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**LEGISLATIVE AND REGULATORY RESPONSES TO TAX
AVOIDANCE: EXPLICATING AND EVALUATING THE
ALTERNATIVES**

ERIK M. JENSEN*

INTRODUCTION

Nothing is certain but death and taxes? Not true. If taxes are certain, then so too are tax avoidance, tax evasion, and governmental efforts to contain the avoidance and evasion.¹

This Article examines anti-avoidance efforts in the United States—in particular, legislative and regulatory responses to tax avoidance.² To be sure, the judiciary has been involved as well, having developed many important anti-avoidance doctrines over the years. But judicial efforts are reactive, necessarily limited to disputes that reach the courts, and generalist judges can be overwhelmed by technical tax issues.³ In contrast, Congress and the Internal Revenue Service can look at the larger picture, systematically taking advantage of the learning of tax experts, and act preemptively.⁴ If judicial doctrines have significant prospective effect, it is because the Service invokes those doctrines in policing the system.

Part I of the Article describes the avoidance problem and gives two examples of transactions that can be considered tax shelters—examples that will serve as test cases for the anti-avoidance methods discussed in the rest of the Article. The following parts of the Article consider the merits of several statutory and regulatory methods of dealing with shelters: enacting statutes or regulations aimed at particular avoidance transactions (Part II); enacting

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1. Attempts to avoid or evade death will always be with us as well, but, as far as I can tell, they will not succeed, at least not in the long run.

2. From now on, I will use only the term “avoidance.” For “evasion,” the illegal stuff, the substantive legal doctrines are, by definition, already in place. And, on the enforcement side, much of what I discuss in Parts VI and VII, dealing with disclosure and standards of practice, is just as relevant to evasion as to avoidance.

3. For that matter, even specialized judges, like those on the Tax Court, can be overwhelmed.

4. Congress is not made up of tax experts, of course, but the staffs of the congressional committees are first-rate.

“outcomes-oriented” legislation intended to deal with wider patterns of avoidance behavior (Part III); codifying an “economic substance” or other general anti-avoidance doctrine, something the United States resisted until 2010 (Part IV); imposing anti-abuse doctrines through regulations (Part V); requiring disclosure of potentially abusive transactions in order to gather information and deter problematic deals (Part VI); and creating national standards to govern advice that tax professionals give, so as to keep professionals from blessing suspect transactions (Part VII).⁵

Each method has much to commend it, at least in some circumstances, and each has much that is problematic. In any event, no one method will bring avoidance to acceptable levels by itself; there is no silver bullet. Flexibility works better than rigidity in attacking shelters, and a combination of methods works better than any single one can. Furthermore, our expectations should be realistic. Tax avoidance can be contained; it cannot be eliminated.⁶ Professor Tracy Kaye has written that, at this (and every other) moment, “[s]omewhere in America at a tax boutique firm, creative tax advisors are putting together new tax shelters waiting for Corporate America to earn profits that need sheltering,”⁷ and that is probably right. The target at which Congress and the Service are aiming is moving, and tax avoidance will always be with us.

I. TAX SHELTERS

A. *The Avoidance Problem*

I characterize the avoidance problem as one of “tax shelters,” but I use the term with no precise, technical definition. Moreover, I do not intend to limit the term to arrangements popularly called shelters—like pre-Tax Reform Act of 1986 real estate limited partnerships⁸ or contingent liability transactions used by corporations in the 1990s.⁹ For present purposes, I intend “tax shelter”

5. My work on these issues began with Erik M. Jensen, *The US Legislative and Regulatory Approach to Tax Avoidance*, in *COMPARATIVE PERSPECTIVES ON REVENUE LAW: ESSAYS IN HONOUR OF JOHN TILEY* 99 (John Avery Jones et al. eds., 2008).

6. In fact, it has been suggested that “shutting down shelters actually feeds the shelter market because it creates a demand for the services of tax shelter providers.” David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 *SMU L. REV.* 73, 78 (2001). That is true, in a way, just as a strong national defense might encourage potential aggressors to increase military spending. But unilateral disarmament is not a defense policy, and knowing that folks will always seek to avoid taxes does not mean that we should give up on countering avoidance.

7. Tracy A. Kaye, *The Regulation of Corporate Tax Shelters in the United States*, 58 *AM. J. COMP. L.* 585, 604 (2010).

8. The utility of that sort of shelter was limited by the passive activity loss rules of I.R.C. § 469. *See infra* Part III.

9. *See infra* Part I.B.1 (describing *Black & Decker Corp. v. United States*, a contingent liability case); notes 72–79 and accompanying text (describing legislative fix for contingent liability shelters).

to refer to a transaction with claimed tax benefits that are questionable in light of congressional intentions and basic good sense, but that have sufficient authority so that fraud is not involved.

In 2004, Professor Joseph Bankman provided a working definition that is useful but narrower than I would prefer: a shelter, he wrote, is “a (1) tax motivated; (2) transaction unrelated to a taxpayer’s normal business operations; that (3) under a literal reading of some relevant legal authority; (4) produces a loss for tax purposes in excess of any economic loss; (5) in a manner inconsistent with legislative intent or purpose.”¹⁰ A transaction fitting that definition ought to be considered a shelter, but why focus only on transactions intended to create losses? I would also include transactions structured to avoid or defer income recognition,¹¹ to convert ordinary income into preferentially treated capital gain,¹² or to achieve any other favorable tax treatment—if relevant authority is being interpreted “in a manner inconsistent with legislative intent or purpose,”¹³ and regardless of whether the transaction is arguably unrelated to the taxpayer’s “normal business operations.”¹⁴

The typical shelter, broadly understood, has little or no motivation behind it other than hoped-for tax benefits. As Professor (and former Assistant Secretary of the Treasury) Michael Graetz has pithily put it, a shelter is “a deal done by very smart people that, absent tax considerations, would be very stupid.”¹⁵ Moreover, although the typical shelter relies on legitimate authority, it is often read in a mindlessly literal way¹⁶—to achieve results that seem (and probably are) too good to be true when measured against congressional intentions.¹⁷

10. Joseph Bankman, *The Tax Shelter Problem*, 57 NAT’L TAX J. 925, 925 (2004).

11. See David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 334 (2006) (including “transactions that rely on a strained reading of the relevant tax provision[s] . . . to avoid including otherwise taxable income, and the like”).

12. Corporate taxpayers enjoy no preferential rate for net capital gain, see I.R.C. § 1201 (2006) (providing that rate on net capital gain of a corporation cannot exceed what is the top rate anyway), but even with corporations the capital gain-ordinary income distinction matters. Corporations can use capital losses only to offset capital gains. See *id.* § 1211(a). A corporation with otherwise unusable capital losses therefore prefers capital gain over ordinary income.

13. Bankman, *supra* note 10, at 925. If there is doubt about whether a transaction is a shelter, I am happy to have “tax shelter” be the default characterization. We should be skeptical, that is, of any transaction that pushes the envelope.

14. *Id.*; cf. *infra* Part I.B.2 (discussing *Cottage Savings* transaction, which was related to the taxpayer’s trade or business).

15. Lynnley Browning, *How to Know When a Tax Deal Isn’t a Good Deal*, N.Y. TIMES, Sept. 10, 2008, at H6 (quoting Professor Michael Graetz).

16. The authority may be garbled as well. See Schizer, *supra* note 11, at 334 (arguing that shelters “exploit poorly drafted statutes and regulations”).

17. See J. COMM. ON TAXATION, SUMMARY OF JOINT COMMITTEE STAFF “OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES” 2 (2005) (noting that “[r]ecent

Tax planning, which requires close reading of the Internal Revenue Code and Treasury regulations, is usually considered necessary and even desirable in American society,¹⁸ but mindless interpretation of authority is not.¹⁹ (Practitioner Peter Canellos has said that shelters disparage “the intellectual foundations of principled and creative tax practice.”²⁰) It is probably unfair to blame shelters on “textualism,” a defensible method of statutory interpretation, but the perception that some prominent jurists have been applying textualism in an extreme form may have added legitimacy to the shelter phenomenon.²¹

Tax shelters based on hypertechnical interpretations are often furthered by taxpayers being convinced that, because of the “audit lottery” and associated effects, little risk is involved in claiming too-good-to-be-true results. Maybe there will be no audit at all; or any audit will be cursory and uninformed,²² or, for a large taxpayer, questionable transactions will be hidden amongst the details of a massive tax return.²³ The risk of penalties can be a concern, of course, but the concern is often more theoretical than real. Penalties that are unlikely to be imposed are not much of a deterrent to taking aggressive return positions.²⁴

tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by Congress”); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 327 (2002) (defining shelters as “transactions that violate the intent of the Code and the regulations”).

18. *But see* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222 (2002) (“[Tax planning] is almost always positively bad for society—it is worse than worthless.”).

19. “Congress sometimes intends to encourage [tax planning].” Brian Galle, *Interpretative Theory and Tax Shelter Regulation*, 26 VA. TAX REV. 357, 381 (2006) (footnote omitted). True enough, and reading statutes hypertechnically is sometimes justified by citing cases that have blessed planning. *E.g.*, *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) (“Any one may so arrange his affairs that his taxes shall be as low as possible . . .”), *aff’d*, 293 U.S. 465 (1935). But both Judge Hand and the Supreme Court in *Helvering v. Gregory* rejected methods of statutory interpretation that ignore statutory purposes: a carefully structured corporate transaction was not honored because it served no corporate-level business purpose.

20. Peter C. Canellos, *A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 49 (2001).

21. *See* Galle, *supra* note 19, at 359. My point is not that any particular jurists have in fact been using extreme forms of interpretation; it is that they are characterized as doing so.

22. Schizer, *supra* note 11, at 335 (noting shelters “take advantage of poor auditing”).

23. This is not always the case, however. *See infra* note 42 (noting that, because of the magnitude of the claimed losses, the shelter in *Black & Decker* was impossible to hide); notes 63–64 and accompanying text (noting that the transaction at issue in *Cottage Savings* was facilitated by bank regulators).

24. “[T]axpayers choose avoidance and evasion strategies based on expected rather than nominal sanctions.” Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 569 (2006).

In any event, the risk of audit and penalties matters not so much if a transaction is deemed legitimate. Yes, reasonable taxpayers want to avoid audit if possible and want to avoid litigation no matter what. But it is still better to have the law on your side. And, as Professor David Weisbach has emphasized, many shelters “work,” in the sense that, if push comes to shove, taxpayers can convince decision-makers that hypertechnical interpretations are justified.²⁵

One last point about the distinction between tax shelters and other transactions is worth making: taking advantage of authority in a way that is consistent with legislative intent is not “shelter” behavior, as I use the term, regardless of how good the tax results might be. For example, Congress understood when it enacted the Accelerated Cost Recovery System in 1981 that, in most cases, depreciation schedules would dramatically outstrip actual declines in property value²⁶—hence the adjective “accelerated.” ACRS was not intended to be theoretically pure; it was intended to spur investment in depreciable business and investment property.²⁷ We can criticize Congress when it blesses behavior that we think makes no economic sense, but those who take advantage of congressionally endorsed incentives are not engaging in suspect behavior. As Professor Alan Gunn explained, “very favorable tax results, results that may seem too good to be true, are sometimes required by the language and purposes of particular statutory provisions.”²⁸

B. *Examples of Tax Shelters*

This section discusses a couple of transactions that were tax shelters, as I have used the term, and that led to widely noted judicial decisions: *Black &*

25. See Weisbach, *supra* note 6, at 78. If a suspect transaction is challenged by the Internal Revenue Service, well-heeled taxpayers can often outgun governmental legal teams. See Schizer, *supra* note 11, at 335–36.

26. In fact, in better economic times, it was understood that, with some property like commercial buildings, value would not go down at all—indeed, it might go up—but depreciation deductions were still available.

27. I.R.C. § 179 has for many years permitted expensing the cost (“cost” here including acquisition indebtedness) of a limited amount of depreciable personal property by smaller business taxpayers. Section 179 was in part an incentive provision, but it was also intended to lessen bookkeeping difficulties. More recently, a provision for 100% bonus depreciation—i.e., permitting current deductibility of the full cost of some depreciable property, without the limitations of § 179—has created an extraordinary incentive for investment in property that, were it not for the tax break, would make no economic sense. See I.R.C. § 168(k)(5) (2006), *as amended by* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 401, 124 Stat. 3296 (2010) (providing for 100% bonus depreciation on “qualified property” placed in service before 2012). Congress can permit deducting more than the cost of property—investment credits coupled with depreciation deductions have sometimes had that effect—but, when that happens, we have left “cost recovery” for another universe.

28. Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 174 (2001) (footnote omitted).

*Decker Corp. v. United States*²⁹ and *Cottage Savings Ass'n v. Commissioner*.³⁰ (The *Black & Decker* transaction was understood by everyone to be a shelter; not everyone would characterize the *Cottage Savings* deal in that way.³¹) The two cases provide sets of facts that are interesting in their own right but that are also useful for thinking about mechanisms to counter tax avoidance.

1. *Black & Decker*: Contingent Liability Shelters

In *Black & Decker*, the tax results depended on the treatment of contingent liabilities. In 1998, Black & Decker (“B&D”) and several other entities created a new corporation, Black & Decker Healthcare Management Inc. (“BDHMI”).³² B&D transferred \$561 million in cash, together with \$560 million in contingent employee and retiree healthcare benefit claims, to BDHMI in exchange for all the shares of one class of preferred stock.³³ B&D later sold the preferred stock to a third-party facilitator, a trust formed by a former B&D employee, for \$1 million.³⁴

Because B&D was part of a group of transferors of property in control of BDHMI “immediately after the exchange,” the formation of the corporation was tax-free under I.R.C. § 351.³⁵ The basis rules associated with § 351 transactions generally provide for carryover or substituted bases: a transferor of property will generally have a basis in stock received equal to the basis of the property contributed, and the corporation’s basis in contributed property will generally be the same as the transferor’s was.³⁶

Those are the “general” rules, but stock basis must be reduced by, among other things, liabilities transferred.³⁷ If the healthcare claims had to be taken

29. 340 F. Supp. 2d 621 (D. Md. 2004), *aff'd in part, rev'd in part, and remanded*, 436 F.3d 431 (4th Cir. 2006).

30. 499 U.S. 554 (1991).

31. *See infra* note 119.

32. *Black & Decker*, 340 F. Supp. 2d at 622.

33. *Id.*

34. *Id.*

35. *See* I.R.C. § 351(a) (2006) (providing for nonrecognition on exchanges of property solely for stock if, “immediately after the exchange,” the transferors of property are in control of the corporation, with “control” defined in I.R.C. § 368(c)). Because the property being transferred was only cash, no gain would have been recognized by B&D anyway, unless transferred liabilities exceeded the basis of the property transferred, *see id.* § 357(c)(1), and that was not the case.

36. I.R.C. §§ 358(a)(1), 362(a) (2006). There are exceptions to these propositions, but, except for the special treatment of transferred liabilities, they were not relevant in *Black & Decker*.

37. *See* I.R.C. §§ 358(a)(1) (requiring reduction in basis by amount of money distributed), 358(d)(1) (treating relief from liabilities, other than those described in I.R.C. § 358(d)(2) (cross-referencing I.R.C. § 357(c)(3)), as the distribution of money for purposes of computing basis in stock).

into account in determining B&D's basis in the BDHMI stock, that basis would have been only \$1 million (that is, \$561 million less \$560 million), a figure equal to the net value contributed. In that case, no loss would have been recognized on the sale of the stock for that same figure.

B&D in effect took the position, however, that, at the time of the healthcare claims' transfer to BDHMI, the obligations were too contingent to be treated as liabilities under the basis rules. (The idea that liabilities should be ignored, at least for some tax purposes, until significant contingencies have disappeared had authority behind it—in particular, a 1995 revenue ruling cited by B&D.³⁸) As a result, B&D said its basis in the \$1 million worth of BDHMI stock was \$561 million, the amount of cash transferred, unaffected by the contingent obligations.³⁹ When B&D sold the stock for \$1 million, it claimed a \$560 million loss.⁴⁰ B&D had contributed net value of \$1 million, had sold its interest for \$1 million, and nevertheless had claimed a loss of \$560 million—a loss that, if honored, could have been used to offset substantial capital gains that had been realized by the corporation.⁴¹

Of course, the government challenged that position.⁴² There should have been a serious dispute about the meaning of “liability” in the relevant Code provisions,⁴³ but, without discussing the Code, the trial judge in 2004 accepted B&D's interpretation and granted its motion for summary judgment.⁴⁴ And, although the judge understood that only tax considerations had motivated the transaction—B&D had conceded that point for purposes of the summary judgment motion—he concluded that there was enough indisputable economic substance for the transaction to be honored: BDHMI became responsible for the healthcare claims, had employees, and so on.⁴⁵

Had the transaction not taken place, B&D would eventually have been able to deduct the \$560 million anyway, year by year as the claims were satisfied. But, under B&D's theory, accepted by the trial judge, the effect was an

38. See Rev. Rul. 95-74, 1995-2 C.B. 36 (not treating contingent environmental remediation obligations as liabilities for purposes of I.R.C. § 357(c)(3), which is cross-referenced in I.R.C. § 358(d)(2), for purposes of computing basis in stock).

39. *Black & Decker*, 340 F. Supp. 2d at 622.

40. *Id.*

41. See *supra* note 12 (discussing use of capital gains and losses by corporations).

42. This was decidedly not a shelter the success of which depended on the audit lottery. See *supra* notes 22–23 and accompanying text. A claimed loss of that magnitude was not going to escape scrutiny.

43. See I.R.C. § 357 (2006) (especially §§ 357(c)(3), 358(d)).

44. *Black & Decker*, 340 F. Supp. 2d at 623–24.

45. *Id.* at 624.

immediate deduction of the full \$560 million—a dramatic acceleration of the tax benefit.⁴⁶

B&D was right that, at least for some tax purposes, a contingent obligation would not be treated as a “liability” until the contingencies had disappeared. But in this case the technical argument—a *hypertechnical* argument—trumped good sense. Although any particular claim might have been technically contingent—further work was necessary to evaluate each employee’s claim, and some would be found meritless—in the aggregate the obligations were real enough to affect the value of the stock B&D sold. That is why the purchaser of B&D’s stock in BDHMI was willing to pay only \$1 million.

