Codification of the Economic-Substance Doctrine—A Legislative Paradox

By Jonathan M. Prokup

Jonathan M. Prokup examines the codified economic-substance doctrine and considers when the doctrine is "relevant" to a particular transaction, as is required by Code Sec. 7701(o), by examining the confusion between the economic-substance doctrine and the substance-over-form doctrine.

Introduction

In the year since Congress codified the "economic-substance" doctrine,[1] a veritable library of commentary has been written on the likely consequences of the legislation.[2] Reactions have ranged from satisfaction to dismay. With a year's perspective, codification has proven to be quite a legislative paradox: at once marking a significant change in U.S. tax policy, while at the same time causing almost no change in substantive tax law.

On the one hand, the enactment of Code Sec. 7701(o) represented a significant step away from the objective, rule-based system that is the bedrock of U.S. tax law[3] in favor of a subjective, standards-based regime that punishes taxpayers simply for taking tax positions with which the government disagrees. Although Congress has previously used subjective anti-abuse rules for specific types of transactions,[4] the codified economic-substance doctrine represents the first such statute that can be applied to almost any transaction that produces meaningful tax benefits.

On the other hand, codification did not change any substantive tax law. To the contrary, codification of the doctrine may represent the ultimate in tax irony: to fight transactions that lack practical economic effect, Congress passed legislation that lacks practical legislative substance. Notwithstanding preexisting ambiguities in the law about its applicability to particular transactions, the codified doctrine provides no guidance about when or how it is properly invoked or applied. The codified doctrine will not help determine whether a challenged transaction has the sort of "economic substance," however defined, that courts have historically required when applying the doctrine. Instead, codification will only perpetuate and exacerbate the uncertainty with which the economic-substance doctrine has long been associated.

On its own, this lingering uncertainty would be problematic enough; however, a more significant issue arises from the strict-liability penalty that is imposed for transactions that lack "economic substance," as now defined by statute.[5] Because of Congress's failure to clarify the contours of the doctrine, particularly regarding when the doctrine may properly be invoked to disallow the tax benefits of a transaction (*i.e.*, is "relevant"), taxpayers now risk punishment for a variety of ordinary tax-motivated decisions. As former IRS Chief Counsel Donald Korb once counseled against, the doctrine risks becoming "a general anti-abuse rule to be trotted out by the

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IRS every time it confronts a tax shelter transaction it simply does not like."[6]

Rather than simply decrying the failings of the codified doctrine, this article suggests guidelines that could be used to administer the doctrine going forward. In particular, this article considers when the doctrine is "relevant" to a particular transaction, as is required by Code Sec. 7701(o), by examining the confusion between the economic-substance doctrine and its closely related cousin, the substance-over-form doctrine.[7] Because the disallowance of a transaction that lacks economic substance carries with it a strict-liability penalty, it should be "relevant" only for transactions that are so egregious that a taxpayer could never execute them with reasonable cause and in good faith. The guidelines proposed here might not result in the imposition of penalties for every aggressive interpretation of the Internal Revenue Code; however, that consequence reflects the reality that not every aggressive interpretation of the law warrants punishment *per se*.

In the year since Congress codified the "economic-substance" doctrine, a veritable library of commentary has been written on the likely consequences of the legislation.

I. If It Ain't Fixed, Break It Some More

When Congress considered codifying the economic-substance doctrine more than a decade ago, courts and commentators had already acknowledged the doctrine's shortcomings, at least as it was being applied in practice.[8] It is not surprising, then, that the earliest proposals to codify the doctrine reflected a desire to "clarify" it as well.[9]

Some confusion of the doctrine was probably inevitable because the use of inherently subjective standards (*e.g.*, the sufficiency of a nontax purpose) is inconsistent with the broader objective criteria that generally govern the U.S. tax system.[10] Perhaps acknowledging this inconsistency, the earliest proposals to codify the doctrine relied on relatively objective criteria, such as disallowing a transaction only if its expected pre-tax profit was "insignificant" relative to its expected tax benefits.[11] Even these ostensibly objective proposals, though, were criticized for their failure to adequately distinguish between "abusive" tax shelters and common, nonabusive business transactions.[12]

Having entertained the idea of codification for more than a decade, Congress had plenty of time to consider how to craft legislation that would address these criticisms and meaningfully improve the state of the law. For instance, rather than relying on a comparison of pre-tax profits with tax benefits, Congress could have employed a more objective *disqualifying* test that would disallow the benefits of a transaction only if the transaction was structured so that it *could not* give rise to pre-tax profit under any reasonable scenario.[13] Although such a test might allow some putatively abusive transactions to be respected, it would prohibit the most egregious transactions, which are deliberately prewired to avoid the possibility of any economic risk or reward.[14] Unfortunately, however, Congress chose a different route, enacting a rule that can be described only as "sham legislation." Other than imposing a strict-liability penalty, Congress did not change or clarify anything about the economic-substance doctrine.[15]

Notably, the statute punts on most of the difficult questions involved in applying the economic-substance doctrine.[16] For instance, the statute applies only "[i]n the case of any transaction to which the economic substance doctrine is relevant … ."[17] As discussed in Part III below, whether the doctrine is relevant to a particular transaction is perhaps the central uncertainty about the doctrine. Nevertheless, Congress specifically disclaimed any responsibility for answering that question, providing that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this [provision] had never been enacted."[18]

Congress did not even explain what it means for the doctrine to be "relevant" to a given transaction. Perhaps Congress meant that the doctrine would be "relevant" whenever a court invoked it to disallow the tax benefits of a transaction on the basis of the transaction lacking economic substance. If that is what Congress intended, however, it chose rather vague language to convey that intent.

