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## CLARITY OR CONFUSION?: THE COMMON LAW ECONOMIC SUBSTANCE DOCTRINE AND ITS STATUTORY COUNTERPART

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### INTRODUCTION

Each election cycle, U.S. politicians campaign on promises to simplify the federal income Tax Code (“the Code”) and peel back the complex layers of exemptions, deductions, and credits. “Tax reform” has become a mere euphemism for tax complication as the book of rules and regulations with which taxpayers must comply grows thicker. Despite lawmakers’ best efforts, enhanced code specificity has failed to foreclose room for opportunistic behavior by taxpayers hoping to minimize their tax liability. The increase in globalization has enabled corporate taxpayers in particular to creatively structure transactions and apply favorable Tax Code provisions to situations unidentified by Congress. Courts have responded with judicially crafted devices to deter abuse and fill gaps in the Code. The economic substance doctrine is one of the most pervasive defense mechanisms courts have invoked to combat the rise of corporate tax shelters.

From its inception in the 1930s, courts have used the economic substance doctrine as a means of invalidating transactions that comply with the strict letter of the Tax Code but which result in an unintended tax benefit. Over time, Federal Circuit Courts of Appeal took divergent approaches to interpreting and applying the doctrine, leading to the emergence of disuniformity and unpredictability for taxpayers.<sup>1</sup> In an effort to reconcile these inconsistencies and clarify the economic substance doctrine’s applicability, in 2010 Congress enacted Section 7701(o) of the Internal Revenue Code<sup>2</sup> (“I.R.C.”) purporting to supplement—rather than supplant—the common law doctrine.<sup>3</sup> Notwithstanding the doctrine’s codification, courts and taxpayers alike remain hopelessly confused as to the doctrine’s proper role in tax law.

This Note explores the dynamic between the codification of the economic substance doctrine, its common law counterpart, and similar anti-abuse substance over

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<sup>1</sup> Compare *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006) with *Kirchman v. Comm’r*, 862 F.2d 1486 (11th Cir. 1989).

<sup>2</sup> Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

<sup>3</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 369 (JCS-2-11, March 2011).

form doctrines similarly aimed at effectuating congressional intent. Rather than achieving uniformity among circuits, the enactment of Section 7701(o) has undermined its stated purpose and enhanced taxpayer uncertainty with respect to the doctrine's applicability. This confusion is further exacerbated by the relationship between the economic substance doctrine and other distinct but related anti-abuse common law doctrines. Certainty and predictability are imperative to taxpayer confidence in the Code, as well as in the overarching tax system. In particular, corporate taxpayers engaged in fiscally large transactions, especially those undertaken for legitimate business purposes, and carefully planned financial budgets require assurance of the tax consequences *ex ante*. The uncertainty and unpredictability created by these doctrines ultimately hinder the Tax Code's efficacy and integrity.

Part I of this Note will establish the economic substance doctrine's history and discuss the divergent approaches adopted by circuit courts over the course of its evolution. Part II of this Note will provide an overview of Section 7701(o)'s enactment and assess its effectiveness in achieving the simplification Congress intended. Part III of this Note will explore the economic substance doctrine's relationship with substance over form principles in tax law broadly, while Part IV will identify the issues this complexity poses. Finally, Part V of this Note will advocate for a true simplification in Tax Code interpretation.

## I. THE ECONOMIC SUBSTANCE DOCTRINE

### A. ORIGIN AND PURPOSE

"A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences."<sup>4</sup> In response to this inescapable truth, the judiciary has assumed a gap-filling function, developing common law doctrines to prevent taxpayers from abusing favorable Code provisions. One particularly influential doctrine used to address transactions lacking economic substance arose out of a 1934 Second Circuit opinion written by Judge Learned Hand.<sup>5</sup>

*Helvering v. Gregory* involved a taxpayer, Mrs. Gregory, who orchestrated a complex transaction for the sole purpose of minimizing her federal income tax liability.<sup>6</sup> Gregory was the sole shareholder of Corporation A; Corporation A in turn held shares in Corporation B.<sup>7</sup> Gregory sought to sell her shares in Corporation B at a profit, without incurring the large amount of capital gains tax this transaction would inevitably generate for Corporation A.<sup>8</sup> To this end, Gregory incorporated a new entity, Corporation C, and on the same day, transferred all of her ownership in

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<sup>4</sup> *Id.*

<sup>5</sup> *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1934).

<sup>6</sup> *Id.* at 810.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

Corporation B to the newly formed entity.<sup>9</sup> Corporation C subsequently sold the Corporation B stock at a gain, and Gregory dissolved Corporation C three days later.<sup>10</sup>

Gregory reported her federal income tax on the theory that under the contemporary Tax Code, this transaction constituted a corporate “reorganization” and as such, the gain realized need not be recognized.<sup>11</sup> Internal Revenue Service (“IRS”) Commissioner, Guy T. Helvering, challenged Gregory’s reported income as deficient, on the grounds that Gregory’s sole purpose for creating the temporary corporation was obviously tax avoidance, and therefore this transaction could not constitute a corporate reorganization within the meaning of the Code.<sup>12</sup> While conceding that the transaction was undertaken to mitigate her tax liability, Gregory appealed the deficiency to the Board of Tax Appeals, contending her underlying motivation was irrelevant to her tax liability. The Board of Tax Appeals expunged the deficiency, finding that under a strict reading of the Code, this transaction constituted a corporate reorganization irrespective of Gregory’s purpose for engaging in the reorganization.<sup>13</sup>

The Second Circuit reversed this determination on appeal, ruling in favor of the Commissioner.<sup>14</sup> Writing for the court, Judge Learned Hand opined that while a “transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by the desire to avoid, or . . . to evade, taxation,” dodging “the shareholders’ taxes is not one of the transactions contemplated as corporate reorganizations.”<sup>15</sup> Based on the Code provision’s history and legislative intent, Judge Hand concluded that “the transactions were no part of the conduct of the business of either or both companies[,]” and therefore did not satisfy the definition of a corporate reorganization.<sup>16</sup> In essence, although the transaction fit within the literal definition of a corporate reorganization, the transaction was not one which Congress had intended to benefit from this provision.

Gregory appealed the decision to the Supreme Court, which affirmed the Second Circuit’s holding.<sup>17</sup> The Court echoed Judge Hand’s rationale, opining, “[t]he whole undertaking, though conducted according to the terms of [the Code provision], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else.”<sup>18</sup> The transaction could not fit within the definition

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* Section 112(i)(1)(B) of the Revenue Act of 1928 defined a “reorganization” as “a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.” I.R.C. § 112(i)(1)(B) (1928). Section 112(g) provided that gain realized pursuant to a corporate reorganization shall not be recognized. *See* § 112(g).

<sup>12</sup> Gregory, 69 F.2d at 810.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 811.

<sup>15</sup> *Id.* at 810–11.

<sup>16</sup> *Id.* at 811. Judge Hand reasoned that “the underlying presupposition is plain that the re-adjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution.” *Id.* Moreover, notwithstanding the legitimacy of the steps taken, “their only defect was that they were not what the statute mean[t] by a ‘reorganization,’ because the transactions were no part of the conduct of the business of either or both companies; so viewed, they were a sham, though all the proceedings had their usual effect.” *Id.*

<sup>17</sup> Gregory v. Helvering, 293 U.S. 465 (1935).

