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Strictly Wrong as a Tax Policy: The Strict Liability Penalty Standard in Noneconomic Substance Transactions

Cover Page Footnote

J.D. Candidate, 2011, Fordham University School of Law; B.A., 2003, University of Pennsylvania. I would like to thank Professor Matthew McKenna for his assistance. This Note is dedicated to my parents, my sister Seung, and my husband Zhi for inspiring me to strive at every endeavor, covering me always with abounding love, and trusting me with utmost confidence.

STRICTLY WRONG AS A TAX POLICY: THE STRICT LIABILITY PENALTY STANDARD IN NONECONOMIC SUBSTANCE TRANSACTIONS

Mik Shin-Li*

This Note analyzes the propriety of using a strict liability standard to assess tax penalties for transactions lacking economic substance. Noneconomic substance transactions lack legitimate business objectives and exist only to produce tax benefits. Under current law, the Internal Revenue Service can disallow the tax benefit claimed by the taxpayer and then assess a penalty for the taxpayer's understatement of tax liability. In response, the taxpayer can assert a reasonable cause exception, which can serve as a defense to the penalty should the taxpayer demonstrate that he had reasonable basis for his tax position. In the last decade, numerous legislative proposals sought to eliminate the reasonable cause exception and replace it with a strict liability standard. This Note examines the conflict created by this potential change in the tax law.

This Note begins by defining the economic substance doctrine, as used in the U.S. courts of appeals, to determine whether a transaction lacks economic substance. This Note then explains the accuracy-related penalty assessed for noneconomic substance transactions, as well as the reasonable cause exception to the penalty. Two cases illustrate the interaction of the economic substance analysis, the tax penalty, and the reasonable cause exception. Next, this Note summarizes legislative proposals spanning from 1999 to 2009, which would codify the economic substance doctrine and adopt a strict liability penalty standard. The strict liability standard is then analyzed at length, as this Note discusses the arguments for and against it. Ultimately, this Note concludes that on balance, the strict liability standard should not be adopted, but regardless of whether the current penalty regime is retained or alternative solutions are developed, the reasonable cause exception should remain a feature of the standard by which to penalize noneconomic substance transactions.

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INTRODUCTION

In *Klamath Strategic Investment Fund v. United States*,¹ two law partners, Cary Patterson and Harold Nix, each made thirty million dollars between 1998 and 2000 by representing the State of Texas in its litigation against the tobacco industry.² To manage their sixty million dollars of wealth, Patterson and Nix sought investment vehicles through their long-time accounting firm, which in turn identified Presidio Advisory Services, an investment advisory firm involved in foreign currency trading.³ Presidio designed a complex plan by which Patterson and Nix could create large artificial losses, which could then be used as tax deductions to offset their taxable income.⁴ As a result of this transaction, the details of which will be discussed in Part I.B.3.a, Patterson and Nix each claimed over twenty-five million dollars in artificial tax deductions.⁵

1. 472 F. Supp. 2d 885 (E.D. Tex. 2007), *aff'd in part, vacated in part*, 568 F.3d 537 (5th Cir. 2009).

2. *Klamath*, 568 F.3d at 540.

3. *Id.* at 541.

4. *See id.* at 541–42.

5. *Id.* at 542.

Tax shelters are defined by the Internal Revenue Code (I.R.C. or Code) as any "entity, plan, or arrangement" that has the "significant purpose" of avoiding or evading federal income tax.⁶ These transactions are not entered for a money-making business purpose, but solely as a means to reduce federal tax liability.⁷ These tax shelters can be described as abusive in the sense that they depart from genuine economic objectives and fundamental tax principles to exploit a loophole in the tax law.⁸