Since the legislation was passed, taxpayers have received little additional guidance regarding

the transactions to which the codified doctrine will be considered relevant. To date, the IRS has dismissed taxpayer concerns about the statute's ambiguity regarding the "relevance" of the doctrine,[19] suggesting that taxpayers should look to "old authorities" and "appropriate case law" as guideposts for understanding when it is relevant.[20] Nevertheless, Congress could not have meant for the relevance of the doctrine to be ossified, being asserted only against transactions that have been previously challenged on that basis. As a result, the scope of the doctrine's "relevance" has been left open for the IRS and the courts to sort out the confusion over *whether* to apply the doctrine to a particular transaction.

Likewise, the statute provides almost no meaningful guidance regarding *how* to apply the doctrine after it has been determined to be "relevant" to a transaction. For instance, notwithstanding recent cases that have defined the "transaction" much more narrowly than was historically considered appropriate,[21] the statute provides no methodology to aggregate or disaggregate multiple steps, as the case may be, to identify the "transaction" to be tested.[22]

Moreover, the statute leaves to regulatory and judicial authors the task of determining what constitutes (i) a "meaningful" change to a taxpayer's economic position, and (ii) a "substantial purpose" for entering into the transaction.[23] True, the statute clarifies how specific items are to be treated (*e.g.*, the treatment of foreign taxes as expenses for calculating pretax profit).[24] At a conceptual level, though, those clarifications are fairly superficial, narrow and backward-looking. They do nothing to resolve the more fundamental issues related to the overall framework of the doctrine. Thus, codification has done little to advance the substantive state of the economic-substance doctrine.

What, one might protest, about the codification of the so-called conjunctive test (*i.e.*, requiring both an "objective" economic effect and a "subjective" purpose to satisfy the doctrine)?[25] Didn't the legislation resolve a major split among the circuit courts as to whether taxpayers should be required to satisfy both standards, rather than just one or the other?[26] While such protests may accurately reflect the text of the statute and the preexisting circuit split, they ignore how the doctrine works in practice.

The reality of the economic-substance doctrine is that the distinction between the "economic substance" of a transaction, on the one hand, and its motivating "purpose," on the other, is largely artificial. Where a transaction effects a meaningful change to a taxpayer's economic position,[27] the taxpayer's intent to bring about that economic effect serves as the purpose for the transaction.[28] In other words, where a taxpayer undertakes a transaction that has objective economic substance, courts will infer that the taxpayer intended to bring about that substance. Taxpayers do not stumble into economic substance.[29]

> To the contrary, codification of the doctrine may represent the ultimate in tax irony: To fight transactions that lack practical economic effect, Congress passed legislation that lacks practical legislative substance.

Consistent with this theory, a number of pre-codification decisions recognized that the economic substance and business purpose inquiries were not intended to be discrete tests each of which needed to be satisfied to show economic substance.[30] Rather, these inquiries share a reciprocal relationship in which the taxpayer's subjective purpose for entering the transactions rests upon its objective possibility of realizing benefits from a transaction, and the objective possibility of realizing benefits arises from the taxpayer's subjective purpose to obtain those benefits. This reciprocal relationship helps explain the rarity (if not complete absence) of cases applying the inquiries disjunctively (*i.e.*, requiring taxpayers to satisfy only one inquiry) and finding a transaction to satisfy one inquiry but not the other.

In sum, the codification of the "conjunctive" test is not as significant as it would initially appear, because the choice between applying the doctrine conjunctively or disjunctively does not, as a practical matter, affect the outcome of economic substance cases. Together with Congress' failure to answer other key issues, such as when the doctrine is "relevant," it is difficult to discern how the codified doctrine introduces any substantive improvements into the law. Thus, the statute lacks legislative substance, accomplishing little more than the codification of a strict-liability penalty regime.

II. Are We Punishing Reasonable Differences?

The above discussion should not be construed as an indictment of the economic-substance doctrine *per se*. Notwithstanding its shortcomings, the economic-substance doctrine arguably provides a valuable backstop to the literal text of the Internal Revenue Code.[31] Likewise, the imposition of penalties for unreasonably aggressive interpretations of the Code can appropriately discourage uneconomic activity that would not occur but for the hope of obtaining tax benefits.

That being said, the economic-substance doctrine has long suffered from an identity crisis. As the Joint Committee on Taxation recognized, the economic-substance doctrine is not easily distinguishable from other common-law doctrines (such as the substance-over-form and step-transaction doctrines), "and their application to a given set of facts is often blurred by the courts, the IRS, and litigants."[32]

Historically, the blurring of these doctrines had few practical consequences for taxpayers, particularly in the determination of whether penalties would be imposed on the disallowance of tax benefits from a transaction. No matter what doctrine (or statute, for that matter) was used, the taxpayer would generally be liable for penalties only if an understatement resulted and the taxpayer could not demonstrate either (i) "substantial authority" or a "reasonable basis" for its treatment of the transaction,[33] or (ii) having acted with "reasonable cause" and in "good faith" for such treatment.[34]

Even where the "substantial authority" and "reasonable basis" defenses were not available—*e.g.*, for "tax shelters"[35] and so-called reportable transactions[36]—taxpayers could still avoid penalties under a reasonable cause and good faith defense, albeit only by showing greater confidence in the merits of the transaction than was ordinarily required.[37] Thus, the touchstone for avoiding penalties generally remained "the extent of the taxpayer's effort to assess [its] proper tax liability."[38]