<sup>18</sup> *Id.* at 470.

of a corporate reorganization “because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.”<sup>19</sup>

## B. COMMON LAW EVOLUTION

The economic substance doctrine emerged out of Judge Hand’s substance over form interpretation of the Tax Code in *Helvering v. Gregory*. Today, the economic substance doctrine is available as a judicial remedy to transactions in which “a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.”<sup>20</sup> The doctrine’s scope is not limited to corporate taxpayers or transactions, “but rather applies to the federal taxing statutes generally.”<sup>21</sup> Because the doctrine developed at common law, its precise form varies by jurisdiction. Most federal courts apply a variation of the modern two-part test articulated by the Tax Court in *ACM Partnership v. Commissioner*.<sup>22</sup> First, the court inquires “whether the transaction has any practical economic effects other than the creation of income tax losses.”<sup>23</sup> If this threshold inquiry is answered in the affirmative, the second separate but related question is whether the taxpayer engaged in the transaction for a legitimate non-tax business purpose.<sup>24</sup>

The test’s first prong, commonly referred to as the “economic prong,” is an objective inquiry dependent on the particular facts and circumstances of a given transaction.<sup>25</sup> A transaction has a non-tax economic effect if it “offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.”<sup>26</sup> The second prong, known as the “business purpose test,” looks to the taxpayer’s subjective “expectations and motives” for engaging in the transaction.<sup>27</sup> To withstand scrutiny under the test’s second leg, the taxpayer must establish a motive unrelated to obtaining beneficial tax treatment. A transaction that “is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not

<sup>19</sup> *Id.*

<sup>20</sup> *ACM P’ship v. Comm’r*, 73 T.C.M. 1997–115 1997 WL 93314, at \*36, *aff’d in part, rev’d in part*, *ACM P’ship v. C.I.R.* 157 F.3d 231 (3d Cir. 1998).

<sup>21</sup> *Id.* at \*38 (internal quotations omitted).

<sup>22</sup> *Id.* The Tax Court recognized the hazy line between the production of profit and the reduction in taxes. The court nonetheless concluded that tax law “requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction.” *Id.* at \*36.

<sup>23</sup> *ACM*, 157 F.3d at 248 (quoting *Jacobson v. Comm’r*, 915 F.2d 832, 837 (2d Cir. 1990)); *see also* Nicholas Giordano, *Putting the Substance Back into the Economic Substance Doctrine*, 11 BROOK. J. OF CORP., FIN., AND COMM. L. 469, 470 (2017).

<sup>24</sup> *ACM*, 157 F.3d at 248.

<sup>25</sup> *See, e.g., Tucker v. Comm’r*, 766 Fed. Appx. 132 (5th Cir. 2019).

<sup>26</sup> *Portland Golf Club v. Comm’r*, 497 U.S. 154, 169 n.19 (1990) (quoting *Gefen v. Comm’r*, 87 T.C. 1471, 1490 (1986)).

<sup>27</sup> Joseph Bankman, *The Economic Substance Doctrine*, 75 S. CAL. L. REV. 5, 27 (2000) (“The [subjective] leg is similar, if not identical, to the business purpose doctrine, and is sometimes simply referred to as the business purpose requirement.”). Bankman critiques the subjective prong on the grounds that it is “impossible to know a taxpayer’s (or anyone else’s) actual subjective intent.” *Id.* Moreover, the subjective prong “must inevitably look to objective indicia of intent: contemporaneous documents, evidence of meetings, and the like. These indicia may be subject to manipulation. A primary criticism of the business purpose test is that it leads to the creation of false or misleading documents that evidence nontax motives.” *Id.*

shaped solely by tax-avoidance features” will satisfy the second prong.<sup>28</sup> Conversely, a transaction lacking “economic substance separate and distinct from economic benefit achieved solely by tax reduction[.]”<sup>29</sup> will be denied the provision’s afforded benefit and a penalty may be imposed.

### C. A CIRCUIT SPLIT EMERGES

Despite its prevalence in tax law, federal courts disagree as to the economic substance doctrine’s proper application.<sup>30</sup> The ways in which the Federal Circuit Courts of Appeal apply the common law economic substance doctrine diverge in three primary respects: (1) the test’s structure; (2) the test’s relevance; and (3) the necessary threshold for establishing the existence of economic substance. Understanding each of these departures is helpful in assessing the statutory changes accompanying Section 7701(o)’s enactment.

Federal courts have traditionally disagreed as to the doctrine’s proper structure. Prior to the 2010 legislation, some courts applied a strict conjunctive test, requiring both the objective and subjective prongs be satisfied,<sup>31</sup> while other circuits applied a more lenient disjunctive test, allowing the taxpayer to withstand the test by establishing *either* the objective *or* subjective prong.<sup>32</sup> Still other circuits took a holistic approach, evaluating the nature of the transaction as a whole, and rejecting to distinguish between the objective and subjective prongs.<sup>33</sup> The 2010 legislation eradicated this particular discrepancy in the test’s application by mandating that all courts apply the test in its conjunctive form.<sup>34</sup> Under this approach, “[t]he threshold question is whether the transaction has economic substance.”<sup>35</sup> If the answer is yes, the question becomes whether the taxpayer was “motivated by profit to participate in the transaction.”<sup>36</sup>

In addition to the test’s structure, there is also a lack of consensus among courts as to the proper context in which the economic substance doctrine is relevant. As the Fifth Circuit observed, “the line between disregarding a too-clever-by-half accounting

<sup>28</sup> *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978).

<sup>29</sup> *ACM P’ship v. Comm’r*, 73 T.C.M. 1997–115 1997 WL 93314, at \*36, *aff’d in part, rev’d in part*, *ACM P’ship v. C.I.R.* 157 F.3d 231 (3d Cir. 1998).

<sup>30</sup> *Compare* *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006) *with* *Kirchman v. Comm’r*, 862 F.2d 1486 (11th Cir. 1989).

<sup>31</sup> The Fifth, Sixth, and Federal Circuits apply a form of the stricter conjunctive test, preventing economic substance in the absence of a showing meeting both prongs of the test. *See, e.g.*, *Dow Chem.*, 435 F.3d; *Boca Investorings P’ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003); *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002); *United Parcel Serv. of Am., v. Comm’r*, 253 F.3d 1014 (11th Cir. 2001). Under the conjunctive test, as the Court of Appeals for the Federal Circuit explained, “[w]hile the doctrine may well also apply if the taxpayer’s sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer’s sole motive is tax avoidance.” *Coltec Indus. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006).

<sup>32</sup> In contrast, the Fourth, Eighth, and Eleventh Circuits only require one prong be satisfied as a prerequisite to finding economic substance. *See, e.g.*, *Kirchman*, 862 F.2d at 1490.

<sup>33</sup> *See, e.g.*, *ACM P’ship v. Comm’r*, 157 F.3d 231 (3d Cir. 1998); *Sacks v. Comm’r*, 69 F.3d 982, 985 (9th Cir. 1995); *James v. Comm’r*, 899 F.2d 905, 908 (10th Cir. 1995).