The Internal Revenue Service (IRS) invalidated the tax deductions claimed by Patterson and Nix, concluding that the transaction giving rise to the tax deductions lacked real economic substance and was entered for the sole purpose of avoiding taxes.⁹ As a result, Patterson and Nix owed higher taxes.¹⁰ Furthermore, the IRS assessed accuracy-related penalties for their substantial understatement of tax liability, at twenty percent of the claimed tax deduction amount, based on Internal Revenue Code section 6662.¹¹ Patterson and Nix argued before the U.S. District Court for the Eastern District of Texas that, inter alia, the accuracy-related tax penalties should not apply because they had reasonable cause for their tax treatment.¹²

The court's analysis of the accuracy-related penalties assessed against Patterson and Nix is detailed in Part I.B.3.a. For now, consider whether Patterson and Nix should be given the opportunity to assert a reasonable cause exception to the penalties in light of the following facts: (1) Patterson and Nix entered the transaction with genuine intent to invest in a seven-year foreign currency portfolio;¹³ (2) Patterson and Nix did not know that Presidio Advisory Services designed the transaction to effect an early withdrawal before the end of the seven-year investment period;¹⁴ and (3) Patterson and Nix were unaware of the tax benefit that would result from their withdrawal until after such withdrawal.¹⁵ In light of these circumstances, should Patterson and Nix have been subjected, not only to a disallowance of the tax deduction claimed, but also to a penalty amounting to approximately ten million dollars collectively?¹⁶

6. I.R.C. § 6662(d)(2)(C) (2006).

7. See Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 52–53 (2001).

8. See *id.* at 56, 69.

9. *Klamath*, 568 F.3d at 542.

10. *Id.*

11. See *Klamath Strategic Inv. Fund v. United States*, 472 F. Supp. 2d 885, 898–99 (E.D. Tex. 2007).

12. *Id.* at 902–04.

13. *Id.* at 896.

14. *Id.*

15. *Id.* at 893.

16. The ten million dollar penalty amount is a rough estimation, calculated using fifty million dollars in tax deductions claimed by Patterson and Nix and the accuracy-related penalty rate of twenty percent of the claimed tax deduction amount. See *supra* notes 5, 11 and accompanying text.

This Note analyzes the conflict embodied in a legislative proposal considered under the 111th Congress that sought, among other things, to eliminate the reasonable cause exception to accuracy-related penalties assessed against transactions lacking economic substance (noneconomic substance transactions). The bill, America's Affordable Health Choices Act of 2009,¹⁷ or H.R. 3200, proposed to eliminate the reasonable cause exception, thereby making the penalty standard one of strict liability.¹⁸ This Note evaluates the pros and cons of changing the penalty standard from reasonable cause to strict liability. This debate is important not only in the context of bills such as H.R. 3200, but as an outstanding issue about the proper standard by which to penalize tax shelters. Congress has considered legislative proposals regarding noneconomic substance transactions since 1999 when tax shelters began to attract public attention, and in every subsequent Congress thereafter, giving rise to the inference that the debate over the proper penalty standard will likely continue even if a particular bill under the current Congress does not pass into law.¹⁹ Hence, this Note is anchored in the framework of H.R. 3200 but should be read in the larger context of policy concerns surrounding the proper standard by which to penalize noneconomic substance transactions.²⁰ Along the same

17. H.R. 3200, 111th Cong. (2009).

18. See *id.* §§ 452–53; STAFF OF J. COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF THE REVENUE PROVISIONS OF H.R. 3200, THE “AMERICA’S AFFORDABLE HEALTH CHOICES ACT OF 2009” 36, 49 (Comm. Print 2009) [hereinafter STAFF OF J. COMM. ON TAXATION ON H.R. 3200], available at <http://www.copyrights.org/mariofRevenueProvisionsofHouseTriComBillH.R.32007.14.09.pdf>.