Codification threw that regime out the window. Reasonable cause and good faith no longer matter if the benefits of a transaction are disallowed "by reason of [the] transaction lacking economic substance … or failing to meet the requirements of any similar rule of law."[39] In such circumstances, the Code now mandates the imposition of a 20-percent penalty on any disallowed benefits, and a 40-percent penalty if the taxpayer does not adequately disclose on its tax return the relevant facts affecting the tax treatment of the transaction.[40]

A straight-faced argument can be made that taxpayers participating in transactions that lack economic substance should face such a strict-liability penalty. The "reasonable cause and good faith" exception to the penalty provisions are designed primarily to prevent taxpayers from being punished for falling victim to the complex, and often ambiguous, language of the Code. In the case of transactions that lack economic substance, however, taxpayers generally do not fall victim to the complexity and ambiguity of the tax laws. Rather, such taxpayers affirmatively seek to exploit that complexity and ambiguity to undertake transactions that would not exist but for the creation of putative tax benefits.[41]

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To parrot the language of the regulations, participants in "noneconomic transactions" are not penalized for having made insufficient "effort[s] to assess [their] proper tax liability."[42] To the contrary, such taxpayers are penalized for having made *too much* of an effort to seek out, and wreak havoc in, the dark corners of the law. Taxpayers do not stumble into noneconomic transactions.[43] Therefore, all things being equal, a reasonable defense could be mounted for the proposition that such planning is *per se* unreasonable, justifying the imposition of a strict-liability penalty on such transactions.

All things, however, are not equal. After all, the above justification for imposing penalties on noneconomic transactions could apply to almost any form of tax planning that relies on a structure (or even discrete steps) the sole function of which is to produce a favorable tax result.[44] For instance, Congress enacted Code Sec. 351 to specify the tax consequences of what are essentially noneconomic transactions. A taxpayer's transfer of assets to a corpo-

ration in exchange for stock, by its very nature, does not meaningfully change the transferor's economic interest in the transferred assets.[45]

Nevertheless, both the IRS and the Department of Justice have for many years questioned the "economic substance" of such exchanges where they perceived the exchange to be (i) part of a larger "abusive" transaction,[46] and (ii) the source of the ostensible abuse.[47] Likewise, the IRS continues to challenge many items that the Joint Committee on Taxation identified as (in theory, if not in practice) beyond the reach of the economic-substance doctrine, such as the choice of using debt or equity to capitalize an enterprise, or the choice to enter into a transaction with a related party.[48]

Absent a distinction between abusive noneconomic transactions and reasonable tax planning, the strict-liability penalty that is designed to be imposed on abusive transactions is likely to be imposed on ordinary tax planning as well. Thus, the tax law needs to distinguish between transactions that are so egregious as to be unreasonable *per se* and transactions that, while of debatable legal merit, possess enough substance to warrant penalties only if the facts of a given transaction make the taxpayer's legal position unreasonable. The remainder of this article focuses on this distinction and suggests one method of drawing the line between transactions that lack economic substance and, under Code Sec. 6662, are subject to penalties *per se* and transactions the taxpayers' treatment of which is improper, but not necessarily unreasonable. This distinction, as discussed below, should form the basis for determining whether the economic-substance doctrine is "relevant" to particular transactions.

III. Not All Substance Is Created Equal

As discussed above, codification has not affected *how* tax-advantaged transactions are analyzed under the economic-substance doctrine; nevertheless, codification has raised the stakes over *whether* such transactions are analyzed under the doctrine. If courts disallow a transaction as lacking economic substance, the taxpayer will be subject to a strict-liability penalty. Consequently, the IRS should assert the doctrine only in appropriate circumstances. This section suggests the limited circumstances when the IRS should assert, and courts should analyze, the doctrine for these purposes.

Within the last year, authors have taken different positions about whether the statutory merits of a transaction should be considered before invoking the economic-substance doctrine.[49] This article remains agnostic on that question, focusing instead on the relevance of the economic-substance doctrine in the context of its historical confusion with other common-law doctrines.

In challenging the technical tax results of a transaction, the government typically has at its disposal two primary weapons.[50] First, the government may conceptually restructure a transaction into a form that produces less favorable tax consequences.[51] Into this category fall most prominently the "step transaction" and "substance-over-form" doctrines. (For simplicity, these doctrines will be referred to collectively as "substance over form.") Rather than accepting the facts of the transaction as they are, these doctrines recharacterize—albeit with some limitations[52]—some or all of the transaction so that the resulting transaction implicates different operative tax rules.[53]

Alternatively, and more aggressively, the government may simply disregard a transaction entirely and disallow any claimed tax benefits.[54] Into this category falls what is commonly thought of as the "economic substance" (or, as it is sometimes known, the "sham transaction") doctrine. Unlike transactions that are recharacterized under the substance-over-form doctrine, transactions that are disregarded for lacking "economic substance" produce no economic consequences other than the creation of tax benefits.[55]

Although both doctrines allow the government to disallow tax benefits when a transaction's substance differs from the taxpayer's claimed form, the conceptual distinction between them is critical. The substance-over-form doctrine applies when a transaction accomplishes some ultimate objective, but in an unnatural, roundabout way that typically produces a more favorable tax result than would otherwise exist.[56] In other words, the doctrine is predicated on being able to describe what happened as another transaction that taxpayers ordinarily undertake—with or without tax benefits. In contrast, the economic-substance doctrine should apply only when the challenged transaction *cannot* be recast as another ordinary transaction. That is the essence of a transaction "lacking economic substance" because no part of the transaction accomplishes anything that a rational person would do absent the tax benefits that it produces.[57]

This critical distinction also explains why the imposition of a strict-liability penalty can be defended for transactions that lack economic substance but not for transactions that are recharacterized to reflect their substance, rather than their forms. Although the U.S. tax system generally determines tax liability through objective rules that are applied to specific transactional forms, most any economic objective can be achieved through myriad economically equivalent forms, each of which may produce different tax consequences based on arbitrary distinctions drawn by Congress.[58] As a result, taxpayers and the government can reasonably dispute the form (for tax purposes) into which a given transaction should fit. In contrast, when a transaction does nothing other than create tax benefits, the taxpayer cannot defend the transaction as a reasonable form for accomplishing some nontax objective.