<sup>34</sup> *See* I.R.C. § 7701(o)(1) (2018).

<sup>35</sup> *Pasternak v. Comm’r*, 990 F.2d 893, 898 (6th Cir. 1993).

<sup>36</sup> *Id.*

trick and nullifying a Code-supported, tax-minimizing transaction can be elusive.”<sup>37</sup> While some circuits have restricted the doctrine’s application to corporate transactions, others have taken a more liberal approach, invoking the doctrine against individual taxpayers as well. As elaborated on in Part II of this Note, the legislature abstained from guiding courts and taxpayers on the appropriate context for the economic substance doctrine, but rather left this matter to the court’s discretion.<sup>38</sup>

Finally, “[t]here is also a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance.”<sup>39</sup> For instance, a taxpayer who did not realize the purported business benefits of a transaction is at risk of being stripped of a claimed tax benefit in some jurisdictions.<sup>40</sup> On the other hand, some courts have denied a tax benefit in a transaction where the risk-to-profit potential is disproportionately large.<sup>41</sup> Still other courts have entertained the notion that tax benefits could be a permissible motivating factor in deciding to engage in a particular transaction, so long as it was not the taxpayer’s primary purpose for engaging in the transaction.<sup>42</sup> These disparities between circuits served as a catalyst for the economic substance doctrine’s legislative enactment in 2010.

## II. CONGRESSIONAL “CLARIFICATION”

In 2010, Congress enacted a statutory version of the economic substance doctrine with the stated intent not of displacing the common law doctrine, but rather providing clarification surrounding its application and cultivating uniformity across circuits.<sup>43</sup> Ironically, by leaving the common law doctrine intact and adding an additional layer of complexity to an area with pre-existing divergent interpretation, the statute had the opposite effect. Instead of clarifying the doctrine as Congress intended, the statute has further complicated the framework, creating more uncertainty for both taxpayers and courts. As provided by I.R.C. Section 7701(o), any transaction entered into after March 31, 2010,

<sup>37</sup> *Summa Holdings v. Comm’r*, 848 F.3d 779, 787 (6th Cir. 2017).

<sup>38</sup> According to the Sixth Circuit, indicia of either the presence of economic substance or a lack thereof include, “the presence or absence of arm’s-length price negotiations, the relationship between the sales price and fair market value, the structure of financing of the transaction, whether there was a shifting of the benefits and burdens of ownership, and the degree of adherence to contractual terms.” *Rose v. C.I.R.*, 88 T.C. 386, Tax Ct. Rep. (CCH) 43,687, 410–11 (1987), *aff’d*, 868 F.2d 851, 853 (6th Cir. 1989). A lack of economic substance can be further corroborated by evidence that “[t]ax benefits were the focus of promotional materials . . . [or] the assets in question consist of packages of purported rights, difficult to value in the abstract and substantially overvalued in relation to tangible property included as part of the package . . . .” *Id.* at 412.

<sup>39</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 369, 371 (JCS-2-11, March 2011).

<sup>40</sup> See, e.g., *Coltec Indus. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006).

<sup>41</sup> See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960).

<sup>42</sup> Rebecca Rosenberg, *Codification of the Economic Substance Doctrine: Substantive Impact and Unintended Consequences*, HASTINGS BUS. L. J. 55, 94–95 (2019).

<sup>43</sup> See Rebecca Rosenberg, *Codification of the Economic Substance Doctrine: Agency Response and Certain Other Unforeseen Consequences*, 10 WM. & MARY BUS. L. REV. 199 (2018). Congressional intent is further informed and corroborated by the subsection’s title “Clarification of the Economic Substance Doctrine,” as well as I.R.C. § 7701(5)(A) (2018), which defines the doctrine by way of reference to the common law.

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to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.<sup>44</sup>

While cases involving the economic substance doctrine have been litigated since Section 7701(o)'s enactment, a federal court has yet to interpret the statute.<sup>45</sup> Consequently, the impact the statutory overlay will have on courts' application of the common law doctrine will be determined in time. Until then, the only means of assessing the statute's effectiveness are the text and legislative history of the statute itself.

Congress explicitly assured courts and taxpayers alike that Section 7701(o) was not enacted as an effort to displace the common law doctrine.<sup>46</sup> Rather, the statute's legislative history manifests Congress's unambiguous intent to clarify the test's application and in turn, eliminate the disparities among federal circuits.<sup>47</sup> Given the lack of uniformity among courts and the general disagreement regarding the economic substance doctrine's proper application, there is an inherent tension between these two policy objectives. This raises the question: which doctrinal aspects are courts bound to comply with and which aspects are left to judicial discretion?

The statutory enactment of Section 7701(o) made three fundamental doctrinal alterations to the common law economic substance doctrine. First, the statute unified the doctrine's form by requiring the test be applied in its conjunctive form.<sup>48</sup> Additionally, the statute significantly reformed the objective prong of the test by requiring the transaction in question change the taxpayer's economic position in a "meaningful way"<sup>49</sup> Finally, the statute slightly reformed the test's subjective prong by broadly defining "transaction" so as to include a series of transactions.<sup>50</sup> Notwithstanding these modifications, Section 7701(o) has largely failed to clarify the economic substance doctrine's relevance in tax law.

#### A. UNIFICATION IN FORM: THE CONJUNCTIVE TEST

The statute unambiguously mandates that in transactions to which the doctrine is relevant courts must analyze the economic substance of the transaction through a two-

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<sup>44</sup> See § 7701(o)(1).

<sup>45</sup> Rosenberg, *supra* note 42, at 66. This is due to the fact that the transactions in recent cases have all occurred prior to the statute's effective date. *Id.*

<sup>46</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 369, 379 (JCS-2-11, March 2011).

<sup>47</sup> *Id.* at 378 ("The provision clarifies and enhances the application of the economic substance doctrine . . . [t]he provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.").

<sup>48</sup> See § 7701(o)(1).

<sup>49</sup> See *id.* § 7701(o)(1)(A).

<sup>50</sup> See *id.* § 7701(o)(5)(D).

part conjunctive test.<sup>51</sup> To establish the economic substance of a transaction, the taxpayer bears the burden of showing the challenged transaction “change[d] in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such a transaction, in order for a transaction to be treated as having economic substance.”<sup>52</sup>

As explained by the Joint Committee on Taxation, “[t]his clarification eliminates the disparity that exists among the Federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.”<sup>53</sup> Critics of the statutory enactment contend that this clarification will not realistically eradicate much disparity because “a circuit’s particular framing of the economic substance test (conjunctive, disjunctive, flexible, or other) [typically] made no difference to the result of an economic substance case.”<sup>54</sup>

Nonetheless, by requiring the test be applied in its conjunctive form, the legislature eliminated the discretion courts previously had to adopt a disjunctive or holistic assessment, thereby cultivating convergence in the doctrine’s structure. In this regard, Congress achieved its objective of unifying judicial application of the doctrine. Not only does this alteration create uniformity in application, but by requiring that both prongs be satisfied, Congress heightened the burden of persuasion for corporate taxpayers in circuits previously allowing just one prong to satisfy the test. As one scholar explained, “Section 7701(o) gives the government a better chance of disallowing a tax benefit, because now it only needs to win one of the two prongs (and taxpayers, conversely, must meet both in every circuit.”<sup>55</sup>

#### B. STATUTORY ALTERATIONS TO THE OBJECTIVE PRONG

Section 7701(o) further altered the common law doctrine’s objective prong by requiring that the transaction change the taxpayer’s economic position in a “meaningful way (apart from Federal income tax effects).”<sup>56</sup> Nonetheless, the Code fails to define what constitutes a meaningful change in economic position and the Treasury has yet to issue any guidance on this point. Moreover, Congress was adamant that where the statute is silent, or where terms remain undefined, courts are to continue applying common law doctrine as if the statute had never been enacted:

No inference is intended as to the proper application of the economic substance doctrine under present law. The provision is not intended

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<sup>51</sup> See *id.* § 7701(o)(1). This is supported by both the statutory language, as well as the legislative history of the provision. “there must be an inquiry regarding the objective effects of the transaction on the taxpayer’s economic position as well as an inquiry regarding the taxpayer’s subjective motives for engaging in the transaction.” JCS-2-11 at 380.

