law is clear that this penalty applies to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701 (o)) . . . " Yet the penalty also applies to "a transaction . . . failing to meet the requirements of any similar rule of law." Congress thus gave the Service and the Treasury the ability to apply the strict liability penalties to "any similar rule of law." The statute does not define what "any similar rule of law" means, but the statute's legislative history suggests that Congress intended this language to respond to the judiciary's use of inconsistent terminology. Although some have argued that, by "similar rule of law," Congress meant to allow the Treasury to apply the penalty whenever any substance over form principle disallowed the claimed tax benefits, this argument seems misguided in light of this legislative history. In any event, the Service has refused to apply the strict liability penalty provision so broadly.

265 Id. § 6664(e)(2) ("[The reasonable cause exception] shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6)."); see also STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE “RECONCILIATION ACT OF 2010,” AS AMENDED, IN COMBINATION WITH THE “PATIENT PROTECTION AND AFFORDABLE CARE ACT”, 56 (Comm. Print 2010) (“No exceptions (including the reasonable cause rules) to the penalty are available . . . .”); H.R. REP. No. 111-443, at 295, 304 (2010) (“No exceptions (including the reasonable cause rules) to the penalty are available . . . .”)

266 LEANDRA LEDERMAN & STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE 42 (3d ed. 2008) (discussing the reasonable cause exception for avoiding tax penalties); Chirelstein & Zelenak, supra note 30, at 1941 (noting that if a taxpayer were unlucky enough to be audited, the taxpayer could “honestly assert that he sought the opinion of a reputable counsel and was assured thereby that the tax shelter scheme was consistent with the requirements of the law.”).

267 I.R.C. § 6662(b)(6).

268 Id.

269 Id.

270 STAFF OF JOINT COMM. ON TAXATION, supra note 265, at 155 n.359; accord H.R. REP. NO. 111-443, at 304 n.161 (similarly referring to factors and analysis). As I noted above, the common law form over substance doctrines are not consistently defined in the existing jurisprudence. See supra text accompanying note 72.

271 Wright, supra note 251, at 664 (noting that the language is broad enough to cover the other substance over form doctrines “and possibly some of the myriad anti-abuse provisions in the Code.”).


273 On July 15, 2011, the Service issued a directive stating that "until further guidance is
When it enacted section 7701(o), Congress claimed it was simply clarifying the economic substance doctrine.\textsuperscript{274} If true, was codification truly necessary, or was the Bush administration correct in saying that the codification was redundant?\textsuperscript{275} Congress was wrong: its codification did more than clarify. With codification Congress identified which version of the test applied (namely, the conjunctive version), made minor changes, and offered consistent terminology for each of the two prongs.\textsuperscript{276} Moreover, codification strengthened the Treasury's ability to rely on the doctrine. For those judges, particularly textualists, who may have been hesitant to impose the judicially created doctrines, codification removes their choice. Finally, the severity of the new penalty provisions is stunning.\textsuperscript{277} With its strict liability standard, the statute significantly enhanced the Treasury's ability to penalize taxpayers who structured transactions in disingenuous ways. In the past, these taxpayers could have offered legal opinions with literal reasoning to insulate their bad behavior.\textsuperscript{278} With Congress's codification,
this option was removed. Thus, codification was more than a simple clarification.

VI: EVALUATING CONGRESS’S CODIFICATION

Unlike the Treasury, Congress had the constitutional authority to radically reform the judicially created economic substance doctrine;\(^\text{279}\) indeed, Congress made some significant changes. Notably, Congress’s penalty changes, particularly the strict liability aspect, were remarkable. Yet although Congress did make changes to the doctrine, Congress chose mostly to echo and clarify existing common law doctrine rather than alter and augment it.

Congress’s codification mirrored the Treasury’s promulgation in two significant ways. As noted earlier, the judicially created economic substance doctrine included two prongs — business purpose and economic substance — which courts applied conjunctively, disjunctively, or as a factors test.\(^\text{280}\) Pursuant to the conjunctive test, a transaction could be recast when either business purpose or economic substance was lacking. Both the Treasury and Congress adopted a conjunctive test. By adopting the conjunctive version of the doctrine, the Treasury and Congress increased the government’s power to recast abusive transactions.