Unfortunately, the government does not always respect this distinction, attempting to disallow transactions on the basis of the economic-substance doctrine when an argument based on substance-over-form would have been more appropriate and, likely, more successful. For instance, the government lost both the *IES*[59] and *Compaq*[60] cases on economic-substance arguments when the transactions could have easily (and more persuasively) been recharacterized as repurchase agreements ("repos") with the tax consequences determined accordingly.[61]

Such an approach would have allowed the court to avoid the still disputed question of whether the transaction technically resulted in a "profit" for the taxpayer.[62] Likewise, it would not have required reference to the unanswerable question of whether Congress intended for taxpayers to use such short-term repos solely for the purpose of obtaining foreign tax credits.[63] Instead, recasting the transaction in accordance with well-accepted tax principles would have denied the taxpayers their tax credits without getting caught up in the web of asking whether the transactions had sufficient "substance" to be respected for tax purposes.

To be sure, when the government asserts the economic-substance doctrine properly, courts' analyses of that assertion are reminiscent of the chestnut about the "strict scrutiny" standard of review in constitutional law: It is "'strict' in theory and fatal in fact."[64] Indeed, the number of litigated economic substance cases that are decided in taxpayers' favor is far outweighed by the number of such cases that are decided in the government's favor. That record of success in economic substance litigation, however, does not mean that the government always raises the doctrine in appropriate circumstances.[65] In the economic-substance cases that the government loses, the doctrine often should not have been asserted in the first place.[66]

If courts find against the government in such cases, what is the danger of the government asserting the economic-substance doctrine against transactions that could be challenged on less aggressive grounds (*e.g.*, substance over form)? The distinction between these doctrines is not limited to conceptual or tactical concerns. To the contrary, where 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 strict-liability penalty may be enough to coerce the taxpayer into settling a dispute on unfavorable terms. Such coercion is certainly not consistent with the purpose of the penalty statutes.

So, what standards can be employed to ensure that the economic-substance doctrine is asserted only when it is "relevant"?[67] The foregoing discussion suggests a two-tier process for determining whether the economic-substance doctrine is relevant to the treatment of a transaction for federal tax purposes. First, the government and the courts should examine the transaction to determine whether it is more naturally characterized as something other than what the taxpayer claims. If the substance of the transaction is more properly recharacterized as another form that carries different tax consequences, the economic-substance doctrine should not be considered relevant. Only after the government and the courts determine that the transaction cannot be recharacterized as another form should attention be turned to the economic-substance doctrine.[68]

In other words, the substance-over-form doctrine (and step-transaction doctrine) should be given priority over the economic-substance doctrine because if the transaction can be recharacterized as something

that rational actors would do, that is a good indication that the transaction has economic substance. Conversely, the inability to analogize the economics of a challenged transaction to any sort of transactions that taxpayers ordinarily undertake without tax benefits may itself turn out to be a valuable indicator that the transaction lacks economic substance. Prioritizing the doctrines in this way would help avoid some of the confusion that has historically plagued this area of the tax law.

The application of this prioritization scheme is perhaps best shown by applying it to the facts of *Gregory v. Helvering, supra*, the foundational case that ensured confusion between the economic-substance and substance-over-form doctrines. Recall that in *Gregory*, the taxpayer owned a corporation, which in turn owned stock of another corporation, which the taxpayer desired to sell. Hoping to distribute the stock to herself in the most tax-efficient manner, Mrs. Gregory effected that distribution by forming, transferring the stock to, and then liquidating, a new corporation, all of which had the effect of putting the stock in her hands.

Based on the language of the applicable statute, Mrs. Gregory claimed that transaction constituted a "reorganization" and subsequent liquidation, giving rise to capital gain, rather than ordinary income, on the transfer of the shares to her.[69] In recasting the putative reorganization and liquidation as an ordinary distribution from the corporation to the taxpayer, the Court invoked elements of both the economic-substance and substance-over-form doctrines.[70] On the one hand, the Court treated the temporarily formed corporation as a sham and effectively disregarded its existence, suggesting an economic-substance analysis of the entity.[71] On the other hand, the Court concluded that the transaction undertaken by the taxpayer did not constitute a "reorganization" as contemplated by the relevant statute.[72] As a result, the Court recharacterized Mrs. Gregory's transaction as a distribution of the stock from the corporation she owned directly to herself.

In other words, the Court effectively "shammed" both the corporation and the reorganization, but recharacterized the transaction as something else for tax purposes. Importantly for our purposes, the Court could recast the entire endeavor as something that rational people do even without tax benefits—*i.e.*, distribute corporate assets to shareholders. The transaction accomplished Mrs. Gregory's objective of getting stock out of the corporation but did so through a form that was not consistent with substance contemplated by the relevant statutes. Thus, assuming Mrs. Gregory deserved to lose,[73] under the prioritization scheme discussed here, the transaction should have been treated as a case to which the economic-substance doctrine would not be "relevant," and no strict liability penalty would be imposed.[74]

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.