<sup>52</sup> JCS-2-11 at 378.

<sup>53</sup> *Id.* at 380.

<sup>54</sup> Rosenberg, *supra* note 42, at 61.

<sup>55</sup> *Id.* at 72.

<sup>56</sup> See § 7701(o)(1)(A).



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to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.<sup>57</sup>

In this sense, the requirement that the change in economic position be “meaningful” is hardly useful in bringing congruity to the doctrine’s application. Courts retain great deference in deciding what constitutes “meaningful” and could theoretically set the threshold so low as to effectively dispense with the requirement all together.

### C. STATUTORY ALTERATIONS TO THE SUBJECTIVE PRONG

Similarly, Section 7701(o) imposes an additional requirement on the taxpayer by requiring the taxpayer’s motive behind engaging in a particular transaction be “substantial.”<sup>58</sup> The Joint Taxation Committee clarified that an accounting motive does not qualify as a significant non-federal-income tax benefit for purposes of this section.<sup>59</sup>

Moreover, the statute broadly defines the term “transaction” as including a series of transactions.<sup>60</sup> The Joint Committee on Taxation reiterated its position that “[t]he provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine.”<sup>61</sup> Thus, the statutory interpretation is left to the discretion of the courts, leaving ample room for divergence in interpretation among the circuits.<sup>62</sup> Further, according to the House Report, “[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 meaningful economic alternatives is largely or entirely based on comparative tax advantages.”<sup>63</sup> Exempting certain business transactions provides some direction for courts and an opportunity to create uniformity across jurisdictions.

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<sup>57</sup> JCS-2-11 at 381.

<sup>58</sup> See § 7701(o)(1)(B).

<sup>59</sup> JCS-2-11 at 381.

<sup>60</sup> See § 7701(o)(5)(D).

<sup>61</sup> JCS-2-11 at 379.

<sup>62</sup> *But see* Rosenberg, *supra* note 43 (arguing the requirement enhances uniformity in the application of the doctrine by forcing courts to consider more than just profit when analyzing a change in economic position).

<sup>63</sup> H.R. REP. NO. 111-443, at 296 (2010).

“Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied. Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.” *Id.* at 228.

#### D. EVALUATING “CLARIFICATION” OF THE COMMON LAW DOCTRINE

By requiring that both the objective and subjective prongs of the test be satisfied to establish economic substance in a transaction, Section 7701(o) heightens the burden of proof for the taxpayer and removes judicial discretion in deciding which form of the test to apply.<sup>64</sup> In addition to making it more challenging for a taxpayer to overcome this challenge, the Legislature also heightened the stakes for taxpayers who run astray of the economic substance doctrine. To further deter corporate Tax Code abuse, the Health Care and Education Reconciliation Act implemented Section 6662(b)(6), which imposes a penalty in the amount of twenty percent of “any portion of an underpayment on a return” attributable to a transaction which is determined to lack economic substance.<sup>65</sup> If a taxpayer fails to adequately disclose such a transaction, the penalty imposed doubles to forty percent of the transaction’s value.<sup>66</sup> This penalty provision substantially increases the risks associated with violating the economic substance doctrine.

Despite the alterations the statutory enactment brought to the common law economic substance doctrine, Section 7701(o) largely failed to clarify the doctrine’s applicability. First, the Legislature intentionally refrained from clarifying the doctrine’s “relevance” or otherwise indicate which transactions trigger the economic substance doctrine. This is unambiguously evidenced by the Joint Committee on Taxation’s report which explicitly notes, “[t]he determination of whether the economic substance doctrine is relevant to a transaction is made in the manner as traditionally has been (as if Section 7701(o) had never been enacted).”<sup>67</sup> Similarly, the IRS has declined to provide guidance on when the doctrine is relevant. In a public notice, the Service stated “the IRS will continue to rely on relevant case law under the common law economic substance doctrine in applying the two-prong conjunctive test in [S]ection 7701(o)(1).”<sup>68</sup> Congress left open the possibility that the doctrine could apply to individuals and corporate entities alike. However, for individuals, the scope of applicability is confined to transactions in connection with a trade, business, or an activity engaged with the purpose of producing income.<sup>69</sup> Without any direction courts will continue applying the economic substance doctrine in accordance with jurisdiction specific case law. As a result, the legislature fails to resolve any of the pre-legislative

<sup>64</sup> See Rosenberg, *supra* note 43, at 208–09.

<sup>65</sup> I.R.C. § 6662(i)(1) (2018).

<sup>66</sup> *Id.* § 6662(i)(1).

<sup>67</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 369, 378 (JCS-2-11, March 2011); see also *Codification of the Economic Substance and Effected Penalties*, MERTENS LAW OF FEDERAL INCOME TAXATION, CIVIL PENALTIES AND ADDITIONAL TAX (noting that to determine whether a taxpayer’s economic position is sufficiently altered so as to satisfy the first prong, “the Service will apply cases under the common law economic substance doctrine pertaining to whether the tax benefits of a transaction are not allowable because the transaction does not satisfy the economic substance prong of the economic substance doctrine”).

<sup>68</sup> I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010). Rosenberg contends that taxpayers could plausibly argue that this notice should be interpreted as the IRS treating the doctrine unchanged by the recent statutory enactment. See Rosenberg, *supra* note 43, at 216.

<sup>69</sup> JCS-2-11 at 381.

ambiguity regarding the doctrine's relevance and instead, provided vast opportunity for variance between circuits.

Further, the statute fails to clarify when and how the doctrine is to be applied by the courts. Section 7701(o) abstains from defining what constitutes a "transaction" or a meaningful economic change in position.<sup>70</sup> Moreover, courts remain free to aggregate or disaggregate transactions in accordance with their own common law precedent. Thus, circuit courts will continue applying the doctrine differently. Rather than creating certainty in the doctrine's application, however, the codification created a divide between Federal Circuit Courts of Appeal in how the doctrine is interpreted and applied.<sup>71</sup>

In sum, the most important alteration to the economic substance doctrine's application implemented by Section 7701(o) is the elimination of the disjunctive test and the requirement that taxpayers satisfy both prongs of the test. Moreover, the statute requires the change in economic position be "meaningful" and provides a broad definition of what constitutes a "transaction." In these regards, Congress successfully clarified the doctrine's proper application. Nonetheless, the statute falls short of attaining this objective in many regards. By instructing courts to apply the test predominantly in the same manner as before the statute was enacted, courts retain significant discretion to determine when, and how, the test is applied. Because the statute was intended to codify existing common law, the standards applied to the objective and subjective prongs remain in the jurisdictional province of case law. Consequently, the enactment of Section 7701(o) is unlikely to result in the desired clarification in the doctrine's applicability and unification across circuits.