Similarly, the Treasury and Congress both strengthened the business purpose prong. Section 7701(o) provides that a transaction has economic substance when “the taxpayer has a substantial purpose . . . for entering into such transaction.”\(^\text{281}\) This standard is virtually identical to the standard the Treasury adopted in its anti-abuse regulation. The Treasury required that “each partnership transaction or series of related transactions . . . must be entered into for a substantial business purpose.”\(^\text{282}\) The Treasury’s addition of the word “business” in its version is the only notable difference; thus, transactions of a personal nature, such as an investment, would arguably suffice under the section 7701(o) standard, but not under the Treasury’s anti-abuse regulation, which requires that the transaction have a substantial business purpose. In any event, the Treasury and Congress agree that a transaction lacks economic substance when bad motive is a substantial

\(^{279}\) U.S. CONST. art. I, § 8, cl. 18.

\(^{280}\) See supra Part II.B.1.

\(^{281}\) I.R.C. § 7701(o)(1)(B) (emphasis added).

reason for the transaction. In contrast, under common law, economic substance was lacking when bad motive was \textit{the principal} reason for the transaction. Thus, both the Treasury and Congress strengthened the business purpose prong of their codified anti-abuse doctrine, which in both cases gave the government more power to recast transactions.

At this point, however, the similarities between Congress’s codification and the Treasury’s “miscodification” end. Under its first prong, section 7701(o) defines a transaction as having economic substance when that transaction changes a taxpayer’s economic position “in a meaningful way.”\textsuperscript{283} This articulation of the standard differs somewhat from the common law standard primarily because courts disagreed as to the proper interpretation of this prong.\textsuperscript{284} Nonetheless, courts did generally agree that a transaction must possess a prospect of profit before taxes, or be “imbued with tax-independent considerations”\textsuperscript{285} to satisfy the prong. Congress’s requirement that the taxpayer’s economic position be changed in a “meaningful” way therefore seems similar, even if it is not completely identical to that of common law.

In contrast, the Treasury was less than clear whether the common law economic substance \textit{principle}, or prong, applied. The anti-abuse regulation simply provided that “[t]he form of each partnership transaction must be respected under substance over form principles.”\textsuperscript{286} As noted earlier, the Treasury likely intended to include \textit{all} the substance over form principles, including the economic substance \textit{principle}, but the Treasury did not clearly articulate such an intention. Instead, the Treasury simply mentioned all of these principles. In contrast, Congress left no uncertainty.\textsuperscript{287} Not only did Congress clearly articulate that the economic substance principle applied, Congress explicitly incorporated only the economic substance principle; Congress did not mention the other substance over form principles, suggesting that Congress intentionally omitted them under the canon of

\textsuperscript{283} I.R.C. § 7701(o)(1)(A).

\textsuperscript{284} See, e.g., \textit{In re CM Holdings, Inc.}, 301 F.3d 96, 103 (3d Cir. 2002) (defining the inquiry as “whether the transaction affected the taxpayer’s financial position in any way.”); \textit{United Parcel Serv. of Am., Inc. v. Commissioner}, 254 F.3d 1014, 1018 (11th Cir. 2001) (including “the creation of genuine obligations enforceable by an unrelated party.”); \textit{IES Indus., Inc. v. United States}, 253 F.3d 350, 354 (8th Cir. 2001) (defining the inquiry as “whether there was a reasonable possibility of profit . . . apart from tax benefits . . . .” (quoting \textit{Shriver v. Commissioner}, 899 F.2d 724, 726 (8th Cir. 1990))).

\textsuperscript{285} \textit{Frank Lyon Co. v. United States}, 435 U.S. 561, 584 (1978).

\textsuperscript{286} \textit{Treas. Reg. § 1.701-2(a)(2)}.

\textsuperscript{287} \textit{Lederman, supra} note 24, at 391 (arguing that the modern economic substance doctrine was replaced by a search for congressional intent).
expressio unius.\textsuperscript{288} Congress included only the business purpose and economic substance prongs, like the judicially created economic substance doctrine.

