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Codification of the Economic Substance Doctrine: Agency Response and Certain Other Unforeseen Consequences

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CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE: AGENCY RESPONSE AND CERTAIN OTHER UNFORESEEN CONSEQUENCES

REBECCA ROSENBERG*

ABSTRACT

Section 7701(o) of the Internal Revenue Code incorporates the controversial judicial doctrine of economic substance into statutory language. In other words, it “codifies” the doctrine. (The economic substance doctrine generally provides that a tax benefit that goes beyond Congressional intent can be disallowed by the courts, even if the taxpayer meets all of the literal Code and regulatory requirements for claiming the benefit.)

This codification appears to have accidentally dissuaded the relevant agency (the Internal Revenue Service, or IRS) from raising economic substance issues—an effect that is contrary to Congress’s intent in enacting the doctrine into legislation. Essentially, Congress imported a set of judicial principles into the Code, in order to make a particular judicial doctrine stronger, but then the agency effectively discarded those now-codified judicial rules.

The IRS response to codification raises bigger picture issues, such as an agency’s ability to disregard (or decline to enforce) a statute and the parameters of an agency’s ability to issue public guidance using informal means (rather than formal regulations). In addition, this codification raises structural issues, including the interaction between the three branches of government in this context and the impact of Congressional approval on arguments about the validity of this judicial doctrine. Lastly, such codification places new emphasis on distinguishing between the now-codified economic substance doctrine and other anti-abuse doctrines.

The economic substance doctrine has been the subject of recent litigation in the “STARS” cases. One of such cases has just

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been appealed to the Eighth Circuit, and that appeal may later result in a split between the circuits. In addition, the recent 2017 Tax Act (the Tax Cuts and Jobs Act) may lead to more emphasis on the economic substance doctrine, as taxpayers attempt to comply with the letter of new tax provisions while arguably circumventing such provisions' intent. For these reasons, the economic substance doctrine is likely to become increasingly important in the near future. In addition, as the IRS attempts to implement and provide guidance on a massive new tax act, there are likely to be recurring issues regarding the limits of agency discretion to not enforce a statute, and the use of informal means to communicate guidance to the public.

TABLE OF CONTENTS

INTRODUCTION 202

I. BACKGROUND 205

A. Brief Description of Pre-Codification Economic Substance Doctrine 205

B. Brief Overview of Section 7701(o) 208

II. AGENCY INTERPRETATION OF THE STATUTE: INFORMAL TREASURY GUIDANCE UNDER SECTION 7701(O) 212

A. Overview 212

B. Two IRS Notices on Economic Substance After Codification 212

 1. *Two IRS Directives Discourage Agents from Raising Economic Substance Issues* 226

III. AGENCY RESPONSE TO AND CERTAIN BIGGER PICTURE ISSUES RAISED BY SECTION 7701(O) 235

A. Issues Regarding the Agency 235

 1. *Interaction Between the Three Branches of Federal Government* 235

 2. *Agency Authority to Issue Guidance* 236

a. Grant of Regulatory Authority 236

b. Informal Guidance Issued by the IRS 239

 3. *IRS Deterred from Raising Economic Substance Issues* 248

B. Selected Additional Impacts of Codification 254

 1. *Impact on the Application of Other Anti-abuse Doctrines* 254

a. May Push the IRS and Courts to Try Other Anti-abuse Rules Instead 254

b. Puts More Pressure on Distinguishing Between Economic Substance and Other Judicial Doctrines ... 255

 2. *Impact on Validity of the Economic Substance Doctrine* 259

SUMMARY AND CONCLUSION 265

INTRODUCTION

Section 7701(o) of the Internal Revenue Code of 1986¹ (the Code) imported the judicial doctrine of economic substance into statutory language, with some changes.² Under this long-standing doctrine, the courts can disallow a tax benefit that is contrary to Congressional intent, even if all of the statutory and regulatory requirements for claiming the benefit are met.³

Section 7701(o) is thus a set of legislative rules about the content of a substantive judicial doctrine, and it gives the agency (for the first time) the ability to issue guidance governing the application of this doctrine.⁴ This Article addresses section 7701(o)'s unintended impact on the IRS, and certain other consequences of the codification (placement into the Internal Revenue Code) of the economic substance doctrine.

First, the Article discusses the IRS's response to section 7701(o): codification seems to have inadvertently deterred the IRS from raising economic substance issues, which in turn prevents such issues from reaching the courts.⁵ This deterrence is especially ironic because it follows government successes in using the doctrine in court,⁶ and because section 7701(o) gives the IRS, for the

¹ I.R.C. § 7701(o) (2012).

² *Id.* § 7701(o). See generally Rebecca Rosenberg, *Codification of the Economic Substance Doctrine: Substantive Impact and Unintended Consequences*, 15 HASTINGS BUS. L.J. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3158795 (discussing changes that section 7701(o) made to the economic substance doctrine).

³ See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 107, 125 (2d Cir. 2015), *cert. denied sub nom.* 136 S. Ct. 1375 (2016) (citing *Gregory* to show that the doctrine is aimed at discerning whether a claimed tax benefit is consistent with Congressional intent). See generally Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000) (discussing the history of the economic substance doctrine).

⁴ See § 7701(o).

⁵ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); see also Lee A. Sheppard, *IRS Repeal of the Economic Substance Statute*, TAX NOTES TODAY, Feb. 21, 2012, <https://www.taxnotes.com/tax-notes/tax-system-administration-issues/news-analysis-irs-repeal-economic-substance-statute/2012/02/20/qq00>.

⁶ See, e.g., *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 26 (1st Cir. 2016), *cert. denied*, 2017 U.S. LEXIS 4194 (June 26, 2017); *Bank of N.Y. Mellon Corp.*, 801 F.3d at 107; *Salem Fin., Inc. v. United States*, 786 F.3d

first time, the ability to affect the content of the economic substance doctrine by means of guidance.⁷ Yet codification has instead resulted in IRS reluctance to apply the doctrine.⁸ This is apparently because the IRS is averse to applying the penalties that were enacted with codification and that are now mandatory when lack of economic substance causes a tax deficiency.⁹

Among other things, this situation clearly raises issues about the parameters of an agency's discretion to decline to apply a statute. In this case, such non-application contradicts Congress's clear intent to make the economic substance doctrine more effective.¹⁰ This Article discusses those issues and also considers whether an agency's authority to disregard a statute differs (practically speaking) when the agency's action favors (rather than disadvantages) taxpayers. If no one is likely to object to agency action, are there any limits to agency authority?

In addition, the IRS has used informal communication to issue de facto guidance regarding the economic substance statute, in two different contexts. First, the IRS has expressed its aversion to applying the economic substance doctrine by issuing written instructions that impose heavy requirements for IRS employees to meet before they can raise the doctrine.¹¹ Those written instructions are available to the public.¹² Secondly, the IRS has

932, 951 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016); *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1140, 1142 (D. Minn. 2017), *appeal docketed*, No. 17-3578, No. 17-3676 (8th Cir. Nov. 24, 2017). These cases are collectively referred to as the STARS cases.

⁷ See §§ 7701(o), 7805(a) (2012).

⁸ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011). See generally Kathleen DeLaney Thomas, *The Case Against a Strict Liability Economic Substance Penalty*, 13 U. PA. J. BUS. L. 445, 466–67 (2011).

⁹ See §§ 6662(b)(6), (c), 6676 (2018); § 6664(d) (2015).

¹⁰ See H.R. REP. NO. 111-443(I), at 295 (2010).

¹¹ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011). This directive only applies to the Large Business and International (LB&I) division of the IRS.

¹² See generally *U.S. Dept. of Justice v. Tax Analysts*, 492 U.S. 136 (1989). These IRS instructions to IRS employees are easily available online. See, e.g., Heather C. Maloy, *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*, A.B.A. (July 15, 2011), <https://www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-dillon-irs-guidance-paper.authcheckdam.pdf> [<https://perma.cc/UXK8-PFRK>].

issued a notice stating that it will continue to follow pre-codification descriptions of the two prongs of the economic substance doctrine until further guidance is issued.¹³ That may not be a valid interpretation of the statute.¹⁴ These letters and the notice (and an additional notice on section 7701(o))¹⁵ are relied on by taxpayers, and are treated by practitioners as if they were binding agency guidance.¹⁶ But these communications are issued without formal notice and comment procedures and with very limited public input.¹⁷ These uses of informal communication to implement policy decisions about non-enforcement and about substantive interpretation raise issues about when informal guidance is appropriate.¹⁸

Codification also pushes the IRS and the courts to use other anti-abuse doctrines instead of economic substance (in order to avoid the penalties now associated with the economic substance doctrine).¹⁹ In turn, this puts new pressure on distinguishing between the various anti-abuse doctrines, which tend to overlap.²⁰ Previously, there was little need to carefully differentiate between them, but that has now changed.²¹

¹³ I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

¹⁴ See Rosenberg, *supra* note 2 (manuscript at 25).

¹⁵ I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹⁶ See, e.g., Amy S. Elliott, *Economic Substance Notice's Sham Treatment Reverses LB&I Course*, TAX NOTES TODAY, Oct. 20, 2014, <https://www.taxnotes.com/tax-notes-today/penalties/economic-substance-notices-sham-treatment-reverses-lbi-course/2014/10/20/fly5> (reporting that practitioners treated Notice 2014-58 as if it reversed actual guidance created by the second directive, and as if that directive had previously provided rules that taxpayers could rely on: "Practitioners are ... faulting the notice for its reversal of course on a prior IRS directive that exempted the sham transaction doctrine from being considered a 'similar rule of law.' ... [P]ractitioners ... had found relief in a 2011 Large Business and International Division directive ... that exempted the sham transaction doctrine from similar application") (emphasis added).

¹⁷ See Leslie Book, *A New Paradigm for IRS Guidance: Ensuring Input and Enhancing Participation*, 12 FLA. TAX REV. 517, 547–51 (2012) (discussing ways the IRS issues informal guidance).

¹⁸ See *id.* at 552.

¹⁹ See *infra* Section III.B.1.a; see also Erik M. Jensen, *Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives*, 57 ST. LOUIS L.J. 1, 31 (2012) (noting the IRS's and courts' power to use other anti-abuse doctrines).

²⁰ See *infra* Section III.B.1.b; see also Jensen, *supra* note 19, at 22–23.

²¹ See *infra* Section III.B.1.b; see also Jensen, *supra* note 19, at 24–25.

Lastly, there is an issue as to whether codification ends questions about the validity of the economic substance doctrine. Such invalidity assertions have been based either on arguments that the doctrine is an incorrect interpretation of historic case law²² or on separation of powers concerns.²³ This Article argues that codification puts to rest the former type of validity argument, but not the latter.

I. BACKGROUND

A. Brief Description of Pre-Codification Economic Substance Doctrine

The economic substance doctrine is a long-standing, court-created doctrine that essentially provides that tax benefits claimed under a provision of the Internal Revenue Code will not be respected if they violate the intent of that provision, even if the taxpayer meets all of the literal Code and regulatory requirements for claiming such benefit.²⁴ In other words, the doctrine allows the courts to override the literal words of the Code and regulations, in favor of Congressional intent.²⁵ If a transaction is found to lack economic substance, then all tax results of that transaction—the claimed tax benefit, income, deductions, etc.—are disregarded

²² See *infra* note 320 and accompanying text; see also, e.g., *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716, 752 (2004) (suggesting that the Supreme Court in *Gregory* did not intend to create the economic substance doctrine as currently implemented), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006).

²³ Rosenberg, *supra* note 2 (manuscript at 3 n.6).

²⁴ See, e.g., *ACM P'ship v. Comm'r*, 73 T.C.M. (CCH) 2189, 2215 (Mar. 5, 1997) (the doctrine addresses “tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings”), *aff'd*, 157 F.3d 231 (3d Cir. 1998), *and cert denied*, 526 U.S. 1017 (1999). This description of the economic substance doctrine was cited, apparently with approval, by the House Report that accompanied section 7701(o); see H.R. REP. NO. 111-443(I), at 292 (2010); see also, e.g., *Horn v. Comm'r*, 968 F.2d 1229, 1237 (D.C. Cir. 1992) (“[T]he sham transaction doctrine seeks to identify a certain type of transaction that Congress presumptively would not have intended to accord beneficial tax treatment.”).

²⁵ See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 113 (2d Cir. 2015); see also H.R. REP. NO. 111-443(I), at 292–93; Joseph Bankman, *supra* note 3, at 8 n.4. (discussing the application of the doctrine).

for federal tax purposes, as if the transaction had never occurred.²⁶ However, if part of the challenged transaction is found to be separable, and passes the economic substance test, such separable part (and its associated tax benefits) can be respected.²⁷

Judicial application of the economic substance doctrine, in hundreds of cases, generally involves examination of whether the challenged transaction was reasonably expected to generate a profit (or to otherwise have an economic effect), and also whether the taxpayer was subjectively motivated by more than just tax benefits.²⁸ In this two-step analysis, the inquiry regarding profit and economic effects is often called the objective prong.²⁹ The subjective inquiry is often referred to as the business purpose prong or subjective analysis.³⁰

Different circuits describe their application of the economic substance doctrine in various ways.³¹ Some circuits apply a conjunctive test, requiring that the taxpayer pass both the objective and subjective prongs before the transaction can be respected as

²⁶ See, e.g., *Bank of N.Y. Mellon Corp.*, 801 F.3d at 113; *Compaq Computer Corp. v. Comm’r*, 277 F.3d 778 (5th Cir. 2001); *Alessandra v. Comm’r*, 69 T.C.M. (CCH) 2768, 2771 (June 1, 1995). Arguments to the contrary were recently rejected by trial courts in the context of summary judgment motions in the *Santander* and *Wells Fargo* cases, respectively. See *Santander Holdings USA, Inc. v. United States*, 2018 WL 3448243 (D. Mass. July 17, 2018), *summary judgement denied after remand*, 844 F.3d 15 (1st Cir. 2016) (“A transaction’s lack of economic substance is broadly fatal to tax benefits that arise only because of the condemned contrivance.”); *Wells Fargo & Co. v. United States*, 2017 WL 4083148 (D. Minn. Sept. 15, 2017). See generally Amanda Athanasiou, *No Summary Judgment for Santander in STARS Case*, TAX NOTES INT’L (July 23, 2018).

²⁷ See, e.g., *Bank of N.Y. Mellon Corp.*, 801 F.3d at 124 (holding that a loan was separable from a related transaction that was an economic sham and finding that interest deductions therefore were allowable); *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1140, 1146–47 (D. Minn. 2017).

²⁸ See Bankman, *supra* note 3, at 12.

²⁹ See *id.*

³⁰ *Id.* at 27.

³¹ See H.R. REP. NO. 111-443(I), at 293 (2010) (describing the differing approaches taken by various circuits); Jensen, *supra* note 19, at 26 (noting that circuits diverge on whether to apply the prongs conjunctively or not). See generally Amanda L. Yoder, Note, *One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine*, 75 MO. L. REV. 1409, 1419–24 (2010) (describing in detail each circuit’s application of the doctrine).

having economic substance.³² Other circuits apply a disjunctive test, under which taxpayers only need to meet one prong—either the objective or the subjective analysis—in order to prevail on the challenged tax benefits.³³ Still other circuits use a more flexible analysis, which considers the transaction’s tax and non-tax aspects, including the taxpayer’s subjective purpose and whether the taxpayer had a reasonable expectation that the transaction would result in either profit or other economic effects.³⁴

Regardless of which type of description they use, almost all courts that apply the economic substance test have actually analyzed both the objective and subjective prongs described above.³⁵ This occurs even in disjunctive-test circuits, where the taxpayer technically only needs to win one prong to prevail, and in conjunctive-test circuits, where the taxpayer’s loss of only one prong should technically prevent the tax benefit from being respected.³⁶

Almost always, the courts have reached the same conclusion on both prongs (finding that the transaction either meets both the objective and subjective tests, or fails both such analyses).³⁷

³² See, e.g., *Bank of N.Y. Mellon Corp.*, 801 F.3d at 115; *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009); *Pasternak v. Comm’r*, 990 F.2d 893, 898 (6th Cir. 1993).

³³ See, e.g., *Horn v. Comm’r*, 968 F.2d 1229, 1234–35 (D.C. Cir. 1992); *Rice’s Toyota World v. Comm’r*, 752 F.2d 89, 91–92 (4th Cir. 1985).

³⁴ See, e.g., *ACM P’ship v. C.I.R.*, 157 F.3d 231, 247 (3d Cir. 1998); *Sacks v. Comm’r*, 69 F.3d 982, 987 (9th Cir. 1985).

³⁵ See generally *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1140, 1144–45 (D. Minn. 2017); see also generally *Rosenberg*, *supra* note 2.

³⁶ See, e.g., *IES Industries, Inc. v. United States*, 253 F.3d 350, 355 (8th Cir. 2001). Similarly, the First Circuit in *Santander* examined subjective motives, even though the opinion said that the circuit prefers to examine only objective aspects of the test. See *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 15, 24 (1st Cir. 2016), *cert denied*, 2017 U.S. LEXIS 4194 (June 26, 2017). But see *Cherin v. Comm’r*, 89 T.C. 986, 992 (1987) (declining to reach a finding on the taxpayer’s subjective motives after finding that there was no reasonable possibility of profit).

³⁷ See, e.g., *IES Industries*, 253 F.3d at 353–54 (stating that the Eighth Circuit has never had to decide which version of the test it uses because it always decides both prongs the same way—yes to both or no to both); *Wells Fargo & Co.*, 260 F. Supp. 3d at 1146 (noting that, because the various formulations of the economic substance test yield the same result for many fact patterns, some circuits may not have needed to choose between the conjunctive, disjunctive, and flexible analyses); *Wells Fargo & Co. v. United States*, 143 F. Supp. 3d

Therefore, the disjunctive, conjunctive, and flexible versions of the test almost always reach the same result.³⁸ In addition, the objective prong (the profit and economic effect analysis) tends to be emphasized, and the business purpose prong (subjective analysis of the taxpayer's motivation) is almost never determinative, regardless of the type of economic substance test the court applies.³⁹

Against this backdrop, Congress enacted section 7701(o), as described below.⁴⁰ It decreases variation among the circuits' descriptions of the economic substance test by requiring a conjunctive test.⁴¹

B. Brief Overview of Section 7701(o)

Section 7701(o) provides that "if the economic substance doctrine is relevant [to a transaction], such transaction shall be treated as having economic substance only if" it satisfies both an objective and a subjective prong.⁴² Thus, the disjunctive version of the economic substance test is no longer allowed, and all circuits

827, 834 (D. Minn. 2015) (giving a similar description of the Eighth Circuit's precedents). Another court said that the litigants were unable to cite any case in which a court held in the taxpayer's favor on one prong and against the taxpayer on the other. *Santander Holdings USA, Inc. v. United States*, 144 F. Supp. 3d 239, 244 (D. Mass. 2015), *rev'd*, 844 F.3d 15, 26 (1st Cir. 2016). In a recent, rare exception, a jury held that a loan had objective profit potential but lacked business purpose. *See Wells Fargo & Co.*, 260 F. Supp. 3d at 1142–43; *see also* Wesley Elmore, *Jury Sides with Government in Wells Fargo STARS Case*, TAX NOTES TODAY, Nov. 18, 2016, <https://www.taxnotes.com/tax-notes-international/litigation-and-appeals/jury-sides-government-wells-fargo-stars-case/2016/11/21/svb5?highlight=Jury%20Sides%20with%20Government%20in%20Wells%20Fargo%20STARS%20Case>; Cara Salvatore, *Jury Sides with Feds in Wells Fargo \$76M Tax Credit Suit*, LAW360 (Nov. 18, 2016), <https://www.law360.com/articles/864145/jury-sides-with-feds-in-wells-fargo-76m-tax-credit-suit>. The court subsequently held that, given those findings, the loan met the economic substance test when the court applied the flexible version of that test. *See Wells Fargo & Co.*, 260 F. Supp. 3d at 1146.