### III. OVERLAP AMONG COMMON LAW DOCTRINES

A long-established principle in Tax Code interpretation is "the importance of regarding matters of substance and disregarding forms . . . ."<sup>72</sup> The substance over form principle is so integral to tax law as to be regarded as "the cornerstone of sound taxation."<sup>73</sup> Under the substance over form doctrines, "courts are permitted to ignore or disregard the text of the Internal Revenue Code on the basis of economic principles or taxpayer motivation or both."<sup>74</sup> This doctrine is not only enshrined in the text of the Code, but it also serves as an canon of construction overarching the tax system in its entirety. The economic substance doctrine and the step-transaction doctrine are two well-known variations of the substance over form principle.

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<sup>70</sup> *Id.* at 379 (noting "[t]he provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine").

<sup>71</sup> See Giordano, *supra* note 23.

<sup>72</sup> *Contrast* U.S. v. Phellis, 257 U.S. 156, 168 (1921) (recognizing "the importance of regarding matters of substance and disregarding form" when interpreting the Tax Code) with *Gamble v. United States*, 139 S.Ct. 1960 (2019) (demonstrating the Court's hesitation to liberally interpret Congress's words—thereby enabling substance to triumph over form—in other practice areas such as criminal law).

<sup>73</sup> *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961).

<sup>74</sup> Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 701 (2003).

### A. VARIATIONS OF SUBSTANCE OVER FORM

The economic substance doctrine is but one example of courts elevating the substance of the Tax Code over its form when evaluating transactions.<sup>75</sup> Separate from, but related to, the economic substance doctrine is the step transaction doctrine, which enables the IRS and the court to “collapse, combine, or ignore certain steps in a series of business transactions” if the result “of a series of transactions would have been the same even without some transitory intermediate steps, or if certain intermediate steps are “interdependent” with other steps.”<sup>76</sup> When applying the test, court asks “whether certain of the steps have independent, non-tax significance (i.e. legal or economic consequences which do not depend on the tax consequences).”<sup>77</sup> In the absence of independent significance, the court is enabled to tax the transaction as a whole, rather than each individual step separately when the steps are all taken in furtherance of achieving the same result.<sup>78</sup>

Like the economic substance doctrine, the step transaction doctrine enables courts to prevent abuse of the Tax Code by refusing to recognize transactions based on their substance, despite their formal compliance with the law. The step transaction and the economic substance doctrines are equitable variations of the deeply embedded substance over form principle. Each doctrine is designed with the aim of giving priority to congressional intent behind a given Code provision and disregarding technical compliance when the two conflict. While they all address the same issue, each doctrine differs in structure.<sup>79</sup> While the step transaction doctrine is broader and is conceivably applicable to any type of transaction. The economic substance doctrine on the other hand is more specific; its focus is on transactions that seemingly lack economic substance.

### B. BENEFITS AND DRAWBACKS TO EXALTING SUBSTANCE OVER FORM

Substance over form doctrines are often criticized on two primary grounds. First, they are denounced for the ambiguity between the various doctrines and the uncertainty this creates. Despite the slight distinctions between the various substance over form doctrines, “[t]hese common-law doctrines are not entirely distinguishable,

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<sup>75</sup> See Philip Sancilio, *Clarifying (Or is it Codifying?) The “Notably Abstruse”: Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 141 (2013) (“The general principle that taxation should give effect to transactions’ substance, rather than their form, underlies much of tax law and impels many more specialized doctrines, including the economic substance and step transaction doctrines.”).

<sup>76</sup> Michael G. Pfeifer & Sae Jin Yoon, *IRS Weapons Against Aggressive Tax Planning*, 25 TRUSTS & TRUSTEES 69, 72 (2019).

<sup>77</sup> *Id.*

<sup>78</sup> See *MAS One Ltd. P’ship v. U.S.*, 271 F. Supp. 2d 1061, 1064 (S.D. Ohio 2003) (explaining “[c]ourts apply the step transaction doctrine in cases where taxing the individual steps of the transaction rather than the transaction as a whole would eviscerate the substance of the transaction resulting in improper tax treatment of the whole transaction”).

<sup>79</sup> Under the step transaction doctrine for instance, “finding a step closely related to and integrated into a larger series may be reason to disregard it. When framing transactions for economic substance analysis, however, disallowance depends on characterizing a step as ‘outside . . . routine business activities’ or ‘engineered . . . solely for tax purposes.’” Sancilio, *supra* note 75, at n. 119 (quoting *Shell Petroleum Inc. v. United States*, Civil Action No. H-05-2016, 2008 WL 2714252, at \*36, \*38 (S.D. Tex. July 3, 2008)).

and their application to a given set of facts is often blurred by the courts, the IRS, and litigants.”<sup>80</sup> Moreover, “[t]he precise relationship between the economic substance doctrine and conventional statutory interpretation is ambiguous.”<sup>81</sup> The doctrines are frequently applied in conjunction with one another.<sup>82</sup> As one scholar notes, “in order to reach the same result, the two [tests] need to look at different facts and ask different questions.”<sup>83</sup> Therefore, it may be critical to the taxpayer’s outcome whether the step transaction, or the economic substance doctrine, is applied to a transaction.

Due to the equitable nature of these common law doctrines, courts are not bound to agree on their applicability. It may be quite possible that application of either doctrine could lead to the same conclusion, making the determination of which doctrine applies irrelevant to the outcome of the case. Nonetheless, certainty is a core policy objective of the Tax Code. It is imperative to a self-reporting tax system that taxpayers know *ex ante* what the potential consequences of a judicial analysis are before structuring a transaction.<sup>84</sup> Due to a conceptual overlap, and ambiguity in the economic substance doctrine’s relevance, the relationship between the doctrines is nothing short of confusing for taxpayers, the Service, and courts alike.<sup>85</sup> The uncertainty in outcome is further exasperated by the fact that courts may apply the two tests to different types of transactions.

All three principles, substance over form, step transaction, and the economic substance doctrine achieve the unitary goal of disallowing tax benefits in transactions that undermine the legislative intent of the Code.<sup>86</sup> If applied narrowly, there may be a time and place for application of each individual doctrine. Moreover, some scholars recognize the interplay between the doctrines and the possibility that there could be situations that call for their conjunctive application. Nevertheless, the overlap between the doctrines and the inconsistency with which courts apply them leads to inevitable confusion and unnecessary complication in the tax system. In turn, this unpredictability undermines the integrity of the Tax Code and the taxpayers’ confidence in the broader taxation system as well. Due to the overlap in these common

<sup>80</sup> See Sancilio, *supra* note 75, at 162 (“The doctrines clearly overlap, although the extent of the overlap varies between courts’ formulations.”).