Whether the grant of summary judgment was consistent with “legislative intent or purpose” depends on what that phrase means, of course. The average Congressman—indeed, the above-average Congressman—is clueless about corporate taxation; in that respect, there was no legislative intent to search for. Nevertheless, I am confident that, *if* Congress had been able to focus on such a transaction, and had in fact done so—a lot of counterfactuals here—it would not have intended the result reached by the judge. As a matter of first principles, the result was too good to be true.⁴⁷

The system did adjust. As will be discussed presently, Congress in 2000 enacted remedial legislation that, although it did not apply to *Black & Decker*, cut the heart out of contingent liability transactions.⁴⁸ It took a while, but good sense entered the judicial system as well. On appeal in 2006, the Fourth Circuit accepted a variant of B&D’s basis analysis—that the healthcare claims were not liabilities for purposes of the basis calculations because of express language in § 357(c)(3)⁴⁹—a defensible, albeit hypertechnical, result.⁵⁰ But the

46. The loss on the sale of the stock was capital rather than the ordinary deduction that would have been taken had the claims been satisfied, but B&D had sufficient capital gains to use the capital loss currently. *See supra* note 12 (discussing use of capital gains and losses by corporations).

The timing issue was critical in *Black & Decker*, but something else might have been at stake as well. BDHMI apparently took deductions as the claims were satisfied. If B&D had prevailed, the result would effectively have been double deductions, immediately to B&D and later to BDHMI.

47. And it was not as though Congress had explicitly blessed the too-good-to-be-true results. *See supra* notes 26–28 and accompanying text. If the shelter worked, it was because B&D was openly and notoriously exploiting a quirk in the statute.

48. *See infra* notes 72–79 and accompanying text.

49. B&D would have been entitled to deduct the obligations if it had paid them. Under I.R.C. § 357(c)(3), such an obligation is not a liability for purposes of I.R.C. § 357(c) and, by cross-reference, the stock basis rule of I.R.C. § 358(d)(1). *See* I.R.C. §§ 357(c)(3), 358(d)(2) (2006) (cross-referencing I.R.C. § 357(c)(3)). I.R.C. § 357(c)(3) was clearly intended to take cash-basis payables out of the definition of “liabilities” for these purposes. When that section was enacted, no member of Congress was thinking of obligations like those in *Black & Decker*.

Fourth Circuit also remanded the case for consideration of whether B&D's desired result, even if apparently consistent with statutory language, should have been disallowed because the transaction was a sham.⁵¹ Satisfying statutory requirements that are interpreted in a hypertechnical way should not necessarily be enough for a transaction to be honored. Before the trial on remand began, B&D, recognizing that it was probably fighting a losing battle, accepted a settlement offer from the government.⁵²

In a perfect world—with statutory, regulatory, and judicial doctrines lined up to prevent bizarre results—B&D's argument would have been a loser to begin with, with little to discuss. But it was not a clear loser at the time—if it had been, B&D would not have participated in the contingent liability shelter⁵³—and that is why there is a lot to discuss.

2. *Cottage Savings*: Exchanges of Bundles of Mortgages

The contingent liability transaction in *Black & Decker* was a tax shelter under anyone's definition of that term. If the system could not adjust to deal with transactions of that sort, the system was beyond repair.⁵⁴ A harder case that serves as a good test for anti-avoidance doctrines is *Cottage Savings Ass'n v. Commissioner*,⁵⁵ decided by the Supreme Court in 1991. Because real economic losses were involved, and because the transactions at issue were related to the taxpayer's trade or business, the *Cottage Savings* deals are generally not thought of as tax shelters; they would not have fit Professor Bankman's definition.⁵⁶ But, as Professor Weisbach has noted, in *Cottage Savings* “[a]bsolutely nothing happened except for tax.”⁵⁷ In that respect, this was a shelter *par excellence*.

The taxpayer, a savings and loan association, was holding low-interest home mortgages in a market (the late 1970s) with dramatically rising interest

50. *Black & Decker Corp. v. United States*, 436 F.3d 431, 437–38 (4th Cir. 2006). This argument, that the obligations were not liabilities because B&D would have been able to take the deductions if it had paid the claims itself, is probably the one that B&D should have been hammering to begin with, rather than focusing on contingencies.

51. *See id.* at 443. The sham transaction doctrine was a judicial creation. *See Knetsch v. United States*, 364 U.S. 361, 364–65 (1960).

52. Sheryl Stratton, *Black & Decker to Settle; Bigger Case on Horizon*, TAX NOTES TODAY, Mar. 5, 2007, available at LEXIS, 2007 TNT 43-1.

53. B&D had its corporate eyes open when it entered into this transaction, which was conceded (at least for summary judgment purposes) to have been motivated only by tax considerations.

54. It did adjust. *See supra* notes 51–52 and accompanying text (discussing remand of *Black & Decker* for consideration of sham transaction doctrine and subsequent settlement); *see also infra* notes 72–79 and accompanying text (discussing statutory fix).

55. 499 U.S. 554 (1991).

56. *See supra* text accompanying note 10.

57. Weisbach, *supra* note 6, at 75.

rates.⁵⁸ As rates rose, the value of the mortgages inevitably declined. In the American income tax system, however, decline in value generally does not create a deductible loss—even if the decline can be irrefutably demonstrated and even if the loss is unquestionably attributable to business or investment. For the most part, the system does not work on a mark-to-market basis.⁵⁹ Something else—a “realization” event, like a sale—must occur.⁶⁰

In an attempt to create tax losses, Cottage Savings in 1980 in effect exchanged bundles of ninety percent participation interests in those mortgages for other, almost identical bundles put together by other financial institutions.⁶¹ (In form Cottage Savings sold participation interests to several S&Ls and then purchased other, fungible interests from those S&Ls, but the transactions were effectively exchanges of value for value.) The new bundles were secured by different homes and the obligors were different, but the bundles relinquished and the bundles received were economically fungible.⁶²

The transactions would have been disastrous if losses had had to be recognized for financial accounting purposes; regulators might have had to shut Cottage Savings (and other S&Ls) down. No one, including bank regulators, wanted that to happen, however, and transactions of this sort would not have occurred had the regulators, with their eyes wide open, not given the go-ahead: the regulators made the exchanges nonevents for financial accounting purposes.⁶³ The goal was to permit S&Ls like Cottage Savings to recognize losses for tax purposes,⁶⁴ without having to do so otherwise.

58. *Cottage Savings*, 499 U.S. at 556.

59. Congress has enacted some income provisions, however, that do not require realization. *See, e.g.*, I.R.C. § 1256 (2006) (providing for marking to market of “section 1256 contract[s],” like “regulated futures contract[s]” and “foreign currency contract[s]”).

60. “Realization” is also generally necessary on the income side. *See Eisner v. Macomber*, 252 U.S. 189, 195 (1920) (holding that realization is a constitutional requirement to have “income” within the meaning of the Sixteenth Amendment). Many think realization is no longer constitutionally required, but it is still often understood as part of the definition of “gross income” under I.R.C. § 61. *See Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding that “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion” are gross income unless Congress provides otherwise). *But see supra* note 59 (noting that some Code provisions do not require realization). In any event, the Court in *Glenshaw Glass* did not explicitly say that realization is a requirement under I.R.C. § 61. It said only that *if* there has been an accession to wealth, clearly realized, etc., the result is gross income.

61. *Cottage Savings*, 499 U.S. at 557.

62. *Id.* at 557–58. Furthermore, since Cottage Savings would have continued to service the loans, borrowers would not have known that anything had happened. They would have continued to write checks to Cottage Savings.

63. *Id.* at 557.

64. *Id.* The exchanges were of bundles of equal value, as one would expect legitimate exchanges to be. The losses came from receiving value less than the *bases* of the bundles exchanged.

It has long been recognized that financial accounting and tax accounting can (and often do) diverge; the rules are different because the two regimes serve different purposes.⁶⁵ Inconsistency in accounting treatment was thus not by itself an indication of any abuse in *Cottage Savings*.

But if the appropriate baseline was that tax losses should not be recognized until a realization event has occurred, these exchanges provided a weak foundation for a deduction. Exchanges are generally realization events,⁶⁶ but in *Cottage Savings*, the Commissioner reasonably argued that, for tax purposes, nothing had happened.⁶⁷ When the dust had settled, *Cottage Savings*' economic position was unchanged. A relevant Treasury Regulation said that, unless otherwise provided, "gain or loss realized from . . . the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained,"⁶⁸ and, the government argued, there were no material differences between the relinquished and replacement bundles of mortgages.

The Supreme Court held, however, that the bundles were "materially different" because they embodied "legally distinct entitlements," with different obligors and different homes involved.⁶⁹ It is often said that the government in *Cottage Savings* was trapped by its own regulation, and there is something to that: as structured, the regulation implies that an exchange is presumptively taxable.⁷⁰ But "differing materially" is not self-defining, and the term did not have to be interpreted in a hypertechnical way. As interpreted, however, the test was a hair trigger: almost any difference between relinquished and

65. See *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 545–46 (1979) (holding that, even if a write-down of inventory was permissible, and maybe required, for financial accounting purposes—so as to send the right signal to investors about the taxpayer's financial health—the write-down was not a realization event, and it therefore created no deductible loss for tax purposes). The two sets of rules *have* to diverge. For example, when Congress enacts depreciation rules that do not correspond to economic reality, as it often does, see *supra* notes 26–28 and accompanying text, it would be absurd, and maybe dangerous, to expect financial accounting to follow those rules.

66. See *Helvering v. Bruun*, 309 U.S. 461, 469 (1940) (including "exchange of property" in a list of realization events).

67. *Cottage Savings*, 499 U.S. at 559–60.

68. Treas. Reg. § 1.1001-1(a) (2007).

69. *Cottage Savings*, 499 U.S. at 566–67.

70. In other situations where a technical realization event seems to lack substance—sale of loss property from one family member to another, for example, so that the family unit retains control—Congress has specifically provided for nonrecognition. See, e.g., I.R.C. § 267(a)(1), (c) (2006) (denying loss recognition on sales or loss properties from one related person to another). Implicit in I.R.C. § 267(a)(1) is the idea that the transaction would otherwise be a taxable event. See I.R.C. § 1031(a)(1) (2006) (providing for nonrecognition of gain or loss on exchanges of like-kind property); *Cottage Savings*, 499 U.S. at 566 (inferring from I.R.C. § 1031 that exchanges of very similar property are taxable unless Congress provides otherwise).

replacement properties was enough for realization. For Cottage Savings, there had been no change in economic position, but there were deductible losses for tax purposes—a result, in the minds of some, too good to be true.⁷¹

3. Responding to Shelters

Any methods proposed to deal with tax avoidance should take cases like *Black & Decker* and *Cottage Savings* into account. Some absurd results are inevitable in a complex tax system, of course, but how do we prevent results that, while tenuously supported by a serious legal argument, are nonetheless bizarre? And how do we do so without causing serious damage to legitimate economic activity?

Those are questions Congress and the Internal Revenue Service must constantly wrestle with. And those questions are addressed in the rest of this Article, which surveys and evaluates several statutory and regulatory methods to counter tax avoidance.

II. TARGETED LEGISLATION (OR REGULATIONS)

If statutes or regulations are being read hypertechnically to facilitate tax avoidance, one possible remedy is to amend the authority to clarify that offending interpretations are impermissible, at least in the context of particular transactions.

A. Examples of Targeted Legislation

Congress did just that to deal with contingent liability transactions like the one in *Black & Decker*, which had become widespread. In 2000, after the *Black & Decker* transaction had occurred, but before the litigation developed, Congress modified the stock basis rule that applies for § 351 (and other) transactions to provide as follows: if the result under the otherwise applicable rules would be a basis greater than fair market value, that basis must be reduced (but not below value) by the amount of liabilities *not* taken into account under § 358(d)(1).⁷² For this purpose, with a couple of exceptions, “the term ‘liability’ shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title.”⁷³ That definition, in § 358(h)(3), explicitly picked up contingent obligations like those in *Black & Decker*.⁷⁴ As a result,

71. A “hair trigger” standard is not so good, however, for taxpayers who are trying to avoid gain recognition on the exchange of appreciated assets for fungible assets. *See infra* notes 88–89 and accompanying text.

72. I.R.C. § 358(h)(1) (2006).

73. *Id.* § 358(h)(3).

74. For that matter, it picks up any obligations, whether contingent or not, that are not taken into account under I.R.C. § 357(c)(3) and I.R.C. § 358(d)(2). That would include the classic

whether or not transferred liabilities are contingent, they are generally required to reduce the stock basis—either under the general rule or under the 2000 extension of that rule.⁷⁵

The statutory change did not apply in *Black & Decker* because of the effective date,⁷⁶ but, had it applied, B&D's basis in the BDHMI stock would have been \$1 million. Start with the \$561 million in cash. The claims might have been contingent, and therefore would not have been taken into account under § 358(d).⁷⁷ But that would have left the basis in the stock above fair market value, so the special rule of § 358(h) would have come into play,⁷⁸ reducing the basis to \$1 million.⁷⁹ Problem solved—at least until smart people find ways around the amended statute.

Another example of targeted legislation is the partnership disguised sale provision in § 707(a)(2)(B), enacted in 1984.⁸⁰ Taxpayers had occasionally used contributions to and distributions from partnerships to disguise sales of property.⁸¹ Suppose a taxpayer is holding a parcel of real estate that is worth \$20,000 but which he acquired for only \$5,000. If he sells the property for \$20,000, he would pay tax on \$15,000 of gain. But suppose he instead contributes the parcel to a partnership and later receives a distribution of \$20,000 in cash. Contributions to and distributions from partnerships are generally nontaxable events. If each step is analyzed alone, the taxpayer would

situation at which I.R.C. § 357(c)(3) was directed: cash-basis payables that would have been deductible if payment had been made by the transferor.

75. The difference between the general rule and the special rule is that reductions in basis under I.R.C. § 358(d)(1) can result in a stock basis less than fair market value. Any reduction mandated by I.R.C. § 358(h)(1), however, will not go below fair market value.

76. In addition, the Service had provided in Notice 2001-17, 2001-1 C.B. 730, that it would challenge contingent liability transactions. IRS Notice 2001-17, 2001-1 C.B. 730. That notice was also not in place when B&D entered into its transaction.

77. If they had been deemed to be liabilities under general principles, the basis would have been reduced under I.R.C. § 358(d)(1) anyway, and we would not have needed to apply the new rule.

78. The exceptions in I.R.C. § 358(h)(2) would not have applied; no business assets were transferred, just cash.

79. See Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 1(a)(7), 114 Stat. 2763 (2000). The existence of the new statute and the notice, both of which were on the books when the case was litigated, could have been understood to strengthen B&D's argument that its transaction worked under the authority in place when the deal was consummated. Otherwise, why amend the statute? See *infra* text accompanying note 97.

80. I.R.C. § 707(a)(2)(B) (2006).

81. See, e.g., *Barenholtz v. Comm'r*, 77 T.C. 85, 90–91 (1981) (finding disguised sale, on the facts, before enactment of I.R.C. § 707(a)(2)(B)). But see *Otey v. Comm'r*, 70 T.C. 312, 321–22 (1978) (coming to opposite conclusion on the facts).

receive the economic benefit, but not the tax liability, from the “disguised” sale—assuming sufficient basis in the partnership interest.⁸²

Disguising a sale using a partnership was never the norm,⁸³ but the potential for abuse was there. In the 1984 legislation, Congress set out circumstances in which a contribution and distribution would be recharacterized as a sale of all or part of the contributed property. Taxpayers (and judges too) were put on notice that step-transaction and substance-over-form principles *had* to be applied to determine if the two transfers, “when viewed together, [were] properly characterized as a sale or exchange of property.”⁸⁴ In some respects the enactment merely codified existing understanding,⁸⁵ but that understanding was embellished by subsequent regulations, providing rules as to when a contribution and a distribution were to be “viewed together.”⁸⁶

B. *The Limitations of Targeted Statutes and Regulations*

Legislation and regulations that target particular transactions can have an effect—because of the 2000 amendments, a *Black & Decker*-like transaction is a nonstarter today⁸⁷—but in some cases they will not work, even in the short run. Modification of the regulation involved in *Cottage Savings* might have changed the result in later, similar cases, but with the risk to the government that transactions involving exchanges of *appreciated* fungible assets could fall on the tax-free side of the line. *Cottage Savings* was in form a loss for the government, but a hair-trigger standard of realization has revenue-raising potential on the gain side.⁸⁸ From the government’s standpoint, a technical

82. A distribution of cash *is* taxable to the extent it exceeds a partner’s basis in his partnership interest. *See* I.R.C. § 731(a)(1) (2006). For my example to be potentially tax-free, assume the partner has a basis of at least \$20,000 before the distribution.

83. The formal results were not all positive, and the competing interests of the contributing and noncontributing partners generally prevented abusive transactions. If the transaction is not a sale, the partnership would take the property with a basis of only \$5,000, not \$20,000. *See id.* § 723.

84. *Id.* § 707(a)(2)(B).

85. But even if the codified set of rules was not fundamentally new, adding the congressional seal of approval gave added weight to those principles.

86. *See* Treas. Reg. §§ 1.707-3–1.707-6. Two recent cases have found disguised sales by applying I.R.C. § 707(a)(2)(B). *See* *Canal Corp. v. Comm’r*, 135 T.C. 199 (2010); *Va. Historic Tax Credit Fund 2001 LP v. Comm’r*, 639 F.3d 129 (4th Cir. 2011), *rev’g* T.C. Memo. 2009-295.

87. Codification of the economic substance doctrine would also make contingent liability shelters unworkable today. *See infra* Part IV.

88. How, for example, should exchanges of barrels of oil by petroleum companies be treated? Such exchanges take place all the time, for good business reasons, and the nonrecognition rule of I.R.C. § 1031 (2006), dealing with like-kind exchanges, does not apply to exchanges of inventory. *See* I.R.C. § 1031(a)(2)(A). Does a barrel of appreciated North Slope oil differ materially from a barrel of appreciated North Sea oil?

change to fix the *Cottage Savings* “problem” might have been worse from a revenue standpoint than doing nothing, unless the regulatory draftsmen were willing to contemplate different realization rules for gains and losses.⁸⁹

Even when they do work, statutes or regulations directed at particular transactions can go only so far. At best, they react to specific events and apply to specific sorts of transactions. By the time Congress or the Internal Revenue Service realizes a barn door is open, the horse is often across the state line.⁹⁰

Whether the horse is gone or not, a quick statutory response is unlikely in the U.S., with its system of separation of powers.⁹¹ And targeted statutes (and, to a lesser extent, regulations) typically have only prospective effect, doing nothing about transactions already under contract or already consummated.⁹² (In that case, even if the escaped horse has remained in the neighborhood,⁹³ it is lost to the tax system.) The Constitution does not seriously limit enactments with retroactive, negative effect—at least if the retroactivity is modest⁹⁴—but Congress is generally reluctant to make statutes retroactively negative.⁹⁵

89. One can imagine having a hair-trigger test on the gain side and a more stringent rule on the loss side. But supporters of symmetry might object, and one might reasonably wonder whether the Service would have authority to adopt an asymmetrical rule of that sort without an explicit congressional directive.

90. One argument in favor of a disclosure regime is to help the government secure the barn to prevent the door from opening in the first place. *See infra* Part VI.