³⁸ *See supra* note 37 and accompanying text.

³⁹ *Wells Fargo & Co.*, 260 F. Supp. 3d at 1146. *See generally* Rosenberg, *supra* note 2 (discussing the pre-codification overlap between the objective and subjective prongs, as actually applied by the courts).

⁴⁰ *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067 (2010) (adding I.R.C. § 7701(o) to the Code).

⁴¹ *Id.* at 124 Stat. 1068.

⁴² I.R.C. § 7701(o)(1) (2012). Relevance is left to the courts to determine. *Id.*

must apply both prongs of the test. (A flexible version of the economic substance analysis may still be permissible under section 7701(o), if taxpayers must satisfy both the objective and the subjective analyses in order to meet such flexible test.)⁴³

Section 7701(o)'s version of the objective prong requires that "the transaction change[] in a meaningful way ... the taxpayer's economic position."⁴⁴ Its description of the subjective prong is met if "the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."⁴⁵ The statute also imposes a ratio requirement regarding profit potential: the "potential for profit ... shall be taken into account [for both prongs] only if the present value of the reasonably expected pre-tax profit is substantial in relation to ... expected net tax benefits."⁴⁶

For individuals, section 7701(o) applies only to "transactions entered into in connection with a trade or business or an activity engaged in for the production of income."⁴⁷ Other transactions of individuals remain subject to the economic substance case law (including pre-codification cases), but are not covered by section 7701(o).

Several new penalty provisions relating to the economic substance doctrine were enacted concurrently with section 7701(o).⁴⁸ Under these penalty rules, tax deficiencies attributable to the economic substance doctrine (as described in section 7701(o)) are subject to a twenty percent penalty⁴⁹ (which rises to forty percent if the facts regarding the claimed tax benefit are not adequately disclosed on a tax return).⁵⁰ Tax deficiencies relating to any "similar

⁴³ See Rosenberg, *supra* note 2 (manuscript at 7) (noting the conjunctive test mandated by section 7701(o) does not prevent consideration of other factors in addition to the objective and subjective prongs).

⁴⁴ § 7701(o)(1)(A).

⁴⁵ *Id.* § 7701(o)(1)(B).

⁴⁶ *Id.* § 7701(o)(2)(A). This Article refers to such rule as the "ratio test" or "profit ratio test." Section 7701(o) also requires the Treasury to issue regulations that treat foreign taxes as expenses in computing pre-tax profit "in appropriate cases." *Id.* § 7701(o)(2)(B).

⁴⁷ *Id.* § 7701(o)(5)(B).

⁴⁸ See §§ 6662(b)(6), (c), 6676 (2018); § 6664(d) (2015).

⁴⁹ See § 6662(b)(6) (applying section 6662(a)'s penalty to tax deficiencies attributable to the economic substance doctrine or similar doctrines).

⁵⁰ See *id.* § 6662(i)(1)–(2) (regarding failure to adequately disclose on the tax return or a statement attached thereto). For a critique of the new penalty

rules of law” are subject to the same penalty rules.⁵¹ Such penalties (relating to the economic substance doctrine or any similar rules of law) cannot be avoided by means of reasonable cause,⁵² such as reliance on a tax advisor’s opinion.⁵³

Because of codification, the Treasury is now able to issue regulations and other guidance regarding the economic substance doctrine. Such ability stems from Treasury’s generic authority to issue guidance with respect to all Code provisions.⁵⁴ The only specific grant of regulatory authority regarding the economic substance doctrine is Congress’s mandate that the Treasury issue guidance regarding the treatment of foreign taxes in the computation of pre-tax profit.⁵⁵ One exception to the Treasury’s regulatory abilities in this area is the question of whether the economic substance doctrine is “relevant” with respect to any particular transaction. That issue remains the exclusive province of the courts.⁵⁶

Therefore, the economic substance doctrine is now governed partly by statutory terms, partly by case law, and partly (if it chooses to issue guidance) by the agency. Under section 7701(o), Congress has mandated some of the rules applicable under the economic substance doctrine (e.g., the profit ratio test).⁵⁷ But other aspects of the doctrine remain open to interpretation by the courts

provisions, arguing that such increased penalties are unfair, overly harsh, and unnecessary, see Thomas, *supra* note 8, at 465–67.

⁵¹ See *id.* § 6662(b)(6).

⁵² See *id.* § 6662(b)(6); § 6664(d)(1)–(2) (2015); see also § 6676 (2018) (regarding lack of a reasonable basis exception for penalties with respect to excessive amounts attributable to the economic substance doctrine or any similar doctrine).

⁵³ The Joint Committee on Taxation’s description of these penalties includes the following language:

No exceptions (including the reasonable cause rules) to the penalty are available. Thus, under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law.

STAFF OF THE JT. COMM. ON TAX’N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, AS AMENDED, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT JCX-18-10 (Comm. Print 2010) [hereinafter JOINT COMM. REP.].

⁵⁴ § 7805(a) (2012).

⁵⁵ § 7701(o)(2)(B) (2012).

⁵⁶ *Id.* § 7701(o)(5)(C).

⁵⁷ *Id.* § 7701(o)(2)(A).

(including the meaning of undefined statutory terms, such as “substantial”) and by the Treasury (through its regulatory authority).⁵⁸ The preliminary question of relevance is left to the courts,⁵⁹ as are any other aspects of the doctrine that are neither constrained by statutory language nor addressed by agency guidance. The standards and terms contained in section 7701(o) should increase the various circuits’ consistency with each other as they apply the economic substance doctrine in the future. However, each circuit is still able to use its own interpretation of terms that the statute leaves undefined, at least until the Treasury issues guidance.⁶⁰

One of section 7701(o)’s biggest impacts on the judicial doctrine of economic substance is the changed balance of power it creates between the courts and the agency on this topic.⁶¹ After codification, the IRS has the ability to impose modifications to the economic substance doctrine (except with respect to the preliminary question of relevance).⁶² However, despite this new ability to affect the doctrine and despite recent government victories on economic substance issues (under pre-codification case law),⁶³ the IRS has shown reluctance to apply the post-codification version of the economic substance doctrine.⁶⁴ The discussion below considers how and why the IRS has communicated this decision, as well as the appropriateness of the use of informal guidance to make such policy choices.⁶⁵

⁵⁸ See §§ 7805(a) (general regulatory authority), § 7701(o)(1)(B) (“substantial”), (2)(A) (“substantial” as part of the ratio test). See generally Rosenberg, *supra* note 2 (discussing the substantive provisions of section 7701(o)).

⁵⁹ §§ 7701(o)(1), (5)(C).

⁶⁰ See H.R. Rep. No. 111-443(I), at 293 (2010) (describing various circuit’s interpretations of the economic substance doctrine before codification); Erik M. Jensen, *Sometimes Unguided (or Maybe Misguided) Economic Substance Guidance*, 32 J. TAX’N INV. 27, 39 (2015) (The conjunctive test “requirement might not provide for complete consistency among circuit courts, but it is a step in the right direction.”).

⁶¹ § 7701(o).

⁶² *Id.* § 7701(o)(1), (5)(C).

⁶³ See generally Rebecca Rosenberg, *STARS Wars: Application of the Economic Substance Doctrine to Foreign Tax Credits, and What the Future Holds*, 42 U. DAYTON L. REV. 165 (2017).

⁶⁴ See generally *id.*

⁶⁵ See *infra* Part II.

II. AGENCY INTERPRETATION OF THE STATUTE: INFORMAL TREASURY GUIDANCE UNDER SECTION 7701(O)

A. Overview

So far, the Treasury has issued two notices (and no other official guidance) to the public regarding section 7701(o).⁶⁶ The first notice states (among other things) that the IRS will continue to apply pre-7701(o) case law to interpret section 7701(o), but it declines to give the much-requested guidance on “relevance.”⁶⁷ The second notice expands (not very helpfully) on the definition of the tested “transaction,” and drastically cuts back on the potential application of penalties.⁶⁸ The IRS has also issued two letters to its own employees regarding section 7701(o).⁶⁹ All four documents are largely taxpayer-favorable.⁷⁰ None was issued under notice and comment procedures.⁷¹ These notices and letters, and the substantive and authority issues that they raise, are discussed further below.⁷²

B. Two IRS Notices on Economic Substance After Codification

The two IRS notices regarding section 7701(o) purport to provide “guidance” with respect to such Code section, and both apply to transactions that occur after March 30, 2010 (which is also section 7701(o)’s effective date).⁷³ Notices are a lesser type

⁶⁶ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁶⁷ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁶⁸ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

⁶⁹ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010) [hereinafter collectively “the directives” or “the IRS directives”].

⁷⁰ I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

⁷¹ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

⁷² See discussion *infra* Section II.B.

⁷³ I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

of “guidance” (as compared to regulations)⁷⁴: they are not subject to the notification and comment procedures of the Administrative Procedure Act (APA).⁷⁵ One could therefore question whether it is appropriate to use notices to provide rules that are binding on taxpayers. Notices are often used to predict that the IRS will issue regulations in the future, that such regulations will have content described in the notice, and (sometimes) that the regulations’ effective date will be the notice’s effective date (or soon thereafter).⁷⁶ Other notices purport to themselves issue enforceable rules.⁷⁷ One

⁷⁴ See, e.g., *Stobie Creek Invs. v. United States*, 82 Fed. Cl. 636, 671 (Ct. Cl. 2008) (“As a general proposition, IRS notices are press releases stating the IRS’s position on a particular issue and informing the public of its intentions; such notices do not constitute legal authority.... IRS notices are not promulgated pursuant to a notice-and-comment period, the process which gives regulations their legal authority and entitles them to *Chevron* deference.”) (citation omitted), *aff’d*, 608 F.3d 1366 (Fed. Cir. 2010); *Pritired 1, L.L.C. v. United States*, 816 F. Supp. 2d 693, 728 (S.D. Iowa 2011) (reasoning that “A notice is akin to a ‘revenue ruling’ and is an interpretation of the law offered by the IRS. While not binding precedent, revenue rulings—and notices—are entitled to ‘some weight,’ because the IRS ‘consider[s] them authoritative and binding.’”) (Citations omitted); *In re Wyly*, 552 B.R. 338 (U.S. B.R. N.D. TX 2016) (“This notice is not entitled to deference under *Chevron*. This is because the IRS Notice has not gone through the notice and comment rulemaking process. However, this notice has persuasive weight under *Skidmore*.”); cf. also *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 978 (7th Cir. 1998) (“Revenue rulings receive the lowest degree of deference—at least in this circuit. In *First Chicago*, we held that revenue rulings deserve ‘some weight,’ ... and are ‘entitled to respectful consideration, but not to the deference that the *Chevron* doctrine requires in its domain.’ ... In other circuits this question has generated inconsistent rulings ranging from *Chevron* deference to no deference.”) (citations omitted).

⁷⁵ Treasury regulations, even interpretative regulations, are generally issued under notice and comment procedures. See generally *Bankers Life*, 142 F.3d at 978 (stating that the IRS takes the position that notice and comment requirements do not apply to interpretative regulations issued under the general regulatory authority of section 7805, but that the IRS nonetheless generally follows such procedures for such regulations; notice and comment procedures are not followed for revenue rulings, which the IRS views as binding and at least some courts see as deserving some level of deference as the agency’s interpretation).

⁷⁶ See, e.g., I.R.S. Notice 2014-45, 2014-34 I.R.B. 388 (Aug. 18, 2014); I.R.S. Notice 2014-58, 2014-44 I.R.B. 746–47 (Oct. 27, 2014); I.R.S. Notice 98-5, 1998-3 C.B. 52 (Jan. 20, 1998) (withdrawn).

⁷⁷ See, e.g., I.R.S. Notice 90-26, 1990-1 C.B. 336 (Jan. 1990) (purporting to withdraw a portion of Temp. Reg. § 1.905-3T (Nov. 7, 2007)); I.R.S. Notice 89-35, 1989-1 C.B. 675 (Jan. 1989) (purporting to modify Treas. Reg. § 163-8T).

could legitimately question whether notices (as an administrative vehicle) are legally capable of issuing rules that are binding on taxpayers, without the issuance of regulations that set forth those same rules.⁷⁸ In other words, one could debate whether notices can substitute for regulations, revenue rulings, or revenue procedures, rather than merely forecasting the future issuance of such formal types of guidance.

Notice 2010-62 says that “[t]he IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1).”⁷⁹ It does not specify that it refers to pre-7701(o) case law, and presumably instead means the economic substance case law as it evolves over time. But at the moment, more than eight years after codification and after the notice’s issuance, there is no post-codification case law that interprets section 7701(o). The notice thus states the IRS’s intention to use pre-section 7701(o) case law to interpret section 7701(o)’s requirements,⁸⁰ which is logically a little odd (unless one assumes that section 7701(o) merely summarized the existing conjunctive-test case law).

The notice further states, more specifically, that it will use case law relating to the objective and subjective prongs, respectively, to interpret the two prongs described in section 7701(o).⁸¹ On the one hand, this defers to the judiciary and declines to give any guidance on the meaning of the statute’s two prongs. On the other hand, it equates the two prongs described in the statute with the two prongs previously applied in the pre-codification case law (because there is no post-codification economic substance case law yet). This seems to overlook the differences between section 7701(o)’s versions of the two prongs and the pre-enactment versions of the two prongs, as they appear in pre-codification case law. (For example, it does not address the statute’s implication that the objective and subjective prongs cannot now be identical to each other. Nor does it address differences between section

⁷⁸ Cf. *Bankers Life & Cas. Co.*, 142 F.3d at 978 (discussing the issuance of regulations and the lower weight given to lesser types of authority, like revenue rulings).

⁷⁹ I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁸⁰ See *id.*

⁸¹ *Id.*

7701(o)'s phrasing of the two prongs and the usual description of such prongs in pre-7701(o) case law.)⁸²

Taxpayers may argue that the notice⁸³ means that section 7701(o) should be read as not changing the pre-enactment versions of the objective and subjective factors (i.e., as exercising the IRS's regulatory authority to provide such an interpretation of section 7701(o)). Such a choice by the IRS in Notice 2010-62 appears to be inadvertent, is arguably more than a mere notice could accomplish, and could potentially be subject to a validity challenge on the grounds that it conflicts with the statute.⁸⁴ These points may become moot in the future, if and when the courts begin to interpret post-codification economic substance doctrine (thus removing the issue of whether IRS reliance on pre-codification judicial interpretations is valid). The notice also says that the IRS will apply a conjunctive test for the economic substance analysis, and will challenge any taxpayer effort to apply the disjunctive test⁸⁵ (which is consistent with section 7701(o), although it means (for now) pre-codification versions of the conjunctive test).

The notice further acknowledges that "relevance" of the economic substance doctrine (i.e., whether the economic substance doctrine can be applied to a transaction) is left to the courts.⁸⁶ The relevance issue is specifically reserved to the courts by the statute, which states that relevance determination "shall be made in the same manner as if this subsection had never been enacted."⁸⁷ Consistent with this reservation of the relevance issue to the courts, the notice states that the IRS will continue to analyze relevance by examining the case law, just as it did before codification.⁸⁸ The notice also acknowledges that the IRS expects the

⁸² See generally Rosenberg, *supra* note 2 (describing changes that section 7701(o) makes to the economic substance doctrine).

⁸³ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁸⁴ However, as discussed further below, taxpayers are unlikely to challenge any IRS guidance that is taxpayer-favorable. See *infra* notes 202–03 and text accompanying.

⁸⁵ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁸⁶ See *id.*; see also I.R.C. § 7701(o)(5)(C) (2012). The issue of whether the doctrine applies is merely the gateway question of whether the IRS or the courts should complete the economic substance analysis. Even if the analysis is conducted, the transaction might still meet—or instead fail—the economic substance test. See *id.* § 7701(o)(1).

⁸⁷ *Id.* § 7701(o)(5)(C).

⁸⁸ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

case law regarding relevance to “continue to develop.”⁸⁹ Lastly, the notice confirms that “the Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either does or does not apply.”⁹⁰

Taxpayers have asked the IRS to issue guidance on when the economic substance doctrine is relevant.⁹¹ Sometimes taxpayers have requested either a list of transactions to which the economic substance doctrine does apply, or (instead) an “angel list” or “white list” of transactions to which the doctrine never applies.⁹² The IRS’s decision not to issue guidance on relevance is contrary to taxpayer requests, but is consistent with the Treasury’s lack of regulatory authority on this issue.⁹³

⁸⁹ *Id.*

⁹⁰ *Id.* at 412.

⁹¹ See, e.g., Michael J. Desmond et al., *Firms Seek Codified Economic Substance Doctrine Guidance*, TAX NOTES TODAY, Feb. 2, 2015, <https://www.taxnotes.com/tax-notes-today/penalties/firms-seek-codified-economic-substance-doctrine-guidance/2015/02/04/fq0y?highlight=Desmond> (“[W]e recommend that Treasury and the IRS issue substantive guidance on which taxpayers and practitioners can rely regarding whether the economic substance doctrine is ‘relevant’ to a transaction.”); see also Peter H. Blessing, *NYSBA Tax Section Recommends More Guidance on Codification of Economic Substance Doctrine*, TAX NOTES TODAY, Jan. 5, 2011, <https://www.taxnotes.com/tax-notes-today/corporate-taxation/nysba-tax-section-recommends-more-guidance-codification-economic-substance-doctrine/2011/01/07/vq8c> (asking the IRS to “enunciate a few principles identifying broad categories of transactions to which the [doctrine] is not ‘relevant’”).

⁹² See, e.g., Blessing, *supra* note 91, at 7.