Conclusion

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. Taxpayers can expect the IRS and the Department of Justice to push aggressively for the application of this statute in future controversies. Because Congress did not provide guidance about key ambiguities of the doctrine, courts are left with the responsibility of distinguishing between transactions for which a strict-liability penalty may be warranted (*i.e.*, transactions that lack economic substance) and those for which it clearly is not (*i.e.*, transactions that are recharacterized as something else).

If the government continues to be *too* aggressive in its assertion of the economic-substance doctrine, it may find some courts unwilling to conclude that a transaction lacks economic substance to avoid the imposition of the strict-liability penalties.[75] Because of the size of the penalties involved, overly aggressive assertions of the doctrine's relevance may present courts with a Hobson's Choice: either let taxpayers off the hook for aggressive transactions or punish them with a penalty that the court may not believe is justified under the circumstances. This possibility is vaguely reminiscent of some judges' unwillingness to enforce federal sentencing guidelines where they could not reconcile harsh sentences with underlying crime.

This article presents a principled way of ensuring that the government will invoke the codified doctrine only when the imposition of a strict-liability penalty would even arguably be appropriate. Thus, the prioritization scheme described above will help avoid the imposition of a strict-liability penalty on taxpayers whose only offense is to characterize a transaction in a manner with which the government disagrees.

Endnotes

[1] Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), §1409, 124 Stat. 1029 (Mar. 30, 2010).

[2] *E.g.*, Howard E. Abrams, *Did Codification of Economic Substance Repeal the Partnership Anti-Abuse Rule?* 51 Tax Mgmt. Mem. 299 (2010); Bruce Givner and Ken Barish, *Economic Substance Doctrine: The Curious Case of Codification*, J. Tax Prac. & Proc., Apr.–May 2010, at 21; Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 Tax Notes 289 (Apr. 19, 2010); Martin J. McMahon, *Living with the Codified Economic Substance Doctrine*, 128 Tax Notes 731 (Aug. 16, 2010); Lee A. Sheppard, *Economic Substance Codification: Did We Do The Right Thing?* 129 Tax Notes 157 (Oct. 11, 2010).

[3] *See* Joint Committee on Taxation, Technical Explanation Of The Revenue Provisions Of The "Reconciliation Act Of 2010," As Amended, In Combination With The "Patient Protection And Affordable Care Act," JCX-18-10 ("JCT Explanation"), at 142 (Mar. 21, 2010).

[4] *E.g.*, Code Sec. 357(b)(1) (addressing an assumption of liability "the principal purpose" of which was either to avoid tax on a Code Sec. 351 exchange or otherwise not a *bona fide* business purpose).

[5] Code Sec. 6662(b)(6); Code Sec. 7701(o)(1).

[6] Donald L. Korb, Remarks at the 2005 University of Southern California Tax Institute (Jan. 25, 2005).

[7] A question left unanswered by the legislation is whether the substance-over-form doctrine is considered to be "a similar rule of law," the use of which invokes the new penalty in Code Sec. 6662(b)(6) just like the economic-substance doctrine.

[8] *E.g., D.G. Collins*, CA-9, 88-2 ustc ¶9549, 857 F2d 1383, 1386: "[Economic] substance tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *ACM P'ship*, CA-3, 98-2 ustc ¶50,790, 157 F3d 231, 265 (McKee, J., dissenting): "I can't help but suspect that the majority's conclusion to the contrary is, in its essence, something akin to a 'smell test.'" *See also* Alexandra M. Walsh, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 Stan. L. Rev. 1541, 1545 (2001).

[9] *See* Joint Committee on Taxation, Summary of Tax Provisions Contained In the President's Fiscal Year 2001 Budget Proposal, JCX-13-00, 21 (Feb. 7, 2000).

[10] *See* President's Fiscal Year 2001 Budget: Hearing Before The H. Comm. on Ways & Means, 106th Cong. (2000) (Testimony of Lindy Paull, Chief of Staff of the Joint Committee on Taxation).

[11] *See, e.g.*, The Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong., 1st Sess. Even a test that relies on such a comparison, though, requires a subjective determination of just how much pre-tax profit is "significant" enough to satisfy the doctrine.

[12] David P. Hariton and Robert H. Scarborough, *Treasury's Proposal To Codify The Economic Substance Doctrine*, 88 Tax Notes 937 (Aug. 14, 2000).

[13] *Accord id.*

[14] *See, e.g., K.F. Knetsch*, SCt, 60-2 ustc ¶9785, 364 US 361; *Stobie Creek Investments, LLC*, CA-FC, 2010-1 ustc ¶50,455, 608 F3d 1366; *K.P. Kirchman*, CA-11, 89-1 ustc ¶9130, 862 F2d 1486.

[15] *See* Sheppard, *supra* note 2, at 157: "We repealed the common-law economic substance doctrine and replaced it with a penalty." McMahon, *supra* note 2, at 731: "[F]or the most part the effective date of the new provisions likely will prove to be significant only regarding the strengthened penalty regime."

[16] Perhaps most surprising about the codified doctrine is what has been omitted—namely, an operative rule to disallow the tax benefits of a transaction that is determined to lack economic substance. Most earlier proposals to codify the doctrine contained a provision that would disallow tax benefits. *E.g.*, Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong., 1st Sess.: "In determining liability for any tax under subtitle A, noneconomic tax attributes shall not be allowed." Congress, however, did not include such a provision in the legislation that was ultimately enacted.