91. Even if one political party controls the presidency and both houses of Congress, party discipline is weak and concerted action is unlikely. Parliamentary systems are better able to take quick action to curb abuses with targeted legislation, which is one reason the British tax system is more formalistic than the American.

92. Regulatory agencies can act faster than Congress, but here too remedies are usually prospective. For example, on May 31, 2007, the Service announced it would issue regulations, effective that day, dealing with stock repurchases made by foreign subsidiaries of U.S. corporations in triangular mergers—treating funds used as subject to U.S. taxation because of deemed repatriation to the U.S. IRS Notice 2007-48, 2007-1 C.B. 1428. The Notice responded to an IBM announcement, *two days* earlier, that it had effected a \$12.5 billion repurchase. IBM saved \$1.6 billion that would have been due had the deal proceeded under the new rules. *See* William M. Bulkeley, *IBM's Under-the-Wire Tax Break*, WALL ST. J., June 7, 2007, at A3.

93. *Neighborhood, get it?*

94. *See* *United States v. Carlton*, 512 U.S. 26, 27 (1994) (finding no constitutional problem in retroactivity that went slightly beyond the beginning of the year of enactment); ERIK M. JENSEN, *THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION* 184–85 (2005) (discussing retroactivity and the Constitution).

95. Regulations sometimes do have retroactive effect, although retroactivity is constrained by I.R.C. § 7805(b)(1), generally providing that proposed, temporary, and final regulations shall not apply “to any taxable period ending before the earliest of” three dates: the date of filing with the Federal Register; for a final regulation, the date on which proposed or temporary regulations relating to the final regulation were so posted; or the date of any notice that substantially described what was to be in the regulations. I.R.C. § 7805(b)(1) (2006). I.R.C. § 7805(b) also provides several exceptions to that general rule, permitting retroactivity, for example, for “promptly issued regulations” (i.e., regulations issued within eighteen months of the date of

(Statutes with retroactive *positive* effects are another matter.⁹⁶) Furthermore, new authority with a prospective effective date may invite the argument that Congress or the Service implicitly blessed transactions consummated before that date.⁹⁷

Targeted provisions clog up the Code and regulations. If new language is drafted to deal with the specifics of each potentially abusive transaction, the already out-of-control body of authority gets even worse. As the late Professor (and one-time Assistant Secretary of the Treasury) Stanley Surrey wrote in 1969, “It is clear that [anti-avoidance provisions and doctrines] save the tax system from the far greater proliferation of detail that would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of substantive provisions written to govern the everyday world.”⁹⁸

And, even if effective—maybe *especially* if effective—detailed provisions can have a short useful life, while they continue as part of the Internal Revenue Code. Think of the poor, young tax associate trying to figure out the meaning of complex Code provisions that were directed at avoidance transactions of the distant past—transactions the associate is unlikely to see in practice.⁹⁹ The effectiveness of a statute—drying up transactions at which it was directed—can make its meaning obscure to later generations.¹⁰⁰

Finally, new statutory or regulatory language is, well, new language, something that energizes tax professionals. Give us new words to interpret, and we will interpret them as favorably to our clients as possible. As the late, great Marty Ginsburg predicted, in his “Law of Moses’ Rod,” “[E]very stick crafted

enactment of the related statute; where retroactivity is necessary to prevent abuse; to correct procedural defects in a previously issued regulation; and when Congress has specifically authorized the issuance of regulations with retroactive effect). See I.R.C. § 7805(b)(2), (3), (4), (6).

96. That sort of thing is politically popular, and no one has standing to complain, at least not in court.

97. See *supra* note 79. If Congress has blessed too-good-to-be-true results, the Service is not going to prevail by raising anti-avoidance doctrines. See *supra* notes 26–28 and accompanying text.

98. Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673, 707 n.31 (1969).

99. Perhaps it is unfair to say that a statutory provision which deters particular transactions has a short effective life. If, because of a statute, no one even contemplates doing such a transaction, the statute has obvious effect. My point is that once such transactions are not even being considered in the real world, young lawyers have no reason to try to understand what the statute was intended to do. But the provision stays on the books, creating confusion for future generations.

100. The statutory fix for contingent liability shelters is one that might bewilder young lawyers in the future, requiring, as it does, bouncing back and forth between a couple of Code provisions. See *supra* notes 72–79 and accompanying text. And it is not obvious to the casual observer, either from the face of the amendment or its placement—tacked on in I.R.C. § 358(h), rather than being added to I.R.C. § 358(d)—what the reason for enactment was.

to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner [of Internal Revenue] on the hind part.”¹⁰¹ No matter how well intentioned, changing statutory and regulatory language can breed, rather than deter, tax avoidance.

III. OUTCOMES-ORIENTED LEGISLATION

In some situations, a congressional response more promising than targeted legislation of the sort described in Part II is to go after broad categories of behavior based on outcomes rather than the technical calculations of, or the motivations behind, transactions. This strategy is illustrated by the oxymoronic passive activity loss (“PAL”) rules of § 469, enacted in 1986 and directed at the then prevalent shelters marketed to individual investors.¹⁰²

The typical investment structure for the shelters targeted by the passive activity loss rules was a limited partnership engaged in a business intended to generate losses (through accelerated depreciation and the like) that purely passive investors (lawyers, doctors, and other high-income folk) could use to offset income from other sources. The fact that the same structure (high-income persons investing as limited partners in limited partnerships) was used for many different types of shelters (real estate, movie production, research and development, and others) gave congressional drafters something to aim at. In that respect, the PAL rules are another example of targeted legislation, although the nature of the target is different from what I described earlier—a particular sort of arrangement with particular, potential outcomes, rather than a particular transaction.¹⁰³

In form complex—§ 469 of the Code goes on and on—the PAL rules actually operate in a simple way. Losses from a trade or business in which a taxpayer does not materially participate (a “passive activity”)—a category that generally includes a limited partnership interest in a limited partnership that conducts a trade or business—can be used only to offset income from other passive activities.¹⁰⁴ The losses cannot be used against income from practicing medicine or law, say. Nor can they be used to offset what came to be called portfolio income—interest, dividends, royalties, and the like—the sort of thing that most of us would have thought of as passive income if Congress had not

101. Martin D. Ginsburg, *The National Office Mission*, 27 TAX NOTES 99, 100 (1985).

102. In this Part, I discuss only legislation, and not regulations. In theory, one can imagine regulations with broad effect of the sort I am discussing, but there could be serious questions about Treasury’s authority to issue such regulations without express congressional authorization. Cf. *infra* Part V (discussing partnership anti-abuse regulation, which was issued without specific statutory authority and which seemed to go beyond the statute to which it is tied).

103. The difference between outcomes-oriented legislation and the targeted legislation considered in Part II may therefore be one of degree rather than kind.

104. I.R.C. § 469(a)(1), (d)(1), (h)(2) (2006).

defined the term differently in § 469.¹⁰⁵ By restricting their utility, § 469 made losses from passive activities less valuable than had been true before 1986 and therefore made loss-generating passive investments less attractive. The PAL rules largely took away the benefit of those shelters for individuals, and, as a result, the shelters largely disappeared.

The PAL rules worked in an imaginative and administrable way. Professor George Yin has praised how the rules did not require many difficult judgment calls. Section 469 is not concerned with whether the taxpayer's activities are undertaken for valid business purposes or tax avoidance purposes, or with any other particular motive or intent. It is not concerned with how the amount of tax savings resulting from a transaction compares to its pre-tax economic return. Section 469 "operates to prohibit or constrain certain outcomes, however they may be achieved and for whatever reason."¹⁰⁶ The PAL rules earned a high grade for predictability, as well as scope, of application.¹⁰⁷

Section 469 is not above criticism, however. Despite its complexity, the provision simplified the world by eliminating shelters of a particular sort. However, it can affect other transactions as well, including ones that do not seem abusive in any way, and its complexity is therefore not of purely historical interest.

For example, suppose a passive investor is contemplating putting real dollars—cool, hard cash—into a business that will, in its early stages, generate losses—as new enterprises generally do. It is hard to see anything automatically wrong in permitting the deductibility of out-of-pocket outlays connected to business activity,¹⁰⁸ as long as no capitalization issues are involved,¹⁰⁹ but § 469 would come into play in this situation. The investor

105. See *id.* § 469(e)(1). That income may be attributable to *someone's* trade or business, but an investor (e.g., a shareholder in a corporation) is not treated as being engaged in a trade or business by reason of his investment. This most passive of all income was intentionally not treated as income from a passive activity.

106. George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 219 (2001).

107. The predictability point might be made about the *Black & Decker* fix as well, see *supra* notes 72–79 and accompanying text, but the scope of that fix is much narrower than the PAL rules.

108. Assume, that is, that there is no attempt to generate deductions heightened by the *Crane* basis rule, where a small cash outlay coupled with nonrecourse indebtedness could potentially generate deductions with economic value far in excess of the actual outlay. See *Crane v. Comm'r*, 331 U.S. 1 (1947). In this hypothetical, nothing in the at-risk rules of I.R.C. § 465 (Congress's first big attack, in 1976, on the effects of the *Crane* basis rule) would limit deductions because the taxpayer would be considered at risk for the full amount of cash contributed.

109. If outlays are capital expenditures, related to a hoped-for future income stream, they should not be currently deductible. And with a new business the expenditures could be start-up expenditures, a form of capital expenditure for which some limited relief is provided in I.R.C. § 195. But the capitalization issues are independent of I.R.C. § 469.

would be able to currently deduct losses from his investment only to the extent he has income from other passive activities, and he therefore may be unwilling to make the investment in the first place. But why should the utility of those deductions be limited? This is not the sort of transaction at which the PAL rules were aimed or should be aimed.

Of course any effective anti-avoidance doctrine, codified or not, will reach, and therefore deter, some behavior that ought not to be disfavored; some glitches are inevitable.¹¹⁰ But § 469 might go too far in that direction. It is one thing to deter questionable transactions, even if they are perhaps defensible. It is quite another to deter transactions that have no conceivable avoidance problems, and that, moreover, might even be socially useful.¹¹¹ (Targeted fixes of the sort discussed in Part II are less likely to be overbroad in this way.¹¹²)

In addition, because shelter planners work around the law as it exists, § 469, which is in form a set of black-letter rules, does not reach new generations of shelters.¹¹³ (The same criticism can obviously be leveled at the targeted provisions discussed earlier.) Since 1986, the tax shelter problem in the U.S. has shifted to different sorts of transactions (like basis or income shifting using tax-indifferent parties¹¹⁴) often entered into by different sorts of legal persons, including corporations. The PAL rules do not speak to these new forms of shelters and generally do not apply to the investors in them.¹¹⁵

It might be that another form of outcomes-oriented legislation could help with new shelters, and some possibilities have been suggested. For example, Professors Marvin Chirelstein and Lawrence Zelenak have proposed rules emphasizing outcomes, actual or foreseeable, rather than economic substance or taxpayer motive: “(1) No deduction shall be allowed for losses substantially in excess of any measurable reduction in the taxpayer’s net worth, and (2) no deduction or exclusion from gross income shall be allowed through the

110. *Cf.* Weisbach, *supra* note 6, at 82 (“[I]f strong anti-shelter doctrines do catch a few transactions that we might otherwise allow, it is hard to see the harm.”).

111. As will be discussed in subsequent parts of this Article, more general anti-avoidance doctrines can operate to cut off transactions that are not picked up by specific statutory fixes. That is, even if you dot all the *i*’s and cross all the *t*’s that seem to be required by the statute, you might not get your desired results. Perhaps there ought to be the equivalent understanding working the other way: even though your transaction fits clearly within the PAL rules, you ought to be immune if the underlying purpose of those rules is not implicated.

112. *Cf. supra* text accompanying note 98 (quoting Professor Surrey to the effect that anti-avoidance doctrines save the tax system from the proliferation of targeted regulations that would be necessary to prevent each potentially abusive transaction).

113. By “black-letter rules,” I do not mean rules without ambiguities. Except for statutes directed at the most ordinary behavior, ambiguities are inevitable.

114. A “tax-indifferent party” is—*duh*—one indifferent to the effect of taxes, such as a tax-exempt entity.

115. *See* I.R.C. § 469(a)(2) (2006) (limiting application of PAL rules to enumerated persons, not including widely held corporations).

allocation of noneconomic income to a tax-indifferent party”¹¹⁶ These proposed rules are intended to be bright-line tests, not standards or principles to guide decision-makers.

And Professor Alan Gunn has found in the partnership anti-abuse regulation, which I will discuss later,¹¹⁷ a meritorious standard that also would look to outcomes. It would deny “a tax result that no sensible legislator would have approved of if the transaction had been called to the legislator’s attention when the statute was drafted”¹¹⁸—regardless of motive, economic substance, or anything else. It would be difficult to enact a statute in that form—would Congress acknowledge it cannot think of everything and that “sensible legislator” is not redundant?—but perhaps Congress could explicitly say that results inconsistent with legislative intent are not to be honored. Surely Congress has the power, at least to some extent, to provide for how its enactments should be interpreted.

Conceptually, those positions have much to commend them. If either Chirelstein-Zelenak or Gunn were enacted, courts reluctant or unwilling to apply anti-avoidance doctrines would have no choice but to apply the outcomes test. Furthermore, either standard, properly applied, would lead to the right result in a case like *Black & Decker*: no loss on sale of the BDHMI stock.

No test is perfect by itself, however, and Chirelstein and Zelenak recognize that their proposal would not change the result in a case like *Cottage Savings*, where real economic losses were involved.¹¹⁹ And, although I assume Gunn’s “sensible legislator” would condemn *Cottage Savings*, I could be wrong, given Congress’s traditional sympathy for the S&L industry.

It is also the case that the positives Professor Yin saw in the PAL rules are absent from these proposals. Neither would call traditional tax planning into question, but uncertainty in application would be great.¹²⁰ Measures of “net worth” or “noneconomic income” cannot be scientifically precise. (I am not sure that *science* can be scientifically precise.) And trying to discern what a sensible legislator would have thought had she been thinking about a matter has its own conceptual difficulties. Maybe they can be overcome, at least to some extent. Some cases are easy—when the results are too good to be true, and there is no reason to think Congress intended to be so generous.

116. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1952–53 (2005) (footnotes omitted).

117. See *infra* Part V.

118. Gunn, *supra* note 28, at 160.

119. Chirelstein & Zelenak, *supra* note 116, at 1960–61. Chirelstein and Zelenak question, however, whether the *Cottage Savings* transaction should be considered a shelter in the first place. *Id.*

120. See Yin, *supra* note 106, at 220–21.

Furthermore, when good results, although questionable, are intellectually defensible—so that a “sensible legislator” might not be outraged by them—perhaps anti-abuse rules should not apply at all. In any event, we need to recognize that these suggestions would not be self-executing in codified form.

Besides, the Chirelstein-Zelenak proposal comes from fuzzy-headed academics, which means it has no prospect of enactment. And Gunn’s interpretation, another academic product, will also not reach the halls of Congress. These suggestions seem to make more sense as interpretive standards than as codified rules. And that brings me to a new set of issues: whether codification of general anti-avoidance doctrines is a good idea in the United States.

IV. CODIFYING ANTI-AVOIDANCE DOCTRINES: THE NEW ECONOMIC SUBSTANCE PROVISION

Drafting carefully tailored, substantive provisions that will put a dent into tax-shelter activity has always been difficult, which is one reason general anti-avoidance doctrines developed judicially and why they have attracted new interest as statutory fixes. Many other industrialized nations have enacted general anti-avoidance rules (“GAAR”s),¹²¹ but, until recently, the United States had resisted. Although some anti-avoidance provisions had been enacted to deal with particular situations, like deductions associated with corporate acquisitions,¹²² fifteen years ago Professor Charles Gustafson could accurately write that “Congress ha[d] never seriously considered and no administration ha[d] proposed the adoption of a general anti-avoidance or anti-abuse rule that would apply to all situations.”¹²³

It is still true that no codified rule applies to “all situations,” but, with the urging of the Obama administration, Congress codified one version of the economic substance (or business purpose) doctrine. The Democratic Congress started making serious noises about doing this during the second Bush administration,¹²⁴ but that administration balked. In 2010, however, with Democrats controlling both the White House and Congress, codification of the

121. See Zoe Prebble & John Prebble, *Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law*, BULL. INT’L TAX’N, Apr. 2008, at 151 (discussing some of the GAARs in effect—for example, in Germany and New Zealand).

122. See I.R.C. § 269 (2006) (denying deductions and credits for corporate acquisitions if the “principal purpose . . . is evasion or avoidance of Federal income tax”).

123. Charles H. Gustafson, *The Politics and Practicalities of Checking Tax Avoidance in the United States*, in TAX AVOIDANCE AND THE RULE OF LAW 349, 350 (Graeme S. Cooper ed., 1997).

124. See *Senate Finance Tax Counsel Says Codification of Economic Substance Likely*, TAX NOTES TODAY, May 17, 2007, available at LEXIS, 2007 TNT 97-3. Tax Analysts later removed the cited item from its database, noting that “[t]he information at this cite was not intended for publication.” I assume that means the tax counsel’s comments were intended to be off the record.

doctrine (or, more accurately, *a* doctrine) was included in the ObamaCare legislation.¹²⁵

A. *The Merits and Demerits of Codifying an Anti-Avoidance Doctrine*

There was principle behind codification of economic substance, to be sure, but dollars-and-cents concerns were involved as well. 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.¹²⁶ But what, if anything, would codification add in a system that already prided itself on not being formalistic? Or to put the question another way, why was it anticipated that revenue would be raised?

After all, whether economic substance is a statutory requirement or not, the Internal Revenue Service can invoke anti-avoidance doctrines, including economic substance, and courts can apply them. Indeed, it was understood forever, or so it seemed, that the Internal Revenue Code is to be enforced with the aid of several overlapping judicial anti-avoidance doctrines: substance-over-form (the substance, not form, of a transaction should determine tax consequences¹²⁷); step transaction (formally discrete, but substantively related, steps should be collapsed into one transaction to determine tax results¹²⁸); sham transaction (a transaction having no purpose other than achieving particular tax results should be disregarded for tax purposes¹²⁹); business purpose (a transaction that in form is business-related should not be honored if

125. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067 (amending Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010)).

126. The Congressional Budget Office estimated penalties from codification totaling \$4.2 billion in 2016. See *CBO Estimates Distribution of Health Insurance Mandate Penalties*, TAX NOTES TODAY, Apr. 22, 2010, available at LEXIS, 2010 TNT 78-32. The Joint Committee staff estimated \$4.5 billion for the period 2010–2019. See STAFF OF J. COMM. ON TAXATION, 111TH CONG., ESTIMATED REVENUE EFFECTS OF THE AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 4872, THE “RECONCILIATION ACT OF 2010,” AS AMENDED 3 (Comm. Print 2010). One reader of an early draft questioned my reference to \$4.5 billion as a “small” amount, but, in the context of overall budgets over ten years, that really is a drop in the bucket.