⁹³ Notice 2010-62 further states that the IRS will not issue private letter rulings or determination letters regarding either relevance or whether a particular transaction meets the economic substance test. I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010). Later, in Notice 2014-58, the IRS said that “[w]hether the economic substance doctrine is relevant ... will be considered on a case-by-case basis, depending on the facts and circumstances of each individual case.” I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014). Because the IRS has admitted that it does not have regulatory authority to provide guidance on relevance, the quoted language presumably refers to the IRS’s analysis of whether it can raise economic substance as an issue (e.g., at the audit level or in litigation), not whether it should issue binding guidance. *Id.* A court would then be free to disagree with the IRS’s determination of whether the economic substance doctrine applied to a particular transaction or not (i.e., whether a particular type of tax benefit was exempt from the doctrine).

On a different issue, Notice 2010-62 also states that the IRS and the Treasury “intend to issue regulations” regarding the circumstances in which foreign taxes are treated as a cost in computing profit (for purposes of applying the economic substance doctrine).⁹⁴ Such issuance would comply with section 7701(o)’s mandate that the Treasury issue guidance on this topic.⁹⁵ Despite the notice’s 2010 statement, no agency guidance has yet been issued on this subject.

Section 7701(o) provides that profit potential is taken into account for the two prongs of the economic substance analysis only if reasonably expected profit is substantial as compared to expected tax benefits (determined as if the transaction were respected).⁹⁶ Notice 2010-62 says that the IRS plans to follow this rule.⁹⁷ However, it describes the rule as relating to whether “profit motive” is taken into account, rather than “potential for profit.”⁹⁸ The use of the word “motive” is puzzling, but the IRS does not appear to mean that the ratio test applies only for purposes of determining subjective intent. (Nor would such an interpretation necessarily be a valid reading of the statute.) The IRS applies its “profit motive” limitation to both prongs (“[i]n determining whether the requirements of section 7701(o)(1)(A) and (B) are met”), which implies that “profit motive” may be intended to mean “reasonably expected profit.”⁹⁹

⁹⁴ I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁹⁵ See I.R.C. § 7701(o)(2)(B) (2012).

⁹⁶ See *id.* § 7701(o)(2)(A).

⁹⁷ I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

⁹⁸ Compare *id.* with § 7701(o)(2)(A).

⁹⁹ I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010). In addition, the IRS “will apply existing relevant case law and other published guidance” to implement the ratio test, according to the notice. It is not clear what this “existing ... guidance” might be (other than the two notices themselves), given that there is no other published administrative guidance to date (other than the internal IRS letters, discussed below) and no court case has yet interpreted section 7701(o)’s ratio test. The phrasing of the ratio test described in the statute (e.g., the use of the word “substantial”) differs from the pre-codification case law’s comparisons of expected profit and expected tax benefits, although it resembles the wording of (withdrawn) Notice 98-5 (which predicted the issuance of certain regulations regarding foreign tax credits). See § 7701(o)(2)(A); I.R.S. Notice 98-5, 1998-3 C.B. 49 (Jan. 20, 1998) (withdrawn); *Knetsch v. United States*, 364 U.S. 361, 365–66 (1960) (holding that expected profit that was “a relative pittance” was not enough); *Salem Fin., Inc. v. United States*, 786 F.3d

The notice also provides further guidance on how to meet the disclosure requirements of some of the amendments that accompanied section 7701(o).¹⁰⁰ In addition, it states that the IRS is particularly interested in taxpayer comments regarding such disclosure mechanics.¹⁰¹

Issued four years later, Notice 2014-58 focuses on the definition of the “transaction” to be tested under the economic substance doctrine and the interpretation of “similar rule of law” (which is relevant for the penalty provisions enacted concurrently with section 7701(o)).¹⁰²

Regarding the delineation of the tested transaction, Notice 2014-58 does not add much.¹⁰³ It essentially says that the tested transaction is determined based on the facts and circumstances. It adds that the primary consideration is whether particular steps were “tax-motivated steps that are not necessary to accomplish the non-tax goals.”¹⁰⁴ These types of steps “may” be treated as one transaction, with remaining steps tested separately (as a different transaction).¹⁰⁵

The notice begins by providing a default definition of a testable transaction. A “transaction’ generally includes all the

932, 951, 960 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016) (finding that profit “grossly disproportionate to the tax benefits” was not enough); WFC Holdings Corp. v. U.S., 728 F.3d 736, 746 (8th Cir. 2013) (holding that “modest profits” compared to “substantial tax benefits” were insufficient) (citation omitted); Sheldon v. Comm’r, 94 T.C. 738, 767–68 (1990) (finding that profit that was “infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions” was not sufficient). *See generally* Rosenberg, *supra* note 2 (discussing differences between the ratio test and pre-codification case law, and similarities between the ratio test and Notice 98-5).

¹⁰⁰ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

¹⁰¹ See *id.*

¹⁰² I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹⁰³ Cf. Amy S. Elliott, *IRS Ruling Was First Under New Significant Issue Policy*, TAX NOTES TODAY, Oct. 17, 2014, <https://www.taxnotes.com/tax-notes/corporate-taxation/irs-ruling-was-first-under-new-significant-issue-policy/2014/10/20/qxcm> (reporting on public comments by then–Associate Chief Counsel (Corporate) William Alexander: Notice 2014-58 was “merely rearticulating what the Service has said all along,” he said. Sowell asked why the government felt the need to issue the guidance now. Alexander said he didn’t know, reiterating that he didn’t think the IRS said anything in the notice that it hadn’t said before”).

¹⁰⁴ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹⁰⁵ See *id.*

factual elements relevant to the expected tax treatment ... *and* any or all steps that are carried out as part of a plan.”¹⁰⁶ The first phrase of that definition is similar to the case law, although “relevant to” the claimed tax benefit is a little broader than the common case law formulation of steps “necessary” to achieve the tax benefit.¹⁰⁷ The second phrase quoted above (“any or all steps”) seems to require a facts and circumstances analysis to define the “plan,” but does not specifically state that “relev[ance] to the expected tax treatment” is the standard to be applied. The definition quoted above is adapted by the IRS from a regulation issued in the “analogous context of reportable transactions.”¹⁰⁸

The notice then says that the default rule described above “may” be changed—and steps may be aggregated or disaggregated in order to determine the transaction to be tested—if there is a “tax motivated step that is not necessary to achieve a non-tax objective.”¹⁰⁹ In that case, the tested transaction “may” consist only of such steps.¹¹⁰ This part of the IRS’s discussion is phrased a little differently than some courts’ formulations: several courts have said that the tested transaction consists of the steps necessary to claim the challenged tax benefit.¹¹¹ The notice, in contrast, says that steps that are both insufficiently connected to non-tax utility (rather than those affirmatively necessary for

¹⁰⁶ *Id.* (emphasis added).

¹⁰⁷ *See, e.g.,* Salem Fin., Inc. v. United States, 112 Fed. Cl. 543, 585 (Fed. Cl. 2013) (“the links between the Trust and Loan components of STARS are artificial, and further, ... the disputed foreign tax credits are attributable solely to the Trust. Accordingly, the Court will bifurcate the STARS transaction and examine the Trust structure for economic substance, independent of the Loan,” although the court also analyzed the transaction without bifurcating the loan and trust), *aff’d in part, rev’d in part*, 786 F. 3d 932 (Fed Cir. 2015), *and cert. denied*, 136 S. Ct. 1366 (2016); Bank of New York Mellon Corp. v. Comm’r, 801 F.3d 104, 115, 121 (2d Cir. 2015) (focusing on the transaction that generated the disputed tax benefit), *cert. denied*, 136 S. Ct. 1377 (2016); ACM P’ship v. Comm’r, 157 F.3d 231, 262 (3d Cir. 1998) (allowing deductions for losses that were “separate and distinct” from the tax benefits that were the main point of the challenged transaction), *cert. denied*, 526 U.S. 1017 (1999).

¹⁰⁸ *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014) (referring to the definition of “transaction” in Treas. Reg. § 1.6011-4(b)(1), which relates to disclosure requirements for reportable transactions described in section 6011).

¹⁰⁹ *Id.*

¹¹⁰ *See id.*

¹¹¹ *See supra* text accompanying note 107.

a tax benefit, as described in the case law) and also “tax motivated” are separated from other steps of the taxpayer.¹¹²

The IRS’s language regarding whether various steps are “necessary to achieve a non-tax objective” resembles the language of the tax court in *ACM v. Commissioner*.¹¹³ That particular phrasing was part of that court’s description of the economic substance test, but this wording is sometimes cited as a description of the subjective prong.¹¹⁴ (The *ACM* court did not apply either a conjunctive or disjunctive format, but instead described the economic substance test as a more flexible analysis, including consideration of both profit potential and subjective motive.)¹¹⁵ Notice 2014-58 essentially adapts the *ACM* court’s description of transactions that meet the economic substance test (i.e., of what the economic substance test is seeking to determine, and what will allow a transaction to pass the test) and uses that phrasing to separate steps that seem to have more business content from other, tax-benefit-focused steps.¹¹⁶ In other words, the notice uses the tax court’s phrasing (or, more specifically, language that resembles such phrasing) for a different purpose than the tax court did.

Using the word “may”¹¹⁷ is consistent with the notice’s later emphasis that “whether a transaction should be disaggregated will

¹¹² This test appears to require that taxpayers meet only one of the two stated criteria: steps meeting *either* the non-tax-motivated *or* necessary-to-a non-tax-objective standards may be respected as part of a larger whole and not re-characterized as separable from the rest of the transaction. Steps failing only one of such two criteria do not appear to necessarily be treated as separable from the rest of the transaction. However, the notice qualifies its default test by stating that facts and circumstances analyses may be applied. *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹¹³ *See ACM P’ship v. Comm’r*, 73 T.C.M. (CCH) 2189, 22157 (Mar. 5, 1997) (“Key to this determination is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and useful in light of the taxpayer’s economic situation and intentions.”).

¹¹⁴ *See, e.g., Compaq v. Comm’r*, 277 F.3d 778, 781 (5th Cir. 2001); *Austin v. Comm’r*, T.C. Memo. 2017-69, 11 (2017); *Salina Partnership L.P. v. Comm’r*, T.C. Memo. 2000-352, 13 (2000); H.R. REP. NO. 111-443 at 297 (2010).

¹¹⁵ *See ACM P’ship v. Comm’r*, 157 F.3d 231, 247 (3d Cir. 1998) (“[T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.”).

¹¹⁶ *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹¹⁷ If there is a “tax motivated step that is not necessary to achieve a non-tax objective,” then the tested transaction “may” consist only of such steps. *See id.*

be considered on a case-by-case basis, depending on the facts and circumstances of each individual case.”¹¹⁸ The notice avoids giving clear, mechanical rules, opting instead for weighing and balancing of all of the facts and circumstances.¹¹⁹

Notice 2014-58 also addresses the meaning of “similar rule of law.”¹²⁰ That term is important because tax deficiencies attributable to “similar rules of law” are subject to the same enhanced penalty provisions as tax deficiencies arising under section 7701(o).¹²¹ Notice 2014-58 states that no Code or regulatory provision will be treated as such a “similar rule of law” (except section 7701(o) itself, and regulations issued thereunder).¹²² That leaves only judicial doctrines as potential “similar rules of law.”

The notice explains that a “similar rule of law” is one “that applies the same factors and analysis” as section 7701(o),¹²³ “even if a different term” is used to describe such rule of law or doctrine.¹²⁴ It lists “step transaction” and “substance over form” as doctrines that are *not* “similar rules of law.”¹²⁵ However, the notice gives “sham transaction doctrine” as an example of such a “different term.”¹²⁶ This implies (without directly stating) that the sham

¹¹⁸ *Id.*

¹¹⁹ *See id.*

¹²⁰ *Id.*

¹²¹ *See* I.R.C § 6662(b)(6), (c), 6676 (2018); § 6664(d) (2015).

¹²² I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct.27, 2014).

¹²³ The notice adapts this terminology from the House Report’s description of circumstances in which the enhanced penalties would apply. *See* H.R. REP. NO. 111-443, at 304 (2010); Thomas C. Vanik, Jr., *Torpedoing a Transaction: Economic Substance Versus Other Doctrines and the Application of the Strict Liability Penalty*, 64 CLEV. ST. L. REV. 109, 117 n.65 (2015) (pointing out that this language in Notice 2014-58 mirrors language in the House Committee report: “The notice relied on the legislative history, which states that the ‘penalty would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision [section 7701(o)] for an economic substance analysis, even if a different term is used to describe the doctrine’”).

¹²⁴ The notice also defines “similar rule of law” as meaning a doctrine that disallows tax benefits because a transaction fails either the objective or subjective prong (as described in section 7701(o)). This is the equivalent of section 7701(o)’s conjunctive test, despite the use of the word “or” rather than “and”: a transaction meets the economic substance test if it passes both prongs, and fails the test if it fails either prong (i.e., if it fails the objective or the subjective prong). *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹²⁵ *Id.*

¹²⁶ *Id.*

transaction doctrine is a “similar rule of law” for purposes of section 6662(b)(6) and the other relevant penalty provisions.¹²⁷

Despite that implication, the notice literally only treats “sham transaction doctrine” as a “similar rule of law” if the IRS (or a court) treats the sham transaction doctrine as applying “the same factors and analysis” as section 7701(o).¹²⁸ If a court used the term “sham transaction doctrine” to mean a different theory or analysis (as compared to economic substance), such application by the court presumably would not be treated as a similar doctrine.¹²⁹ For example, the case law has distinguished between “factual shams” (in which the claimed steps did not actually occur) and “economic shams” (in which the steps did occur, but did not fall within Congressional intent for generating a particular type of tax benefit).¹³⁰ Thus, “sham transaction,” if used to refer to a factual sham, might not be similar to the economic substance doctrine. The whole point of the notice’s approach is that the term used to describe a doctrine is not determinative—the question (for deciding if there is a “similar rule of law”) is whether the factors and analysis described in section 7701(o) are used.¹³¹

There is an argument that any doctrine that uses the same factors that are described in section 7701(o) would fall within the definition of the “economic substance doctrine”¹³² in section

¹²⁷ *See id.*

¹²⁸ *See id.*

¹²⁹ *Cf.* William R. Davis, *Economic Substance Notice Not Intended to Implicate All Shams*, TAX NEWS TODAY, Feb. 2, 2015, <https://www.taxnotes.com/taxpractice/penalties/economic-substance-notice-not-intended-implicate-all-shams/2015/02/02/1s831?highlight=%29%20Economic%20Substance%20Notice%20Not%20Intended%20to%20Implicate%20All%20Shams%20Economic%20Substance%20Notice%20Not%20Intended%20to%20Implicate%20All%20Shams> (describing public comments by Treasury official (Tax Legislative Counsel), Thomas West, who said that the notice does not mean that the sham transaction doctrine will always be treated as a similar doctrine to economic substance, and that he was surprised that practitioners read the notice that way, without giving a detailed explanation of what exactly the notice’s wording does mean).

¹³⁰ *See infra* note 310 and accompanying text.

¹³¹ *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹³² *See* I.R.C. § 7701(o)(5)(A) (2012) (defining the economic substance doctrine as “the common law doctrine under which tax benefits under subtitle A ... are not allowable if the transaction does not have economic substance or lacks a business purpose”). For example, the disjunctive test falls within the statute’s definition of the economic substance doctrine. *See* H.R. REP. NO. 111-43, at 297 n.128. If a court

7701(o). If that is the case, the notice effectively states that no judicial doctrine (that was not already subject to section 7701(o) and treated as the “economic substance doctrine” for purposes of that section) would be treated as a “similar rule of law.” Because the notice also excludes statutory and regulatory rules from being “similar rules of law” for this purpose,¹³³ “similar rules of law” would be a null set (other than section 7701(o) itself). Under that interpretation, the notice has made “similar rule of law” moot and meaningless. Query whether defining “similar rule of law” as a null set is within, or instead beyond, Treasury’s regulatory authority (on the grounds that such an interpretation may be inconsistent with the statute, and that interpretations that render statutory language moot are generally disfavored).¹³⁴

Alternatively, taxpayers might argue that no judicial anti-abuse rules use the same factors as section 7701(o) because section 7701(o)’s descriptions of the two prongs differ from the case law definitions.¹³⁵ (They could cite, for example, the requirement for “substantial” business purpose, as well as the profit ratio test that applies for both prongs.)¹³⁶ Such an argument also leads to no doctrines being treated as “similar rules of law,” under the notice’s rules. We can expect that the IRS and taxpayers may vigorously debate the meaning of “same factors and analysis [as section 7701(o)].”¹³⁷

defined the sham transaction doctrine as having two prongs that are equivalent to section 7701(o)’s prongs, the so-defined sham transaction doctrine appears to fall within section 7701(o)’s definition of the economic substance doctrine.

¹³³ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹³⁴ See, e.g., *Hibbs v. Winn*, 542 U.S. 88, 101 (2004) (“A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant”); *Bailey v. United States*, 516 U.S. 137, 146 (1995) (“We assume that Congress used two terms because it intended each term to have a particular, nonsuperfluous meaning.”); *Gustafson v. Alloyd Co.*, 513 U.S. 561, 577–78 (1995); *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883) (“give effect, if possible, to every clause and word of a statute, avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed”).

¹³⁵ See § 7701(o); see also Rosenberg, *supra* note 2 (discussing differences between section 7701(o) and the pre-codification case law).

¹³⁶ See §§ 7701(o)(1)(B), (2)(A). See generally Rosenberg, *supra* note 2 (discussing new rules enacted by section 7701(o), as compared to pre-enactment case law).

¹³⁷ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

The courts are not bound by the notice's rule about similar doctrines. That rule, by its terms, applies only to predict whether the IRS will argue that a doctrine is a "similar rule of law."¹³⁸ The notice does not provide authoritative guidance in the same way as a regulation.¹³⁹

The notice also narrows the potential range of arguments that the IRS could treat as "similar rules of law" in another manner: the notice states that no tax deficiency will be treated as attributable to a "similar rule of law" unless the IRS also raises section 7701(o).¹⁴⁰ In other words, if the IRS does not assert section 7701(o), then it will not argue that any other authorities it relies on are "similar rules of law" for purposes of the penalty provisions.¹⁴¹

The notice also narrows the potential range of arguments that the IRS could treat as "similar rules of law" in another manner: the notice states that no tax deficiency will be treated as attributable to a "similar rule of law" unless the IRS also raises section 7701(o).¹⁴² In other words, if the IRS does not assert section 7701(o), then it will not argue that any other authorities it relies on are "similar rules of law" for purposes of the penalty provisions.¹⁴³ There appears to be a validity issue with respect to that choice also, on the grounds that the IRS's decision disregards (and renders moot) the statutory requirement that the penalty amendments enacted with section 7701(o) apply both to section 7701(o) and to "similar rules of law."¹⁴⁴ If the IRS will never argue that there is a "similar rule of law" unless it raises section 7701(o), then the inclusion of "similar rules of law" in the penalty provisions is meaningless (because the penalty never applies unless section 7701(o) is raised, so the reference to the economic substance doctrine is sufficient, without more).¹⁴⁵ Also query whether

¹³⁸ *See id.*

¹³⁹ *See id.*; *Understanding IRS Guidance—A Brief Primer*, IRS (May 9, 2018), <https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer> [<https://perma.cc/R9MH-DVE6>].