19. See *infra* Part I.C.1.

20. This Note’s treatment of H.R. 3200 relies in part on the analysis of the Joint Committee on Taxation (JCT) on the President’s Fiscal Year 2010 Budget Proposal, which is intended to contain provisions on the codification of the economic substance doctrine (ESD) and the penalty standard that are substantively identical to those in H.R. 3200. As the JCT acknowledges in its analysis, the President’s proposal does not anchor itself to a particular bill in Congress; therefore the analysis proceeds with the assumption that it will encompass another bill that Congress eventually passes. H.R. 3200 was noted as one of the most recent bills proposing codification of the ESD. Thus, this Note uses the framework of H.R. 3200 on the premise that the underlying issues are likely to remain unchanged even if another bill with substantively identical provisions supersedes the version of H.R. 3200 discussed in this Note. Where the JCT borrows certain assumptions from similar 2007 proposals, this Note uses H.R. 3200 to the extent that the underlying analysis remains valid. See STAFF OF J. COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2010 BUDGET PROPOSAL PART TWO: BUSINESS TAX PROVISIONS 40 n.104, 48 n.132, 69 (Comm. Print 2009) [hereinafter STAFF OF J. COMM. ON TAXATION], available at http://www.novoco.com/hottopics/resource_files/jcs-3-09.pdf. As of October 2009, H.R. 3200 has been superseded by H.R. 3962, which contains identical provisions regarding codification of the ESD and the penalty standard. See Press Release, Comms. on Ways & Means, Energy & Commerce, and Educ. & Labor, Topline Changes from Introduced Bill to Blended Bill (Oct. 29, 2009), available at <http://bishop.house.gov/usermedia/HCR%20Topline%20Changes.pdf> (summarizing the changes between H.R. 3200 and H.R. 3962, the Affordable Health Care for America Act); Posting of Betsy Miller Kittredge to EdLabor Journal, *America’s Affordable Health Choices Act*, <http://edlabor.house.gov/blog/2009/07/americas-affordable-health-choices-act.shtml> (July 14, 2009, 15:00 EST); Govtrack.us, H.R. 3962: Affordable Health Care for America Act, <http://www.govtrack.us/congress/bill.xpd?bill=h111-3962> (last visited Feb. 21, 2010).

lines, some of the arguments for or against the proposed penalty standard originated with legislative proposals preceding H.R. 3200, but are incorporated into the current debate to the extent that such arguments relate to provisions that are substantively identical under the current proposal and remain relevant to the considerations at issue today.

Part I of this Note defines the Economic Substance Doctrine (ESD) under common law, explains accuracy-related penalties that are assessed under the Code for noneconomic substance transactions, and traces legislative proposals to codify the ESD both in the past and at present. Part II discusses the conflict between the reasonable cause exception and the strict liability standard by examining arguments for and against the strict liability standard. Part III posits that on balance, the arguments weigh against adopting the strict liability standard, and regardless of whether the current penalty regime is retained or alternative solutions are developed, the reasonable cause exception should remain a feature of the standard by which to penalize noneconomic substance transactions.

I. THE ECONOMIC SUBSTANCE DOCTRINE AND TAX PENALTIES: THE EXISTING JUDICIAL APPLICATION VERSUS THE PROPOSED STATUTORY STANDARD

Part I provides the background information necessary to understand the conflict over the proper tax penalty standard to use in noneconomic substance transactions. Part I.A defines the ESD by its judicial application in the circuit courts. Part I.B explains the accuracy-related tax penalties assessed for noneconomic substance transactions and the reasonable cause exception to that penalty. Part I.C summarizes legislative efforts to codify the ESD under the I.R.C., including the proposal to penalize noneconomic substance transactions using the strict liability standard.

A. *Economic Substance Doctrine Under Common Law*

Part I.A introduces the ESD in its present state. Part I.A.1 defines this common-law doctrine and its role in the tax shelter problem. Part I.A.2 recounts the various forms of the doctrine as used across the circuit courts and previews the implications of this circuit split on efforts to codify the doctrine.