127. Substance-over-form language is pervasive in American jurisprudence, but on many issues it is accepted that form controls. See, e.g., Rev. Rul. 84-111, 1984-2 C.B. 88 (holding that tax results of incorporating a partnership are governed by form).

128. See, e.g., *Am. Bantam Car Co. v. Comm’r*, 11 T.C. 397 (1948), *aff’d per curiam*, 177 F.2d 513 (3d Cir. 1949) (considering whether incorporation and subsequent changes in stock ownership should be treated as single transaction for purposes of analysis under what is now I.R.C. § 351).

129. See *Knetsch v. United States*, 364 U.S. 361 (1960) (holding that leveraged annuity arrangement that made no economic sense apart from anticipated tax consequences was a sham, and that purported interest payments should therefore not have been deductible).

it lacks a non-tax purpose¹³⁰); and economic substance (a transaction lacking economic substance, looking to both objective and subjective criteria, should not be honored¹³¹).

Before 2010, however, only bits and pieces of these doctrines had appeared in statutes and regulations, like the partnership disguised sale statute described earlier.¹³² Several arguments were advanced to support broader codification. For one thing, it was argued that codification would strengthen courts' application of anti-avoidance doctrines. Some judges had always been gung ho about doing so, but, for a variety of reasons, others had been bewildered or openly hostile.¹³³ (Although reversed on appeal, several courts had concluded they had no authority to apply uncodified anti-avoidance principles.¹³⁴) But if Congress tells the judiciary it must apply an economic substance test—if a textualist is told statutorily that she should not apply textualism in interpreting statutes¹³⁵—even a reluctant judge will have to go through the motions.¹³⁶

In addition, Professor Ellen Aprill noted the positive effect codification could have on the Internal Revenue Service and the enforcement of tax laws generally: “Codifying these standards . . . will give administrative officers greater ability to attack taxpayer transactions.”¹³⁷ Judicial responses are “unpredictable, episodic, and *ex post*,”¹³⁸ limited, as they are, to resolving

130. See *Gregory v. Helvering*, 293 U.S. 465, 470 (1935) (holding that transaction which, in form, seemed to be a corporate reorganization should be disregarded because it lacked a corporate level business purpose).

131. See, e.g., *ACM P'ship v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998).

132. See *supra* notes 80–86 and accompanying text.

133. See Chirelstein & Zelenak, *supra* note 116, at 1946–47. Reluctance to conclude that a technically structured transaction does not work is understandable, particularly if judges are not tax experts. Judicial inconsistency is exacerbated by the multiple fora in which tax cases may be brought—Tax Court, Court of Federal Claims, federal district court—and the many appellate courts, with their sometimes conflicting decisions, add to doctrinal confusion.

134. See, e.g., *Coltec Indus. Inc. v. United States*, 62 Fed. Cl. 716, 752–56 (2004), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006).

135. See Galle, *supra* note 19, at 372.

136. Maybe it will not matter. Chirelstein and Zelenak noted the following:

[A]lthough codification would prevent a court from concluding that the doctrine does not exist, courts would remain free to conclude that the doctrine is not relevant in particular situations. And even when they did find the doctrine relevant, courts would remain free to find meaningful changes in economic positions and substantial nontax purposes in highly dubious circumstances.

Chirelstein & Zelenak, *supra* note 116, at 1950. The latter point is clearly right, and any appellate review would be under a clearly erroneous standard. But a determination as to whether an economic substance doctrine is relevant is presumably at least in part a legal issue, with more stringent appellate review therefore applicable.

137. Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9, 20 (2001).

138. Ellen P. Aprill, *The Interpretive Voice*, 38 LOY. L.A. L. REV. 2081, 2087 (2005).

particular disputes and constrained by the adversarial nature of those disputes. (Poorly argued cases do not lead to the development of well-considered doctrine.) In contrast, the Service fights shelters on an everyday basis. Of course it can invoke judicially created doctrines anyway, but, in the allocation of authority, codification is arguably a point in the Service's favor.¹³⁹

A further, and even more compelling, argument for codification was that courts applying an economic substance doctrine had not been consistent in their understanding of the components of that doctrine.¹⁴⁰ Did the doctrine have two prongs or three? Were objective and subjective components of the doctrine to be applied conjunctively or disjunctively? (That is, for a transaction to be honored, did it have to satisfy both a subjective and an objective test, or was it enough to satisfy one or the other?) 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, *federal* tax law. The Supreme Court could have established consistency in application of judicially created doctrines, of course, but the Justices would not have undertaken that task with enthusiasm. In general, Supreme Court Justices want to avoid tax issues—especially complex, technical ones.¹⁴¹

The arguments did not all favor codification, however. Skeptics, including Bush administration officials and many commentators from the academy and the bar, advanced a number of arguments against codification that went beyond redundancy (i.e., that the doctrines already existed, so what was the point?). Some complained about “the ambiguous and untrustworthy application” of economic substance doctrine in general.¹⁴² Indeed, Professor Leandra

139. Moreover, if the Service makes a fact-dependent determination about economic substance, a reviewing court would generally apply an “abuse of discretion” standard. *See* Aprill, *supra* note 137, at 20–22.

140. A similar point could have been made about other anti-avoidance doctrines as well. For example, what standard should determine when multiple steps are to be collapsed into a single transaction? *See, e.g.,* Am. Bantam Car Co. v. Comm’r, 11 T.C. 397, 405–06 (1948), *aff’d per curiam*, 177 F.2d 513 (3d Cir. 1949) (noting that some courts looked to mutual interdependence of the steps; others required a binding commitment; and so on).

141. *See* Martin D. Ginsburg, *A Uniquely Distinguished Service*, 10 GREEN BAG 173, 174 (2007) (quoting Ruth Bader Ginsburg in her pre-judicial life: “I don’t read tax cases.”); Erik M. Jensen, *Of Crud and Dogs*, 58 TAX NOTES 1257 (1993) (quoting several justices disparaging tax cases).

142. Chirelstein & Zelenak, *supra* note 116, at 1948. One might have thought, however, that the ambiguous nature of the doctrine in its uncoded form might have been a justification for codification and clarification. *But see* Allen D. Madison, *Rationalizing Tax Law by Breaking the Addiction to Economic Substance*, 47 IDAHO L. REV. 441, 476 (2011) (arguing that the doctrine, in either its judicial or codified form, “operates like a hand grenade where a bug spray will do”). Professor Madison argues that the codified doctrine is not rule-like, and it “makes the tax law vague, uncertain, and fallacious.” *Id.*

Lederman argued that *courts* should abandon the doctrine because it was too easily manipulated.¹⁴³ The ABA Section of Taxation said, in 2007, that other mechanisms, especially disclosure of suspect transactions, worked better: “The legislative and regulatory actions imposing greater transparency are having the intended effect of limiting aggressive transactions while at the same time allowing taxpayers to engage in tax planning to minimize their taxes legally.”¹⁴⁴ In contrast, uncertain doctrines can deter tax planning, and tax planning is legitimate (and, from the standpoint of the tax bar, certainly desirable) behavior.¹⁴⁵

Most important, many skeptics were concerned that codification could *hinder* the fight against shelters by taking away flexibility. Judicial doctrines can evolve to deal with changing circumstances and can adapt to new hypertechnical readings of statutes in a way that targeted or outcomes-oriented legislation cannot.¹⁴⁶ Codifying economic substance would, it was argued, make the doctrine rule-like. Define “economic substance” rigidly, and imaginative shelter architects will provide for the minimum substance required by the statute.¹⁴⁷ Besides, if only one anti-avoidance doctrine is codified, might taxpayers and courts not infer that other anti-avoidance doctrines were disfavored?¹⁴⁸

Reflecting the second Bush administration’s hostility to codification, an Internal Revenue Service official noted in 2007 that, if the economic substance or business purpose doctrine had been codified in 1935, when the Supreme Court in *Gregory v. Helvering*¹⁴⁹ enunciated the business purpose test, the

143. Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 392 (2010). Professor Lederman recommended instead that courts look to whether claimed tax benefits were consistent with the congressional intent behind the controlling Code provisions. *Id.*

144. Am. Bar Ass’n Section of Taxation, *Economic Substance Codification: ABA Has “Substantial Reservations”*, 115 TAX NOTES 389, 391 (2007) (critiquing doctrine as proposed in 2005).

145. *But see supra* note 18 (quoting Professor Weisbach about how tax planning is societally wasteful).

146. *See, e.g.*, Bernard Wolfman, *Why Economic Substance Is Better Left Uncodified*, 104 TAX NOTES 445, 445 (2004) (complaining that codifying a “rigid or formulaic” version of economic substance would be constraining).

147. *See* Steven A. Bank, *Codifying Judicial Doctrines: No Cure for Rules But More Rules?*, 54 SMU L. REV. 37, 41 (2001) (“The adoption of more rules may be seen as an invitation to structure a transaction that strictly complies with the letter of such rules, but only loosely, if at all, comports with the underlying justification.”).

148. Might codification of an economic substance doctrine suggest that, say, substance-over-form principles should not be invoked? What was the point of codifying only one judicially created doctrine unless Congress wanted to favor one over the others? *But see infra* note 181 and accompanying text (noting that Joint Committee report concludes codification of economic substance was not intended to lessen the importance of other doctrines).

149. 293 U.S. 465 (1935).

doctrine would have been inadequate to deal with later generations of abusive activity: “Given the imagination and energy with which tax shelters seem to be evolving, . . . it’s useful to let the organic nature of the economic substance doctrine also evolve.”¹⁵⁰ Although the government had had a mixed record in shelter litigation over the years, by the time of that statement it had compiled a string of victories relying on uncodified doctrines.¹⁵¹

B. *The 2010 Codification*

In its judicial form, the economic substance doctrine had generally been considered to have a subjective prong (looking to whether a taxpayer’s motives were largely tax-based) and an objective one (looking at a transaction’s expected economic effects apart from tax consequences). But courts had disagreed about how the two prongs fit together—whether they should be applied conjunctively or not—and whether another prong might exist as well.¹⁵² The Third Circuit in 1998 explained its understanding of the concept in this way: “[T]hese distinct aspects of the economic [substance doctrine] do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.”¹⁵³ That is fuzzy, and other courts had applied the doctrine with different emphases.¹⁵⁴

1. The Statute

In the Health Care and Education Reconciliation Act of 2010,¹⁵⁵ signed by President Obama on March 30, 2010, Congress codified aspects of the doctrine, generally applicable to transactions entered into after that date, in

150. Heidi Glenn, *IRS Official, Practitioners Pan Economic Substance Codification*, 115 TAX NOTES 888, 888 (2007) (quoting William C. Sabin, Jr., senior legal counsel in the IRS Large and Midsize Business Division).

151. See Audrey Nutt, *O’Connor Cites Justice Gains in Combating Tax Shelters*, 115 TAX NOTES 697, 697–98 (2007); Susan Simmonds, *Government Continues Winning Streak in Shelter Litigation*, 115 TAX NOTES 913, 913–14 (2007).

152. See Jerald David August, *The Codification of the Economic Substance Doctrine, Part I*, BUS. ENTITIES, Sept./Oct. 2010, at 4, 21 (noting that the Fifth, Sixth, Eleventh, and Federal Circuits had applied a two-pronged conjunctive test; the Fourth and Eighth required that only one prong be satisfied for economic substance to exist; and the Ninth and Tenth had applied an “all factors” approach).

153. *ACM P’ship v. Comm’r*, 157 F.3d 231, 247 (3d Cir. 1998).

154. See Amanda L. Yoder, Note, *One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine*, 75 MO. L. REV. 1409, 1419–24 (2010).

155. Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067. I earlier wrote about some of these issues in Erik M. Jensen, *Codification of the Economic Substance Doctrine*, 28 J. TAX’N INVESTMENTS, Winter 2011, at 89.

order to (as a report from the Joint Committee on Taxation put it) “clarif[y] and enhance[]” the doctrine.¹⁵⁶

The statute is chock-full of interpretive issues, and it makes sense to quote chunks of newly designated § 7701(o):

(o) Clarification of economic substance doctrine

(1) Application of doctrine. 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, and

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

(2) Special rule where taxpayer relies on profit potential

(A) In general. The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

* * *

(5) Definitions and special rules

For purposes of this subsection—

(A) Economic substance doctrine. The term “economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) Exception for personal transactions of individuals. In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

156. STAFF OF J. 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,” 152 (Comm. Print 2010). It has been suggested that the new statute “does not codify the [economic substance doctrine] but rather codifies a precondition to taxpayer’s escaping the [doctrine].” Henry Stow Lovejoy et al., *Foreign Tax Credits, Economic Substance and the Future*, ABA SEC. OF TAX’N, COMM. ON BANKING AND SAVINGS INST. (Feb. 17, 2012). That is technically true, as the discussion below will demonstrate, but, since almost everyone refers to the codification of the doctrine, I will use that terminology as well.

(C) Determination of application of doctrine not affected. The 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.

(D) Transaction. The term “transaction” includes a series of transactions.¹⁵⁷

Paragraphs (1), (2)(A), and (5) will be important in the following discussion.

As important as—maybe even more important than—the codified, substantive rules, was the associated penalty regime. Rather than simply relying on the existing accuracy-related penalties, Congress provided that the new rules are enforced through a strict-liability penalty—twenty percent of the underpayments of tax attributable to a transaction lacking economic substance if the matter had been disclosed in a return or in a statement attached to a return, forty percent otherwise.¹⁵⁸ (Disclosure thus helps, but it has its own obvious downside.) Congress specifically provided that the “reasonable cause exception for underpayments” does not apply to transactions that fail the economic substance test.¹⁵⁹

2. The Effects of Codification

If the economic substance and business purpose doctrines existed anyway, did codification matter? (The economic substance doctrine is defined as encompassing both economic substance and business purpose, although I will refer only to economic substance in the subsequent discussion.¹⁶⁰) At one level, the answer might have seemed to be “no.” Economic substance is economic

157. I.R.C. § 7701(o) (Supp. 2010).

158. See I.R.C. § 6662(a) (2006) (setting out the generally applicable 20% penalty for understatements); *id.* § 6662(b)(6) (Supp. 2010) (defining as an understatement covered by the rule “[a]ny 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”); *id.* § 6662(i) (increasing the penalty to 40% for any “nondisclosed noneconomic substance transactions”—i.e., “transaction[s] described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return”). Practitioner Kathleen DeLaney Thomas has criticized the strict-liability penalty as unnecessary, overlapping with existing penalties, adding complexity, creating uncertainty in application, and unfairly treating taxpayers worse than other tax shelter investors to whom the strict-liability penalty does not apply. See Kathleen DeLaney Thomas, *The Case Against a Strict Liability Economic Substance Penalty*, 13 U. PA. J. BUS. L. 445, 448–49 (2011).

159. See I.R.C. § 6664(c)(2) (2006); see also I.R.C. § 6664(d)(2) (Supp. 2010) (eliminating the reasonable cause exception for “reportable transaction understatement[s]”).

160. I.R.C. § 7701(o)(5)(A) (Supp. 2010). The collapsing of the two doctrines is legitimate, at least insofar as the economic substance doctrine is being applied in a business context. Having a non-tax business purpose would be necessary to satisfy the subjective prong of the economic substance doctrine anyway.

substance, or so one might think. And by its terms § 7701(o) purports to be merely a “clarification” of a common law doctrine.¹⁶¹

For one very important thing, however, the strict-liability penalty by itself makes people pay attention¹⁶²: no opinion of counsel (or anything else) is going to protect a taxpayer against the penalty if the transaction is deemed to lack economic substance. And remember that, although the statute does not say this, the Joint Committee report referred to the codification as “enhanc[ing]” as well as “clarif[y]ing.”¹⁶³ Indeed, the codification is expected to bring in revenue,¹⁶⁴ which certainly sounds like an enhancement.¹⁶⁵

Another important enhancement is that § 7701(o) gives mandatory content to the economic substance test. In form, the “common law doctrine” is picked up,¹⁶⁶ but it must be applied with a *conjunctive* two-part test, thereby resolving judicial disagreement on that point.¹⁶⁷ To have economic substance, a transaction must “meaningful[ly]” change a taxpayer’s economic position (an objective test), *and* the taxpayer must have a “substantial” non-tax purpose for the transaction (a subjective test).¹⁶⁸ If either component is lacking, the strict-liability penalty applies (either twenty percent or forty percent, as applicable) to any understatement associated with a “transaction to which the economic substance doctrine is relevant”¹⁶⁹

In short, if you participate in such a transaction, if the transaction does not have economic substance, and if you underpay tax as a result, you are subject to a penalty, regardless of your good intentions. It is not that your motivations are irrelevant: you do need to have a “substantial purpose (apart from Federal income tax effects)” to have economic substance.¹⁷⁰ But if you fail the

161. *Id.* § 7701(o).

162. *See supra* note 158.

163. *See supra* note 156 and accompanying text.

164. *See supra* note 126 and accompanying text.

165. *See* Jodi J. Schwartz, *Economic-Substance Doctrine and Subchapter C: What, Me Worry?*, TAXES—THE TAX MAGAZINE, Mar. 2011, at 113, 117 (“Despite indications in the JCT and House Reports that the codification . . . was generally not intended to effect a significant change in existing law, . . . this is far from clear from the statutory text and, to a large extent, the JCT and House Reports themselves.”).

166. *See* I.R.C. § 7701(o)(5)(A).

167. I suppose there can still be judicial disagreement in the following respect. One might read the statute as setting a minimum, and a particular court could determine that other requirements must be satisfied as well for a transaction to have economic substance. But even then the objective and subjective requirements must be satisfied conjunctively, something that was not previously obvious to all courts. *See, e.g., supra* notes 44–45 and accompanying text (noting analysis in *Black & Decker*).

168. I.R.C. § 7701(o)(1).

169. *Id.*

170. *Id.*

objective test, good motivations and regular church attendance¹⁷¹ will not save you from the strict-liability penalty (nor, as I indicated earlier, will a favorable legal opinion about the transaction's merits). In addition, if the Service raises an economic substance issue along the way, it will have raised the stakes sufficiently, because of the possible strict-liability penalty, to increase the likelihood of settlement on terms favorable to the government.¹⁷²

Even without the strict-liability penalty, codification was clearly intended to increase the force of the doctrine.¹⁷³ Think back to *Black & Decker*, discussed in Part II. For purposes of the summary judgment motion, B&D had conceded that the only reason for entering into the contingent liability transaction was favorable tax results, and it convinced the trial judge that sufficient, apparently indisputable, non-tax economic effects existed to justify summary judgment in its favor.¹⁷⁴ With codification of the economic substance doctrine, however, that concession would be fatal today (assuming the doctrine is relevant to begin with, as it would be¹⁷⁵), and it therefore would not be made.