¹⁴⁰ *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹⁴¹ *See id.*

¹⁴² *See id.*

¹⁴³ *See id.*

¹⁴⁴ *See* §§ 6662(b)(6), 6662(c), 6676 (2018); § 6664(d) (2015).

¹⁴⁵ Assume, however, that the IRS raised section 7701(o) in litigation with respect to a particular transaction, and also asserted three other judicial anti-abuse doctrines (other than economic substance). Further assume that the court

a court could conclude that a tax deficiency is attributable to a “similar rule of law” (triggering the same penalties that would apply if section 7701(o) were the basis of a deficiency), even if the IRS does not raise that argument.¹⁴⁶

Viewed as a whole, the notice provides that the IRS will not argue that a tax deficiency is attributable to a “similar rule of law” for purposes of the penalty provisions unless a) such rule of law is a judicial doctrine, b) that doctrine uses the same factors and analysis as section 7701(o), and c) the IRS also raises section 7701(o).¹⁴⁷ If one takes the notice at face value, one could say that the required three factors considerably narrow the potential scope of “similar rules of law” (possibly to zero), but also provide more predictability for taxpayers regarding the application of the strict liability penalties associated with economic substance issues.¹⁴⁸ One could further note that the notice’s guidance on this topic appears to require a case-by-case analysis, rather than giving a list of doctrines that always are or always are not “similar rules of law.”¹⁴⁹

Looking at the IRS’s asserted three factors logically, however, the notice appears to be saying that there are no “similar rules of law,” other than judicial doctrines that are identical to (redundant with) section 7701(o) but are called by another name and are raised where the IRS is already raising section 7701(o). This makes no sense—the notice is literally saying that the IRS will never assert that any doctrine is a “similar rule of law” unless

held for the government under one of those other three doctrines. In that case, the IRS might treat such other doctrine as a similar rule of law (for purposes of the penalty provisions), but only if such doctrine used the same factors and analysis as section 7701(o). The step transaction doctrine, for example, is not treated as a “similar” doctrine under Notice 2014-58. *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014). The IRS likely would not assess the enhanced penalties for deficiencies relating to the step transaction doctrine even though it had attempted to use the economic substance doctrine against the same transaction. Theoretically, however, there might be another doctrine that uses the same factors as section 7701(o), even if the relevant circuit refers to that doctrine by another name, for example if the court refers to such other rules as the “economic sham doctrine.” Is such a fact pattern sufficient to stop the phrase “similar other doctrine” from becoming moot under the notice’s approach?

¹⁴⁶ Presumably, the IRS could prevent such a conclusion by formally conceding (in a particular case) that its arguments are not “similar rules of law.”

¹⁴⁷ *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹⁴⁸ *See id.*

¹⁴⁹ *See id.*

that doctrine is completely duplicative of the IRS's other argument (section 7701(o)) in the same case. This interpretation appears to read the "similar rule of law" language out of the statutory framework and is arguably an instance of the agency publicly communicating that it will not implement language ("similar rule of law") enacted by Congress.

1. Two IRS Directives Discourage Agents from Raising Economic Substance Issues

The IRS has also issued two directives to its own examiners regarding section 7701(o) (the codified version of the economic substance doctrine).¹⁵⁰ The first directive, issued in 2010, was addressed as "examination guidance" to employees of the former Large and Mid-Sized Business (LMSB) Division.¹⁵¹ Its substantive guidance consisted of one sentence: "To ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6)" on tax deficiencies that occur by reason of the economic substance doctrine or any similar rule of law, "any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed."¹⁵²

The IRS (at least the former LMSB Division) was thus focused on the penalties associated with the economic substance doctrine (and imposed by reason of the penalty amendments that accompanied section 7701(o)). The directive's requirement that raising such penalties must first be approved by a Director of Field Operations is clearly a barrier to asserting such penalties: it imposes another procedural layer (which is a disincentive for IRS examiners) and raises the possibility that the Field Director could say no. Because the penalties are a mandatory consequence of any tax deficiency attributable to section 7701(o) (or any similar rule of law), the additional approval requirement presumably also dissuaded examiners from raising economic substance (and similar

¹⁵⁰ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); see also I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

¹⁵¹ See I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

¹⁵² See *id.*

issues), not just the penalties. This IRS policy presumably reduces the intended deterrent effect (and revenue-raising potential) of the enhanced penalties that were enacted with section 7701(o).

The IRS later expanded its internal guidance on section 7701(o) by issuing another directive, this time addressed to the newly formed Large Business and International (LB&I) Division.¹⁵³ This second directive “instruct[ed] examiners and their managers how to determine when it is appropriate to seek the approval of the DFO (Director of Field Operations) in order to raise the economic substance doctrine.”¹⁵⁴ It also provided procedures for the examiner to follow in order to seek such approval, which included submitting a written analysis of thirty-five specified factors.¹⁵⁵ These paperwork requirements created hurdles that must have been meant to (and likely did) dissuade examiners from raising the economic substance doctrine.

The directive also provided that, “until further guidance is issued,” no rule or doctrine would be treated as a “similar rule of law” for purposes of penalty assertion.¹⁵⁶ In particular, the sham transaction doctrine, step transaction doctrine, and substance over form doctrine would not be so treated.¹⁵⁷ The agency (or part thereof) appeared to be declining to implement particular statutory language (relating to penalty provisions enacted with respect to tax deficiencies attributable to “similar rules of law”).¹⁵⁸ As described above, this part of the directive is now obsolete, because further guidance has been issued: Notice 2014-58 defines “similar rule of law” (ruling out the step transaction and substance over form doctrines, and including the sham transaction doctrine, but only where the latter uses the same analysis as section 7701(o) and the IRS raises section 7701(o)).¹⁵⁹

The directive also states that generally “a series of interconnected steps with a common objective” is one “transaction” for purposes of applying the economic substance doctrine.¹⁶⁰ It “may be appropriate” to treat as a separate transaction “tax-motivated

¹⁵³ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

¹⁵⁴ *See id.*

¹⁵⁵ *See id.*

¹⁵⁶ *See id.*

¹⁵⁷ *See id.*

¹⁵⁸ *See* I.R.C. §§ 6662(b)(6), (c), 6676 (2018); § 6664(d) (2015).

¹⁵⁹ *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

¹⁶⁰ *See* I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

steps that bear only a minor or incidental relationship to a single common business or financial transaction.”¹⁶¹ But in order to bifurcate steps “with a common objective,” an examiner “is required to seek guidance from their manager and consult with their local counsel.”¹⁶²

The directive requires an examiner to complete four steps before seeking approval to raise the economic substance doctrine.¹⁶³ First, the examiner must consider a series of eighteen listed factors that would indicate that it is “likely not appropriate” to raise the doctrine.¹⁶⁴ Those factors include whether the tax benefit at issue is consistent with legislative intent.¹⁶⁵ They also ask whether the “[t]ransaction creates meaningful economic change on a present value basis (pre-tax)” and whether it “has credible business purpose apart from federal tax benefits.”¹⁶⁶ These two factors resemble section 7701(o)’s two main requirements, except that the directive does not ask if the business purpose is “substantial,” as required by section 7701(o).¹⁶⁷

The directive also specifically states that “it is likely not appropriate” to assert the doctrine in four specific instances: the choice between debt and equity, the choice of a foreign rather than a U.S. entity to make a foreign investment, “[t]he choice to enter into a ... corporate organization or reorganization under subchapter C,” or “[t]he choice to utilize a related-party entity in a transaction, provided that arm’s length standard of section 482 and other applicable concepts are satisfied.”¹⁶⁸ These four instances mirror the legislative history’s list of circumstances in which section 7701(o) is generally not expected to change the tax result.¹⁶⁹

¹⁶¹ *See id.*

¹⁶² *See id.*

¹⁶³ *See id.*

¹⁶⁴ *See id.*

¹⁶⁵ *See id.*

¹⁶⁶ *See* I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

¹⁶⁷ *See id.*; *see also* I.R.C. § 7701 (2012).

¹⁶⁸ *See* I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

¹⁶⁹ *See* H.R. REP. NO. 111-43, at 296 (2010) (“The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”); *see also* JOINT COMM. REP., *supra* note 53 (giving same four non-exclusive examples of basic business conduct for which section 7701(o) was not intended to alter the tax treatment). Immediately

Next, the examiner must consider a second list of seventeen factors that conversely indicate that the application of the economic substance doctrine “*may* be appropriate.”¹⁷⁰ These seventeen factors are generally just the reverse of each of the eighteen factors described above (except for the factor regarding Congressional intent, which does not appear in the reverse in the second list).¹⁷¹ It is not clear why both (mostly duplicative) lists are necessary, rather than one being sufficient.

This second list asks whether the “transaction has no credible business purpose,” again not examining whether such purpose is “substantial.”¹⁷² Nor does either list of factors apply the profit ratio test imposed by section 7701(o)(2)(A).¹⁷³ It is particularly striking that although section 7701(o) lists two factors (the objective and subjective prongs), the directive lists eighteen (if one counts each of the duplicative factors only once).¹⁷⁴ Under these lists, merely failing the two prongs (as modified by the directive to omit both the ratio test and the requirement that business purpose be substantial) is not enough to show that the economic substance doctrine should be raised as an issue (much less that the transaction lacks economic substance).¹⁷⁵ Instead (before the economic

after the four examples, the House and Joint Committee Reports both state that “[l]easing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.” H.R. REP. NO. 111-43, at 296; JOINT COMM. REP., *supra* note 53, at 153. It is not totally clear whether this indicates that the four examples will not be examined in accordance with all of their facts and circumstances (which seems an odd interpretation), or whether instead the four examples are included within the “all other transactions” that (like leasing transactions) will be so examined. *See* H.R. REP. NO. 111-43, at 296. The latter interpretation is bolstered by the immediately following confirmation that “the fact that a transaction does meet the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.” *Id.* Also, under section 7701(o), the issue of whether the doctrine applies (i.e., the type of transaction or tax benefit to which it applies) is ultimately left to the courts. *See* § 7701(o)(5)(C).

¹⁷⁰ *See* I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011) (emphasis added).

¹⁷¹ *See id.*

¹⁷² *See id.*

¹⁷³ *See* § 7701(o)(5)(A).

¹⁷⁴ *See* § 7701(o)(1); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

¹⁷⁵ *See* I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

substance doctrine can be raised), multiple other factors also need to be taken into account (without any indication of relative weight), and then the examiner must perform the additional two steps of the process and the DFO must approve the assertion of the issue.¹⁷⁶

Thirdly, the examiner must address a list of seven “inquiries.”¹⁷⁷ Each inquiry describes circumstances in which the economic substance doctrine “should” not be applied (rather than definitively saying that it cannot be applied).¹⁷⁸ In particular, inquiry five says that the doctrine should not be applied if another judicial doctrine is more appropriate.¹⁷⁹ In other words, the economic substance doctrine should not be applied in addition to another doctrine (if the other doctrine is more appropriate), even if the economic substance doctrine is also a viable argument.¹⁸⁰ This appears aimed at preventing the use of the enhanced penalties associated with economic substance. Inquiry seven asks whether the economic substance doctrine is “among the strongest arguments available.”¹⁸¹ If not, the doctrine “should” not be applied “without specific approval of the examiner’s manager in consultation with local counsel.”¹⁸²

Lastly, after completion of the above steps, the examiner must describe the above analysis in writing, “in consultation with his or her manager and territory manager” in order to seek DFO approval of raising economic substance arguments.¹⁸³ That written analysis is then submitted to the DFO, who should “consult with Counsel before a decision is made.”¹⁸⁴

In addition, an examiner is required to notify the taxpayer that the examiner is considering raising the economic substance doctrine (as soon as possible, and not later than the time the examiner begins the required pre-DFO-approval analysis of factors).¹⁸⁵ Before granting approval to raise the economic substance

¹⁷⁶ *See id.*

¹⁷⁷ *See id.*

¹⁷⁸ *See id.*

¹⁷⁹ *See id.*

¹⁸⁰ *See id.*

¹⁸¹ *See id.*

¹⁸² *See id.*

¹⁸³ *See id.*

¹⁸⁴ *See id.*

¹⁸⁵ *See id.*

doctrine, the DFO “should” give the taxpayer an opportunity to respond in writing or in person.¹⁸⁶

Neither of the above directives are irrevocable for the IRS (which can change its mind at any time), nor may either directive technically be relied on by taxpayers.¹⁸⁷ Each directive states that it is “not an official pronouncement of law, and cannot be used, cited, or relied upon as such.”¹⁸⁸ However, because such directives are publicly available and because they help predict the enforcement choices of the IRS, taxpayers treat them as if they were official guidance.¹⁸⁹ Further, the directives provide mandatory guidance for IRS examiners and other IRS employees, unless and until such directives are modified.¹⁹⁰

The second directive requires an examiner to consider much more than whether a transaction fails one of section 7701(o)’s two prongs.¹⁹¹ One could argue that the directive effectively requires a variant of the flexible version of the economic substance test, rather than the conjunctive (meeting two prongs is sufficient) or disjunctive (meeting one prong is enough) test. The directive does not specify how many factors must be met (or failed) before the economic substance doctrine is raised (or before raising the economic substance argument is determined to be inappropriate).¹⁹²

Presumably, examiners can also consider additional factors (as well as the eighteen listed in the directive), as long as they consider the listed items. In other words, the lists are not necessarily the exclusive factors, although the directive does not address that point.¹⁹³

¹⁸⁶ *See id.*

¹⁸⁷ *See id.*; *see also* I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

¹⁸⁸ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

¹⁸⁹ *See, e.g., Elliott, supra* note 16 (reporting that practitioners treated Notice 2014-58 as if it reversed actual guidance created by the second directive, and as if that directive had previously provided rules that taxpayers could rely on: “Practitioners are ... faulting the notice for its reversal of course on a prior *IRS directive that exempted the sham transaction doctrine from being considered a ‘similar rule of law.’*”) (emphasis added).

¹⁹⁰ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

¹⁹¹ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

¹⁹² *See id.*

¹⁹³ *See id.*

All of the required analyses and consultation, followed by written description of the analyses and seeking approval of the examiner's manager and DFO, create disincentives for examiners to raise the economic substance doctrine.¹⁹⁴

These numerous obstacles (many analyses, multiple approvals, and a written report of the analyses), before an LB&I examiner is even allowed to assert the economic substance doctrine,¹⁹⁵ raise questions about the appropriate limits of an agency's enforcement discretion. If anyone had standing, could one argue that the IRS has essentially chosen to almost never enforce section 7701(o),¹⁹⁶ despite Congress's clear statement (in section 7701(o)) that the courts are the final determiners of whether the doctrine applies?¹⁹⁷ Could one argue that such nonenforcement goes beyond the agency's authority? Or does the agency always have discretion not to raise a judicial doctrine as a legal argument? Has codification altered the extent of such allowable discretion? Might the IRS argue that because the directives are not technically binding guidance, therefore such directives need not follow any rules that might require an agency to more closely adhere to Congressional intent?

The second directive's thirty-five factors (eighteen, if duplicative ones are disregarded) can also be read as creating standards for treating certain transactions as meeting the economic substance test (in practice).¹⁹⁸ A transaction for which the economic substance test is not raised is effectively treated as if it meets the economic substance analysis.

Under the statute, transactions must meet at least the two prongs in order to pass the economic substance analysis.¹⁹⁹ But

¹⁹⁴ See Sheppard, *supra* note 5 (arguing that the LB&I directive creates hurdles that discourage IRS employees from raising the economic substance doctrine).

¹⁹⁵ In contrast, Chief Counsel review (by an Associate office or the office of the Taxpayer Advocate) is required for section 7701(o) cases only if the fact pattern is "novel." See CC-2016-009 (June 30, 2016), Exhibit 35.11.1-1, Part II, Procedure and Administration issue 22 (Chief Counsel Notice that preceded expected changes to the Chief Counsel Directives Manual) ("The application of the codified economic substance doctrine under section 7701(o) in novel cases.").

¹⁹⁶ See Sheppard, *supra* note 5 (criticizing the second directive).

¹⁹⁷ See I.R.C. § 7701(o)(5)(C) (2012).

¹⁹⁸ Alternatively (or in addition), the IRS directive can be viewed as determining relevance (in practice), which is outside the IRS's authority under the statute. See § 7701(o)(5)(C).

¹⁹⁹ See § 7701(o)(1).

the directive requires analysis of far more than just variants of the objective and subjective prongs set forth in the statute, before the doctrine can be raised.²⁰⁰ The directive thus can be read as changing the statutory minimum (in effect): even transactions that fail the code's objective and subjective prongs are safe from having the economic substance doctrine raised if they meet some (unspecified) combination of the directive's eighteen (or thirty-five) factors.

That is the directive's practical result, although the directive technically governs examiners' behavior in raising the doctrine rather than literally setting forth a test (or safe harbor) for meeting the doctrine. A transaction can fail one or both prongs (which would cause failure under the newly required conjunctive test or under former versions of the disjunctive test, respectively) and still be exempt from an economic substance analysis under the directive's factors (although such factors are vague).

Because the IRS has created a policy under which a transaction must fail more than just one of the two prongs before such transaction is treated as lacking economic substance, that standard (more taxpayer favorable than the conjunctive test) appears questionable under the statutory language. Now that Congress has mandated the conjunctive test (meaning that taxpayers must meet both prongs, and that failing even one prong is sufficient to fail the economic substance test),²⁰¹ how can the directive require that eighteen factors be analyzed before the doctrine is even raised? For that reason, the directive is arguably an invalid exercise of administrative discretion (because it appears to allow a transaction that fails one or both prongs to nonetheless avoid the economic substance analysis, thereby de facto being respected as having economic substance).

But the extent of the IRS's authority only matters if any taxpayer (or other member of the public) has standing²⁰² to challenge

²⁰⁰ Compare I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011) (eighteen factors and multiple steps), with § 7701(o)(1) (requiring application of the subjective and objective prongs).

²⁰¹ See § 7701(o)(1).