[17] Code Sec. 7701(o)(1).

[18] Code Sec. 7701(o)(5)(C).

[19] Jeremiah Coder, *Determining Relevance of Economic Substance Doctrine Is Not Hard, Alexander Says*, 2010 TNT 107-2 (June 4, 2010).

[20] *Id.*; Jeremiah Coder, *Prior Case Law Should Guide Application of Codified Economic Substance, Butler Says*, 2010 TNT 216-3 (Nov. 9, 2010).

[21] *See Klamath Strategic Investment Fund*, CA-5, 2009-1 ustc ¶50,395, 568 F3d 537; *Coltec Indus. Inc.*, CA-FC, 2006-2 ustc ¶50,389, 454 F3d 1340. For criticisms of this analysis, *see* Mark J. Silverman, Matthew D. Lerner and Gregory N. Kidder, *A New Form of Obscenity? Sorting Through the Federal Circuit's "We Know It When We See It" Ruling in* Coltec, 793 PLI/Tax 453 (2007).

[22] *Cf. Shell Petroleum, Inc.*, DC-TX, 2008-2 ustc ¶50,422 (criticizing the government's "slicing and dicing" of the taxpayer's transaction).

[23] Code Sec. 7701(o)(1).

[24] Code Sec. 7701(o)(2)(B). *See also* Code Sec. 7701(o)(3) (treating state and local tax benefits like federal tax benefits, thus prohibiting them from being a meaningful economic change or substantial purpose); Code Sec. 7701(o)(4) (prohibiting financial accounting benefits arising from reductions in federal income tax from being considered a nontax purpose).

[25] *See* Sheppard, *supra* note 2, at 158: "The principal worthwhile feature of the new statute is that it requires both an objective substance, which may be shown by pretax profit potential, and a subjective business purpose." JCT Explanation, at 153.

[26] *Compare Rice's Toyota*, CA-4, 85-1 ustc ¶9123, 752 F2d 89, at 91 (requiring taxpayer to satisfy only one prong) *with Coltec*, *supra* note 21, 454 F3d, at 1355, note 14 (requiring taxpayer to satisfy both prongs).

[27] *E.g., Frank Lyon Co.*, SCt, 78-1 ustc ¶9370, 435 US 561; *IES Indus., Inc.*, CA-8, 2001-2 ustc ¶50,471, 253 F3d 350.

[28] *IES Indus., Inc., supra* note 27, 352 F3d, at 355; *but see F.C. Pasternak*, CA-6, 93-1 ustc ¶50,226, 990 F2d 893, at 898: "The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."

[29] It is possible to conceive of circumstances in which an economic change might arise as a result of serendipity, in which case the transaction's economic substance might be harder to defend; however, the apparent rarity of such cases counsels against the need to be overly concerned about such situations.

[30] *E.g., ACM P'ship*, CA-3, 98-2 ustc ¶50,790, 157 F3d 231, at 265.

[31] *E.g.*, David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?* 60 Tax L. Rev. 29, 33 (2007); *but see* Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U.

Continued on page 45

proper characterization, provide better matching of income and costs and simplify recordkeeping, Rev. Proc. 2011-17 provides a safe-harbor treatment.

Under this safe harbor, a taxpayer can treat a gift card issued for returned goods as (1) a cash refund payment in the amount of the gift card, and (2) a sale of the gift card for the same amount. The amount deemed received from the sale of the gift card may be accounted for under the income deferral rules of Reg. §1.451-5 or Rev. Proc. 2004-34. A taxpayer can use this treatment whether or not it is the taxpayer's policy to provide a cash refund for returned goods.

To fall within this safe-harbor treatment, a customer must not be required to perform any act or service in addition to presenting the issued gift card (such as purchasing additional products) to obtain goods and/or services. A gift card is broadly defined as any evidence of a promise to provide a specific dollar amount of goods and/or services to a customer in a future sale, whether imprinted electronically on a plastic card, issued electronically with a special code, provided as a printed certificate, or recorded on a taxpayer's books.

Procedures to Change Accounting Method

A taxpayer generally can obtain an automatic consent to change to the safe-harbor method in accordance with §19.10, Appendix of Rev. Proc. 2011-14. If the taxpayer also wants to make a change to the one-year deferral method under Rev. Proc. 2004-34 for the deemed cash proceeds received from the gift card, the taxpayer must file a single Form 3115 for both changes. If a taxpayer wants to change to the safe-harbor method and the two-year deferral method under Reg. §1.451-5, it must follow Rev. Proc. 97-27 to obtain advance consent.

Although this revenue procedure seems to suggest that any change to the one-year deferral method can be an automatic change, this might not be entirely the case. In Rev. Proc. 2011-18, a change to the one-year deferral under Rev. Proc. 2004-34 will require advance consent in the case where the deferral is determined on a statistical basis or on the basis of clear reflection of income. It is unclear if a taxpayer would file a single Form 3115 for both changes for advance consent, or two separate Forms 3115—one for automatic change to treat the issued gift cards as a cash refund and one for advance consent to the one-year deferral method. Presumably a single Form 3115, as in the case of changing to the two-year deferral under Reg. §1.451-5, would be filed.

As described earlier for Rev. Proc. 2011-18, the general scope limitations for changes are waived for a taxpayer's first and second tax year ending on or after December 31, 2010.