In addition, as noted earlier, for judges unsure about their authority to apply extra-statutory principles, codification of economic substance makes the extra-statutory statutory, and, for those judges unsympathetic to government arguments, codification obligates them to take economic substance

171. Or, for a corporation, the corporate equivalent of regular church attendance.

172. See Jonathan M. Prokup, *Codification of the Economic-Substance Doctrine—A Legislative Paradox*, TAXES—THE TAX MAGAZINE, Apr. 2011, at 17, 22.

[W]here the government improperly attempts to disallow tax benefits on economic-substance grounds, and a court analyzes a transaction on that basis, even if the taxpayer ultimately prevails, the government has arguably planted a flag that the doctrine is “relevant” to such transactions.

As a result, in future federal tax examinations, taxpayers face the risk that revenue agents will attempt to disallow the benefits of a transaction on the grounds that it lacks economic substance solely for the purpose of putting at issue the possibility of a strict liability penalty. Except for the most stout-hearted (or well-resourced) taxpayers, the risk of a 20- or 40-percent . . . penalty may be enough to coerce the taxpayer into settling . . . on unfavorable terms.

Id.

173. See Amy S. Elliott, *Practitioners Propose Guidance on Economic Substance Penalty*, TAX NOTES TODAY, Nov. 16, 2010, available at LEXIS, 2010 TNT 220-3 (quoting tax lawyer Monte Jackel: “I do not see how one could say you apply the statute as if it had never been enacted when it uses terms [like ‘meaningful’ and ‘substantial’] that were not part of the law before the statute became law.”).

174. See *supra* notes 43–45 and accompanying text.

175. The appellate court did remand *Black & Decker* for sham-transaction scrutiny. See *supra* note 51 and accompanying text. As discussed below, however, it is unlikely that a *Cottage Savings* transaction would be treated as one for which the economic substance doctrine would be relevant. See *infra* notes 197–201 and accompanying text.

seriously.¹⁷⁶ It is true 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,”¹⁷⁷ but that language cannot mean that a judge has discretion to ignore a doctrine she does not like.¹⁷⁸ And, also as noted earlier, codification affects the allocation of authority between the courts and the Service. Codification gives the Service the power to police the system on an everyday basis.¹⁷⁹

Furthermore, codification does not take away the Service’s power to invoke other doctrines. Whatever the scope of the economic substance doctrine, the Joint Committee report makes it clear that codification was not intended to limit the powers otherwise available to the Service or to courts to curb abusive behavior.¹⁸⁰ Other judicially created doctrines that have been used in the past can continue to be invoked.¹⁸¹ In fact, at a minimum, it seems to be essential that the substance-over-form and step-transaction doctrines be applied first to determine what the “transaction” is that will be evaluated under the codified economic substance doctrine.

What the full effect of codification will be continues to be debated. In 2010, IRS Associate Chief Counsel (Corporate) William Alexander said that the doctrine should not apply to transactions where it would have been irrelevant in the past and, as a result, codification should have little real-world effect.¹⁸² But many practitioners are skeptical that the effect will be so limited—in part because of uncertainty about the scope of the codified doctrine (what was the point if codification added little?) and in large part because of the strict-liability penalty.¹⁸³

In any event, Mr. Alexander was not always so reassuring, noting, for example, that economic substance “is a living doctrine, and in order to have some vitality, it has to have the freedom to be explored and developed.”¹⁸⁴ At

176. See *supra* notes 133–36 and accompanying text.

177. I.R.C. § 7701(o)(5)(C) (Supp. 2010).

178. To be sure, artful judges can minimize the effects of economic substance codification. See *supra* note 136 (quoting Chirelstein and Zelenak). But, after codification, the doctrine cannot be ignored.

179. See *supra* notes 137–38 and accompanying text.

180. STAFF OF J. COMM. ON TAXATION, *supra* note 156, at 155.

181. *Id.*

182. See Amy S. Elliott, *Codification of Economic Substance Should Have Minimal Effect on Practice, IRS Official Says*, TAX NOTES TODAY, May 15, 2010, available at LEXIS, 2010 TNT 90-2; Jeremiah Coder, *Determining Relevance of Economic Substance Doctrine Is Not Hard, Alexander Says*, TAX NOTES TODAY, June 3, 2010, available at LEXIS, 2010 TNT 107-2; Elliott, *supra* note 173 (quoting Alexander: “The economic substance doctrine asks, ‘Are you in a real investment?’”).

183. See Amy S. Elliott, *Practitioners Skeptical of IRS Assurances on Economic Substance Relevance*, TAX NOTES TODAY, July 12, 2010, available at LEXIS, 2010 TNT 133-2.

184. Elliott, *supra* note 173.

one level, that is an unsurprising way to describe what even the statute refers to as a “common law doctrine,” which of course can evolve.¹⁸⁵ But that also means *statutory* meaning can evolve—intelligent design has its limits—and that idea is unsettling to some. As one practitioner put it, “[a] living doctrine simply cannot coexist with a strict liability penalty.”¹⁸⁶

3. Interpretive Issues

Much of the grousing about economic substance codification has been overdone—the parade of horrors imagined by some commentators seems to be the results of hallucinating (e.g., that *every* transaction might be subject to special scrutiny because of codification)—but that is not to say that no serious uncertainties exist. This section looks at a few of the many interpretive questions arising from the new statutory language.

To what transactions does the doctrine apply? The conjunctive two-part rule is to apply “[i]n the case of any transaction to which the economic-substance doctrine is relevant,”¹⁸⁷ and “[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.”¹⁸⁸ That is a confusing proposition; pretend to ignore something that you really cannot ignore.¹⁸⁹ (It is like saying, “Don’t think about a bear.”) This should mean at a minimum, however, that everyday transactions will not be scrutinized under the codified doctrine. (Purely personal transactions are explicitly not covered.¹⁹⁰)

But what about slightly more exotic transactions? Can one conclude that, simply because economic substance analysis has not been applied in reported cases, the doctrine does not apply? Or do we need to find cases or rulings explicitly rejecting such scrutiny? And how specific does the ruling body have to have been in referring to the economic substance doctrine?¹⁹¹ Does the

185. See *infra* text accompanying note 193 (quoting from IRS notice).

186. Elliott, *supra* note 173 (quoting tax lawyer Kimberly S. Blanchard).

187. I.R.C. § 7701(o)(1) (Supp. 2010).

188. *Id.* § 7701(o)(5)(C).

189. See *supra* text accompanying note 156 (noting the intended “enhancement” effect of codification).

190. See I.R.C. § 7701(o)(5)(B).

191. For example, the New York State Bar Association Tax Section has recommended guidance to the effect that the economic substance doctrine ought to be treated as having been applied only if a court “analyzed both the economic substance and business or non-tax purpose of such a transaction . . . and found it lacked either or both.” Peter H. Blessing, *NYSBA Tax Section Recommends More Guidance on Codification of Economic Substance Doctrine*, TAX NOTES TODAY, Jan. 5, 2011, at 2, available at LEXIS, 2011 TNT 5-14 [hereinafter NYSBA Tax Section] (containing January 5, 2011, Report on Codification of the Economic Substance Doctrine). In the New York tax bar’s view, judicial consideration of other anti-avoidance

administrative practice of the IRS count for this purpose? For example, if the government has not raised economic substance arguments over the years, and courts have therefore been silent on the issue, is the government estopped from raising the issue now? One would think that, in nearly all cases where the government did not raise economic substance issues in the past, it was because there were no serious economic substance issues in the first place. But can we be sure about that? Finally, what about the situation posited by practitioner Monte Jackel, based on a recent decision: “If one court deems it relevant to discuss the economic substance doctrine when the case can be decided on narrow technical grounds . . . , but the court to which the decision is appealed refuses to address the doctrine, does that mean the doctrine is or is not relevant in resolving future cases with similar facts and issues?”¹⁹² Good questions all.

In a notice published late in 2010, the IRS announced it will continue to do the following:

[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. Consistent with section 7701(o)(5)(C), codification of the economic substance doctrine should not affect the ongoing development of authorities on this issue.¹⁹³

That statement of policy, while helpful, is not responsive to many of the concerns, particularly insofar “as the circumstances in which the economic substance doctrine is relevant will continue to develop.”¹⁹⁴

In some cases it should be easy to conclude that economic substance *is* an issue. The statutory fix for contingent liability shelters like that in *Black & Decker* effectively shut those shelters down, but, if it mattered any longer, that sort of transaction would also be subject to the penalty regime under the

doctrines, like substance-over-form, should not be considered in applying economic substance. *Id.*

192. Monte A. Jackel, *When Is the Economic Substance Doctrine Relevant?*, 132 TAX NOTES 77, 77 (2011) (discussing *Merck & Co. v. United States*, 652 F.3d 475 (3d Cir. 2011), where the Third Circuit affirmed a district court’s conclusion but without addressing the economic substance doctrine applied by the lower court); *see also* Richard M. Lipton, *Flextronics, Sundrup, and the Application of the Economic Substance Doctrine*, 114 J. TAX’N 160, 166–67 (2011) (criticizing arguably inconsistent analysis of the economic substance doctrine in two recent Tax Court memorandum decisions, and worrying about the significance of that inconsistency in applying the codified economic substance doctrine).

193. IRS Notice 2010-62, 2010-2 C.B. 411.

194. *Id.*

economic substance doctrine. Remember that in *Black & Decker* the appellate court remanded the case for consideration of sham transaction issues,¹⁹⁵ a factor that goes to the relevance of the economic substance doctrine. If the doctrine is relevant, as it surely would be, the transaction would fail the conjunctive economic substance tests, if only because there was no non-tax purpose for the transaction. Slam dunk.

But a set of facts like *Cottage Savings* presents a decidedly more difficult set of issues, leading to a counterintuitive result if such a transaction were attempted today. Even though the transactions in that case would clearly fail both subjective and objective tests—the only purpose was the hoped-for tax benefits, the recognition of losses, and there was no non-tax, economic effect at all from the exchanges—lack of economic substance matters not a whit if the transaction is not one “to which the economic substance doctrine is relevant.”¹⁹⁶

And the Supreme Court’s treatment of the issues in *Cottage Savings* strongly suggests the doctrine is not relevant. The Court devoted almost all of its energy to interpreting a regulation, not anti-avoidance doctrines. The Court did refer to the “economic substance” doctrine in one part of its opinion, but it did not take the doctrine seriously, nor had the Commissioner done so.¹⁹⁷ The Court noted that the Commissioner had raised the argument “in one sentence in a footnote in his brief without offering further explanation.”¹⁹⁸ Without more, the Court was unwilling to question the economic substance of exchanges between unrelated, sophisticated financial institutions.¹⁹⁹ With that background, when we make “[t]he determination of whether the economic substance doctrine is relevant to a transaction . . . in the same manner as if this subsection had never been enacted,”²⁰⁰ the conclusion appears obvious: the Supreme Court gave its blessing to the desired tax consequences of the exchanges. How could the economic substance doctrine possibly be relevant?²⁰¹

195. See *supra* note 51 and accompanying text.

196. I.R.C. § 7701(o)(1) (Supp. 2010). There were real economic losses in *Cottage Savings*, and perhaps that should affect the way we think about the case. But the transactions in that case nevertheless lacked economic substance as that term is defined in the codification.

197. See *Cottage Savings Ass’n v. Comm’r*, 499 U.S. 554, 567–68 (1991).

198. *Id.*

199. *Id.*

200. I.R.C. § 7701(o)(5)(C).

201. *But see* Patricia A. Thompson, *AICPA Seeks More Guidance on Codification of Economic Substance Doctrine*, TAX NOTES TODAY, Jan. 18, 2011, available at LEXIS, 2011 TNT 14-20 (including letter from American Institute of Certified Public Accountants, dated January 18, 2011, urging Service to issue further guidance on codification).

“[C]hanges in a meaningful way . . . the taxpayer’s economic position” and “substantial purpose (apart from Federal income tax effects).”²⁰² The questions about “meaningful” and “substantial” ask themselves. Fuzzy though this language may be, it is no fuzzier than other legal terms we have to deal with (the “reasonable man,” for example). For that matter, it is no fuzzier than the economic substance doctrine in its common law form, and to the extent that fuzziness is desirable for purposes of deterrence, this language works. (On the other hand, fuzzy concepts are easier to deal with if a strict-liability penalty is not hovering overhead.)

Profit potential to satisfy conjunctive tests. A taxpayer need not use profit potential to satisfy either the objective or the subjective test of the codified doctrine,²⁰³ but if the taxpayer does rely on profit potential, that potential is to be taken into account “only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.”²⁰⁴ Whew! That statement seems straightforward enough in some respects, but it masks the extraordinary difficulties implicit in any present-value analysis. The key word “substantial” adds uncertainty to the already uncertain mix. On the other hand, because the provision makes it clear that a taxpayer need not rely on profit potential, the sale of property at a loss, for example, is not deemed to fail economic substance merely because no potential for profit existed.²⁰⁵

The meaning of “transaction.” The codification specifically provides that “[t]he term ‘transaction’ includes a series of transactions,”²⁰⁶ which presumably means that, in some cases, the step transaction doctrine might require treating a series of steps as part of a single, larger transaction, and that we would then look to see whether that larger transaction has economic substance. That is consistent with longtime understanding: you need to figure out what the “transaction” is before you test its legitimacy.

Some commentators have asked whether the reverse might be the case as well—whether a single step in a series of related steps might have to satisfy economic substance requirements on its own.²⁰⁷ (That concern is attributable,

202. I.R.C. § 7701(o)(1) (emphasis added).

203. See Martin J. McMahon, Jr., *Living with the Codified Economic Substance Doctrine*, 128 TAX NOTES 731, 738 (2010) (“The . . . test recognizes that taxpayers often undertake transactions related to their businesses . . . that do not in isolation produce an identifiable profit stream . . .”).

204. I.R.C. § 7701(o)(2)(A).

205. Furthermore, assuming that the sale is for cash, rather than an exchange like that in *Cottage Savings*, one might question whether the transaction is one to be evaluated under the economic substance doctrine. See *supra* notes 196–201 and accompanying text.

206. I.R.C. § 7701(o)(5)(D).

207. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 15 (2000) (“In theory, by expanding or contracting the number of related events, a decisionmaker

in part, to a passage in the Joint Committee's technical explanation that says codification "does not alter the court's ability to aggregate, *disaggregate*, or otherwise recharacterize a transaction when applying the doctrine."²⁰⁸) Break a transaction down too far—get to the level of the quark—and satisfying either of the conjunctive tests might be impossible.²⁰⁹ One obviously cannot provide a bright-line test to determine when a series of events rises to the level of a "transaction," but the use of that term does imply that not every event is to be tested for economic substance.

In comments, the ABA Section of Taxation has noted that "how the 'transaction' is defined will have outcome-determinative consequences in many cases,"²¹⁰ which is undoubtedly true. Additionally, the Section of Taxation recommended a presumption that "transaction" be broadly defined "to include a connected set of business, economic and investment objectives,"²¹¹ which is consistent with the traditional understanding of the step-transaction doctrine.

But the ABA folks might be overly nervous about some of this. They provide as an example of a problematic "transaction" the sale of an asset at a loss: "In isolation, the sale will never generate a pre-tax profit and will always fail the economic substance test, resulting in disallowance of any loss deduction under section 165."²¹² That worry is grossly overblown.²¹³ To begin with, unless it has some worrisome attributes, such a transaction is almost certainly not one to which the economic substance doctrine is relevant.²¹⁴ Even if the doctrine is relevant, a taxpayer need not rely on "profit potential" to demonstrate economic substance.²¹⁵ Why would there not be economic substance anyway, when an asset is converted into cash (a pretty clear change

could reach virtually any result it wanted under the doctrine."); David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 TAX L. REV. 29, 40–41 (2006) (noting that legitimate transactions routinely include steps that, if evaluated by themselves, do not improve a taxpayer's economic position).

208. STAFF OF J. COMM. ON TAXATION, *supra* note 156, at 153 (emphasis added).

209. See Jeremiah Coder, *News Analysis: Tax Planning After Economic Substance Codification*, 129 TAX NOTES 772, 773–74 (2010) (noting concerns of tax lawyer George M. Clarke III).

210. Charles H. Egerton, *ABA Members Seek More Guidance on Codification of Economic Substance Doctrine*, TAX NOTES TODAY, Jan. 18, 2011, at 26, available at LEXIS, 2011 TNT 12-13 (containing comments submitted to Internal Revenue Service on January 18, 2011, by members of the ABA Section of Taxation).

211. *Id.* at 28.

212. *Id.* at 27.

213. Professor McMahon calls it a "red herring[]." McMahon, *supra* note 203, at 742.

214. Or, in the alternative, the "transaction" ought to be the "overall acquisition, holding, and disposition of the property," *id.*, in which case economic substance almost certainly existed.

215. See I.R.C. § 7701(o)(2)(A) (Supp. 2010).

in economic position²¹⁶) and the taxpayer can demonstrate non-tax reasons for making the sale?²¹⁷

4. How Problematic Are Uncertainty and Lack of Guidance?

Any new provision, even one billed as a “clarification,” is going to create some uncertainty. Government officials have tried to lessen concerns about codification of economic substance in their public pronouncements, but they have not been entirely successful. Whatever officials say now, a new set of officeholders might be more aggressive in interpreting economic substance.

Is the lack of certainty with codification a problem, particularly if some of the doctrine is evolving? Uncertainty is an issue with any anti-abuse doctrine, of course, whether codified or not, and fuzziness does cause uncertainty in some situations. How could it not? Opponents of anti-avoidance doctrines have been condemning fuzziness and uncertainty for decades:²¹⁸ Who knows whether a court will determine that substance diverges from form, or that two formally distinct transactions are one?

Uncertainty is a legitimate doctrinal concern. Professor Weisbach has noted, “If [anti-abuse provisions] are not more certain than other approaches to solving the rules/standards/complexity problem, they are undesirable If they are more certain, they are desirable.”²¹⁹ Would uncertainty be so great that legitimate business activity would be deterred? Or would a carefully drafted doctrine miss some abusive behavior? Ultimately, as Professor Aprill writes, “Deciding whether over-inclusion or under-inclusion produces the greatest danger is an empirical question—how many tax shelters and at what size would be stopped by codifying judicial doctrines versus how many legitimate transactions and at what size would be stopped by this codification.”²²⁰ We just do not know: “The [e]ffects of [u]ncertainty [a]re [u]ncertain.”²²¹

Although we have little data, uncertainty associated with judicial anti-avoidance doctrines may have been more apparent than real, and one would expect the same to be true with the codified economic substance doctrine. As good (or bad) tax professionals, we can come up with an unlimited number of tricky hypotheticals to test the scope of the doctrine, but uncertainty of this sort does not affect the everyday practice of the vast majority of American tax

216. It cannot be the case that a value-for-value exchange—i.e., the normal exchange—should automatically be treated as not changing a taxpayer’s economic position in a meaningful way, or no exchange would ever have economic substance.