<sup>81</sup> Bankman, *supra* note 27, at 11–12.

<sup>82</sup> *Id.* at 11 (“Precisely because the doctrine can be applied without formal discussion of text, intent, or purpose, its application is usually accompanied by, or entwined with, interpretation of the statute using those conventional tools.”).

<sup>83</sup> Sancilio, *supra* note 75, at n. 119.

<sup>84</sup> Even the Congressional Joint Committee on Taxation recognizes the danger of leaving too much interpretation in the hands of the judiciary (conceding that “[a]lthough these doctrines serve an important role in the administration of the tax system, they can be seen as at odds with an objective, ‘rule-based’ system of taxation.”). JCS-2-11 at 369.

<sup>85</sup> Sancilio, *supra* note 75, at 160 (“[T]he exact relationship between the [step transaction doctrine and the economic substance doctrine] is unclear. Disagreement centers on the relevance to the step transaction inquiry of whether each step in a series, and the series as a whole, has economic substance or a business purpose.”).

<sup>86</sup> *Coltec Indus. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006) (noting “although the taxpayer has an unquestionable right to decrease or avoid his taxes by means which the law permits, the law does not allow a taxpayer to reap tax benefits from a transaction that lacks economic reality”). Nonetheless, the Federal Circuit upheld the doctrine as constitutional because the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking economic substance. *Id.* at 1354.

law doctrines and the chaos that has resulted, it is not readily apparent why having each of these separate doctrines is necessary.<sup>87</sup>

The second line of attack against the substance over form principle is for its broad statutory construction, which is perceived of as a violation of the separation of powers for allowing the judiciary to liberally construe the meaning of the Legislature's mandates.<sup>88</sup> Opinions this extreme, however, often fall on deaf ears. Functionalism is widely accepted as a necessity to Tax Code interpretation, possibly more so than in other jurisprudence.<sup>89</sup> One possible explanation for this is the endless number of variations and nuances in transactions, which make Congress inept at addressing each unique scenario. Alternatively, courts may use this flexible approach as a mechanism of preventing abuse of tax shelters. Whatever the rationale, courts have traditionally approached Tax Code interpretation from under a substance over form principal. This guiding principle enables courts to look past the form of the transaction giving right to taxable income and question whether in substance, the tax benefit obtained complies with the statutory intent. In other words, the transaction must not only comply with the substance, but also the spirit, of the Code.

Regardless of its function, substance over form doctrines serve an important role in Tax Code interpretation. Where vagueness can be perceived as a vice, it can also be viewed as a virtue. As one scholar noted, "in some areas, [substance over form doctrines] are influential primarily because they are vague; when the meaning of a provision is veiled by fog, taxpayers may tread more warily than when the landmarks are clearly visible."<sup>90</sup> This ambiguity in interpretation serves as a general deterrent to suspect transactions and encourage taxpayers to err on the side of caution. Whether the uncertainty this creates is an adequate price to pay for this general deterrent is subject to debate.

#### IV. BALANCING COMPETING OBJECTIVES

When Judge Hand first articulated the economic substance doctrine in its preliminary form, it served as a means of preventing tax avoidance and abuse of favorable Tax Code provisions. Nearly a century later, the principle's aim remains fundamentally unchanged. The economic substance doctrine's overarching objective is two-fold. On the one hand, courts employ the doctrine to "set boundaries between

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<sup>87</sup> See Madison, *supra* note 74, at 722 ("These attempts [to use substance over form principles to prevent Tax Code abuse] have resulted in chaos. The various courts of appeals have not agreed on which substance-over-form doctrines apply, how the doctrines apply, or when the doctrines apply.").

<sup>88</sup> *Id.* at 703 ("The basis for textualist interpretation rests on a theory of separation of powers inherent in American democracy.").

<sup>89</sup> See, e.g., *Diedrich v. Comm'r*, 457 U.S. 191 (1982) (affirming that "[t]he substance, not the form, of the agreed transaction controls in determining whether taxable income was realized").

<sup>90</sup> See BITTKER & LOKKEN, *Pervasive Judicial Doctrines*, in *FEDERAL TAXATION OF INCOME, ESTATES, & GIFTS* ¶ 4.3 (1989). Demonstrating his support for this view, Justice Brandeis drew the following analogy: "If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone, you may slip, and go over; but anybody can tell you where you can walk perfectly safely within convenient distance of that precipice." *Id.* at ¶ 4.3.1.

acceptable tax planning and abuse.”<sup>91</sup> Delineating the line between tax planning and tax abuse can be thought of in terms of as judicial Code interpretation as a means of giving effect to legislative intent. On the other hand, the economic substance doctrine is a means of “maintaining public confidence in the integrity of the tax system.”<sup>92</sup> These objectives are arguably at odds.<sup>93</sup> By giving effect to legislative intent, courts invariably elevate substance above form. Yet in doing so, taxpayers are left without certainty when it comes to tax planning. Whether the economic substance doctrine successfully strikes a balance between these two competing objectives is the subject of much scholarly debate.

#### A. EFFECTUATING CONGRESSIONAL INTENT

The I.R.C. and Treasury Regulations, like any other statute or administrative regulation, are incomplete without judicial interpretation. Clarifying hazy Code provisions and preventing unintended tax consequences can be thought of more broadly as the judiciary giving effect to congressional intent. Judicial Tax Code interpretation is particularly integral to tax law for two reasons.

First, due to its rule-based nature, the Code “cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised . . . .”<sup>94</sup> Consequently, anti-abuse doctrines like the economic substance doctrine, substance over form, and the step transaction doctrine enable the judiciary to give effect to legislative intent. Legislative intent has been dubbed the “touchstone of the economic substance doctrine” because of its role in determining “whether the treatment goes beyond the tax benefits that Congress intended to grant.”<sup>95</sup> Courts can use the economic substance doctrine as a mechanism to defend and preserve the Tax Code as written by Congress.

Critics of the economic substance doctrine attack the doctrine on the grounds that it unduly expands the power of the judiciary, affording them the power to legislate. As articulated by the Court of Federal Claims, using the doctrine “to trump mere compliance with the Code would violate the separation of powers . . . .”<sup>96</sup> Moreover, the First Circuit has argued this about legislative intent:

The Legislature has the power to decide what the policy of the law shall be, and if it is intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces to be set out in terms, but it is not an adequate discharge of duty for

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<sup>91</sup> *ACM P’ship v. Comm’r*, 73 T.C.M. 1997-115 1997 WL 93314, at \*36, *aff’d in part, rev’d in part*, *ACM P’ship v. C.I.R.* 157 F.3d 231 (3d Cir. 1998).

<sup>92</sup> *Id.*

<sup>93</sup> See generally Madison, *supra* note 74.

<sup>94</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 369, 378 (JCS-2-11, March 2011).

<sup>95</sup> *Id.*

<sup>96</sup> *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123–24, 128); *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007) (quotations omitted).

courts to say: We see what you are driving at, but you have no said it, and therefore we shall go on as before.<sup>97</sup>

Similarly, the economic substance doctrine also serves as a guard against Tax Code manipulation and abuse. As a result of its rule-based nature, the Code inevitably leaves ample room for taxpayer discretion. Despite the immense level of detail in the Code, its effectiveness depends in part on a degree of broadness. However, with discretion comes corresponding room for abuse. Tax abuse transactions rely “upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by Congress.”<sup>98</sup> The principal virtue of anti-abuse doctrines, like the economic substance doctrine, lies in the courts ability to prevent taxpayers from using the Code to generate favorable tax benefits in situations unintended by Congress.