1. The Tax Shelter Problem and the Role of the Economic Substance Doctrine

The I.R.C. is the body of law that establishes statutory tax rules to compute one's tax liability.²¹ Where the taxpayer attempts to avoid taxes by engaging in transactions that comply with the literal requirements of the Code but have the effect of circumventing tax liability he would otherwise

21. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 34. See generally I.R.C. (2006).

bear, courts can disallow the tax benefit claimed by the taxpayer.²² This principle is termed “substance-over-form” for the idea that courts will look to the “transaction’s substance rather than its form” in determining whether true economic substance exists to justify the tax deduction.²³ Stated differently, the legislative purpose behind the I.R.C. prohibits taxpayers from reaping tax benefits by entering into transactions lacking economic reality.²⁴

Tax shelter transactions differ from real economic transactions in essence.²⁵ Real economic transactions have the purpose of making a profit by increasing revenues or decreasing operating expenses and, hence, must generate a level of economic return that exceeds the cost of capital at risk of loss.²⁶ In contrast, tax shelter transactions have the sole and specific purpose of reducing the taxpayer’s tax liability by generating losses or tax credits and, hence, are not necessarily expected to make a positive return on the cost and fees invested into the transaction.²⁷ The transactions are designed, however, to limit any losses to small predictable losses and avoid large unpredictable losses.²⁸ Essentially, tax shelters are not real business transactions but artificial transactions designed to exploit a loophole in the tax law.²⁹ According to a conservative estimate in 1999, tax shelter transactions cost the federal government approximately seven billion dollars in federal taxes.³⁰ Another estimate in 2003 places tax shelter costs at eighty-five billion dollars.³¹

22. See *Coltec Indus. v. United States*, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006) (“The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.”).

23. See *Freytag v. Commissioner*, 904 F.2d 1011, 1015 (5th Cir. 1990) (noting that economic substance is required to claim a tax deduction, which is consistent with the I.R.C.’s premise that taxation is based on a “transaction’s substance rather than its form”); Donald L. Korb, Chief Counsel, Internal Revenue Serv., *The Economic Substance Doctrine in the Current Tax Shelter Environment*, Remarks at the 2005 University of Southern California Tax Institute 6 (Jan. 25, 2005), available at [http://www.irs.gov/pub/irs-utl/economic_substance_\(1_25_05\).pdf](http://www.irs.gov/pub/irs-utl/economic_substance_(1_25_05).pdf).

24. See *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 543 (5th Cir. 2009); STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 34.

25. See *Canellos*, *supra* note 7, at 52–55.

26. See *id.* at 52–53.

27. See *id.*

28. See *id.* at 53.

29. See *id.* at 56.

30. See *Corporate Tax Shelters: Hearing Before the H. Comm. on Ways & Means*, 106th Cong. 39–40 (1999) [hereinafter *Hearing on Corporate Tax Shelters*], available at <http://ftp.resource.org/gpo.gov/hearings/106h/66992.pdf> (statement of Lindy Paull, Chief of Staff, J. Comm. on Taxation).

31. See Press Release, Senate Comm. on Homeland Sec. & Governmental Affairs, Lieberman Says Tax Shelters Must Have Economic Substance To Deter Industry Built Around Tax Evasion (Nov. 18, 2003), available at http://hsgac.senate.gov/public/index.cfm?FuseAction=Press.MajorityNews&ContentRecord_id=09d681fd-74b4-4ea8-9357-4e6708765540&Region_id=&Issue_id=baeab989-7f6a-4e7a-83b9-f18fa0a065c9

Donald Korb, the former IRS Chief Counsel, has remarked that abusive tax shelters have been one of IRS's biggest problems in the last decade.³² Similarly, the Obama Administration recently issued a press release recognizing the tax shelter problem, noting that eighty-three percent of the largest U.S. corporations have subsidiaries in tax havens,³³ or low-tax countries to which the corporation can transfer its revenue to avoid taxes.³⁴ Other commentators echo that the tax shelter problem is proliferating.³⁵