217. Would getting rid of an underperforming asset not always be treated as being justified for non-tax purposes?

218. See, e.g., David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 879 (1999).

219. *Id.*

220. Aprill, *supra* note 137, at 34.

221. Weisbach, *supra* note 18, at 247.

professionals. Even for those whose practices push envelopes, the difficulties may be manageable. Peter Canellos has noted that,

[a]lthough in theory the line between a tax shelter and an aggressively structured real transaction may appear difficult to draw, in actuality the distinction is generally rather easy to establish That is why it may be hard to define shelters legislatively . . . but so easy for courts to determine whether an actual transaction is a shelter.²²²

A good tax practitioner will know it when she sees it.

Practitioner Canellos's intuitions correspond to those of academics. Professor Weisbach believes "tax lawyers are sufficiently trained and share a sufficiently common understanding of the tax law to be able to determine which transactions anti-abuse rules target and which they do not."²²³ Of course, poorly trained or inexperienced lawyers are going to feel uncomfortable with fuzziness, but they will get over it—or find another way to fill their days. Professor Graeme Cooper came to the same conclusion about codified general anti-avoidance rules in other countries. Although many had worried about GAARs being "loose canon[s]" on the tax ship of State, injuring friend and foe alike,²²⁴ he concluded that "the experience with a GAAR does not support the worst fears of tax advisors."²²⁵

In fact, anti-avoidance doctrines can *support* simplification and certainty. No set of explicit rules can cover every conceivable transaction, and anti-avoidance doctrines can help avoid the proliferation of detailed (and therefore uncertain) rules drafted in response to particular, abusive transactions.²²⁶ It is hard to imagine the American tax system relying only on substantive rules.²²⁷ Try to mesh a multitude of bright-line, but transaction-specific, rules into a coherent whole, and the monster that is the Internal Revenue Code will grow several more heads.²²⁸

Besides, some uncertainty is valuable for the tax system; it deters taxpayers from getting too close to abusive territory.²²⁹ Such deterrence is one

222. Canellos, *supra* note 20, at 53–54.

223. Weisbach, *supra* note 218, at 881 (citing Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 *TAX LAW.* 807, 809 (1995)).

224. Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 *SMU L. REV.* 83, 117 (2001).

225. *Id.* GAARs have also "not proved to be the panacea of revenue authorities," however. *Id.*

226. *See* Weisbach, *supra* note 218, at 865 ("[R]ules must systematically be more complex than standards.").

227. It is of course also impossible to imagine the system relying only on general standards. *See id.* at 876.

228. *See supra* notes 98–100 and accompanying text.

229. *Cf.* David Weisbach, *Is Knowledge of the Tax Law Socially Desirable?* 2 (Univ. of Chi. Law Sch. John M. Olin Law & Econ., Working Paper No. 563, 2011) ("A criticism of the economic substance doctrine is that it makes it too hard for people to know what the law is. If

of the reasons many commentators opposed codifying judicially developed, anti-avoidance doctrines in the first place.²³⁰ Professor Weisbach goes farther than I would in condoning *significant* uncertainty, but I accept his basic points: “[W]e should have no presumption that reducing uncertainty . . . is a good thing We cannot say that uncertainty is necessarily bad and cannot say that we should not impose significant uncertainty if it is needed to implement strong anti-shelter doctrines.”²³¹

In any event, a combination of rules and standards appears inevitable, with standards coming into play “in situations where strict application of the rules produces perverse results.”²³² The codification of economic substance, with its evolving doctrines, has the arguably happy consequence of retaining the flexibility that existed over the years with judicial, anti-avoidance doctrines,²³³ while adding some much-needed clarifications to the doctrines (such as making clear that the objective and subjective tests for economic substance should be applied conjunctively).²³⁴ In a very real sense, the codification has combined the benefits advanced by supporters of codification with the benefits of an evolving, flexible doctrine.

Members of the tax bar had asked the Treasury and the Service for an angel list of transactions to which the economic substance doctrine will not apply, but the government refused.²³⁵ The government’s recalcitrance has caused more consternation than is justified, however; there are reasons for the Treasury’s position. If some particular transactions were omitted from a list, for whatever reason,²³⁶ what might have been inferred about their status under

knowledge of the tax law is undesirable, however, this criticism is muted or possibly even completely flipped.”); *see also* McMahon, *supra* note 203, at 753 (concluding that it is a good thing that detailed guidance about the economic substance codification is unlikely). “Detailed regulations implementing codification of the business purpose and economic substance doctrines would create their own ambiguities, uncertainty, and loopholes.” *Id.*

230. *See supra* notes 146–51 and accompanying text.

231. Weisbach, *supra* note 6, at 81.

232. *Id.* at 79.

233. *See supra* notes 146–51 and accompanying text. *But see* Prokup, *supra* note 172, at 23 (“The codification of economic substance represents an unfortunate development in tax law, primarily because a vague statute that uses subjective standards to impose a strict-liability penalty has no place in a tax system that is based upon objective, form-based rules.”). It is true, of course, that some areas of tax law are quite formalistic. But as a whole, anti-avoidance doctrines have had such an important effect in American tax law precisely because form often does *not* control.

234. The clarification was needed if only because taxpayers in different parts of the country were subject to different versions of the economic substance doctrine. *See supra* notes 140–41 and accompanying text.

235. *See* IRS Notice 2010-62, *supra* note 193 (“The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.”).

236. For one thing, a list obviously could not include transactions that had not yet been devised when the list was compiled.

the codified doctrine? The answer should be nothing at all, but many would have drawn a different inference. It would have been nice, perhaps, for the Treasury and the Service to have provided more examples, pro and con, but an exhaustive list would have been impossible.²³⁷

Although commentators have worried that codification of economic substance might be invoked to challenge all sorts of transactions that have long been accepted, indeed encouraged, that cannot be a serious worry. For example, like-kind exchanges of appreciated property are common transactions, and they are clearly tax-motivated. Without Code § 1031, which makes such transactions tax-free except to the extent “boot” (property not of like kind) is involved, real-estate swaps would occur much less frequently,²³⁸ and deferred “exchanges” would probably not occur in their present forms at all.²³⁹ But it would be absurd to think that, by codifying the economic substance doctrine and leaving § 1031 intact, Congress intended to call into question the legitimacy of these exchanges. These are transactions that are explicitly blessed by a Code provision.²⁴⁰ How could they possibly be transactions “to which the economic substance doctrine is relevant”?²⁴¹ The Joint Committee report explaining codification emphasized that “[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.”²⁴² Quite right.

237. See Coder, *supra* note 209, at 772 (quoting tax lawyer Julian Y. Kim, who argued that an angel list “could swallow the rule”). The New York tax bar recommended that the Service “enunciat[e] a few principles identifying broad categories of transactions to which the [doctrine] is not ‘relevant.’” NYSBA Tax Section, *supra* note 191, at 2.

238. In a down economy, they are not occurring very often anyway, but in strong economies they are common transactions and would not be so common were it not for I.R.C. § 1031.

239. See I.R.C. § 1031(a)(3) (2006).

240. See August, *supra* note 152, at 8 (“[I]f a transaction . . . falls within the Code language, it should be respected by the IRS and, ultimately, the courts.”). I.R.C. § 1031 has its academic critics, but it is unquestionably the case that Congress has given its institutional approval to like-kind exchanges. See *supra* notes 26–28 and accompanying text (arguing that congressionally approved transactions ought not to be characterized as tax shelters, no matter how favorable the results).

241. See NYSBA Tax Section, *supra* note 191, at 3 (suggesting that guidance should provide that the economic substance doctrine is not relevant “where the circumstances of the transaction are such that the tax benefits are ‘clearly consistent’ with the provisions and purposes of the Code or Regulations”).

242. STAFF OF J. COMM. ON TAXATION, *supra* note 156, at 152 n.344. The report specifically lists several credits, like low-income housing credits (I.R.C. § 42) and new markets tax credits (I.R.C. § 45D), as being exempt from economic substance scrutiny, on the ground that Congress had specifically provided for the credits. *Id.*

And it has always been understood that many tax-motivated decisions can coexist with the economic substance doctrine. For example, the Joint Committee report made it clear that “[t]he provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”²⁴³ To illustrate this point, the report cites (1) the choice between debt and equity in capitalizing a business enterprise; (2) the choice between using a U.S. or a foreign corporation to make a foreign investment; (3) the choice to reorganize a corporate structure in a way recognized as a tax-free reorganization; and (4) the choice to use a related party in a transaction, assuming arm’s length standards are satisfied.²⁴⁴ Taxpayers should continue to be able to make these decisions, and others,²⁴⁵ without worrying about the economic substance doctrine.²⁴⁶

243. *Id.* at 152. *But see id.* at 153 (noting that “the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance”). I think that last passage is supposed to mean only that dotting all the *i*’s and crossing all the *t*’s is not enough, but the language reasonably makes some tax professionals nervous.

244. *Id.* at 152–53; Jerald David August, *The Codification of the Economic Substance Doctrine, Part II*, BUS. ENTITIES, Nov./Dec. 2010, at 4, 11.

245. Indeed, if the Code or regulations provide a taxpayer with an explicit choice, in the form of an election, the taxpayer ought to be able to make that choice—obviously doing so as to minimize tax liability—without worrying that the Service might invoke the economic substance doctrine. *See* NYSBA Tax Section, *supra* note 191, at 2 (urging that guidance make that point).

246. A 2005 proposal prepared by staff of the Joint Committee on Taxation recommended applying two-tiered economic substance analysis to transactions having any of six characteristics present in many tax shelters. The list, a catalog of potentially abusive deals, perhaps would have been a useful addition to the economic substance doctrine as ultimately codified: transactions:

- 1) . . . in which (a) the taxpayer holds offsetting positions which substantially reduce the risk of loss, and (b) tax benefits would result from differing tax treatment of the positions;
- 2) . . . which [are] structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain;
- 3) . . . which [are] structured to create or increase a gain in an asset any portion of which would not be recognized for Federal income tax purposes if the asset were sold at fair market value by the taxpayer (or a related person);
- 4) . . . which [are] structured to result in income for Federal income tax purposes to a tax-indifferent party for any period which is materially in excess of any economic income to such party with respect to the transaction for such period;
- 5) . . . in which the taxpayer disposes of property . . . which the taxpayer held for a period less than 45 days; [or]
- 6) . . . which [are] structured to result in a deduction or loss which is otherwise allowable under the Code and which is not allowed for financial reporting purposes.

STAFF OF J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 19–20 (Comm. Print 2005). Under the staff proposal, taxpayers would have had to demonstrate economic substance for a suspect transaction. Others would have been subject to traditional methods of scrutiny.

5. Further Thoughts

Codification was clearly not intended to call into question the bona fides of transactions traditionally deemed legitimate, and it was not intended to call into question transactions unquestionably permitted by the Code. The strict-liability penalty increases the stakes, to be sure—the Service is sensitive to this point²⁴⁷—but codification of economic substance still needs to be understood in a commonsensical way.²⁴⁸ Indeed, Professor Howard Abrams has argued that the breadth of the strict-liability penalties points toward narrowly reading the codification doctrine.²⁴⁹ Not everything should suddenly be up for grabs.²⁵⁰

That is not to say, however, that codification matters not at all. If there is reason to worry about the legitimacy of a transaction, then economic substance considerations might be crucial. In general, lack of economic substance should be a serious issue only with transactions that would have been questionable without codification.²⁵¹ But the strict-liability penalty makes it worthwhile for everyone to pay attention (as we should have been doing anyway).

247. See Rocco Femia et al., *New IRS Internal Guidance on Codified Economic Substance Doctrine Offers Some Pluses for Taxpayers*, 29 J. TAX'N INVESTMENTS, Fall 2011, at 31, 31. Femia and colleagues describe a July 15, 2011, directive from the IRS Large Business & International Division: “Guidance for Examiners and Managers on the Codified Economic Doctrine and Related Penalties.” *Id.* The directive is not binding, but, among other things, it provides what is in effect a safe harbor, listing four categories of transactions for which it would be inappropriate to raise the economic substance doctrine; provides that, pending further guidance, strict liability penalties will not be applied as a result of any other similar rule or judicial doctrine, such as the step transaction doctrine; provides a process that Service personnel must adhere to before applying the economic substance doctrine; and provides that, if a transaction involves a series of connected steps, an examiner who seeks to apply the doctrine to individual steps must first seek further guidance from on high. *IRS Issues LB&I Directive on Codified Economic Substance Doctrine and Penalties*, TAX NOTES TODAY, July 15, 2011, available at LEXIS, 2011 TNT 137-17; see also Mark A. Luscombe, *Tax Trends: IRS Issues Economic Substance Guidance*, TAXES—THE TAX MAG., Sept. 2011, at 3, 3 (also discussing LB&I directive). One commentator has slammed LB&I for issuing the directive and has urged its retraction. See Lee A. Sheppard, *News Analysis: IRS Repeal of the Economic Substance Statute*, TAX NOTES TODAY, Feb. 21, 2012, available at LEXIS, 2012 TNT 34-1.

248. Cf. McMahon, *supra* note 203, at 752 (“Except for the new penalty provisions, the codification of the economic substance doctrine really should not change legal analysis or outcomes very much. It is just old wine in a new bottle.”).

249. See Howard E. Abrams, *Did Health Care Reform Repeal the Partnership Anti-Abuse Rule?*, 51 TAX MGMT. MEMORANDUM 299 (2010).

250. See Coder, *supra* note 209, at 773 (quoting tax lawyer Cary Pugh: “Companies would have to be skirting close to the line for the statutory changes to matter.”).

251. See McMahon, *supra* note 203, at 753 (“If the *raison d’être* for the transaction, or the insertion of an unnecessary element in a transaction that otherwise did have a business purpose, was tax avoidance, the economic substance doctrine will loom large.”).

V. ANTI-AVOIDANCE DOCTRINES AND ADMINISTRATIVE ACTION

Even if Congress had not acted to codify the economic substance doctrine, the Internal Revenue Service might be able to codify other aspects of anti-avoidance doctrines through regulations.²⁵² (It is clear that “economic substance” does not constitute the universe of these doctrines.²⁵³)

The Service probably does not have authority to issue a general anti-avoidance rule that would apply across the board, it has not tried to do so, and, after economic substance codification, that would be a peculiar thing even to contemplate. But the Service might have (or at least claim) authority to do so in particular areas. That is what happened in the mid-1990s in partnership taxation.

The first section in the subchapter of the Internal Revenue Code that deals with partnerships—§ 701—provides simply that “[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”²⁵⁴

No surprise there. It is a premise of American taxation that partnerships are not income-taxpaying entities. Instead, items of income are treated as earned by the partners and are taxed currently to them. Section 701 provides no details on the implementation of the principles of that section; that is what the rest of subchapter K does.

In 1995, the Service finalized a so-called “anti-abuse rule,” in the form of a regulation, under the authority of § 701. In general, the regulation provides that, for arrangements that are not “consistent with the intent of subchapter K,” the Service has power to recast transactions, to treat persons not as partners, and even, in egregious cases, to ignore the existence of a partnership.²⁵⁵

The key concept, the “intent of subchapter K,” has three components: that a partnership be bona fide and enter into transactions with a “substantial business purpose”; that the form of any transaction satisfy substance-over-form principles; and that, in general, the partnership operations and the arrangements between partnership and partners properly reflect income.²⁵⁶ The

252. One reader of an earlier draft questioned my use of the term “codification” to refer to regulations as well as congressional enactments. I use the term to distinguish these rules from those developed judicially, and I note that regulations become part of the Code of Federal Regulations.

253. See *supra* text accompanying note 181.

254. I.R.C. § 701 (2006).

255. Because of limited liability companies, which generally combine corporate characteristics with partnership tax treatment, partnership taxation may be more important today than its sexier older brother, corporate taxation. For an exhaustive treatment of the regulations, see James B. Sowell, *The Partnership Anti-Abuse Rules: Where Have We Been and Where Are We Going?*, TAXES—THE TAX MAGAZINE, Mar. 2011, at 69.

256. Treas. Reg. § 1.701-2(a) (1995).

regulation provides examples to illustrate arrangements that are abusive and others that are not. On the *who-could-have-thought-otherwise?* front, the use of a partnership, which avoids entity level tax and therefore almost certainly has tax avoidance as one of its purposes, is not *ipso facto* abusive. It is obviously consistent with the intent of subchapter K to use a partnership.²⁵⁷

The regulation contains a large amount of substance-over-form and other traditional anti-avoidance language. Because those powers were always available to taxing authorities, however, what, if anything, does codification add? For one thing, the regulation makes it clear that anti-avoidance doctrines are the law in partnership taxation, so that, as discussed earlier, judges reluctant to impose those doctrines now have authority to do so. And, even if it merely reinforces old law, the regulation could have an incremental deterrent effect on those contemplating aggressive planning.

But the regulation may add something substantive as well. The regulation says the doctrines that may be invoked by tax officials are not limited to the generally known ones,²⁵⁸ and Professor Alan Gunn found a new anti-abuse standard in the “intent of subchapter K”:

A transaction can be abusive without running afoul of any of the traditional anti-avoidance doctrines; that is, it can have a business purpose and substance, its substance and form can coincide, and yet it yields a tax result that no sensible legislator would have approved of if the transaction had been called to the legislator’s attention when the statute was drafted.²⁵⁹

Much of the regulation is flawed, in Gunn’s view, but the “concept of ‘abuse,’ distinct from other anti-avoidance doctrines,” is potentially powerful.²⁶⁰

It is indeed, but Professor Gunn might have found more in the regulation than the drafters intended²⁶¹ (and more, for that matter, than the drafters had authority to include). As Professor Lawrence Zelenak pointed out, although the regulation is titled an “anti-abuse rule,” the words “abuse” and “abusive” are

257. *See id.* § 1.701-2(d).

258. *See id.* §§ 1.701-2(i), 1.701-2(d) (“[I]n addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, . . . the Commissioner can recast the transaction as appropriate under . . . this section.”). As critics noted, this calls into question the Service’s authority to issue the regulation. I.R.C. § 701 delegates no explicit power to do so, and the regulation’s principles have a tenuous connection to that section.

259. Gunn, *supra* note 28, at 160.

260. *Id.* Gunn provides an example in which S corporation rules lead to preposterous results. The case “is abusive not because it calls for a bad interpretation of the relevant Code section (it does not), but because it seeks to use a Code section for a purpose its drafters could not plausibly be thought to have contemplated.” *Id.* at 163.