Finally, and most significantly, Congress’s codification differs significantly from the Treasury’s miscodification in that Congress did not add additional factors or prongs. Although there is “significant overlap between the requirements for respecting a transaction under [the anti-abuse regulation] and [the codified economic substance doctrine] . . . . [t]he primary distinction between the two rules, it would appear, is the third prong of the partnership anti-abuse [regulation]; that is, the ‘proper reflection of income’ requirement.”\textsuperscript{289} In contrast, the Treasury augmented the common law test by adding the optional reflection of income prong to its promulgation.\textsuperscript{290} In contrast, Congress included just the two prongs, like both the conjunctive and disjunctive common law versions.

While there is no question that Congress’s codification more closely echoed the existing common law doctrine, albeit strengthening that doctrine in a number of ways, whether Congress did a better job codifying the doctrine than the Treasury remains to be seen.\textsuperscript{291} Certainly, unanswered questions remain.\textsuperscript{292} For instance, courts must still determine whether a particular business purpose is “substantial” and whether a change in a taxpayer’s economic position is “meaningful.” For this reason, “many commentators believe that [the codified doctrine] has little chance of reducing inconsistent judicial outcomes.”\textsuperscript{293}

Also, what is the relevance, if any, of the other judicially created doctrines? Likely, these doctrines remain powerful tools for the Treasury. “[A]t a minimum, it seems to be essential that the substance-over-form and

\textsuperscript{288} \textit{Expressio unius} is a rule of negative implication, meaning the inclusion of one thing means the exclusion of the other. It is implicated when a statute has a gap. The existence of the gap permits two very different inferences: either the legislature intended to omit the circumstance or the legislature never considered the circumstance. The canon presumes the former: that when the legislature includes some circumstances explicitly, then the legislature intentionally omitted other similar circumstances that would logically have been included. JELLUM, supra note 36, at 140.

\textsuperscript{289} Sowel, supra note 226, at 77–78.

\textsuperscript{290} Treas. Reg. § 1.701-2(a)(3).

\textsuperscript{291} Technically, the Treasury has no power to codify a doctrine; rather, the Treasury promulgates regulations. I use the term “codify” in this sense to mean turning into written law.

\textsuperscript{292} Luke, supra note 98, at 560 (“When will taxpayer action rise to the level of a ‘transaction?’ When will such a transaction be scrutinized under the doctrine? When will the doctrine be applied in preference to other tax authorities? When will a transaction be likely to fail the inquiries of the doctrine?”).

\textsuperscript{293} Blank & Staudt, supra note 10, at 1656–57.
step-transaction doctrines be applied first to determine what the ‘transaction’ is that will be evaluated under the codified economic substance doctrine.”

Such an approach would be consistent with prior case law, as judges must still determine what a transaction is before testing its legitimacy. Further, section 7701(o) of the Code specifically defines transactions to include “a series of transactions.” Moreover, the staff of the Joint Committee on Taxation stated that “[this] provision is not intended to alter or supplant any other rule of law, including any common-law doctrine . . . .” This language suggests that the other principles remain viable, but does not explain how.

Perhaps the most important question is just when does section 7701(o) apply? The statute specifies that “[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.” This wording suggests that there will be times when the doctrine does not apply. The statute fails to provide a bright-line test to determine exactly when the doctrine should apply, however.

Further, legislative history offers little guidance, even if one were willing to consider it. Did Congress really intend for the Service and the judiciary, when deciding whether section 7701(o) applies to a particular transaction, to ask first whether the doctrine

294 Jensen, supra note 27, at 31.
295 Id. at 35.
296 I.R.C. § 7701(o)(5)(D).
297 STAFF OF JOINT COMMITTEE ON TAXATION, supra note 265, at 155 (emphasis added); accord H.R. REP. No. 111-443, at 298 (2010) (“No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, the provision shall not be construed as alter [sic] or supplanting any other rule of law, including any common-law doctrine . . . .”)