²⁰² See Ryan Guilds, Comment, *A Jurisprudence of Doubt: Generalized Grievances as a Limitation to Federal Court Access*, 74 N.C. L. REV. 1863, 1885–86 (1996) (describing the judicial principle that a “generalized grievance,” suffered by a large group of citizens, cannot supply standing); Nancy Staudt, *Taxpayers in Court: A Systematic Study of a (Misunderstood) Standing Doctrine*, 52 EMORY L.J. 771, 782, 832, 842 (2003) (agreeing that it is difficult for taxpayers to achieve standing on the basis of a generalized grievance regarding federal tax

it and wishes to do so. This is unlikely, because taxpayers are generally not prone to challenge the validity of anything that makes the IRS less likely to apply the economic substance doctrine, especially given the high penalties that are now associated with the doctrine.²⁰³

The two directives appear to largely survive the later issuance of Notice 2014-58,²⁰⁴ with one exception. The notice's rules

issues, attempting to find a pattern in federal courts' treatment of such standing issues, and contrasting the (more taxpayer-favorable) treatment of generalized grievance standing issues regarding state and local taxes, even in the federal courts); Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 DUKE L.J. 829, 847 (2012) (considering whether third parties, not the subject of potential IRS enforcement actions, have standing to challenge the IRS's lack of action); cf. Daniel Jacob Hemel & David Kamin, *The False Promise of Presidential Indexation*, 36 YALE J. ON REG. (forthcoming) (manuscript at 25, 28–32), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3184051 (discussing the difficulty of achieving standing to challenge potential IRS regulations that index the bases of capital assets, and suggesting that states might have such standing if the states' income tax is computed by reference to the federal income tax calculation). *But see* Patrick J. Smith, *Standing Issues in Direct APA Challenges to Tax Regulations*, TAX NOTES TODAY, Nov. 24, 2015, <https://www.taxnotes.com/tax-notes-today/litigation-and-appeals/standing-is-sues-direct-apa-challenges-tax-regulations/2015/11/24/g083?highlight=%29%20Standing%20Issues%20in%20Direct%20APA%20Challenges%20to%20Tax%20Regulations%20Standing%20Issues%20in%20Direct%20APA%20Challenges%20to%20Tax%20Regulations> (arguing that a taxpayer need not suffer a direct injury in order to have standing to challenge the validity of an IRS regulation). *See generally* Mark Gabel, Note, *Generalized Grievances and Judicial Discretion*, 58 HASTINGS L.J. 1331 (2007) (discussing the generalized grievance doctrine and its evolution over time). It is not clear whether the standing requirement with respect to agency inaction might be different than the criteria for standing to challenge the validity of a Treasury regulation, because the former is a failure to act, while the latter is an active publication of a rule. Conceivably, the IRS's communication of its unwillingness to assert the economic substance doctrine, through its internal letters to its own employees, could be viewed as an action (rather than inaction). There would remain, however, the issue of whether any specific taxpayer suffered identifiable, particularized harm, rather than a generalized grievance shared with a large class of taxpayers or citizens, as a result of the IRS's decision not to apply the economic substance doctrine (or to apply it only rarely).

²⁰³ See § 6662(b)(6) (2018) (imposing a strict liability penalty for tax deficiencies attributable to lack of economic substance (as defined under section 7701(o))). *See also* §§ 6662(c), 6676 (2018); § 6664(d) (2015).

²⁰⁴ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); Andrew Velarde, *ABA Section of Taxation Meeting: 'Wait-and-See' Approach for More Economic Substance Guidance*, TAX NOTES TODAY, Feb. 9, 2015, <https://www.taxnotes.com/tax-notes/penalties/aba-section-taxation-meeting-wait-and-see>

regarding similar rules of law appear to override the second directive's statement that no doctrine will be treated as similar rule of law until further guidance is issued.²⁰⁵ Notice 2014-58 appears to constitute such further guidance.²⁰⁶ In other respects, the directives survive as rules for IRS employees. Although these are technically internal directives within the IRS, they are available to the public, and taxpayers read and rely on them as if they were intended as taxpayer guidance.²⁰⁷

III. AGENCY RESPONSE TO AND CERTAIN BIGGER PICTURE ISSUES RAISED BY SECTION 7701(O)

A. *Issues Regarding the Agency*

1. *Interaction Between the Three Branches of Federal Government*

Section 7701(o)²⁰⁸ raises some interesting issues about the interaction between the three branches of the Federal government. First, it presents a rare instance of the legislative branch writing

-approach-more-economic-substance-guidance/2015/02/09/qy3v?highlight=Approach%20for%20More%20Economic%20Substance%20Guidance (“Rochelle Hodes, attorney-adviser, Treasury Office of Tax Legislative Counsel [speaking at an American Bar Association meeting in 2015] ... said that Notice 2014-58, 2014-44 IRB 746, released in October 2014, in no way overrules previous IRS Large Business and International Division directives from 2010 (LMSB-04-0910 -024) and 2011 (LB&I-04-0711-015), which still serve as guidance to examiners and managers.”).

²⁰⁵ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁰⁶ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁰⁷ See Rosenberg, *supra* note 2; see also Marie Sapirie, *Increase in Informal Guidance Unlikely to Stop Soon*, TAX NOTES TODAY, Jan. 23, 2012, <https://www.taxnotes.com/tax-notes/audits/increase-informal-guidance-unlikely-stop-soon/2012/01/23/qpsv?highlight=%29%20Increase%20in%20Informal%20Guidance%20Unlikely%20to%20Stop%20Soon%20Increase%20in%20Informal%20Guidance%20Unlikely%20to%20Stop%20Soon> (“As a practical matter, if a position is taken in an industry directive, for all intents and purposes I think a taxpayer can in practice rely on that,” said Roland Barral, area counsel (financial services industry), IRS Large Business and International Division;” some practitioners expressed reluctance to rely on the second economic substance directive due to concerns about the application of penalties to “similar rules of law,” but that was before Notice 2014-58 laid such concerns to rest).

²⁰⁸ See § 7701(o) (2012) (codifying the judicial doctrine of economic substance).

rules about the substance of a court-developed doctrine of interpretation in the tax area—not a procedural rule about what kinds of evidence are admissible,²⁰⁹ or what the standard of proof should be, but the content of a judicial rule for respecting tax benefits. This appears to be an unusual level of involvement by the legislative branch regarding a set of substantive rules developed by the courts, except that the whole point of the economic substance doctrine is to implement Congressional intent.²¹⁰ Therefore, perhaps it is logical for Congress to tell the judiciary how it wishes its own intent to be tested. Even if logical, this is an atypical example of Congress altering a broad judicial rule that applies generally to many tax benefits, rather than Congress correcting the judiciary's interpretation of one specific statutory provision.²¹¹ Further, section 7701(o) includes Congressional delegation of regulatory authority to the Treasury. This allows the agency (the IRS) to mandate changes (for the first time) to a long-standing judicial doctrine, by means of issuing guidance under section 7701(o).²¹²

2. Agency Authority to Issue Guidance

a. Grant of Regulatory Authority

The biggest impact of section 7701(o) may be that it grants the Treasury the authority to issue guidance that changes, expands,

²⁰⁹ See, e.g., § 6110(j)(3) (2007) (indicating that non-binding IRS rulings are not admissible in court); Treas. Reg. § 301.6110-7(b) (1988) (indicating that “a written determination may not be used or cited as precedent”).

²¹⁰ See *supra* note 2 and accompanying text; see also *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 113 (2d Cir. 2015) (explaining that the economic substance doctrine is meant to implement Congressional intent).

²¹¹ See, e.g., § 901(i) (2010). There has been some dispute in the past as to whether Treasury regulations can override a pre-existing judicial interpretation of a statute. For example, the “Mexican Railroad cases” held that Treasury regulations could not have that effect. See *Mo. Pac. R.R. Co. v. United States*, 497 F.2d 1386, 204 Ct. Cl. 837 (1974); *Chi., Burlington, & Quincy R.R. Co. v. United States*, 455 F.2d 993 (Ct. Cl. 1972), *rev’d on other grounds*, 412 U.S. 401 (1973); *Mo.-Ill. R.R. Co. v. United States*, 381 F.2d 1001 (Ct. Cl. 1967); *Mo. Pac. R.R. Co. v. United States*, 301 F. Supp. 839 (E.D. Mo. 1967), *aff’d in part and rev’d in part on other grounds*, 411 F.2d 327 (8th Cir. 1969). See generally Rev. Rul. 78-256; G.C.M. 37264 (1977). In that instance, Congress solved the dispute between the courts and the agency by enacting a new statutory provision, section 901(i), that reflected the challenged regulations’ rules. See § 901(i).

²¹² See §§ 7701(o), 7805(a) (2012).

or constrains the judicial anti-abuse doctrine of economic substance (by issuing guidance under section 7701(o)).²¹³ Section 7701(o) has thus shifted the balance of power in the development of the economic substance doctrine away from the courts and towards the Treasury—but only if the Treasury chooses to exercise its regulatory authority.

The scope of the Treasury’s regulatory authority regarding economic substance varies depending on the particular sub-issue.²¹⁴ Section 7701(o) contains specific regulatory authority (a mandate, actually) only with respect to the treatment of foreign taxes as a cost in computing profit (“in appropriate cases”).²¹⁵ In contrast, Congress specifically reserved the relevance determination to the courts, depriving Treasury of the ability to issue guidance on that topic.²¹⁶ But for all other aspects of section 7701(o) (with the possible exception of the definition of the tested transaction),²¹⁷ the Treasury has general regulatory authority under section 7805.²¹⁸ It therefore can presumably issue guidance regarding any wording or concepts contained in section 7701(o) (with the exceptions discussed above). For example, the Treasury clearly has authority to issue guidance on what constitutes “meaningful” change in economic position, for purposes of the objective prong.²¹⁹ Potentially, such guidance could even be retroactive if it is characterized as an anti-abuse rule (because anti-abuse rules are an exception

²¹³ See § 7805(a) (granting the Treasury the authority to issue “rules and regulations for the enforcement of this title”).

²¹⁴ Compare § 7701(o)(2)(B) (“The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases”), with *id.* § 7701(o)(5)(C) (“The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted”).

²¹⁵ § 7701(o)(2)(B).

²¹⁶ *Id.* § 7701(o)(5)(C).

²¹⁷ The definition of the tested “transaction” is not explicitly reserved to the courts, in contrast to the relevance issue. Compare § 7701(o)(5)(D) (addressing transactions), with *id.* § 7701(o)(5)(C) (discussing relevance). But the statute’s description of the “transaction” is consistent with case law, and the legislative history states that the statute was not intended to change the courts’ ability to aggregate and disaggregate steps or actions in order to define which steps or actions should be tested together as one transaction. See H.R. REP. NO. 111-443, at 296–97 (2010). See generally Rosenberg, *supra* note 2.

²¹⁸ See § 7805(a).

²¹⁹ See § 7701(o)(1)(A).

from the general requirement that Treasury guidance must be prospective only).²²⁰ But the agency has so far chosen to issue only two notices, and two internal letters to its own employees, on the subject of section 7701(o).²²¹

If granting regulatory authority is one of the most important aspects of section 7701(o), but the IRS has not used its guidance authority to do much, other than with respect to penalties and reporting requirements (mostly just saying that it will follow pre-section-7701(o) case law on other issues)—then how much has section 7701(o) done, really? Even if there has not been much substantive guidance on section 7701(o) so far, the Treasury has the ability to issue additional guidance about the economic substance doctrine in the future.²²² Also, section 7701(o) contains several mandatory rules (e.g., the profit ratio rule and the requirement for “substantial” non-tax purpose that does not duplicate the objective prong) that apply even without Treasury guidance.²²³

The lack of extensive guidance (more than eight years after section 7701(o)’s enactment) raises an additional question.²²⁴ The IRS has the authority to issue guidance on the economic substance doctrine and has shown itself willing to litigate economic substance issues under pre-section-7701(o) case law.²²⁵ If the agency is willing to take positions on the interpretation of the economic substance doctrine in litigation, why has not it issued

²²⁰ See § 7805(b)(3).

²²¹ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²²² See § 7805(a).

²²³ See §§ 7701(o)(1)(B), (o)(2)(A). See generally Rosenberg, *supra* note 2.

²²⁴ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²²⁵ See, e.g., *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 107, 125 (2d Cir. 2015), *cert. denied sub nom.* 136 S. Ct. 1375 (2016); *Salem Fin., Inc. v. United States*, 786 F.3d 932, 951 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016); *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016), *cert. denied*, 2017 U.S. LEXIS 4194 (June 26, 2017); *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1440 (D. Minn. 2017), *appeal docketed*, No. 17-3578, No. 17-3676 (8th Cir. Nov. 24, 2017).

guidance? Guidance presumably would be more efficient than litigating: more likely to succeed in implementing the IRS's view, less expensive for the U.S. government in general (in terms of collecting tax revenue, as balanced against the costs of litigation or of issuing guidance), and faster and more efficient (in terms of total time expired and person hours consumed). It would, for example, significantly lessen the government's risk of losing future economic substance litigation (for cases addressing transactions that occur after section 7701(o)'s effective date), because the IRS could write government-favorable rules. To be fair, the economic substance cases that the government has litigated so far are pre-section-7701(o) transactions, and would not have been affected by guidance issued under section 7701(o).²²⁶ For those cases, therefore, the government did not have a choice between litigating or issuing guidance, because the IRS had no regulatory authority with respect to the economic substance doctrine for the time periods at issue. But issuing guidance could prevent future litigation or improve the government's odds of winning future cases. Section 7701(o)'s effective date has applied for years now, so cases applying that section should be arriving in the courts soon (if the IRS chooses to raise the issue).

b. Informal Guidance Issued by the IRS

The Treasury has issued two notices on section 7701(o) so far.²²⁷ Other than discussing the penalty provisions applicable to section 7701(o) deficiencies, the notices mostly just say that the IRS will continue to follow conjunctive-test economic substance case law (which currently consists solely of pre-section-7701(o) case law).²²⁸ For example, the notices say that the IRS will continue to apply existing case law to determine if the transaction meets the two prongs described in 7701(o).²²⁹ This fails to acknowledge

²²⁶ See, e.g., *Bank of N.Y. Mellon Corp.*, 801 F.3d at 107, 125; *Salem Fin., Inc.*, 786 F.3d at 951; *Santander Holdings USA, Inc.*, 844 F.3d 15; *Wells Fargo & Co.*, 260 F. Supp. 3d at 1140.

²²⁷ I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

²²⁸ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

²²⁹ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010). The IRS says that it will apply the statute's profit ratio test for both prongs, as a prerequisite

that section 7701(o)'s descriptions of the two prongs might differ from the descriptions in pre-7701(o) case law.²³⁰ In particular, it does not address the definition of "meaningful" change in the objective prong or the "substantial" standard in the profit ratio test.²³¹ It also does not admit that, under section 7701(o), it might not be possible to meet the business purpose requirement solely by a showing of potential profit (or by otherwise duplicating the objective prong).²³²

However, practically speaking, continuing to use pre-7701(o) case law to define the objective and subjective prongs (even after section 7701(o) takes effect) is a taxpayer-favorable position,²³³ and therefore unlikely to face a challenge from taxpayers. However, courts might disagree with the IRS's interpretation of the two prongs *sua sponte*, in theory.²³⁴ It is also theoretically possible that the Department of Justice (DOJ), litigating on behalf of the U.S. government, might take a different litigating position about the meaning of the two prongs than the IRS has taken in its notices.²³⁵

before "profit motive" can be taken into account. But it also says that "[i]n performing this calculation, the IRS will apply existing relevant case law and other published guidance." Presumably, the IRS does not mean that it will use the "de minimis" or "insignificant" profit descriptors of pre-7701(o) case law to interpret the statute's profit ratio test. *See supra* note 99 and accompanying text (citing *Sheldon* and other cases). Such an interpretation of the section 7701(o) prongs would seem vulnerable to a validity challenge, if any taxpayer had standing and chose to question the rule. Practically speaking, though, the agency has more leeway on validity concerns whenever the guidance at issue favors taxpayers.

²³⁰ *See* Rosenberg, *supra* note 2 (manuscript at 49) (discussing the impact of codification on the business purpose prong).

²³¹ *See* I.R.C. §§ 7701(o)(1)(A), (2)(A) (2012); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

²³² *See* Rosenberg, *supra* note 2.

²³³ *See id.*

²³⁴ *See generally* Christopher M. Pietruszkiewicz, *Discarded Deference: Judicial Independence in Informal Agency Guidance*, 74 TENN. L. REV. 1, 2 (2006).

²³⁵ The IRS represents the government in the Tax Court. In all other courts (including the Court of Claims, the District Courts, and all appellate courts), the Department of Justice (DOJ) represents the U.S. government. The taxpayer can choose which court will hear its tax case: the Tax Court, the Court of Claims, or the applicable District Court. Therefore, practically speaking, the taxpayer can choose to litigate against the IRS rather than DOJ, or vice versa. One additional factor is that taxpayers need not pay the disputed tax before challenging

The notices, because they are informal vehicles, are not binding on the courts²³⁶ or on the Department of Justice. Technically, literally, they are not binding on taxpayers—they only set forth the IRS’s policy on how it will interpret section 7701(o).²³⁷ The notices are not a vehicle that requires deference from the courts (unlike, for example, regulations that are issued after notice and comment procedures). These notices thus leave the courts (and taxpayers) able to argue for their own interpretation of the statutory language. But the notices are likely to be good predictors of the IRS’s litigation positions, and its positions on audit with respect to the economic substance doctrine.²³⁸

The other substantive issue addressed in the notices is the idea that “rules of law” (which, like economic substance issues, trigger mandatory penalties) are limited to judicial doctrines that use the same factors and analysis as section 7701(o), and that are asserted in cases where the IRS is also raising section 7701(o).²³⁹ In other words, the IRS will not enforce the statutory requirement regarding penalties for “similar rules of law.”²⁴⁰

With respect to administrative guidance, the focus (by both the Treasury and taxpayers) appears to have been on the penalty consequences of section 7701(o) issues, rather than the substantive impact of section 7701(o) on the economic substance doctrine.²⁴¹

that tax in the Tax Court, while payment of the tax is required before a case is brought in a District Court or the Court of Claims.

²³⁶ See *supra* text accompanying note 87. Cf. William Funk, *Administrative Law Discussion Forum: Legislating for Nonlegislative Rules*, 56 ADMIN. L. REV. 1023 (2004) (suggesting that legislation could address the level of judicial deference that should be given to various types of administrative guidance); Todd Rakoff, *The Choice between Formal and Informal Modes of Agency Guidance*, 52 ADMIN. L. REV. 159 (2000) (discussing the Food and Drug Administration’s increasing use of informal methods of communicating guidance to the public).

²³⁷ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

²³⁸ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

²³⁹ See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014).

²⁴⁰ See discussion *supra* at Section II.B; see also notes 132–47 and accompanying text.

²⁴¹ Cf. Richard M. Lipton, “Codification” of the Economic Substance Doctrine—*Much Ado About Nothing*, 112 J. TAX’N 325, 329 (2010) (“In many respects, the most important aspect of the new legislation is not the substantive law concerning the definition of economic substance but rather the penalty that is imposed on transactions that lack economic substance.”).

There appears to have been less emphasis on the rules for determining whether a transaction lacks economic substance (and whether section 7701(o) has changed those rules) and more attention on the increased penalties caused by other statutory changes that accompanied section 7701(o). The notices discuss (and perhaps received the most attention for) the situations to which the enhanced penalties will apply.²⁴²

The IRS has also issued two internal letters (or directives) to its own employees regarding the application of the economic substance doctrine.²⁴³ The second letter requires examiners to consider eighteen factors, to complete a written report, and to obtain approval from multiple levels of managers before asserting the economic substance doctrine.²⁴⁴ These requirements appear likely to deter IRS employees (at least those in the Large Business and International (LB&I) division) from raising the issue.²⁴⁵ The motivation for these internal procedural hurdles appears again to be IRS reluctance to impose the enhanced penalties associated with the economic substance doctrine.