261. He admits that “[o]nly three of the regulation[’s] seven listed factors aim directly at abuse, as distinct from ‘substance over form’ or mere suspicion.” *Id.* at 166.

not used in the text.²⁶² And the drafters emphasized that “the fundamental principles reflected in the regulation are consistent with the established legal doctrines.”²⁶³

Whether or not Gunn’s principle really can be found in the regulation,²⁶⁴ or in other regulations projects, it is a wonderful concept that—one way or another—ought to be applied generally. I earlier pondered whether a statutory or regulatory provision that used language like Gunn’s would work.²⁶⁵ However we answer that question, it remains the case that no statutory system should ever be interpreted in a way that leads to absurd results unless the legislature clearly intended the absurdity.

VI. DISCLOSURE

If substantive disallowance rules augmented by anti-avoidance doctrines cannot prevent shelters, and that seemed to be the case, particularly before codification of the economic substance doctrine, it is not surprising that American attention turned to a disclosure regime.²⁶⁶ Indeed, some commentators, like Peter Canellos, believe this is where efforts should be concentrated: “The key to deterrence for all classes of tax shelters is reporting and penalties. To fight what amounts to audit lottery and to nip schemes in the bud, airtight, focused, prompt, and efficient disclosure rules are required.”²⁶⁷

Disclosure cannot work to control avoidance by itself, of course. Unless substantive rules are in place that would reach (or might reach) disclosed transactions, disclosure does nothing to disinfect the system—except, perhaps, for a few transactions that “work” for tax purposes, but the content of which is so embarrassing that secrecy is desired for non-tax reasons.²⁶⁸

262. Lawrence Zelenak, *Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. REV. 177, 178 (2001). For that matter, it is more like a “standard” than a “rule.”

263. T.D. 8588, 1995-1 C.B. 112.

264. Practitioner James Sowell conceded that the regulation “would appear to reach beyond transactions that lack economic substance or that violate other judicial doctrines. But it should not.” Sowell, *supra* note 255, at 103. This is because of the increased confusion that would result. And the confusion would be unnecessary, he suggests, in that the Service had been successful anyway in attacking aggressive partnership structures and that, with codification of the economic substance doctrine, “the partnership anti-abuse rules now do little more than add an additional and unnecessary argument in pursuing aggressive partnership transactions.” *Id.*

265. *See supra* notes 117–20 and accompanying text.

266. *See generally* Alan Granwell & Sarah McGonigle, *US Tax Shelters: A UK Reprise?*, 2006 BRIT. TAX REV. 170.

267. Canellos, *supra* note 20, at 69–70; *see also* Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 612 (2006) (“Lack of disclosure is key to taxpayers’ ability to exploit the audit lottery.”).

268. That is not a contentless proposition, but, since we ordinarily are talking about disclosure to tax officials, not to the public, the effect may be limited. For example, it might be publicly

Although critics have concluded that disclosure is misguided (about which, more later), Professor Mark Gergen has argued that the strategy for deterring corporate tax shelters—“monitoring tax shelter activity, blacklisting new shelters when they are identified, and pursuing users of blacklisted shelters through promoters of the shelters along side [sic] more conventional audit techniques”²⁶⁹—can be effective. Tweaking is required as conditions change, to be sure, but disclosure can have an effect.

The disclosure rules mandated by Congress and the Service have several goals.²⁷⁰ Two are compliance and deterrence, of course. And, if the mass of material sent to Washington can be sifted in a manageable way, disclosure can help authorities (particularly the Office of Tax Shelter Analysis, made up of experts “dedicated to identifying and shutting down tax shelter transactions”²⁷¹) learn about new avoidance strategies and act accordingly.²⁷²

This is not the place for a line-by-line discussion of the rules, but a few highlights are in order. (The penalties for noncompliance are obviously an important part of the system.²⁷³)

embarrassing for a taxpayer to enter into a transaction with a foreign entity using child labor, but disclosure of that fact is not going to result from any tax reporting obligations.

269. Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 255 (2002).

270. It is impossible to come up with a precise starting date for the disclosure regime because it developed as a combination of statutory and regulatory changes. The Service was requiring disclosure of some transactions before the concept of “reportable transaction” had been fully developed.

271. Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 FORDHAM L. REV. 961, 1002 (2006).

272. Another recent effort to increase transparency is the requirement, imposed by the Internal Revenue Service on its own, that corporate taxpayers above a certain size (total assets exceeding \$100 million for 2010 and 2011 tax years, with that figure declining to \$50 million for the next two years, and reaching \$10 million for 2014 and subsequent tax years) disclose on a schedule (UTP) included with their tax return any “uncertain tax positions.” In general, those are return positions for which a taxpayer has created reserves that are reflected in audited financial statements. The financial reporting requirement that reserves be created to protect against potential, additional tax liability was imposed by the so-called FIN-48 rules. See ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, FASB Interpretation No. 48 (Financial Accounting Standards Bd. 2006); IRS Announcement 2010-9, 2010-7 I.R.B. 408; IRS Announcement 2010-17, 2010-13 I.R.B. 515; IRS Announcement 2010-30, 2010-19 I.R.B. 668; IRS Announcement 2010-75, 2010-41 I.R.B. 428; IRS, 2011 Instructions for Schedule UTP, at 1–2, available at <http://www.irs.gov/pub/irs-pdf/i1120utp.pdf>.

273. See, e.g., I.R.C. § 6707A (2006) (penalty for not disclosing reportable transaction on returns); *id.* § 6707 (penalty on material advisors for not accurately disclosing reportable transaction); *id.* § 6708 (penalty on material advisors for not maintaining or supplying investor lists); *id.* § 6700 (penalty on promoters of abusive shelters); *id.* § 6662(a) (accuracy-related penalty for understatements of tax liability); *id.* § 6662A (accuracy-related penalty for understatements associated with reportable transactions).

Participants: return disclosure. A taxpayer that participates in a “reportable transaction,” as defined below, is required to attach a form to its tax return describing, among other things, the “expected tax treatment and all potential tax benefits expected to result from the transaction, . . . any tax result protection . . . [and] sufficient detail for the [Service] to be able to understand the tax structure of the reportable transaction and the identity of all parties involved.”²⁷⁴ This requirement increases the probability that a taxpayer that has engaged in a suspect transaction will have its return scrutinized and, if items relating to the transaction fail scrutiny, will be subject to penalties.

In addition, if taxpayers have to disclose questionable return positions, they are less likely to participate in reportable transactions at all. Disclosure is not an admission that a taxpayer’s reporting of a transaction is wrong,²⁷⁵ but it is like tattooing “audit me” on one’s forehead or corporate logo (or so a participant might fear).

Material advisors. As a result of statutory changes in 2004, “material advisors” also must disclose “any reportable transaction” about which they advise.²⁷⁶ (By requiring both taxpayers and material advisors to disclose the same transactions, the disclosure regime is “[r]edundant by design.”²⁷⁷) The term “material advisor” is broadly defined. It includes any person “who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and . . . who [as a result] directly or indirectly derives gross income in excess of the threshold amount.”²⁷⁸ As with return disclosure, the transaction and its potential tax benefits must be described.²⁷⁹

List maintenance. An advisor is also required to maintain a list of those “to whom [the] advisor acted as a material advisor with respect to such [reportable] transaction,” and to provide the list to authorities “upon written request.”²⁸⁰ List maintenance is directed not so much at advisors (although

274. Treas. Reg. § 1.6011-4(d) (as amended in 2010); see I.R.S Form 8886, Reportable Transaction Disclosure Statement (OMB No. 1545-1800) (Rev. Mar. 2011), available at <http://www.irs.gov/pub/irs-pdf/f8886.pdf>.

275. “The fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer’s treatment of the transaction is proper.” Treas. Reg. § 1.6011-4(a) (as amended in 2010).

276. I.R.C. § 6111 (2006).

277. Granwell & McGonigle, *supra* note 266, at 173.

278. I.R.C. § 6111(b)(1)(A). That amount is \$50,000 if “substantially all of the tax benefits” from the reportable transaction go to natural persons, otherwise \$250,000. *Id.* § 6111(b)(1)(B).

279. *Id.* § 6111(a).

280. *Id.* § 6112(a), (b)(1); see also Treas. Reg. § 301.6112-1 (2007) (providing that each material advisor shall maintain a list and furnish it to the IRS upon written request).

penalties for noncompliance apply²⁸¹) as at potential shelter investors who are understandably leery of being on a list of that sort.

Reportable transactions. The taxpayer disclosure, material advisor reporting, and list maintenance obligations are all tied to the concept of “reportable transaction,” statutorily defined as a “transaction . . . of a type which the Secretary determines as having a potential for tax avoidance or evasion.”²⁸² In broad outline, as now constituted the concept of “reportable transaction” encompasses five categories (often called “filters”), with yet another proposed. The categories are not mutually exclusive:

1. “Listed transactions”: generally those labeled as tax avoidance transactions by the Internal Revenue Service in published notices, regulations, or other guidance.²⁸³ In effect, the Service tells the world it is skeptical (or more than skeptical) about the transactions. For example, in 2001 the Service listed contingent liability transactions that were similar to the one in *Black & Decker* and were not subject to the statutory fix.²⁸⁴ Marketed products are almost certain to be listed; “promotion” has been called a “litmus test” for this purpose.²⁸⁵

2. “Confidential transactions”: ones “offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee” (\$50,000 to \$250,000, depending on type of taxpayer).²⁸⁶ The concern is obvious: transactions kept secret in that way emit an unpleasant odor.

3. “Transactions with contractual protection”: ones requiring that any advisor’s fee be returned if all or part of the promised tax results do not materialize.²⁸⁷ How confident should anyone be about the merits of a tax position if the advisor is on the hook like this?

4. “Loss transactions”: ones for which a taxpayer claims a loss above a threshold amount (e.g., \$10 million in one year for a corporation).²⁸⁸ The *Black & Decker* transaction would have fit within this category. Transactions like those in *Cottage Savings* might or might not fit, depending on the nature of the taxpayers and the magnitude of the claimed losses.

281. See I.R.C. § 6708 (2006).

282. *Id.* § 6707A(c)(1). “The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan.” Treas. Reg. § 1.6011-4(b)(1) (as amended in 2010).

283. A compiled list of reportable transactions, accurate as of the date of publication, can be found in IRS Notice 2009-59, 2009-31 I.R.B. 170, but the list is always a work in progress.

284. See IRS Notice 2001-17, *supra* note 76.

285. Morse, *supra* note 271, at 1004.

286. Treas. Reg. § 1.6011-4(b)(3) (as amended in 2010).

287. *Id.* § 1.6011-4(b)(4).

288. *Id.* § 1.6011-4(b)(5).

5. “Transactions of interest”: ones identified by the Service through published guidance as having the “potential for tax avoidance or evasion,” but about which the government has insufficient information to conclude that the deals are in fact avoidance or evasion transactions.²⁸⁹ This category, added by regulations finalized in July 2007, supplements, and significantly strengthens, the listing procedure.

The five categories do not pick up every transaction that you or I might find suspect,²⁹⁰ of course, but they are a good start.²⁹¹ And the Service has issued a proposed regulation that, if finalized, would add to the list “patented transactions,” a category of recent, enormous interest.²⁹² (It has been of such interest, however, that recent legislation restricting tax strategy patents may have made the issue moot.²⁹³) In particular, the power to list a newly

289. *Id.* § 1.6011-4(b)(6); *see also* T.D. 9350, 2007-2 C.B. 607 (announcing new final regulations that include this category). A list of transactions of interest, accurate as of the date of publication, can be found in IRS Notice 2009-55, 2009-31 I.R.B. 170. But as is true with reportable transactions generally, *see supra* note 283, this is always a work in progress.

290. *Cf. Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2255 (2004) (“[T]hese . . . largely unrelated filters . . . suggest[] that the IRS lacks a well-defined principle for distinguishing between legitimate and illegitimate transactions.”).

291. Transactions with large book-tax differences and those “involving a brief asset holding period” (under 46 days) were once reportable as well. The Service decided, however, that a schedule accompanying corporate tax returns requires enough data to make further disclosure on book-tax differences unnecessary. *See* IRS Notice 2006-6, 2006-1 C.B. 385. Commentators convinced the Service that transactions involving brief holding periods did not need to be reported. *See* T.D. 9350, 2007-2 C.B. 607.

292. Prop. Treas. Reg. § 1.6011-4(b)(7)(i), 72 Fed. Reg. 54615, 54617 (Sept. 26, 2007) (defining “patented transaction” as “a transaction for which a taxpayer pays . . . a fee in any amount to a patent holder or the patent holder’s agent for the legal right to use a tax planning method that the taxpayer knows or has reason to know is the subject of the patent”). Commentators have been nearly unanimous in condemning the patenting of tax planning methods, but, for a dissenting view, *see* Jacob Birnbaum, *Why the U.S. Congress Would Be Making a Colossal Mistake by Banning Tax Patents*, 28 J. TAX’N INVESTMENTS., Spring 2011, at 59. Practitioner Birnbaum argues, among other things, that patents are not available anyway for the sorts of things that bother most folks. *Id.* at 61. And to the extent that patents are sought for questionable processes, the government should be delighted to have the disclosure that the patent system provides. *Id.* at 62.

293. Section 14 of the Leahy-Smith American Invents Act, signed by the president on September 16, 2011, for purposes of interpreting §§ 102 and 103 of Title 35 of the U.S. Code, characterizes any “strategy for reducing, avoiding, or deferring tax liability” as “prior art” and therefore unpatentable. Leahy-Smith Invents Act, Pub. L. No. 112-29, § 14, 125 Stat. 284, 327 (2011). The new rule was effective immediately, and thus applied to any patent application pending on or filed on or after September 16. *See* Memorandum from Robert W. Bahr, Acting Assoc. Comm’r for Patent Examination Policy, to Patent Examining Corps (Sept. 20, 2011), available at http://www.uspto.gov/aia_implementation/best-mode-memo.pdf; John W. Hutchinson, *Tax Strategy Patents After the Leahy-Smith America Invents Act*, 29 J. TAX’N INVESTMENTS, Spring 2012, at 35.

discovered transaction, or to denote a transaction as one “of interest,” permits the government to act fast, without having to wait to rule definitively on the merits. (A published notice listing a transaction might include definitive, substantive analysis, as did the one listing contingent liability transactions, but it need not do so.²⁹⁴ Denoting a transaction as “of interest” signals that the Service does not yet know enough to rule definitively.)

The effect of listing is likely to be immediate on investors that are not already participating in such a transaction: they will have been warned that they should probably look elsewhere for tax thrills. The effect of denominating a transaction as “of interest” may not be quite so stark, but it would deter most investors. (It would deter me.)

In the abstract, the deterrent effects of disclosure are obvious, but the system—inevitably?—does not work as smoothly as hoped.²⁹⁵ And critics worry that the government will overemphasize disclosure to the exclusion of other methods. Professor Weisbach has repeatedly stressed the need to reform substantive law.²⁹⁶ Requiring disclosure of a transaction that is deemed to meet legal requirements—like a *Black & Decker* deal (maybe) before Congress acted or a *Cottage Savings* deal today—seems pointless.²⁹⁷

Professor Weisbach is right that disclosure by itself will not do the job, but he may underestimate its positive effects. Professor Ronald Pearlman has stressed the importance of “tax return disclosure” because, he argues, many shelters do *not* “work.”²⁹⁸ Make taxpayers disclose suspect positions that might turn out to be losers, and disclosure can disinfect the system, without Congress’s having to change substantive law.

Even if suspect transactions do “work”—so that a challenged taxpayer would ultimately prevail—not many taxpayers have a “Bring it on!” attitude. Tell them disclosure is required, that the government is curious, and most will do tax planning in other ways. For example, disclosure directed at *promoted* shelters has largely shut those shelters down, whatever legal arguments might

294. See IRS Notice 2001-17, *supra* note 76 (providing alternative rationales for contingent liabilities’ reducing stock basis in a *Black & Decker*-like transaction).

295. Dean Schizer argues that advisors have an incentive to do no more than the minimum to avoid penalties. Moreover, “the tax bar is highly motivated to undermine the effectiveness of [the disclosure] effort[.]” Schizer, *supra* note 11, at 369, through, for example, interpreting a reportable transaction hypertechnically and burying the government in paper. *Id.* at 370.

296. See Weisbach, *supra* note 6, at 78.

297. See *id.* (“Many of these transactions work under current law. . . . [T]hey do not rely on the audit lottery. Disclosure and penalties would not stop them.”). In its notice listing contingent liability shelters, however, the Service made it clear that, in its view, those transactions did *not* work. See Notice 2001-17, *supra* note 76.

298. Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289, 291–93 (2002).

have been marshaled on their behalf.²⁹⁹ (And Professor Weisbach concedes disclosure's potential as a way for the government to learn about new avoidance strategies.³⁰⁰)

Two other skeptics, Professors Chirelstein and Zelenak, argued in 2005 that “disclosure is not a solution” in part because “the government has lost at least as many audited tax shelter cases as it has won.”³⁰¹ But the government's win-loss record in litigation, which improved anyway after Chirelstein and Zelenak wrote those words,³⁰² is not a good measure of disclosure's effect. A possibility of prevailing on the merits is not going to convince many taxpayers to go ahead with a transaction that must be disclosed. A fifty-percent chance of success in litigation for a transaction that might escape discovery is much more appealing than a fifty-percent chance of success for a transaction the government knows about. Disclosure increases the expected cost of any penalties, as well as the expected cost of defending questionable return positions, and higher expected costs affect behavior.

I respect the critics who doubt the efficacy of disclosure, but it is hard to imagine that disclosure is not helping control abusive behavior. Yes, complexity and costs of complying with (or circumventing) the disclosure rules remain concerns. Lawyers are making good livings deciphering those rules—parsing the definition of “minimum fee” or whatever—and that is not the best use of America's human capital.

One nevertheless hopes that, once the rules have become part of the landscape, compliance concerns will largely disappear. Determining whether a transaction is reportable is generally not going to be hard for most taxpayers and advisors. And the cost of planning around disclosure rules will itself be enough of a disincentive to deter some undesirable behavior.

VII. IMPROVING ADVISORS' BEHAVIOR

Another anti-avoidance mechanism in vogue is, in Professor Richard Lavoie's phrase, to “[c]o-opt[] the [t]ax [b]ar into [d]issuading [c]orporate [t]ax [s]helters.”³⁰³ Congress long ago authorized the Secretary of the Treasury to “regulate the practice of representatives of persons before the [Internal

299. See Morse, *supra* note 271, at 1003 (“[L]abeling promoted tax shelter transactions as deviant behavior has . . . translated into an anti-tax shelter compliance norm.”). High-profile prosecution of promoters has also obviously helped in the shutdown. See Granwell & McGonigle, *supra* note 266, at 171–73.