Note, however, that in United States v. Woods, the Supreme Court stated:

Blue Books are prepared by the staff of the Joint Committee on Taxation as commentaries on recently passed tax laws. They are ‘written after passage of the legislation and therefore do not inform the decisions of the members of Congress who vote in favor of the law.’ We have held that such ‘post-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation.’ Of course the Blue Book, like a law review article, may be relevant to the extent it is persuasive.

298 I.R.C. § 7701(o)(5)(C).
299 Cf. Jensen, supra note 27, at 36 (indicating that the term “transaction” implies that “not every event is to be tested for economic substance.”).
300 STAFF OF JOINT COMM. ON TAXATION, supra note 265, at 152–56; H.R. REP. NO. 111-443, at 60–63.
would have applied had codification never occurred?\textsuperscript{301} Apparently it did! As noted earlier, a major reason for Congress’s codification was to remedy the lack of uniformity under the common law doctrine.\textsuperscript{302} This provision neither clarifies nor simplifies. While the legislation as a whole creates a more uniformly applicable doctrine, this specific provision simply adds confusion. “That is a confusing proposition; pretend to ignore something that you really cannot ignore.”\textsuperscript{303} In conclusion, far from eliminating all the uncertainty with the common law economic substance doctrine, in some areas, Congress created new confusion; nevertheless, at least with Congress’s approach, existing case law remained good law.

VII. CONCLUSION

Abusive tax shelters are not going away; thus the government has powerful reasons to combat tax abuse with any legitimate means it can find. While historically turning to rules, more recently, the Treasury and Congress enacted standards to stem the abuse. The Treasury enacted regulation 1.701-2, the anti-abuse regulation. In doing so, the Treasury crafted a super-sized version of the judicially created tax anti-abuse doctrines, which greatly altered and expanded these doctrines. In contrast, Congress more closely mirrored existing common law. Questions remain regarding whether the Treasury assumed power beyond its statutory authority. Congress certainly has the constitutional power to alter existing judicial doctrine, though it chose not to radically alter the law.\textsuperscript{304} Certainly, Congress strengthened existing law, most significantly by dramatically

\textsuperscript{301} Blank & Staudt, \textit{supra} note 10, at 1656–57; Luke, \textit{supra} note 98, at 554.

\textsuperscript{302} One scholar argues, “this language . . . is primarily about maintaining the precodification balance of decision making between tax agencies and courts . . . Included in this web is the general ability of the tax agencies to obtain strong deference from the courts as to the agencies’ authoritative, reasonable interpretations of textual ambiguities.” Luke, \textit{supra} note 98, at 554–55.

\textsuperscript{303} Jensen, \textit{supra} note 27, at 32. To address the confusion, the Service has said it will continue to:

\textit{[A]nalyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o). If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable. The IRS anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop.}


\textsuperscript{304} U.S. CONST. art. I, § 8, cl. 18.
increasing the government’s ability to penalize violators. Yet Congress’s attempt to simply codify existing common law with section 7701(o) is not problem-free. Questions remain, especially as to section 7701(o)’s application to particular transactions.

The Treasury’s particular frustration with the partnership laws stems, in part, from the broad latitude given to businesses to structure partnership agreements.\textsuperscript{305} Partnerships and other pass-through entities remain a commonly abused entity form; thus, the partnership laws offer great opportunities as a vehicle for tax abuse. The Treasury simply cannot evaluate every partnership transaction to see if tax abuse took place; hence, such abuse has been difficult to combat. The anti-abuse regulation allows the Treasury to look at the results of each transaction to determine whether abusive behavior is taking place (such as income-shifting and abusive deductions). Moreover, with its limited resources, the Service has insufficient ability to audit: audit rates are currently quite low.\textsuperscript{306} The Treasury’s goal was indeed laudable.

While the impetus behind the Treasury’s anti-abuse regulation cannot be faulted, the regulation goes too far.\textsuperscript{307} “On the whole, we are probably better off with an IRS forced to follow statutory law and to look to Congress to clean up the statutes and to the courts for equity.”\textsuperscript{308}

\textsuperscript{305} \textit{INTERNAL REVENUE SERV.}, supra note 179.


\textsuperscript{307} Accord Gunn, supra note 25, at 159 (“[The anti-abuse regulation] attempt[s] to make the concept of abuse do too much work.”).