Take tax shelters, for example. “Tax shelter” is an umbrella term used to describe transactions designed to reduce tax liability such that the tax benefits received exceed “any actual profit or loss sustained from participation in the transaction.”<sup>99</sup> A successful tax shelter allows the taxpayer to receive tax benefits from a particular transaction that offset the amount of taxable income derived from the transaction. Tax shelter transactions are often characterized by “the completion of certain formalistic steps to claim the desired tax result”<sup>100</sup> yet are identifiable by their “unusually high transaction costs that are borne, in whole or substantial part, by the corporate beneficiary.”<sup>101</sup> Transactions involving tax shelters are typically in technical compliance with a strict application of the Tax Code but combine provisions in such a way that is not intended or anticipated by the legislature.<sup>102</sup> Tax shelters are undesirable both from practical and policy viewpoints. As a practical matter, the primary objective of federal income taxation is raising revenue. Tax shelters directly undercut this aim by resulting in dramatic losses of revenue.<sup>103</sup> Corporate tax shelters are disfavored on the grounds that they “threaten[] the effectiveness of the current system because of the potential drain on revenue and the threat to the integrity of the self-assessment tax system.”<sup>104</sup> Moreover, as a matter of public policy, when corporations take more than their fair share of tax deductions, the tax burden inevitably shifts onto the shoulders of individual taxpayers who inevitably must compensate for

<sup>97</sup> *Johnson v. US*, 163 F. 30, 32 (1st Cir. 1908).

<sup>98</sup> JCS-2-11 at 378.

<sup>99</sup> Gerald W. Miller, Jr., *Corporate Tax Shelters and Economic Substance: An Analysis of the Problem and Its Common Law Solution*, 34 TX TECH. L. REV. 1015, 1019.

<sup>100</sup> DEP’T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS, 17 (1999).

<sup>101</sup> *Id.* at 23.

<sup>102</sup> Miller, *supra* note 99, at 1025.

<sup>103</sup> As one scholar explained, “[a] rule that allows taxpayers to take advantage of loopholes that naturally present themselves in the course of business operations will be expensive to the federal coffers, but that cost will be limited to the number of ‘naturally present’ loopholes.” Bankman, *supra* note 27, at 11. In contrast, “[a] rule that allows taxpayers not only to take advantage of loopholes but to manufacture circumstances in which they arise would be ruinous to the fisc.” *Id.*

<sup>104</sup> Anthony B. Casarona, *Regulating Corporate Tax Shelters: Seeking Certainty in a Complex World*, 50 CATH. U. L. REV. 111, 112 (2000).



the lost Treasury revenue.<sup>105</sup> In this way, tax shelters directly undercut principles of equity underlying sound tax policy.

The economic substance doctrine has been regarded as the IRS's "most effective tool" in combatting tax shelters.<sup>106</sup> However, scholars in this field generally will be the first to concede that the line delineating tax avoidance and legitimate tax planning is often blurry.<sup>107</sup> Tax planning is both permissible and advisable in the practice of tax law.<sup>108</sup> The objective of tax planning is to structure one's finances in such a way as to minimize tax liability without "crossing the line into impermissible tax avoidance or tax evasion."<sup>109</sup> As a result of the inherent ambiguity in such transactions, anti-abuse doctrines run the risk of over-inclusion. If the legislation is too broad, and courts are eager to disallow transactions with indicia of suspect tax mitigation, there is a risk of deterring efficient, legitimate behavior.

#### B. MAINTAINING CONFIDENCE IN THE CODE

If the economic substance doctrine's primary objective is to give effect to congressional intent by disallowing unintended tax benefits, the doctrine's secondary aim is to maintain taxpayer confidence in the system as a whole.<sup>110</sup> Transactions that take advantage of an ambiguous, or broadly-worded Code provision undermine the Code's authority by creating an environment in which such behavior is normalized. The economic substance doctrine intervenes as an equitable doctrine allowing the law to reach the "right" result. This rationale holds for transactions engineered to unlawfully evade taxation. However, the argument in favor of the economic substance doctrine and other anti-abuse doctrines does not hold when applied to transactions taken in good faith attempt to take advantage of the taxpayer-friendly Code provisions.

The Tax Code is filled with favorable provisions intended by Congress to provide tax relief.<sup>111</sup> Moreover, there is nothing criminal about arranging one's affairs so as to minimize tax liability.<sup>112</sup> The Third Circuit even endorsed such tax saving behavior, assuring that the court does not "suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage."<sup>113</sup> Additionally, "a transaction, otherwise within an

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<sup>105</sup> See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 369, 378 (JCS-2-11, March 2011) (noting that the consequence of successful tax shelters is to "enlarge the tax gap by gaining unintended tax relief and by undermining the overall integrity of the tax system").

<sup>106</sup> Miller, *supra* note 99, at 1017–18.

<sup>107</sup> See Lauren O'Malley, *Delineating Permissible Tax Planning and Abusive Tax Avoidance: Tax Shelters, Pre-Tax Profit, and the Foreign Tax Credit*, 36 B.U. INT'L L. J. 143 (2018).

<sup>108</sup> See BITTKER & LOKKEN, *supra* note 90, ¶ 4.3.2 ("Tax planning is as American as apple pie.").

<sup>109</sup> See O'Malley, *supra* note 107, at 145.

<sup>110</sup> See BITTKER & LOKKEN, *supra* note 90, ¶ 4.3.2.

<sup>111</sup> *Id.*

<sup>112</sup> Not only is this line ambiguous, but it is also "hard to fault a taxpayer who engages in a transaction with significant nontax results (for example, operating a business as a proprietorship rather than in corporate form, or selling property rather than continuing to hold it)" because "even though this decision is motivated more by the tax savings to be achieved than by the transaction's other consequences." *Id.*

<sup>113</sup> *ACM P'ship v. Comm'r*, 73 T.C.M. 1997-115 1997 WL 93314, at \*36, *aff'd in part, rev'd in part*, *ACM P'ship v. C.I.R.* 157 F.3d 231 (3d Cir. 1998) (differentiating the case at hand as one where "the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the

exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation.”<sup>114</sup> Rather, under this longstanding principle,

[o]ne may so arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes . . . there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.<sup>115</sup>

Anti-abuse doctrines like the economic substance doctrine can have the unintended consequence of creating uncertainty for taxpayers who seek to take advantage of a favorable Code provision, who believe in good in faith that Congress intended the provision to apply to their particular situation.<sup>116</sup> In effect, this uncertainty and confusion subverts the integrity of the Tax Code.