The IRS's issuance of instructions to its own examiners raises issues about the interaction between such informal IRS directives and the IRS's regulatory authority. Taxpayers read the former for guidance,²⁴⁶ although technically it is not binding on the courts, can be changed at will by the IRS, is not addressed to taxpayers, and cannot be relied on by taxpayers.²⁴⁷ In particular, one could debate the appropriateness of the IRS using this type of directive

²⁴² See I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010). Similarly, the internal IRS guidance seems intended to avoid imposing such enhanced penalties. See I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

²⁴³ See I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁴⁴ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁴⁵ See Sheppard, *supra* note 5 (arguing that the LB&I directive discourage IRS employees from raising the economic substance doctrine).

²⁴⁶ See Rosenberg, *supra* note 2; *supra* text accompanying note 208; see also, e.g., Jensen, *supra* note 61, at 38 (implying that the 2011 directive had the same weight of authority as Notice 2014-58 and noting that "some commentators have complained that [the notice's reference to the sham transaction doctrine] ... contradicts guidance provided by the Service not so long ago [meaning the 2011 internal IRS directive].").

²⁴⁷ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

as a means to narrow the impact of (or contradict the clear mandate of) statutory language, in a manner that the Treasury could not accomplish by formal guidance²⁴⁸ (because it does not have regulatory authority to either define relevance, alter the statutory mandate for strict liability penalties, or respect as having economic substance a transaction that fails either of the two prongs listed in section 7701(o)).²⁴⁹

The IRS's directives arguably present an instance of an agency thwarting Congressional intent via internal guidance to its employees (which also impacts taxpayer behavior, because the guidance is publicly available). Yet no one is likely to challenge the agency's authority to limit the application of section 7701(o), because such limits are generally taxpayer favorable (because the consequences of applying the economic substance doctrine may often be harsher—especially when penalties are taken into account—than the use of other rules available to the agency).²⁵⁰

The IRS has thus arguably accomplished an end run around its lack of regulatory authority regarding “relevance.”²⁵¹ (Taxpayers indeed had asked the IRS to provide guidance on relevance,

²⁴⁸ Cf. *American Air Liquide, Inc. v. Comm'r*, 116 T.C. 23, 27 (2001) (holding that the executive branch cannot frustrate Congressional intent by declining to issue regulations to provide a rule called for by a statute); *Int'l Multifoods Corp. v. Comm'r*, 108 T.C. 25, 38 (1997). If the executive branch cannot, by passive inaction, prevent legislation from taking effect, how can affirmative executive action (not formal guidance but written directives to employees) appropriately have that same impact of preventing a statutorily envisioned rule from taking effect? One could argue that the IRS is merely exercising its enforcement discretion, or that section 7701(o) does not require that the economic substance doctrine be used (but merely sets parameters that apply if and when the doctrine is raised).

²⁴⁹ See I.R.C. § 6662(b)(6) (2018); *id.* §§ 7701(o)(1), (o)(5)(c) (2012); see also Jensen, *supra* note 60, at 31–32.

²⁵⁰ If a transaction lacks economic substance, it is disregarded for federal income tax purposes, which is harsher than the result under many other anti-abuse rules. See *supra* note 25 and accompanying text; see also Rosenberg, *supra* note 63, at 169 n.12. However, sometimes the economic substance doctrine produces a countervailing benefit for the taxpayer, because it causes all tax effects of a transaction to be disregarded (including taxpayer-unfavorable effects like income inclusions). But the increased penalties currently associated with failing the economic substance doctrine are likely to exceed any taxpayer advantage from disregarding an income inclusion, even if such benefit was not already outweighed by the taxpayer's loss of the originally claimed tax benefit (such as an interest deduction or foreign tax credit).

²⁵¹ See § 7701(o)(5)(c).

despite such lack of authority.)²⁵² So far, none of the Treasury's written pronouncements regarding section 7701(o) (two notices and two letters to IRS employees) are binding (non-reversible) on the IRS as an institution,²⁵³ nor can they technically be relied on by taxpayers. Nor are courts bound to follow the notices or the directives.²⁵⁴ But taxpayers react to both such notices and such letters as if these communications from the IRS can be relied on.²⁵⁵

Because the notices²⁵⁶ and (especially) the internal IRS directives are informal types of "guidance," there is no formal notice and comment procedure for them, and the Treasury appears to believe that the Administrative Procedure Act (APA) does not apply to such vehicles.²⁵⁷ Also, because the notices and letters are not technically binding on the IRS or on taxpayers, and might not literally constitute "guidance," their validity as a permissible exercise of agency power seems harder to challenge as a procedural matter. Nor is there an obvious avenue for objecting to the content of the notices or letters, because they are informal. Conversely, however, the notices and letters function as—i.e., are respected by both taxpayers and the IRS as if they were—official, binding guidance.²⁵⁸

The IRS's written instructions to its examiners, essentially ordering them not to raise the economic substance issue unless it is the only (or the best) option, and requiring many procedural hurdles before examiners can raise the doctrine in any circumstances,

²⁵² See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010).

²⁵³ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011). The letters to LB&I employees may be binding on such employees, but the IRS (following its own institutional processes) can change or ignore the content of such letters any time it chooses to do so.

²⁵⁴ See *Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693, 728 (S.D. Iowa 2011) ("A notice is akin to a 'revenue ruling' and is an interpretation of the law offered by the IRS. While not binding precedent, revenue rulings—and notices—are entitled to 'some weight,' because the IRS 'consider[s] them authoritative and binding.'") (citations omitted).

²⁵⁵ See *supra* text accompanying notes 247–48.

²⁵⁶ See *Pritired 1*, 816 F. Supp. 2d at 728 (stating that IRS notices should be given "some weight," on the theory that they are similar to revenue rulings).

²⁵⁷ See *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 978 (7th Cir. 1998). See generally Book, *supra* note 17, at 547–51 (discussing the manner in which the IRS issues informal guidance).

²⁵⁸ See *supra* text accompanying notes 206–08.

arguably circumvent the will of Congress.²⁵⁹ For example, if a claimed tax benefit could be challenged under both the step transaction doctrine and the economic substance doctrine, and the IRS uses only the former grounds (decreasing its chances of prevailing in court, and preventing the application of the enhanced penalties associated the section 7701(o)), does that raise issues regarding the acceptable limits of agency discretion?

If the IRS attempts to discourage agents from raising economic substance issues (perhaps even when it is the only or best argument), does that choice by the agency arguably violate separation of powers principles by effectively repealing legislation (by refusing to apply it)? Where is the line between invalid frustration of Congressional intent by the agency, on the one hand, and valid exercise of agency discretion, on the other (e.g., if the agency does not have the resources to follow through on everything required by the statute)?²⁶⁰ Are enforcement priorities more allowable

²⁵⁹ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁶⁰ See generally NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS 2017, at vii (Dec. 31, 2017) (“Funding cuts have rendered the IRS unable to provide acceptable levels of taxpayer service, unable to upgrade its technology to improve its efficiency and effectiveness, and unable to maintain compliance programs that promote both compliance and protect taxpayer rights.”); John A. Koskinen, *Woodworth Lecture: The Challenges Facing the IRS of the Future*, 159 TAX NOTES 1163 (May 21, 2018) (discussing funding, resources, and staffing challenges faced by the IRS).

The “Brand X doctrine,” regarding the courts’ application of Chevron deference, doesn’t appear to apply to IRS choices to enforce or not enforce the economic substance doctrine, e.g., on the theory that the IRS is declining to follow case law precedent interpreting the statute. The Brand X doctrine holds that: “A court’s prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency interpretation.” *Nat’l Cable & Telecomm. Ass’n v. Brand X Internet Services*, 545 U.S. 967, 982 (2005). See generally Hemel & Kamin, *supra* note 202 (manuscript at 18). The Brand X doctrine appears to apply where a court has interpreted a statute, and then an agency issues a contrary interpretation of the same statute. So far, at least, no court has interpreted section 7701(o)—the economic substance statute—as compared to pre-section 7701(o) judicial applications of the doctrine. There is therefore no prior judicial interpretation of section 7701(o) (currently) with which the IRS statements about section 7701(o) can conflict (unless one argues that section 7701(o) incorporates prior case law by reference). One could also argue that the IRS decision

in the form of unwritten practices than as written communications (even informal guidance) to the public? The IRS (like any agency) understandably has enforcement priorities, and makes choices about the use of enforcement resources. But the IRS's approach to the economic substance doctrine is a little unusual because it involves apparent reluctance to apply an entire doctrine (an entire legal argument)—in almost any circumstances—rather than a decision not to apply a particular statute or legal principle in specific, narrow fact circumstances.²⁶¹

Are these issues ameliorated because IRS examiners can raise economic substance arguments, if they meet the required internal procedural hurdles and receive permission as required by the LB&I letter? Asserting such economic substance arguments is therefore not prohibited outright, even if the paperwork and approval requirements turn out to have the same effect, in practice.

One could potentially argue that the IRS's disinclination to raise economic substance issues does not constitute lack of enforcement of the statute, and is not mean the IRS is disregarding the statute. Rather, one could say, the statute neither creates nor

to deter enforcement of the economic substance doctrine does not involve the “construction” or interpretation of a statute, but rather the choice of whether to enforce or apply the statute at all.

²⁶¹ For example, the IRS has previously issued informal guidance (addressed to the public) indicating that it will not contest foreign tax credit creditability claims for specific foreign taxes, that it will not assert that frequent flyer miles earned during business travel constitute income (in specific circumstances), and that it will not argue that fans' catching of baseballs during baseball games is income (in particular circumstances). See Ann. 2002-18, 2002-1 C.B. 621 (frequent flyer miles); I.R.-98-56 (IRS News Release regarding baseballs); Notice 2008-3, 2008-1 C.B. 253 (stating that the IRS will not contest creditability of the Mexican “IETU” tax). But all of these address narrow fact patterns, rather than publicly stating a disinterest in asserting an entire legal theory (with the possible exception of egregious transactions, although the second directive's procedural hurdles apply in all circumstances).

These examples also consist of communications that were officially addressed to the public, unlike the internal IRS directives, which were addressed to IRS employees. See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010). It doesn't seem logical that the IRS should have more enforcement discretion if it uses informal communication with taxpayers (e.g., communication not directly addressed to taxpayers at all) compared to official, formal guidance (such as regulations).

requires the use of the economic substance doctrine, but instead merely provides that if the IRS or the courts choose to use the economic substance doctrine, then the doctrine's content must follow the requirements of section 7701(o). Under this interpretation, the IRS is free to ignore section 7701(o) unless and until it decides to raise economic substance issues in particular taxpayer cases, at which time its economic substance arguments must comply with section 7701(o)'s rules. But Congress unambiguously intended to strengthen the economic substance doctrine, and meant for the doctrine to continue to be used where appropriate.²⁶² Although the IRS can decide when to raise economic substance issues (and could also make such choices before the doctrine was codified), the de facto decision that the doctrine should never be raised (or almost never) seems contrary to Congress's intent in enacting section 7701(o).

Practically speaking, any authority issues regarding the Treasury's ability to take the approaches described in the notices and the internal IRS directives (including any issues regarding the agency's role under separation of powers principles) only have an impact if someone challenges those pieces of informal guidance.²⁶³ Taxpayers who benefit from an IRS position do not generally challenge the IRS's authority regarding such taxpayer-favorable guidance (for obvious reasons).²⁶⁴ It is not clear whether any other

²⁶² H.R. REP. NO. 111-443, at 295 (2010).

²⁶³ *Cf., e.g., Altera Corp. v. Comm'r*, 145 T.C. 91, 114 (2015) (discussing taxpayer's challenge to the validity of an IRS regulation), *rev'd*, 2018 WL 3542989 (9th Cir. 2018).

²⁶⁴ One could imagine, however, circumstances (not commonly occurring, but possible) in which taxpayers might want to challenge the validity of the notices or the internal IRS directives and their content. (In that case, the issue might be whether such a person technically has standing to raise such challenge, and in what venue.) For example, assume the following facts: Buyer Corp buys business Z from Seller Corp. The sales contract provides that if the IRS imposes additional tax or interest after the sale with respect to transactions of business Z that occurred in years before the sale, Seller Corp must reimburse Buyer for such taxes and interest (as well as legal fees and any penalties), but only if penalties are imposed. If no penalties are imposed, Seller Corp is not required to reimburse Buyer Corp for any of such amounts (including additional tax or interest). Assume that the IRS raises an issue on audit regarding a pre-sale year of business Z. Buyer Corp wants Seller Corp to be responsible for any additional amounts that the IRS collects by reason of such issue (for the pre-sale year). The dollar amounts are large. The IRS asserts another ground, rather than section

person (anyone not directly affected by the informal guidance) has standing to bring such a challenge.²⁶⁵ Essentially, the agency can issue any content it likes through informal guidance, as long as there is no fact pattern in which a taxpayer or other person would a) want to, b) have standing to, and c) have a procedural mechanism to challenge the Treasury's authority to do so.²⁶⁶ A taxpayer who did meet those criteria might challenge the informal guidance²⁶⁷ on the grounds that a) it may be invalid because it may be inconsistent with section 7701(o) and with Congressional intent regarding that statute and its associated penalties, or b) if it functions (and is treated in every way except admissibility in court) as if it were a regulation (as if it were formal guidance), then it must follow administrative law procedures that apply to regulations (such as notice and comment procedures).

3. *IRS Deterred from Raising Economic Substance Issues*

Congress seems to have accomplished, in some ways, the opposite of what it intended to achieve with section 7701(o).²⁶⁸

7701(o) or economic substance, and does not attempt to collect penalties. Buyer Corp now is motivated to try to get the IRS to raise section 7701(o) and to assert strict liability penalties.

²⁶⁵ See Zelenak, *supra* note 202, at 847 (considering whether third parties, not the subject of potential IRS enforcement actions, have standing to challenge the IRS's lack of action). See generally Staudt, *supra* note 202, at 782 (agreeing that it is difficult for taxpayers to achieve standing on the basis of a generalized grievance regarding federal tax issues, attempting to find a pattern in federal courts' treatment of such standing issues, and contrasting the (more taxpayer-favorable) treatment of generalized grievance standing issues regarding state and local taxes, even in the federal courts). See *supra* text accompanying note 201.

²⁶⁶ See generally Zelenak, *supra* note 202 (discussing pro-taxpayer IRS decisions not to enforce statutory rules in certain fact patterns, considering that the IRS has less leeway, practically speaking, to act in taxpayer-unfavorable ways, and discussing standing to challenge taxpayer-favorable agency actions).

²⁶⁷ I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

²⁶⁸ See H.R. REP. NO. 111-443, at 295 (2010) (expressing Congressional intent to make the economic substance doctrine more effective); Sheppard, *supra* note 5 (arguing that the IRS has essentially stopped enforcing the economic substance doctrine).

Counterintuitively, strict liability penalties associated with economic substance issues (and enacted at the same time as section 7701(o)) may prevent or substantially lessen the application of the economic substance doctrine in practice, by discouraging the IRS from raising the issue.²⁶⁹ The IRS's instructions to its employees make it less likely that such IRS employees will raise economic substance issues, because such instructions require consideration of eighteen factors, completion of a written report, and approval from multiple levels of managers.²⁷⁰ The IRS's expressed aversion to raising economic substance issues appears to be caused not by section 7701(o) itself, but by the accompanying amendments to various penalty provisions.²⁷¹ Those amendments imposed twenty percent and forty percent penalties, without reasonable basis exceptions, for deficiencies asserted under the economic substance doctrine (as defined in section 7701(o)).²⁷² The two notices published with regard to section 7701(o), like the two directives, similarly show a disinclination to apply such penalties.²⁷³

If the IRS does not attempt to collect tax under economic substance arguments, then taxpayers do not wind up in court on economic substance issues, and courts never get involved. In that case, the courts will have no opportunity to apply the doctrine (unless they find a way to raise it *sua sponte*, in cases that arrive in court for other reasons), and no opportunity to interpret section 7701(o)'s effects.²⁷⁴

Because the IRS's internal rules that impede agents from raising economic substance issues are publicly available,²⁷⁵ the

²⁶⁹ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011). However, that directive applies to the Large Business and International Division, and not to the other divisions of the IRS.

²⁷⁰ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁷¹ Cf. Sheppard, *supra* note 5 ("In LB&I-04-0711-015, the IRS has instructed examiners not to assert the penalty against large business taxpayers. The directive accomplishes this by setting insurmountable hurdles in front of agents, some of whom, thankfully, seem to be ignoring the instruction.").

²⁷² See I.R.C. §§ 6662(b)(6)(c), 6676 (2018); § 6664(d) (2015).

²⁷³ See I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (Oct. 4, 2010); I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 27, 2014); I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011); I.R.S. Treas. Dir. LMSB-20-0910-024, IRM 20.1.1, 20.1.5 (Sept. 14, 2010).

²⁷⁴ See Jensen, *supra* note 60, at 28.

²⁷⁵ I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

economic substance doctrine arguably loses any deterrent effect on aggressive tax planning (at least for taxpayers under the jurisdiction of the relevant IRS division), because taxpayers know that the IRS is unlikely to raise the economic substance issue. Of course, the IRS's guidance to its examiners is not binding on the IRS and can change at any time.

The enhanced penalty provisions' apparent effect on the IRS is ironic because stricter penalties—strict liability with no reasonable basis exception—were presumably meant to make the consequences of failing the economic substance analysis harsher for taxpayers (and possibly to deter hyperaggressive tax planning),²⁷⁶ not to prevent the doctrine from ever being applied. Also, Congress appeared to approve of the economic substance doctrine as a tool for judicial safeguarding of Congressional intent, rather than intending the doctrine to be applied less frequently than it was before codification.²⁷⁷ Congress imposed rules on how the doctrine should be applied, but did not indicate in any way that courts should stop using the doctrine.²⁷⁸ Instead, the House Report accompanying section 7701(o) says that codification was meant “to provide greater clarity and uniformity in the application of the economic substance doctrine *in order to improve its effectiveness at deterring unintended consequences.*”²⁷⁹

Congress left the relevance determination to the courts rather than limiting the doctrine's application (and even prevented the Treasury from issuing guidance on relevance).²⁸⁰ In fact, mandating two prongs (in section 7701(o)) makes the doctrine

²⁷⁶ Congressional budget estimators apparently did not expect the strict liability penalties to have a deterrent effect on courts or on IRS enforcement—presumably, that is why they scored the entire legislative package (section 7701(o) and the penalty provision amendments) as a revenue raiser. *See* Lipton, *supra* note 241, at 325 (noting that “although there was no official breakdown [of the revenue estimates between section 7701(o) and its accompanying penalty amendments], it is likely that much of the revenue will be generated by the strict liability penalty.”). Congress appears to have expected the penalties to be actually applied. *See generally* Jensen, *supra* note 19, at 30 (the “strict liability penalty ... may be more important than the substantive rules in deterring questionable taxpayer behavior A penalty of that magnitude should be enough to get anyone's attention.”).