Audit Protection

The effective date of this revenue procedure is for tax years ending on or after December 31, 2010. The IRS will also stop challenging the use of the safe-harbor method for any tax year ending before December 31, 2010.

Conclusion

This post-holiday guidance is welcome news; however, it would be great news if the IRS had extended the two-year deferral treatment under Reg. §1.451-5 to gift card sales by gift card companies. The new guidance is a fair and sensible compromise of two challenging issues. We salute the Treasury and the IRS for the much needed change in policy.

Endnotes

1 Rev. Proc. 2011-17, IRB 2011-5, Jan. 6, 2011, and Rev. Proc. 2011-18, IRB 2011-5, Jan. 6, 2011.
2 Rev. Proc. 2004-34, 2004-1 CB 991.
3 *See* Rev. Rul. 84-31, 1984-1 CB 127.
4 Rev. Proc. 2004-34, *supra* note 2, §5.02(3)(b).
5 Rev. Proc. 2011-14, IRB 2011-4, Jan. 10, 2011. Rev. Proc. 2011-18, §6.01, cites Rev. Proc. 2008-52, IRB 2008-36, 587, which has been modified and superseded by Rev. Proc. 2011-14 issued shortly after Rev. Proc. 2011-18.
6 Rev. Proc. 97-27, 1997-1 CB 680, *most recently modified by* Rev. Proc. 2011-14.

Economic-Substance

Continued from page 24

CHI. L. REV. 859, 863–84 (1982) (criticizing the substance-over-form and economic-substance doctrines); Charles I. Kingson, *The Cowardice of Economic Substance*, 126 TAX NOTES 1657 (Mar. 29, 2010): "I have not seen any case decided for the government on that ground which could not have been won on narrower, more specific, and technical grounds."
32 JCT Explanation, at 142. As discussed in Part III, it is this historical blurring of the doctrine that makes the unresolved question of "relevance" so critical to the proper application of the doctrine.
33 Code Sec. 6662(2)(B). If a taxpayer wanted to avoid a penalty on the basis of having had a "reasonable basis" for its position, the taxpayer also had to adequately disclose the relevant facts in a statement attached to its return.
34 Code Sec. 6664(c)(1). *See Klamath Strategic Investment Fund*, CA-5, 2009-1 USTC ¶50,395, 568 F3d 537, at 546–48 (finding reasonable cause notwithstanding conclusion that the challenged transaction lacked economic substance).
35 For this purpose, a "tax shelter" is defined generally as any arrangement "a significant purpose of [which] is the avoidance or evasion of Federal income tax." Code Sec. 6662(2)(C).
36 Code Sec. 6707A(c).
37 Reg. §1.6664-4(f) (requiring that a corporate taxpayer believe its treatment of a transaction to be "more likely than not" proper).
38 Reg. §1.6664-4(b)(1).
39 Code Sec. 6664(d)(2).

[40] Code Sec. 6662(b)(6), (i).

[41] *E.g., Yosha*, CA-7, 88-2 USTC ¶9589, 861 F2d 494, at 499: "A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive … ."

[42] Reg. §1.6664-4(b)(1).

[43] *See* note 28, *supra*, and accompanying text. To be sure, the distinction between avoiding complexity and seeking it out can be a fine one; and even transactions that have economic substance might nevertheless be structured in a way that seeks to exploit (rather than simply comply with) the complexities of federal tax law. *See, e.g., Canal Corp.*, 135 TC No. 9, Dec. 58,298 (2010).

[44] *See* McMahon, *supra note* 2, at 736–37 (discussing tax-specific rationale for like-kind exchanges).

[45] *Portland Oil Co.*, CA-1, 40-1 USTC ¶9234, 109 F2d 479, 488. (Code Sec. 351 defers recognition of gain or loss from "transactions where gain or loss may have been accrued in a constitutional sense, but wherein popular and economic sense there has been a mere change in the form of ownership in the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture.")

[46] *See Black & Decker Corp.*, CA-4, 2006-1 USTC ¶50,142, 436 F3d 431; *Coltec, supra* note 21; *Shell Petroleum*, supra note *22*.

[47] Notice 2001-17, 2001-1 CB 730. *Coltec, supra* note 21.

[48] JCT Explanation, at 152–53.

[49] *Compare* James S. Halpern, *Putting The Cart Before The Horse: Determining Economic Substance Independent Of The Language Of The Code*, 30 VA. TAX. REV. 327 (2010) with Jasper L. Cummings, Jr., *The New Normal: Economic Substance Doctrine First*, 126 TAX NOTES 531 (Jan. 25, 2010).

[50] The government has additional tools at its disposal, such as the application of specific anti-abuse rules (*e.g.*, Code Sec. 357(b) and Reg. §1.701-2(a)(1)). Because such tools are limited in their applicability to specific fact patterns, they are left aside for present purposes.

[51] *E.g., Court Holding*, SCt, 45-1 USTC ¶9215, 324 US 331 (recasting liquidating distribution and sale of asset by corporate stockholder as sale by the corporation).

[52] *See G.M. Trading Corp.*, CA-5, 97-2 USTC ¶50,658, 121 F3d 977, at 978, note 2: "The step transaction doctrine allows the disregard of steps that have no substance. It does not allow the invention of steps that did not happen." (Citations omitted.)