A judicial doctrine for dealing with tax shelter transactions is the ESD,³⁶ which analyzes whether a transaction has real economic substance beyond tax avoidance.³⁷ *Gregory v. Helvering*³⁸ is one of the first cases to apply the ESD and generally credited to be the case from which the doctrine developed.³⁹ In *Gregory*, the U.S. Supreme Court recognized that taxpayers have a right to decrease or avoid taxes through legal means, which is distinguishable from engaging in transactions solely for tax benefits.⁴⁰ The Supreme Court disregarded intermediate transfers of stocks as transactions that had "no business or corporate purpose" and performed no function other than reducing taxes.⁴¹ Similarly, in *Frank Lyon Co. v. United States*,⁴² the Supreme Court once again distinguished between transactions entered for the sole purpose of tax avoidance and transactions

(referencing an Internal Revenue Service (IRS) estimate of the impact of tax shelter transactions).

32. See Korb, *supra* note 23, at 1.

33. See Press Release, The White House Office of the Press Sec'y, Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas (May 4, 2009), available at http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TAX-INCENTIVES-FOR-SHIFTING-JOBS-OVERSEAS.

34. See generally JANE G. GRAVELLE, CONG. RESEARCH SERV., TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION (2009), available at http://assets.opencrs.com/rpts/R40623_20090709.pdf (explaining tax havens and suggesting approaches to combat them). In the context of international tax avoidance, another increasing problem is transfer pricing, which involves allocating a company's profits and deductions to subsidiaries in low-tax jurisdictions to reduce taxes. Transfer pricing is regulated under I.R.C. section 482. See I.R.C. § 482 (2006).

35. See Canellos, *supra* note 7, at 49 & n.3 (citing a number of studies by the U.S. Department of the Treasury, the Joint Committee on Taxation, and other commentators all noting the increase of tax shelters).

36. ESD is one of several judicial doctrines used to invalidate tax shelter transactions. Other doctrines include sham transaction, substance-over-form, and step transaction, which are similar to the ESD and often used interchangeably. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5 (2000).

37. See *Coltec Indus. v. United States*, 454 F.3d 1340, 1354 (Fed. Cir. 2006); *ACM P'ship v. Comm'r*, 157 F.3d 231, 246–47 (3d Cir. 1998).

38. 293 U.S. 465 (1935).

39. See Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J.L. & BUS. 371, 371 & n.2 (2005) [hereinafter Keinan, *Many Faces*]; Yoram Keinan, *It Is Time for the Supreme Court To Voice Its Opinion on Economic Substance*, TAXES, Dec. 2006, at 27, 28 [hereinafter Keinan, *It Is Time*].

40. See *Gregory*, 293 U.S. at 469.

41. See *id.*

42. 435 U.S. 561 (1978).

entered for nontax purposes that produced accompanying tax benefits, the latter of which should be honored.⁴³

The ESD involves two prongs that are used to determine whether a given transaction has economic substance: The first prong is objective—whether the transaction resulted in a meaningful change in the economic position of the taxpayer other than tax reduction (the economic benefit prong).⁴⁴ The second prong is subjective—whether the taxpayer’s subjective intent in entering the transaction was merely tax reduction or some other nontax business purpose such as profit (business purpose prong).⁴⁵ The taxpayer who claims the tax deduction carries the burden of proving that the transaction has economic substance.⁴⁶ If a court determines that a transaction lacks economic substance, it may recharacterize the transaction to conform to the economic reality and invalidate the tax benefit purportedly arising from the transaction.⁴⁷