²⁷⁷ *See* H.R. REP. NO. 111-443, at 295 (2010).

²⁷⁸ *See id.* *See generally* I.R.C. § 7701(o) (2012).

²⁷⁹ *See* H.R. REP. NO. 111-443, at 295 (2010) (emphasis added).

²⁸⁰ *See* § 7701(o)(5)(C).

tougher, by making it harder for taxpayers to satisfy.²⁸¹ Requiring that reasonably expected profit be substantial in comparison to tax benefits (before profit potential can be taken into account in meeting the two prongs) may also have been intended to make the doctrine more stringent.²⁸² Thus, Congress may have meant to make the economic substance doctrine a stronger safeguard for Congressional intent and a better weapon against unintended tax benefits.²⁸³ Instead, the penalty changes enacted in 2010 have conversely weakened the economic substance doctrine's impact on taxpayers by making the IRS (very publicly) less willing to apply it.²⁸⁴

Lessening any deterrent effect of the economic substance doctrine is arguably a policy problem only in instances where economic substance is the only (or strongest) argument against a transaction.²⁸⁵ But the economic substance doctrine, by its nature, applies where the literal words of Code and regulatory requirements are met,²⁸⁶ and those are exactly the fact patterns in which there may be few other strong arguments available to the IRS, e.g., few arguments under the words of the Code and regulations. There may instead be alternative arguments under other anti-abuse rules, such as section 269,²⁸⁷ the partnership anti-abuse rules,²⁸⁸ and judicial doctrines such as the business purpose and step transaction doctrines.²⁸⁹ Then again, in some

²⁸¹ See *id.* § 7701(o)(1); see also Jensen, *supra* note 60, at 29.

²⁸² See § 7701(o)(2)(A); see also Rosenberg, *supra* note 63, at 173.

²⁸³ See H.R. REP. NO. 111-443, at 295.

²⁸⁴ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011). See generally Leigh Osofsky, *The Case for Categorical Nonenforcement*, 69 TAX L. REV. 73, 124–26 (2015) (discussing agency non-enforcement choices, and positing that it is more legitimate for the agency to state clearly its non-enforcement policies than to keep them hidden).

²⁸⁵ The IRS internal guidance technically still allows examiners to raise the economic substance doctrine in such cases, although it imposes internal procedural hurdles even if raising the issue is justified. See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

²⁸⁶ See generally *supra* text accompanying notes 1, 2, 5.

²⁸⁷ See I.R.C. § 269 (2014).

²⁸⁸ See Treas. Reg. § 1.701-2 (1995).

²⁸⁹ See Lipton, *supra* note 241, at 32 (2010); *infra* notes 309–10 (discussing differences and overlaps between the economic substance doctrine and other anti-abuse doctrines, such as the step transaction, substance over form, and sham transaction doctrines).

fact patterns (e.g., the STARS cases), those alternative arguments may be weaker than the economic substance doctrine.²⁹⁰

Although it appears generally reluctant to raise the economic substance doctrine, the IRS is willing to state in regulatory preambles that it reserves the right to scrutinize transactions under the economic substance doctrine as well as under other judicial doctrines.²⁹¹ Therefore, it has not entirely foreclosed the possibility of raising the doctrine. It may still be willing to raise economic substance issues in especially egregious cases.

In theory, one could challenge the IRS's stated reluctance to apply the economic substance doctrine, which arguably contravenes Congressional intent (if the issue of standing could be addressed).²⁹² But courts have generally been reluctant to review agency inaction,

²⁹⁰ In some of the recent STARS cases, the government began by asserting both economic substance arguments and arguments under other anti-abuse rules, like section 269. *See Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 19 n.3 (1st Cir. 2016), *cert. denied*, 137 S. Ct. 2295 (2017); *Wells Fargo & Co. v. United States*, 2014 U.S. Dist. LEXIS 991, 88-106 (D. Minn. 2014); *Wells Fargo & Co. v. United States*, 143 F. Supp. 3d 827, 846–52 (D. Minn. 2015). But the trial courts rejected these other anti-abuse arguments. *See Santander Holdings USA, Inc.*, 844 F.3d at 19 n.3. At the appellate level the government raised only the economic substance issue. It prevailed on that issue, regarding challenged foreign tax credits, in the three appellate-level STARS opinions. *See id.*; *see also Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 120 (2d Cir. 2015), *cert. denied sub nom.* 136 S. Ct. 1375 (2016); *Salem Fin., Inc. v. United States*, 786 F.3d 932, 942, 954–55 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016). One STARS case, *Wells Fargo*, has yet to be heard on appeal. *See Wells Fargo & Co. v. United States*, No. 09-CV-2764, 2017 U.S. Dist. LEXIS 80401, 2017-1 U.S. Tax Cas. (CCH) P50, 235 (D. Minn. May 24, 2017), *appeal docketed*, No. 17-3578, No. 17-3676 (8th Cir. Nov. 24, 2017).

²⁹¹ *See, e.g.*, I.R.S. Rev. Proc. 2013-52 I.R.B. 798 (providing guidance on dividend equivalents under section 871(m), and stating in the preamble that: “The Treasury Department and the IRS will continue to closely scrutinize other transactions that are not covered by section 871(m) and that may be used to avoid U.S. taxation and U.S. withholding. In addition, the IRS may challenge the U.S. tax results claimed in connection with transactions that are designed to avoid the application of section 871(m) using all available statutory provisions and judicial doctrines (including the substance over form doctrine, the economic substance doctrine under section 7701(o), the step transaction doctrine, and tax ownership principles as appropriate”); I.R.S. Notice CCA 201312045 (Mar. 22, 2013) (“judicial doctrines, including the economic substance doctrine, can be used to challenge a foreign tax credit claim that otherwise meets the technical requirements of the Internal Revenue Code and relevant regulations”).

²⁹² *See supra* text accompanying notes 201, 261 (regarding standing issues).

as compared to agency action.²⁹³ Agency inaction has previously been viewed as an exercise of agency discretion, as part of an agency's use of its expertise to set enforcement priorities.²⁹⁴

Also, inaction may be viewed as less impactful on members of the public than action.²⁹⁵ Depending on the facts, that general conclusion might be debatable: IRS refusal to apply the economic substance doctrine does not harm the specific taxpayers who engaged in particular (otherwise subject to challenge) transactions, but it does harm the U.S. Treasury by giving up on large amounts (hundreds of millions) of dollars of tax revenue. In turn, that lack of revenue indirectly harms many taxpayers who otherwise would have benefitted from the government's use of those dollars (to keep open a military base, hire additional workers, pay food stamp benefits, etc.).

The theory that agency *inaction* is not reviewable, because it is less likely to harm the public (compared to agency action), is consistent with the idea that taxpayer-favorable agency decisions should be less subject to review (and less circumscribed) than taxpayer-unfavorable agency guidance.²⁹⁶ Yet, as discussed above, whether an agency action (or inaction) is taxpayer favorable or unfavorable may not be that easy to distinguish, and may depend on which taxpayers one focuses on.²⁹⁷

²⁹³ See Lisa Schultz Bressman, *Judicial Review of Agency Inaction: An Arbitrariness Approach*, 79 N.Y.U. L. REV. 1657, 1664–75 (2004). However, the result has sometimes been different where the IRS refuses to issue regulations that are required by the statute (where such lack of regulations disadvantages taxpayers). See, e.g., *American Air Liquide, Inc. v. Comm'r*, 116 T.C. 23, 27 (2001); *Int'l Multifoods Corp. v. Comm'r*, 108 T.C. 25, 38 (1997).

²⁹⁴ See *Heckler v. Chaney*, 470 U.S. 821, 831 (1985) (“This Court has recognized on several occasions over many years that an agency’s decision not to prosecute or enforce, whether through civil or criminal process, is a decision generally committed to an agency’s absolute discretion.”).

²⁹⁵ See *Heckler*, 470 U.S. at 832 (“when an agency refuses to act it generally does not exercise its coercive power over an individual’s liberty or property rights, and thus does not infringe upon areas that courts often are called upon to protect. Similarly, when an agency does act to enforce, that action itself provides a focus for judicial review, inasmuch as the agency must have exercised its power in some manner.”).

²⁹⁶ See generally Bressman, *supra* note 293, at 1664–75 (discussing courts’ general reluctance to allow challenges to agency inaction).

²⁹⁷ Cf. Adam B. Thimmesh, *Taxing Honesty*, 118 W. VA. L. REV. 147, 177–81 (2015) (discussing the effects of the non-enforcement of use taxes).

Nor is it clear that agencies often decline to enforce an entire statutory section (as opposed to a single sentence, phrase, or word within a statutory framework).²⁹⁸ IRS disinclination to apply an entire codified doctrine may be especially concerning given the clear Congressional intent (evidenced by the enactment of associated penalties) that the economic substance doctrine should be applied and should be used to collect penalties (thus raising revenue for the Treasury).²⁹⁹

B. Selected Additional Impacts of Codification

1. Impact on the Application of Other Anti-abuse Doctrines

a. May Push the IRS and Courts to Try Other Anti-abuse Rules Instead

Section 7701(o) may have the (apparently unintended) effect of pushing the courts and the IRS to use other anti-abuse rules rather than the economic substance doctrine. The legislative history to section 7701(o) states that codification of the economic substance doctrine was not meant to affect other judicial anti-abuse doctrines.³⁰⁰ But the IRS's desire to avoid imposing the section 7701(o)-related penalties (and, to a lesser extent, potential restrictions on the economic substance doctrine's ability to adapt over time, after codification)³⁰¹ may cause an increased emphasis on alternative anti-abuse approaches. The courts may similarly avoid the economic substance doctrine, if they also attempt to avoid the strict liability penalties associated with section 7701(o).

²⁹⁸ See generally Osofsky, *supra* note 284, at 73–75.

²⁹⁹ H.R. REP. NO. 111-443, at 295 (2010); see also *supra* note 276 and accompanying text (discussing revenue estimates).

³⁰⁰ See H.R. REP. NO. 111-443, at 298 (“No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, the provision shall not be construed as altering or supplanting any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and the provision shall be construed as being additive to any such other rule of law.”); see also JOINT COMM. REP., *supra* note 53, at 15 (same).

³⁰¹ See generally Rosenberg, *supra* note 2 (discussing substantive impact of codification).

The IRS could try instead to apply statutory anti-abuse rules like section 269,³⁰² or judicial anti-abuse doctrines like substance over form, business purpose, or the step transaction doctrine.³⁰³ It could also assert regulatory anti-abuse rules that are specific to particular tax areas or tax benefits, such as the partnership anti-abuse regulations³⁰⁴ (relating to partnership issues). The IRS and Treasury could also issue specific new regulations that more narrowly target particular transactions, such as the “foreign tax credit generator regulations” that responded to the STARS transactions.³⁰⁵

In fact, the IRS appears to be already using alternative approaches, rather than the economic substance doctrine, where it can.³⁰⁶ IRS guidance to examiners suggests that they not raise economic substance as an issue unless it is the only or the strongest argument.³⁰⁷ Oddly, the IRS seems as motivated to avoid economic substance arguments as taxpayers are.³⁰⁸

*b. Puts More Pressure on Distinguishing Between
Economic Substance and Other Judicial Doctrines*

Section 7701(o) increases the importance of distinguishing between the economic substance doctrine and other judicial anti-abuse doctrines (such as the substance-over-form, business purpose,

³⁰² See I.R.C. § 269 (2014). The government raised section 269 and similar arguments in the lower courts in some of the STARS cases, but lost on these issues in the trial courts and did not pursue such arguments on appeal. See *Santander Holdings USA, Inc. v. United States*, 144 F. Supp. 3d 239 (D. Mass. 2015), *rev'd*, 844 F.3d 15 (1st Cir. 2016), *and cert. denied*, 2017 U.S. LEXIS 4194 (June 26, 2017); *Bank of N.Y. Mellon Corp. v. Comm’r*, 140 T.C. 15 (2013), *on rehearing*, T.C. Memo. 2013-225, *and aff’d*, 801 F.3d 104 (2d. Cir. 2015), *and cert. denied sub nom.* 136 S. Ct. 1375 (2016); *Salem Fin., Inc. v. United States*, 786 F. 3d 932 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016).

³⁰³ Notices 2004-19 and 2004-20, for example, contain lists of rules and doctrines (other than the economic substance doctrine) that the IRS might apply in situations that it finds abusive. I.R.S. Notice 2004-19, 2004-11 I.R.B. 606; I.R.S. Notice 2004-20, 2004-11 I.R.B. 608.

³⁰⁴ See Treas. Reg. § 1.701-2 (1995).

³⁰⁵ See Treas. Reg. § 1.901-2(e)(5)(iv); *see also* Rosenberg, *supra* note 63, at 235–49 (discussing possible alternative approaches the Treasury could take, by regulation, to address foreign tax credit claims that are seen as abusive).

³⁰⁶ Jensen, *supra* note 60, at 30.

³⁰⁷ See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

³⁰⁸ *Id.*

step transaction,³⁰⁹ and sham transaction³¹⁰ doctrines). That inquiry was mostly of theoretical interest before.³¹¹ Historically,

³⁰⁹ See *Summa Holdings, Inc. v. Comm’r*, 848 F.3d 779, 785 (6th Cir. 2017) (discussing the substance over form doctrine and declining to apply it to disallow tax benefits from a transaction, where the transaction predated section 7701(o)’s effective date); *CNT Inv’rs v. Comm’r*, 144 T.C. 161, 192–93 (2015) (discussing the overlap and distinctions between step transaction and sham transaction doctrines for a transaction before the effective date of section 7701(o)); *In re Wyly*, 552 B.R. 338, 514–16 (Bankr. N.D. Tex. 2016) (discussing the economic substance, substance over form, and step transaction doctrines, regarding a transaction that occurred before section 7701(o)’s effective date). See generally Philip Sancilio, Note, *Clarifying (or is it Codifying?) the “Notably Abstruse”: Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 148–49 (2013) (comparing post-section 7701(o) economic substance doctrine with the step transaction doctrine).

³¹⁰ Unlike the other doctrines listed in the text above, the sham transaction doctrine is sometimes used as an interchangeable term for the economic substance doctrine. At other times, sham transaction doctrine has a different meaning than economic substance. Such different meanings can include factual shams, in which the alleged events (such as sales or indebtedness) did not actually occur, as compared to economic or substantive shams, in which the alleged events did occur but arguably did not have the asserted tax effects. See *Knetsch v. United States*, 364 United States 361, 366 (1960) (using the “sham” terminology while disallowing tax benefits related to purported debt); *Goldstein v. Comm’r*, 364 F.2d 734, 737–42 (2d Cir. 1966) (holding that loans and interest were not “shams,” but that interest deductions were disallowed as lacking sufficient substance). See generally Jasper L. Cummings, *The Sham Transaction Doctrine*, 145 TAX NOTES 1239, 1242 (2014); Karen Nelson Moore, *Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 659 (1989).

³¹¹ See, e.g., *Santander Holdings USA, Inc. v. U.S.*, 844 F.3d 15, 21 n.9 (1st Cir. 2016) (“The First Circuit has addressed challenges to the economic substance of transactions in a number of cases, although the cases often have not invoked the ‘economic substance doctrine’ by that name.”) (citations omitted). *Santander* describes the Supreme Court’s *Frank Lyon* opinion as “clarify[ing]” the economic substance doctrine, even though the *Frank Lyon* case referred to “this doctrine of substance over form.” See *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978); see also *CNT Inv’rs*, 144 T.C. at 192–93 (applying the step transaction doctrine, discussing the evolution of various doctrines from *Gregory*, and stating that “[t]he parties’ arguments implicate three closely related and frequently conflated legal doctrines: the economic substance doctrine, the sham transaction doctrine, and the step transaction doctrine. Although these doctrines’ distinct names might suggest corresponding substantive distinctions, the lines between and among them blur upon examination”); H.R. REP. NO. 111-443, at 292 (2010) (“These common-law

there has been substantial overlap between various anti-abuse doctrines (such as substance-over-form, business purpose, step transaction, and economic substance), and it is not always easy to distinguish them from each other.³¹² In the past, it has not mattered much—if a tax benefit was disallowed under a judicial anti-abuse doctrine, the precisely accurate name of that doctrine was not important.³¹³ That is likely to change now that section 7701(o) has taken effect.³¹⁴

First, the imposition of enhanced penalties (twenty or forty percent, with no reasonable cause exception) for tax deficiencies asserted under the economic substance doctrine³¹⁵ may increase the need to distinguish between economic substance (and “similar

doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants.”). The court in *CNT Investors* did not apply the economic substance doctrine “because the Government has not invoked the doctrine and because, in any event, the case may be resolved through the application of other principles.” *CNT Inv’rs*, 144 T.C. at 197 n.38. The court referred to Notice 2014-58 as demonstrating the “remaining uncertainty as to the scope, contours, and sources of economic substance and the other, noncodified judicial doctrines.” *Id.* at 193. The case concerned a transaction that occurred before section 7701(o)’s effective date, so the strict liability penalties enacted with that section would not have applied even if the judge had chosen to raise the economic substance doctrine *sua sponte*.

³¹² See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011).

³¹³ See *id.*

³¹⁴ See Amy S. Elliott, *CNT Investors Shines Light on Courts’ Use of Inexact Doctrines*, TAX NOTES TODAY, Apr. 13, 2015, <https://www.taxnotes.com/tax-notes/penalties/cnt-investors-shines-light-courts-use-inexact-doctrines/2015/04/13/qylr?highlight=%29%20CNT%20Investors%20Shines%20Light%20on%20Courts%E2%80%99%20Use%20of%20Inexact%20Doctrines%20CNT%20Investors%20Shines%20Light%20on%20Courts%E2%80%99%20Use%20of%20Inexact%20Doctrines> (quoting practitioner Monte Jackel’s comments on the *CNT Investors* case: “This judge is basically admitting that many times these judges don’t know which doctrine they’re applying,” Jackel said. He questioned whether such an approach can survive in a post-codified economic substance doctrine world.”); Elliott, *supra* note 16 (discussing a practitioner’s complaint that the court in *Kenna Trading LLC et al. v. Commissioner* should have used the substance over form doctrine rather than the economic substance doctrine: “Gomez noted that while the opinion uses the words ‘economic substance,’ it does so as part of what’s really a substance-over-form analysis, making the use of those words ‘unfortunate.’”).

³¹⁵ See I.R.C. §§ 6662(b)(6), (c), 6676 (2018); § 6664(d) (2015).

rules of law”³¹⁶ on the one hand, and other judicial anti-abuse doctrines on the other,³¹⁷ in order to determine whether such enhanced penalties apply.