300. See Weisbach, *supra* note 6, at 78 (“The benefit of disclosure comes only if the government is willing to change, or at least clarify, the law.”); Weisbach, *supra* note 18, at 226.

301. Chirelstein & Zelenak, *supra* note 116, at 1942.

302. See Simmonds, *supra* note 151, at 913.

303. Richard Lavoie, *Deputizing the Gunslingers: Co-opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43, 43 (2001).

Revenue Service],”³⁰⁴ and regulations known as “Circular 230” followed in 1966—with many subsequent revisions.³⁰⁵ “Practice before the . . . Service” is defined so broadly—including not only physical appearances, but also communications, preparing and filing documents, and other activities³⁰⁶—that complying with the requirements of Circular 230 is a *sine qua non* for a tax practitioner.³⁰⁷

For present purposes, the important parts of Circular 230 are the rules governing opinions that practitioners may give about tax shelters. (The term “tax shelter” is no longer used in the regulations, but the idea survives, at least as of this writing, in rules, promulgated in 2004, that govern “covered opinions.”³⁰⁸) Regulate the content of opinions and constrain the way potential investors can use those opinions, and shaky transactions may lose their underpinnings.³⁰⁹

The bar has been critical of Circular 230 in part because many of the rules are directed at the bar. And some of the criticism is justified. Well-motivated though it is, Circular 230 contains a lot of regulatory overkill. Anyone receiving emails from American tax lawyers must chuckle at the attached disclaimers. Following a message like “Lunch at 12:30?” comes the boilerplate—like “IRS Circular 230 Notice: To comply with US Treasury regulations, we advise you that any US federal tax advice included in this communication is not intended or written to be used, and cannot be used, to avoid any US federal tax penalties or to promote, market, or recommend to another party any transaction or matter.”³¹⁰ All you want is a hamburger, and you get a lecture on Circular 230.

304. 31 U.S.C. § 330(a)(1) (2006).

305. See 31 C.F.R. § 10 (2011) [hereinafter Circular 230].

306. *Id.* § 10.2(a)(4).

307. Return preparation, which need not be done by lawyers, accountants, or enrolled agents, has its own set of rules. See Circular 230, *supra* note 305, §§ 10.7(e), 10.22(a), 10.34; I.R.C. § 6694 (2006). Some of the rules were amended by T.D. 9527, 2011-27 I.R.B. 1.

308. Other parts of Circular 230 have been amended more recently. See T.D. 9527, *supra* note 307 (dealing with tax returns and tax return preparers). Proposed amendments, issued on September 17, 2012, would make dramatic changes to Circular 230, including eliminating the concept of “covered opinion.” See RIN 1545-BF96, 77 Fed. Reg. 57055 (Sept. 17, 2012).

309. In making the intriguing argument that knowledge of the tax law is sometimes undesirable, Professor Weisbach suggests that “shelters likely fit into the class of cases where knowledge is undesirable” because “[t]hey are cases where the law is likely suboptimal.” Weisbach, *supra* note 229, at 35. As a result, “one way to see [Circular 230] is as an attempt by the government to limit or make more expensive access to knowledge of the tax law where such knowledge is undesirable.” *Id.*

310. The disclaimers are intended to ensure that the email is not a “reliance opinion” or a “marketed opinion,” as defined below. If the proposed regulations noted in *supra* note 308 are finalized, these disclaimers should disappear from email.

For clients (and others who might see an opinion, such as offerees of a marketed shelter), the big concern is protection against penalties. The risk of taking an aggressive position on one's tax return is not only that, if the position is disallowed, unpaid tax plus interest will be due; it is also that penalties might be imposed. Some penalties do not apply if a taxpayer can demonstrate it acted in "good faith," with "reasonable cause" for the return position.³¹¹ Because the codification of economic substance contains strict-liability penalties,³¹² no opinion of counsel will mitigate the penalty for a transaction deemed to lack economic substance. In other contexts, however, where an opinion of counsel might matter, an opinion will provide penalty protection—"reasonable cause"—only if Circular 230's requirements have been satisfied.³¹³

For tax lawyers,³¹⁴ providing a rosy opinion about a shaky tax position was always risky—damage to reputation, possible malpractice, and the like—but Circular 230 increases the stakes.³¹⁵ Violating Circular 230 can lead to the tax lawyer's losing practice privileges before the Service and to other sanctions.³¹⁶ (These rules are enforced by an Office of Professional Responsibility in the Treasury Department, which, in egregious cases, intends to pursue *public* disciplinary proceedings.³¹⁷) Circular 230 also pushes firms to police themselves, providing for sanctioning bosses who do not adequately supervise their underlings.³¹⁸

The brief overview of Circular 230 that follows should demonstrate why the rules can have significant effect on written advice about any tax shelter—the advice is likely to be a "covered opinion"—but knowing the particulars is unnecessary to understand the underlying ideas. The content of documents, including emails, that provide tax advice is serious business under Circular 230. Because of Circular 230, lawyers should be much less willing than was true in the past to give disclaimer-free, favorable written advice about shelters. As a result, taxpayers are much less likely to get the opinions they require to take aggressive positions on their tax returns while avoiding penalty risk. No favorable opinion, no penalty protection, and, often therefore, no shelter.³¹⁹

311. See I.R.C. § 6664(c)(1), (d)(1) (2006).

312. See *supra* Part IV.

313. See *infra* notes 320–27 and accompanying text.

314. I will refer to lawyers, although the term "practitioners" in Circular 230 includes accountants and others as well. See Circular 230, *supra* note 305, § 10.0.

315. See Charles A. Rose, Note, *The Tax Lawyer's Dilemma: Recent Developments Heighten Tax Lawyer Responsibilities and Liabilities*, 2011 COLUM. BUS. L. REV. 258, 278.

316. See Circular 230, *supra* note 305, § 10.50; Morse, *supra* note 271, at 991–92.

317. See Morse, *supra* note 271, at 992.

318. Circular 230, *supra* note 305, § 10.36.

319. See generally LINDA GALLER & MICHAEL B. LANG, REGULATION OF TAX PRACTICE 103–10 (2010). It bears repeating, yet again, that with a transaction to which the codified

Requirements for “covered opinions.” If opinions are “covered,” they must satisfy requirements that make these opinions “elaborate and expensive exercises.”³²⁰

1. The lawyer must use reasonable efforts to identify and ascertain relevant facts; not base the opinion on unreasonable factual assumptions; and not base the opinion on any factual statement the lawyer knows (or should know) is incorrect or incomplete.³²¹

2. He must relate applicable law to relevant facts; generally not assume favorable resolution of any significant tax issue or otherwise base the opinion on unreasonable assumptions, representations, or conclusions; and not include internally inconsistent analyses or conclusions in the opinion.³²²

3. He must generally consider *all* significant federal tax issues and provide a conclusion as to the likelihood that the taxpayer would prevail on the merits on each significant issue³²³ (*not* taking audit-lottery considerations into account in the evaluation).³²⁴

4. He must provide an overall conclusion as to the federal tax treatment of the transaction, or, if that cannot be done, provide reasons why.³²⁵

If any covered opinion does not reach a more-likely-than-not conclusion (i.e., a confidence level of more than fifty percent) for any significant tax issue, that fact must be disclosed prominently in the opinion.³²⁶ In addition, the opinion must prominently note that, for any such low-confidence issues, “the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.”³²⁷

“*Covered opinion.*” Given those requirements, a covered opinion is obviously not something that should be dashed off at the coffee shop; it is supposed to be a painstaking exercise. And the term includes much more than the formal documents traditionally called legal opinions. It can include almost

economic substance doctrine is relevant, the penalty is a strict-liability one, for which a favorable opinion of counsel would provide no penalty protection anyway.

320. Morse, *supra* note 271, at 991. Written opinions that are not “covered” must still satisfy some specific requirements, and in no event are lawyers to give written advice that takes audit-lottery possibilities into account. Circular 230, *supra* note 305, § 10.37.

321. Circular 230, *supra* note 305, § 10.35(c)(1).

322. *Id.* § 10.35(c)(2).

323. *Id.* § 10.35(c)(3). In some cases, a “limited scope opinion” may address selected tax issues and make factual and legal assumptions that otherwise would not be permitted—assuming that appropriate disclosure is made about the opinion’s limited scope. However, marketed opinions and opinions issued for listed transactions and for transactions where a principal purpose is tax avoidance or evasion can *never* be limited scope opinions. *See id.* § 10.35(c)(3)(v), (e)(3).

324. *Id.* § 10.35(c)(3)(iii). That is, it is not appropriate for a lawyer to give a *don’t-worry-about-it* opinion to the effect that the auditing agent is unlikely to notice the suspect transaction.

325. *Id.* § 10.35(c)(4).

326. Circular 230, *supra* note 305, § 10.35(e)(4)(i).

327. *Id.* § 10.35(e)(4)(ii).

any written advice, including electronic communications,³²⁸ relating to federal tax issues arising from three related, but different, types of transactions: (1) a “listed” or substantially similar transaction, as the term was used in the disclosure discussion;³²⁹ (2) “[a]ny partnership or other entity, any investment plan or arrangement, . . . the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code,” and (3) a “*reliance opinion*,” a “*marketed opinion*,” or an opinion “subject to *conditions of confidentiality*” or “subject to *contractual protection*,” if the opinion relates to “[a]ny partnership or other entity, any investment plan or arrangement,” and a “significant purpose” (a lower standard than the principal purpose test in category (2)) for the arrangement is tax avoidance or evasion.³³⁰

All of that is a mouthful, but one thing is clear: that group of transactions includes almost anything that might be considered a tax shelter. Remember that, although tax *evasion* is illegal, *avoidance*—planning in permissible ways to reduce one’s tax bill—is not. Indeed, it is what tax professionals help their clients do.³³¹ If tax avoidance is at least a “significant purpose”—and, for a shelter, that is obviously (and tautologically) the case—the rules applicable to covered opinions are going to apply. (In both *Black & Decker* and *Cottage Savings*, for example, tax avoidance was the *only* purpose for the transactions.³³²) So, for example, if a “reliance opinion”—one that reaches a conclusion, at a confidence level of more than fifty percent, that one or more significant tax issues would be resolved in the taxpayer’s favor—is issued for a *significant purpose* transaction, that opinion is “covered.”³³³

A “marketed” opinion—one to be used by a person outside the firm in “promoting, marketing or recommending a partnership or other entity,” etc.—is also going to be “covered” if tax avoidance is at least a significant purpose

328. Under current rules, it is some small comfort to practitioners that *oral* communications are not covered (but oral advice would not provide penalty protection anyway). In addition, preliminary written advice to a client during an engagement is not “covered” if the practitioner is expected later to provide written advice that will be a “covered opinion.” *Id.* § 10.35(b)(2)(ii)(A). *But see supra* note 308 (noting proposed regulations that would do away with the concept of “covered opinions”).

329. *See supra* notes 283–85 and accompanying text.

330. Circular 230, *supra* note 305, § 10.35(b)(2)(i).

331. Use of a partnership, say, which avoids entity-level taxation and permits pass-through of losses, presumably always has tax avoidance as at least a *significant* purpose, and in many cases it is the *principal* one.

332. That was stipulated for summary judgment purposes in *Black & Decker*, *see supra* note 45 and accompanying text, although, with codification of the economic substance doctrine, such stipulations are unlikely today. *See supra* note 195 and accompanying text. In *Cottage Savings*, the transaction would not have proceeded without the hope that it would be treated differently for tax and financial accounting purposes. *See supra* notes 63–64 and accompanying text.

333. Circular 230, *supra* note 305, § 10.35(b)(2)(i), (b)(4)(i).

for the transaction.³³⁴ In addition to the other rules applicable to covered opinions, Circular 230 requires that any marketed opinion come to a more-likely-than-not conclusion (a more than fifty percent likelihood of success) about *every* significant tax issue and about the overall tax effect of the transaction.³³⁵ In addition, a marketed opinion must include a disclosure that it was written to support the marketing effort, and that recipients of the opinion should consult their own tax advisors about the transaction described.³³⁶ High standards indeed.

Disclaimers. Circular 230 seems to provide a way around some of the stringent rules through disclaimers (as in emails), but the benefits of disclaiming are chimerical. For example, written advice that includes a disclaimer stating that the advice may not be used to protect against penalties does not count as a reliance opinion.³³⁷ From the lawyer's standpoint, that seems to be good; the requirements for covered opinions might not have to be satisfied. But a taxpayer who is told that he is not entitled to rely on the opinion will not be in a good mood: the disclaimer works for Circular 230 purposes by making the opinion essentially worthless as penalty protection.

Similarly, what would otherwise be a *marketed* opinion will not be subject to the marketed-opinion rules if it contains a disclaimer—that it is not to be used for penalty protection, that the recipient should consult its own tax advisors, and so on.³³⁸ The effect is that an opinion that will do no good in marketing anyway—because nobody can rely on it—need not be treated as a “marketed opinion.” The opinion might be an interesting intellectual exercise, but, for penalty (and therefore marketing) purposes, it will not be worth the paper it is written on, or the electrons it is written with.

* * * * *

Circular 230's requirements are far-reaching, but not as far-reaching as was the case before codification of economic substance imposed strict-liability penalties that, by definition, are unaffected by legal opinions. The economic substance doctrine is not relevant to all shelter transactions, however, and, no matter how broad the scope of Circular 230, it will not eliminate the issuance of favorable opinions for tax shelters.

For example, I think the result in *Cottage Savings* was too good to be true, but I would be willing to give an overwhelmingly favorable opinion about a similar transaction today. My opinion would be “covered”; the “principal,” indeed the only, purpose of the transaction would be tax avoidance. But a very

334. *Id.* § 10.35(b)(2)(i), (b)(5)(i).

335. *Id.* § 10.35(c)(3)(iv), (c)(4)(ii).

336. *Id.* § 10.35(e)(2).

337. *See id.* § 10.35(b)(4)(ii).

338. Circular 230, *supra* note 305, § 10.35(b)(5).

favorable opinion could be safely issued with a Supreme Court case directly on point. (For that reason, the transaction should also be deemed outside the scope of economic substance codification.³³⁹) I might be bothered by the hypertechnical interpretation applied in *Cottage Savings*, but, if the Court says the law is *X*, the law is *X*—unless and until Congress intervenes. As I noted earlier, taxpayers are entitled to too-good-to-be-true results if that is what Congress intended (or is deemed to have intended).³⁴⁰

In a high percentage of shelter situations not governed by the economic substance doctrine, however, the Circular 230 rules should prevent lawyers from issuing unqualifiedly favorable opinions, and, without such opinions, those proposed shelters will not proceed. If the Office of Professional Responsibility is able to meet its enforcement obligations, these rules have bite.

CONCLUSION: BEYOND THE RULES AND DOCTRINES

If there is a lesson in all of this—and there is, of course—it is that no single method of attack on tax shelters is going to be successful. Give too much emphasis to economic substance alone, for example, and, as Professor Weisbach argues, “shelters themselves may get worse” in that they will become more exotic to satisfy the requirement.³⁴¹ But change substantive rules where appropriate, apply anti-avoidance doctrines (including the codified economic substance doctrine) forcefully, add in disclosure, make sure lawyers are not promising better tax results than are justified, and the system just might work—not perfectly, of course, but adequately.³⁴²

The precise mixture of governmental weapons used will have to vary over time because the shelter target is a moving one. Some smart people make sure of that. In an often-quoted line, the late Marty Ginsburg said that “[t]he tax bar is the repository of the greatest ingenuity in America, and given the chance, those people will do you in.”³⁴³ That is funny—and largely true.

“Ingenuity” is great, up to a point. It is generally better to have smart tax lawyers than dumb ones. But it is even better to have smart, honorable tax lawyers. We should not emphasize rules and doctrines to such an extent that we ignore the professional norms that guided American tax lawyers for decades.

339. See *supra* notes 196–201 and accompanying text.

340. See *supra* notes 26–28 and accompanying text.

341. Weisbach, *supra* note 18, at 237.

342. I have largely ignored a factor that should not be ignored: the costs of implementing, and complying with, the various methods. In general, it makes no sense to spend \$100 to bring in \$99 in revenue. However, we do not have sufficient data to do informed cost-benefit analyses.

343. *Legislation Relating to Tax-Motivated Corporate Mergers and Acquisitions: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 97th Cong. 90 (1982) (statement of Martin D. Ginsburg).

One of my colleagues claims that tax lawyers all work for the government. That is not true, of course, but tax lawyers *are* obligated to provide advice in a responsible way. It used to be understood, at the better law firms at least, that certain things were just not done. Certain types of transactions were not the sort that *professionals* worked on. If that understanding has changed, it needs to be resurrected. If it still exists at the better firms, as I think it does—it is one thing that makes those firms “better”—it needs to be preserved and extended.

Recent scholarship recognizes the critical role of the tax lawyer as *lawyer* in curbing abusive behavior—not because anything in Circular 230 applies, but because behaving responsibly and exercising good judgment are part of being a lawyer. Professor Linda Beale emphasizes that “the basic opinion practices [of Circular 230] (e.g., thorough consideration of law and facts, rejection of unrealistic assumptions) are not substantially different from that which has traditionally been considered good lawyering.”³⁴⁴ Professor Tanina Rostain argues that tax lawyers who have moved to accounting firms, which technically are not permitted to practice law, might be less inclined to view themselves in a professionally appropriate way.³⁴⁵ (What they do, however, sometimes looks an awful lot like law practice anyway.) Practitioner Peter Canellos notes that, although many shelter “professionals” are lawyers, they do not adhere to the standards that guide lawyers generally: “The tax shelter professional is a different breed, by experience, temperament, reputation, and calling Tax shelter professionals tend to be specialists rather than generalists and often suffer from the specialist’s lack of judgment.”³⁴⁶ And so on.

Encouraging tax lawyers to act as *lawyers*, as traditionally understood, may seem like endorsing apple pie, motherhood, and baseball (without the designated hitter). In this context, it also might seem otherworldly. How does an academic not engaged in the practice of law (me) have the gall to suggest that lawyers ought not to give opinions that depend only on hypertechnical readings of authority? After all, refusing to provide an opinion can have unhappy economic consequences for a lawyer, and the kids have to eat.

The disclosure rules and Circular 230 do not define honor, however. And the strict-liability penalties associated with economic substance codification do not eliminate the pressure for tax lawyers to issue favorable opinions on suspect transactions. Whatever the rules, acting honorably is what tax lawyers should be doing.

344. Beale, *supra* note 267, at 619.

345. Tanina Rostain, *Sheltering Lawyers: The Organized Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77, 120 (2006). *But see* Mark W. Everson, *Lawyers and Accountants Once Put Integrity First*, N.Y. TIMES, June 19, 2011, at WK8. Everson is a former Commissioner of Internal Revenue.

346. Canellos, *supra* note 20, at 56.