Consistency and certainty are imperative to the integrity of the Tax Code, as well as to sound tax policy.<sup>117</sup> Taxpayers rely on the letter of the Code when planning their financial affairs. Likewise, taxpayers should not be penalized, or dissuaded from, minimizing their tax liability through legitimate transactions in accordance with favorable Code provisions. The law governing tax shelters has been described as a “patchwork of ambiguous statutory authority, which is sometimes arbitrarily applied to the detriment of legitimate business transactions.”<sup>118</sup> It is often difficult to discern the difference between legitimate tax planning and abusive tax evasion. Therefore, it is a delicate balance between using the economic substance doctrine to defend against corporate tax shelters and incentivizing legitimate business transactions.

#### V. A CALL FOR SIMPLIFICATION IN TAX CODE INTERPRETATION

The U.S. tax system is undoubtedly complex.<sup>119</sup> Taxpayers who wish to anticipate the tax implications of a transaction and plan their affairs accordingly must first interpret the I.R.C., Treasury Regulations, revenue rulings, and announcements. This alone is a daunting task. To add to the mix, interpreting these provisions in light of relevant case law makes navigating the Tax Code all the more challenging.<sup>120</sup> With such copious amounts of rules, “it would seem that Congress, the Department of Treasury, and the IRS have communicated to taxpayers exactly what they need to

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taxpayer created actually through the manipulation and abuse of the tax laws.”). The court concluded, “[a] taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance.” *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> See BITTKER & LOKKEN, *supra* note 90, ¶ 4.3.2.

<sup>116</sup> See generally Madison, *supra* note 74.

<sup>117</sup> Casarona, *supra* note 104, at 137.

<sup>118</sup> *Id.* at 130.

<sup>119</sup> Madison, *supra* note 74, at 716 (“Tax law is complex.”).

<sup>120</sup> *Id.*

know to plan their affairs and determine the precise amount of tax to pay the government each year.”<sup>131</sup> Unfortunately for taxpayers, that is not always a reality.

Despite legislative efforts to enhance Code specificity, determining the tax implications of a given transaction is often ambiguous. The “vague, complex judicial doctrines,” such as substance over form and the economic substance doctrine, can often make the outcome of a given transaction unpredictable.<sup>132</sup> As a result of the inevitable ambiguity in the Code, taxpayers may be left with more than one legitimate way to structure a given transaction. When presented with a choice, the rational taxpayer will effect the transaction which results in lower taxable income. There is nothing inherently wrong with structuring transactions so as to minimize the tax burden. In fact, designing a transaction with the intent of achieving the most beneficial tax implications is a seemingly prudent business decision. Moreover, not only does the Tax Code provide room for creativity in structuring tax minimizing transactions, but the Code also provides in numerous instances an intent to afford a tax break to specific groups of people or to incentivize certain behavior. The taxpayer should not have to inquire into the legislative history of each Code section when completing his annual tax return.

Certainty, clarity, and predictability are integral to sound tax policy. Certainty enables taxpayers to plan their finances and proactively structure transactions so as to achieve an intended result. In order to avoid crossing the line between permissible tax planning and tax evasion, taxpayers must be aware of where that line is. In addition, clarity can help cultivate uniformity in the law’s application which in turn can enhance equity. The principle of horizontal equity, a fundamental value in tax policy, requires similarly situated taxpayers to be afforded equal treatment under the law. Without horizontal equity, taxpayers can feel they have been treated unfairly by the tax law and will have less faith in the tax system as a result.

Tax Code interpretation is in dire need of simplification. The U.S. tax system is riddled with complex, overlapping statutes, regulations, and common law doctrines. This ambiguity underlines clarity in the Code and uniformity in Code interpretation. Judicially crafted common law doctrines, like the economic substance doctrine, is a substantial contributor to this complexity. Because many of these doctrines all aim to effectuate legislative intent, the overlap between these doctrines further exacerbates the confusion.<sup>133</sup>

While it may provide the flexibility courts require to adequately assess the multitude of scenarios arising in the tax context, this principal further exacerbates taxpayer uncertainty. When is compliance with the strict letter of the Code sufficient,

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<sup>131</sup> *Id.*

<sup>132</sup> *Id.* (“These detailed statutory provisions, regulations, rulings, procedures, and announcements commingle with another dimension of vague, complex judicial doctrines, the most pervasive of which come from the substance-over-form family of doctrines.”).

<sup>133</sup> One scholar explained, “[i]t is precisely because of our commitment to this relatively objective system that we loathe to overturn the “technical” results which arise from the application of complex rules to complex business transactions.” David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 237 (1999). Moreover, taxpayers are entitled to “rely on the rules and the answers to which those rules give rise. She should not be denied beneficial tax results which she stumbles upon, or even seeks out, in the course of her legitimate business dealings, even if those results are obviously unanticipated, unintended or downright undesirable.” *Id.*

and when is it not? The pervasive application of the substance over form doctrine has been criticized for “remov[ing] hope for certainty in tax planning.”<sup>134</sup> So long as the “substance-over-form doctrines still are valid, the IRS and the courts have a choice as to whether or not they want to follow the text of the statute.”<sup>135</sup> As a result, taxpayers are left “to guess whether the IRS or a court will find that a transaction “smells bad” and thus will use one of the doctrines to override the text of the Code.”<sup>136</sup>

### CONCLUSION

In conclusion, the codification of the economic substance doctrine has been far from successful in attaining its stated objective of clarifying the common law doctrine. Rather than simplifying the Code’s interpretation and application, Section 7701(o) has introduced unnecessary complexity into the tax system. As the doctrine evolved, circuit courts diverged in their application of the doctrine. Prior to the statutory enactment some circuits were applying a disjunctive version of the test, while others were applying the doctrine in its conjunctive form. While the doctrine’s codification successfully eliminated this discrepancy, the legislation left much discretion in the hands of the judiciary. Rather than displacing the common law doctrine, Section 7701(o) supplements its application and allows courts to continue applying the economic substance doctrine in accordance with common law practice. Consequently, Congress failed to attain its stated objective of clarifying the doctrine’s application and eliminating disparities between Federal Circuit Courts of Appeal. This ambiguity in interpretation undermines the doctrines effectiveness and subverts the Tax Code’s integrity.

The confusion surrounding the economic substance doctrine’s proper role in tax law is further complicated by the barrage of common law doctrines, including the step transaction and the substance over form doctrines, each of which purports to serve a similar purpose as that of the economic substance doctrine: giving effect to legislative intent and preventing taxpayers from abusing the Code. However, the ambiguity and lack of clarity surrounding the relationship between these common law doctrines further exacerbates the confusion in Tax Code interpretation. As a result, taxpayers are left with seemingly little guidance when it comes to arranging transactions so as to attain benefits explicitly afforded to them by Congress via the Tax Code. Even when in technical compliance with the Code, taxpayers are still subject to the scrutiny of the courts on the grounds that the substance of a transaction conflicts with legislative intent. This inevitably subverts clarity in the Code and confidence in the overarching tax system. Uniformity, clarity, and integrity are integral values in a well-functioning tax system. Taxpayers have a right to predictability when arranging their finances and certainty that courts will not retroactively criminalize them for complying with the letter of the law. In the words of Judge Learned Hand, “[t]he language of the law must not be foreign to the ears of those who are to obey it.”<sup>137</sup>

<sup>134</sup> Madison, *supra* note 74, at 738.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> LEARNED HAND, 56 THE SPIRIT OF LIBERTY: PAPERS AND ADDRESSES (3d ed., 1960).