Secondly, only the economic substance doctrine triggers the specific rules of section 7701(o) (two prongs, substantial reasonably expected profit required before profit potential can be considered, substantial non-tax purpose, rules about whether financial accounting and state tax effects can be taken into account, etc.).³¹⁸ If either the government or the taxpayer wants to avoid the rules of section 7701(o), that party could argue that another Code or regulatory rule, or another judicial doctrine, applies instead of the economic substance analysis.³¹⁹

Therefore, the distinction between the economic substance doctrine and other judicial anti-abuse doctrines can now affect whether the taxpayer wins or loses (as well as impacting penalties) by determining whether section 7701(o) (and its associated penalties) must be applied.³²⁰ Section 7701(o) may thus have the effect of opening up new lines of analysis for courts, commentators,

³¹⁶ Tax deficiencies attributable to “similar rules of law” are subject to the same strict liability penalties as deficiencies arising under the economic substance doctrine (as defined in section 7701(o)). *See* §§ 6662(b)(6), (c), 6676; § 6664(d). However, the IRS has indicated that there are no other anti-abuse rules or doctrines that it will treat as similar doctrines, practically speaking. *See supra* discussion at Section II.B; *supra* notes 130–47 and accompanying text.

³¹⁷ *See, e.g.,* Vanik, *supra* note 123, at 110–11 (if taxpayers must pay a tax deficiency, they may be motivated to characterize the deficiency as arising under other judicial doctrines rather than under the economic substance doctrine, in order to avoid the strict liability penalties associated with the latter).

³¹⁸ *See generally* § 7701(o) (2012).

³¹⁹ *See* Vanik, *supra* note 123, at 111.

³²⁰ Query how often a taxpayer might be able to win a challenge based on another judicial anti-abuse doctrine when it would have lost on 7701(o)-impacted economic substance. A full discussion of that possibility is beyond the scope of this Article. *See* H.R. REP. NO. 111-443, at 298 (2010) (section 7701(o) “shall not be construed as altering or supplanting any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and the provision shall be construed as being additive to any such other rule of law”); Jensen, *supra* note 19, at 25, n.148 (discussing the potential impact of the codification of the economic substance doctrine on other doctrines, including whether Congress intended to favor economic substance over other doctrines, and pointing out that the Joint Committee report disclaims any Congressional intent to alter the application of any other doctrines by codifying the economic substance doctrine).

and taxpayers, regarding the definitions of and distinctions between various judicial anti-abuse doctrines, due to increased emphasis on such distinctions.³²¹

2. *Impact on Validity of the Economic Substance Doctrine*

Another interesting issue raised by section 7701(o) is whether it affects the legal strength of arguments about the validity of the economic substance doctrine.³²² Both before and after section 7701(o), various commentators argued that the economic substance doctrine is not a valid exercise of judicial authority.³²³ The *Coltec* lower court also accepted such an argument, on the grounds that separation of powers prevented such actions by the courts.³²⁴ The validity issue could be viewed as moot in that case, because the court held that the transaction met the economic substance test in any event and therefore should be respected.³²⁵ This lower court opinion was reversed by the Court of Appeals for the Federal Circuit, which held that the doctrine of economic substance is valid and that the transaction failed to meet such doctrine's requirements.³²⁶ The House Report accompanying section 7701(o) describes the lower and appellate court opinions in *Coltec*, without commenting on any potential impact of section 7701(o) on

³²¹ The IRS second directive to its employees suggests that examiners use a different doctrine if available. See I.R.S. Treas. Dir. LB&I 1-4-0711-015, IRM 20.1.1, 20.1.5 (July 15, 2011). This only helps taxpayers avoid the enhanced penalties if such alternative doctrine is not "similar" to the economic substance doctrine within the meaning of the enhanced penalty provisions and Notice 2014-58. *Id.*

³²² This discussion focuses on the narrower issue of the impact of section 7701(o) on arguments about the validity of the economic substance doctrine. A complete discussion of the merits of such validity arguments is beyond the scope of this Article.

³²³ See, e.g., Jasper L. Cummings, *The Supreme Court's Economic Substance Doctrine Opinion*, 149 TAX NOTES 1295, 1295-97 (2015) (continuing to argue that the economic substance doctrine is invalid, even after the enactment of section 7701(o)); Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 TAX NOTES 969, 970 (2007) (contending that the economic substance doctrine is invalid under Supreme Court case law and principles of statutory interpretation).

³²⁴ See *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716, 753 (2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006).

³²⁵ *Id.* at 755-56.

³²⁶ *Coltec Indus., Inc.*, 454 F.3d at 1360.

validity arguments.³²⁷ Perhaps Congress thought that either the appellate reversal of the lower court's *Coltec* opinion, or codification, ended any concerns about the validity of the doctrine.

Whether section 7701(o) changes taxpayers' and courts' ability to argue that the economic substance doctrine is always invalid—i.e., never applies, because the courts do not have the legal ability to apply such a doctrine—depends on the asserted reason for such invalidity. The statute's enactment quite clearly signals Congressional approval of the economic substance doctrine (even though the doctrine was developed by the courts and did not originate with Congress).³²⁸ This is especially important because the economic substance doctrine's function is the interpretation of Congressional intent.³²⁹

Therefore, arguments for invalidity on the grounds that the economic substance doctrine violates Congressional intent should decrease in force.³³⁰ (Similar arguments about Congressional intent

³²⁷ H.R. REP. NO. 111-443, at 293 (2010).

³²⁸ The House Report describes the reason for enacting section 7701(o) as follows:

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. Thus, many courts have long recognized the need to supplement tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. The Committee recognizes that the IRS has achieved a number of recent successes in litigation. The Committee believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine *in order to improve its effectiveness at deterring unintended consequences.*

H.R. REP. NO. 111-443, at 295 (emphasis added). That certainly sounds like Congressional approval. In fact, the House specifically said that it wanted the economic substance doctrine to be more effective. *Id.*

³²⁹ See *supra* note 2 and accompanying text.

³³⁰ Some commentators argued that codification would actually prevent any further challenges to the validity of the economic substance doctrine, although courts could still find that the doctrine was not applicable to particular fact patterns. See, e.g., Linda D. Jellum, *Codifying and "Miscodifying" Judicial Anti-Abuse Doctrines*, 33 VA. TAX REV. 579, 586 (2014) ("For those judges, particularly textualists, who may have been hesitant to impose the judicially created doctrines, codification removes their choice."); see also Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105

may still be available as part of a separate “relevance” inquiry by the courts, in particular cases. But relevance pertains to whether a specific type of tax benefit, like the low income housing credit, was not intended to be subject to economic substance scrutiny. It does not address whether the entire doctrine of economic substance is invalid and therefore never applies.). In order for a court to decide that the economic substance doctrine never applies to any transaction (due to invalidity), a court now would have to overcome government arguments that section 7701(o) shows Congressional approval of the doctrine. In other words, the court would need a reason for invalidity that does not depend on an asserted violation of Congressional intent.³³¹

However, section 7701(o) might not affect the strength of an argument that separation of powers principles (rather than Congressional intent) do not allow the courts to override compliance with the literal rules of the Code and regulations. One could argue that Congress cannot waive that issue.³³² Regardless of the merits of such arguments about the separation of powers, such merits likely are not significantly changed by the enactment of section 7701(o).

Alternatively, the economic substance doctrine could potentially be viewed as a rule of statutory interpretation³³³ (perhaps

COLUM. L. REV. 1939, 1950 (2005) (discussing, before section 7701(o)’s enactment, the possible impact of future codification: “Although codification would prevent a court from concluding that the doctrine does not exist, courts would remain free to conclude that the doctrine is not relevant in particular situations.”). But treating section 7701(o) as ending validity arguments seems to be an overstatement, because there may be some asserted grounds for invalidity of the doctrine that are not waivable by Congress, as well as the arguments (discussed *infra*) that Congress could not amend a judicial doctrine that did not already exist.

³³¹ In addition, in response to arguments that the courts cannot (are not authorized by Congress to) disallow benefits that meet all of the technical requirements of the Code, the IRS can argue that section 7701(o) (and its two prongs and other rules) are now *part* of the literal, technical requirements to receive certain tax benefits.

³³² If Congress cannot waive any separation of powers issue that affects the economic substance doctrine, perhaps it could not enact a general anti-abuse rule (GAAR) either.

³³³ For example, *Santander* characterized the economic substance doctrine as a rule of statutory interpretation. *See Santander Holdings USA, Inc. v.*

akin to the rule that courts do not give effect to proposed interpretations that are manifestly incompatible with Congressional intent, or that are nonsensical).³³⁴ If that is the case, then section 7701(o) potentially strengthens arguments in favor of the economic substance doctrine's validity, by showing Congressional approval of such an economic substance rule of statutory construction.

On the one hand, section 7701(o)'s phrasing seems to assume that the economic substance doctrine exists and is valid.³³⁵ On the other, it does not purport to create such a doctrine itself, if the economic substance doctrine was already (before enactment) invalid.³³⁶ Instead, section 7701(o) asserts that it only clarifies (according to the statutory provision's title) or "clarif[ies] and enhance[s]" (in the words of the legislative history)³³⁷ an existing doctrine. But if Congress was wrong about economic substance existing as a valid judicial doctrine, that would make section 7701(o) entirely meaningless. Such a judicial finding of invalidity of the

United States, 844 F.3d 15, 15 (1st Cir. 2016) (internal footnotes omitted) ("The federal income tax is, and always has been, based on statute. The economic substance doctrine, like other common law tax doctrines, can thus perhaps best be thought of as a tool of statutory interpretation ...").

³³⁴ See, e.g., *Gardner v. Comm'r*, 954 F.2d 836, 838 (2d Cir. 1992) (per curiam), *cert. denied*, 112 S. Ct. 1940 (1992) (citing statutory construction rules against finding absurd results, in support of court's application of the economic substance doctrine); *Lerman v. Comm'r*, 939 F.2d 44, 54–55 (3d Cir. 1991) (same), *cert. denied*, 112 S. Ct. 590 (1991). See generally Veronica M. Dougherty, *Absurdity and the Limits of Literalism: Defining the Absurd Result Principle in Statutory Interpretation*, 44 AM. U.L. REV. 127 (1994); Steven Wisotsky, *How to Interpret Statutes—Or Not: Plain Meaning and Other Phantoms*, 10 J. APP. PRAC. & PROCESS 321 (2009); Robert W. Scheef, *Temporal Dynamics in Statutory Interpretation: Courts, Congress, and the Canon of Constitutional Avoidance*, 64 U. PITT. L. REV. 529, 555 (2003).

³³⁵ See I.R.C. § 7701(o) (2018).

³³⁶ See *id.*

³³⁷ See *id.*; H.R. REP. NO. 111-443, at 295 (2010); see also JT. COMM. ON TAX'N, JCX-18-10, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, AS AMENDED, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT 156 (2010) (saying that section 7701(o) "clarified and enhanced" the economic substance doctrine). Section 7701(o)'s own title says that it is a "clarification," but it was enacted by section 1409 of the Health Care and Education Reconciliation Act of 2010, which referred to "Codification." Although enhancement, clarification, and codification differ somewhat in their meaning, all connote that the economic substance doctrine already existed, and was not newly created by section 7701(o).

economic substance doctrine would thus need a rationale strong enough to overcome the bias against finding statutory language to be moot, under general principles of statutory interpretation.³³⁸

Taxpayers might potentially argue that by leaving relevance to the courts “as if this subsection had never been enacted,”³³⁹ section 7701(o) leaves the courts to determine the validity of the doctrine and implies that it might be invalid.³⁴⁰ But relevance and validity are two different concepts. The relevance rule addresses not whether the economic substance doctrine is valid (i.e., exists) but whether specific tax benefits are exempt from application of the doctrine. Section 7701(o) applies only when the economic substance doctrine is “relevant.”³⁴¹ As quoted above, the rule leaving the relevance determination to the courts says that courts can determine “whether the economic substance doctrine is relevant *to a transaction*.”³⁴² The phrasing indicates a case-specific determination for each transaction. This language appears to assume that the doctrine is valid and to focus instead on whether such valid doctrine applies to a particular transaction or not. Otherwise, relevance issues do not appear to affect arguments about the underlying validity of the economic substance doctrine.

There is also an argument that, even if the economic substance doctrine were found to technically not have existed (to have been invalid) before section 7701(o)’s enactment, it exists (is valid) after section 7701(o). Under this theory, one would argue that Congress essentially created an economic substance test (or created a modified version of a test that had existed, in differing forms, in the various circuits) and that (after codification) Congress

³³⁸ See *supra* note 132 and accompanying text; cf. Marie Sapirie, *News Analysis: Will the Supreme Court Take Up Economic Substance?*, 150 TAX NOTES 36 (2016) (“Section 7701(o) begins by saying that the doctrine applies only when it is relevant and thus seems to confer congressional imprimatur on the notion that the doctrine is part of common law,’ said Monte A. Jackel of Jackel Tax Law. ‘If there is no such doctrine, then Congress acted unnecessarily,’ he said.”).

³³⁹ See § 7701(o)(1) (lead-in language) (“In the case of any transaction to which the economic substance doctrine is relevant ...”); *id.* § 7701(o)(5)(C) (“The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.”).

³⁴⁰ For an example of such an argument, see Cummings, *supra* note 323, at text accompanying n.52.

³⁴¹ See § 7701(o).

³⁴² See *id.* § 7701(o)(5)(C).

allowed the courts to decide only whether the doctrine applies to particular transactions, not whether it exists at all. This argument derives some support from the fact that Congress imposed some significant changes on the previous forms of the doctrine—including the ratio test that must be met before profit potential can be taken into account under either prong.³⁴³ One could argue that section 7701(o) itself authorizes the judiciary to apply two prongs to evaluate asserted tax benefits where the courts think such analysis is appropriate (i.e., relevant), even if the economic substance doctrine were found not to have existed before.

Overall, although arguments about the validity or invalidity of economic substance as a judicial doctrine are interesting, it seems extremely unlikely that the courts would hold the doctrine to be invalid, given the many, many times that multiple circuits have applied the doctrine without finding it invalid or raising this issue.³⁴⁴ The Supreme Court has not itself decided a recent case that uses the term “economic substance,” but it has applied similar approaches and doctrines (e.g., “substance over form” in *Frank Lyon*,³⁴⁵ and a basic anti-abuse concept in *Gregory*).³⁴⁶ One element that these previous Supreme Court decisions have in common with the economic substance doctrine (among other things) is a willingness to consider whether a tax benefit that meets all of the written Code and regulatory requirements should nonetheless be denied.³⁴⁷

In any event, even if section 7701(o) leaves open the possibility that the Supreme Court could find that the economic substance doctrine does not exist (despite dozens of court cases), e.g., because it is not within the courts’ power to create such a doctrine, that might not be the end of the economic substance analysis. Congress could potentially just amend section 7701(o) to create an economic substance rule, similar to a GAAR.³⁴⁸ Instead of a judicial

³⁴³ *Id.* § 7701(o)(2)(A).

³⁴⁴ See H.R. REP. NO. 111-443, at 293 (2010).

³⁴⁵ See *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

³⁴⁶ See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

³⁴⁷ See *Frank Lyon Co.*, 435 U.S. at 573; *Gregory*, 293 U.S. at 469.

³⁴⁸ See generally Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 SMU L. REV. 83, 117 (2001) (discussing GAARs generally); Tim Edgar, *Building a Better GAAR*, 27 VA. TAX REV. 833 (2008); Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW 807, 809 (1995); Zoe

doctrine, economic substance would become primarily a statutory rule. Section 7701(o) certainly shows Congressional approval of (a version of) the economic substance doctrine, so Congressional amendments to create such a statutory doctrine (if the judicial doctrine is overturned) seem quite possible, as long as the reason for invalidity is something other than separation of powers issues. Thus, debates about validity or invalidity of the judicial doctrine may ultimately be moot (because any finding of invalidity may simply be superseded by later legislation).³⁴⁹

SUMMARY AND CONCLUSION

Section 7701(o) incorporated the long-standing doctrine of economic substance into statutory language. Such “codification” is a rare instance of legislation that mandates the content of a court-created doctrine, and that also gives an agency the regulatory authority to change and impact that judicial doctrine. Codification thus raises issues regarding the interaction of the three branches of the federal government.

In addition, Congress apparently expected that codification of the economic substance doctrine would strengthen the doctrine and result in increased federal tax revenues, partly as a result of strict liability penalties that were enacted with section 7701(o).³⁵⁰ Instead, such penalties seem to have deterred the IRS from raising the economic substance doctrine, so that codification has weakened the economic substance doctrine rather than making it a stronger weapon for tax collection. Section 7701(o) thus presents interesting issues regarding the bounds of agency authority and agency enforcement discretion.

The IRS’s publicly communicated reluctance to raise economic substance issues, implemented by means of internal letters, and its notices (which state, among other things, that the IRS will

Prebble & John Prebble, *Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law*, 62 BULL. INT’L TAX’N (Apr. 2008) (describing GAARs in other countries).

³⁴⁹ Even if validity arguments are moot in the long term (because Congress could choose to create, rather than just modify, an economic substance doctrine in the future), current validity arguments may still be crucial for particular taxpayers, who could benefit from arguing that the economic substance doctrine is invalid for the years in which their transactions occurred.

³⁵⁰ See *supra* text accompanying notes 272–73.

continue to apply pre-section-7701(o) case law), also raise questions about the issuance of rules by informal means, without notice and comment procedures.

The strict liability penalties associated with section 7701(o), in addition to IRS disinclination to raise economic substance issues, may encourage courts and government litigators to turn to other doctrines where they might previously have raised economic substance issues. Section 7701(o) may thus make it more important to distinguish between anti-abuse doctrines in the future, compared to pre-codification periods.

Lastly, section 7701(o) clearly signals Congressional approval of the judicial doctrine of economic substance.³⁵¹ This hinders arguments that the economic substance doctrine is invalid, except to the extent that such contentions are based on separation of powers issues or other grounds that the Congress does not have the ability to waive.

Overall, section 7701(o) of the Internal Revenue Code (which now governs the application of the economic substance doctrine) seems to have had the unintended effect of causing the economic substance doctrine (and the recently enacted penalties associated with that doctrine) to be applied very rarely. Rather than merely translating the existing economic substance doctrine into legislative language, or strengthening it, section 7701(o) seems to have accidentally deterred the agency from raising the issue. Although there are valid arguments about the agency's ability to make (and publicly communicate) these enforcement and interpretation choices, few litigants are likely to bring a legal challenge against such taxpayer-favorable agency action.

The economic substance doctrine may thus be restricted in the future, as a practical matter, to the "worst of the worst" cases, in which claims for unintended tax benefits appear truly egregious. Those may be the only instances in which the agency is still willing to assert the doctrine. No case has yet interpreted section 7701(o). If the IRS remains willing to apply economic substance arguments to the most egregious cases, then judicial examination of section 7701(o) may take place soon.

³⁵¹ See H.R. REP. NO. 111-443, at 293 (2010).