2. Circuit Courts’ Application of the Economic Substance Doctrine

This section discusses how the two-prong test is applied by the circuit courts. There is a split among the circuits as to whether this two-prong test should be used conjunctively or disjunctively, as well as to how each of the two prongs should be defined.⁴⁸ While this Note does not focus on the conflict of this split in authority, it is essential to understand the circuit split as context for the inception and development of the proposals to codify the ESD. Specifically, the circuit courts’ inconsistent application of the ESD has been a prominent ground for attack by proponents of codification, who argue that the ESD should be codified into the I.R.C. to clarify the doctrine as one test for economic substance.⁴⁹

a. *Circuit Split in the Two-Prong Test*

Case law demonstrates a lack of uniformity in the application of the two-prong test in the circuit courts.⁵⁰ The U.S. Courts of Appeals for the Fifth, Sixth, Eleventh, and Federal Circuits apply the two prongs in a conjunctive test, requiring both objective economic benefit and subjective business

43. See *id.* at 583–84.

44. See Korb, *supra* note 23, at 10.

45. See *id.* at 9.

46. See *Coltec Indus. v. United States*, 454 F.3d 1340, 1356 (Fed. Cir. 2006); STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 36–37 (noting that this burden of proof still applies to current law).

47. See, e.g., *Neb. Dep’t of Revenue v. Loewenstein*, 513 U.S. 123, 133–37 (1994) (recharacterizing purported sale and repurchase of municipal bonds as a lending transaction).

48. See *infra* notes 50–64 and accompanying text.

49. See *infra* Part I.C.1.

50. See *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009); Keinan, *Many Faces*, *supra* note 39, at 372–73; Monte A. Jackel, *Farming for Economic Substance: Codification Fails To Bear Fruit*, 119 TAX NOTES 59, 61 (2008); Keinan, *It Is Time*, *supra* note 39, at 27–28 (discussing cases demonstrating inconsistency in the circuit courts’ application of the two-prong test); *infra* notes 51–54 and accompanying text.

purpose to deem the transaction valid for tax purposes.⁵¹ The U.S. Courts of Appeals for the Fourth and Eighth Circuits apply the two prongs in a disjunctive test, meaning that the presence of either the objective prong or the subjective prong is enough to pass judicial scrutiny.⁵² Yet a third approach taken by the U.S. Courts of Appeals for the Ninth and Tenth Circuits considers the objective and subjective prongs simply as factors to analyze whether the transaction creates practical economic effects other than tax benefits.⁵³ In *Klamath*, the Fifth Circuit explicitly acknowledged the existence of this circuit split.⁵⁴

b. Various Factors To Analyze the Two-Prong Test

In addition to the circuit split on whether the two prongs should be used conjunctively or disjunctively, each of the two prongs is defined by various factors.⁵⁵ For the objective economic benefit prong, at least two measures are used to define what constitutes a “meaningful change” in the taxpayer’s economic position: One approach used by the Federal Circuit looks for economic benefit in fact obtained.⁵⁶ Another approach used by the Second Circuit looks for the potential for profit.⁵⁷ In courts using the profit potential approach, some courts look for profit that is more than nominal⁵⁸

51. This means that even if the taxpayer meets the subjective prong by possessing a profit motive, the tax benefit will be disallowed if the transaction objectively lacks economic substance. *See, e.g., Klamath*, 568 F.3d at 545 (requiring both the taxpayer’s subjective profit motive and objective profit potential and disregarding the transaction because it lacked objective profit potential); STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 36 n.84.

52. This means that before a transaction is deemed to lack economic substance, the court will require that the transaction lack both the objective and subjective prongs. *See, e.g., IES Indus. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001) (“[A] transaction will be characterized as a sham if ‘it is not motivated by any economic purpose outside of tax considerations’ . . . and if it ‘is without economic substance because no real potential for profit exists’” (quoting *Shriver v. Comm’r*, 899 F.2d 724, 725–26 (8th Cir. 1990))); *Rice’s Toyota World v. Comm’r*, 752 F.2d 89, 91–92 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.”); *see also* STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 36 n.85.

53. *See, e.g., Sacks v. Comm’r*, 69 F.3d 982, 988 (9th Cir. 1995) (“Instead, the consideration of business purpose and economic substance are simply more precise factors to consider”); *James v. Comm’r*, 899 F.2d 905, 908 (10th Cir. 1990); *see also* STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 36–37 n.86.