[53] Isenbergh, *supra* note 31, at 866: "From the beginning of taxation people have sought advantage in calling one thing another. To avoid a tax imposed on compensation, for example, people would call it a gift. The principle of following 'substance' rather than 'form' has always meant sweeping aside pretenses of this sort." *But see id.*, at 867–68 (criticizing such recharacterization in *Gregory v. Helvering*, 293 US 465 (1935)). For criticisms of the substance-over-form and step-transaction doctrines, *see* David P. Hariton, *Sorting Out The Tangle Of Economic Substance*, 52 TAX LAW. 235, 238–40 (1999).

[54] *See, e.g., Knetsch, supra* note 14; *Yosha, supra* note 41; *Kirchman, supra* note 14.

[55] Whether specific components of a larger transaction, rather than the transaction as a whole, may be subject to an economic substance analysis is beyond the scope of this article. Nevertheless, the "relevance" of the doctrine should not depend on whether it is applied to a component of a transaction or to a transaction as a whole. Whether a specific piece of a larger transaction is disregarded, *Coltec, supra* note 21, or the entire transaction is disregarded, *e.g., Knetsch, supra* note 14, the question is whether the activity being disregarded can be recharacterized as another, economically significant transaction.

[56] *E.g., Court Holding, supra* note 51.

[57] *Yosha*, supra note 41, 861 F2d, at 499; *accord* Hariton, *supra* note 53, at 247: "[such] transactions could not reasonably be described as a 'way' of accomplishing a specified business objective."

[58] Isenbergh, *supra note* 31, at 869: "As a basis for resolving matters of form and substance … economic equivalence is untenable. The Code creates numerous tax differences between economically equivalent transactions."

[59] *IES Indus., Inc., supra* note 27. *IES* and *Compaq, infra*, each involved the short-term purchase and resale of American depository receipts (ADRs), which had the putative effect of transferring to each respective taxpayer the foreign tax credits that arose when foreign taxes were withheld on dividends payable to the taxpayer due to its temporary ownership of the ADRs.

[60] *Compaq Computer Corp.*, CA-5, 2002-1 USTC ¶50,144, 277 F3d 778, *rev'g*, 113 TC 214, Dec. 53,628 (1999).

[61] *See* Kingson, *supra* note 31. Under well-established law, a repo is treated as a secured loan. *Nebraska Department of Revenue v. Lowenstein*, 513 US 123 (1994). Were the *IES* and *Compaq* cases argued on that ground, the government might very well have won on the theory that neither taxpayer actually acquired ownership (for tax purposes) of the underlying ADRs, instead holding them as security for a short-term loan to the respective foreign counterparty.

[62] *Compare* Daniel N. Shaviro and David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 94 TAX NOTES 511 (Jan. 28, 2002) *with* William A. Klein and Kirk J. Stark, Compaq v. Commissioner—*Where Is the Tax Arbitrage?* 94 TAX NOTES 1335 (Mar. 7, 2002).

[63] Congress subsequently amended Code Sec. 901 to requiring taxpayers to hold stock for a specified amount of time to claim foreign tax credits on such stock. Taxpayer Relief Act of 1997 (P.L. 105-34) §1053, 111 Stat. 787 (Sept. 3, 1997). Nevertheless, at the time *IES* and *Compaq* were decided, Congressional intent in this regard was far from clear. Hariton, *supra* note 31, at 38.

[64] Gerald Gunther, *The Supreme Court, 1971 Term—Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection*, 86 HARV. L. REV. 1, 8 (1972).

[65] *Accord* JCT Explanation, at 142.

[66] *See Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561, at 583–84; *United Parcel Service of America, Inc.*, CA-11, 2001-2 USTC ¶50,475, 254 F3d 1014; *IES* and *Compaq, supra*; *Northern Indiana Public Service Co.*, CA-7, 97-1 USTC ¶50,474, 115 F3d 506.

[67] For purposes of this discussion, "relevance" is intended to mean that a transaction should be subjected to an economic substance analysis in the first place. Whether or not a particular transaction satisfies the doctrine will ultimately depend on the facts of that transaction.

[68] The court in *Schering-Plough Corp.*, DC-NJ, 2009-2 USTC ¶50,614, 651 FSupp2d 219, followed this exact sequence, first examining whether the taxpayer's "swap-and-assign" transactions should be recast as loans under a substance-over-form analysis, which would cause different technical tax rules to apply. Incredibly, however, after determining that the taxpayer's transactions were in substance different from what the taxpayer claimed, the court superfluously continued to analyze whether the transactions had economic substance. *Id.*, at 263: "Having found that under the various branches of the substance-over-form doctrine, the 1991 and 1992 swap-and-assign transactions were loans … , the Court need go no further to render judgment for the government. Nonetheless, the transactions also fail the related 'economic substance' analysis."

[69] One can see echoes of this recharacterization in *Schering-Plough, supra*.

[70] Isenbergh, *supra* note 31, at 867: "A difficulty with *Gregory* is that [it] reflect[s] an opinion of greater literary power than sharpness of doctrine."

[71] *Gregory v. Helvering, supra* note 54, at 470. This "shamming" of an entity formed solely for the purpose of tax avoidance would be seen in later cases. *See Haberman Farms, Inc.*, CA-8, 62-2 USTC ¶9612, 305 F2d 787.

[72] *Gregory v. Helvering, supra* note 54, at 470.

[73] Isengbergh, *supra* note 31, at 868.

[74] Whether Mrs. Gregory would be liable for penalties on other grounds (*e.g.*, lacking "reasonable cause" and "good faith") remains a separate question.

[75] Sheppard, *supra* note 2, at 158 (noting that judges will be unlikely to uphold the 40-percent penalty "when there is a reasonable disagreement about the law applicable to the transaction, as is the case with most business tax planning").