54. *See Klamath*, 568 F.3d at 544.

55. *See infra* notes 56–64 and accompanying text.

56. *See, e.g., Coltec Indus. v. United States*, 454 F.3d 1340, 1358–60 (Fed. Cir. 2006) (invalidating a transaction because the purported benefits of managing liabilities and hindering third-party veil piercing claims were not in fact realized); *see also* STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 37 n.91.

57. *See, e.g., Goldstein v. Comm’r*, 364 F.2d 734, 742 (2d Cir. 1966) (invalidating a transaction involving an unprofitable leveraged acquisition accompanied by prepaid interest deduction); *see also* STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 37 n.92.

58. *See, e.g., Sheldon v. Comm’r*, 94 T.C. 738, 768 (1990) (noting that a nominal profit potential is insignificant when compared to the deductions claimed); *see also* STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 38 n.93.

while other courts permit nominal profit potential to satisfy the objective prong of the two-prong test.⁵⁹

The subjective prong is also analyzed using various considerations.⁶⁰ Former IRS Chief Counsel Korb summarized at least seven types of evidence considered by courts when determining a taxpayer's subjective business purpose for entering the transaction.⁶¹ Such evidence includes the taxpayer's capital commitment to the transaction and the nature of the relationship between the parties to the transaction.⁶² Further, there is a split as to whether financial accounting benefit qualifies as subjective business purpose.⁶³ One scholar has suggested that all of these variations should be codified as one set of factors to be considered by a court in determining whether a transaction has economic substance.⁶⁴

An in-depth treatment of the courts' rationale for the various approaches is beyond the scope of this Note.⁶⁵ The relevant takeaway is the understanding that the circuit courts apply the ESD inconsistently, which has served as one of the primary arguments for codifying the ESD into the I.R.C.⁶⁶ Ultimately, the criticism is that the variations serve as means for the courts to invalidate transactions based on a type of "smell test,"⁶⁷ which

59. See, e.g., *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 783–86 (5th Cir. 2001) (requiring any objective profit potential); *Rice's Toyota World v. Comm'r*, 752 F.2d 89, 94 (4th Cir. 1985) (using the objective profit potential test also); see also STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 38 n.94.

60. See *infra* notes 61–64 and accompanying text.

61. See Korb, *supra* note 23, at 9–10 (“[T]he following evidence has been considered by the courts: (i) whether a profit was even possible; (ii) whether the taxpayer had a nontax business reason to engage in the transaction; (iii) whether the taxpayer, or its advisors, considered or investigated the transaction, including market risk; (iv) whether the taxpayer really committed capital to the transaction; (v) whether the entities involved in the transaction were entities separate and apart from the taxpayer and engaging in legitimate business before and after the transaction; (vi) whether all the purported steps were engaged in at arms-length with the parties doing what the parties intended to do; and (vii) whether the transaction was marketed as a tax shelter in which the purported tax benefit significantly exceeded the taxpayer's actual investment.”).

62. See *id.*

63. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 38 nn.95–96. Compare *Am. Elec. Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791–92 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003) (financial accounting benefits do not qualify as subjective business purpose), with *Frank Lyon Co. v. United States*, 435 U.S. 561, 577–78 (1978), and *Newman v. Comm'r*, 902 F.2d 159, 163 (2d Cir. 1990) (financial accounting benefits do qualify as subjective business purpose).

64. See Jefferson VanderWolk, *Codification of the Economic Substance Doctrine: If We Can't Stop It, Let's Improve It*, 55 TAX NOTES INT'L 547, 552 (2009).

65. For a full treatment of the various tests used in the circuit courts, see generally Jeff Rector, Note, *A Review of the Economic Substance Doctrine*, 10 STAN. J.L. BUS. & FIN. 173 (2004); Keinan, *It Is Time*, *supra* note 39.

66. See *infra* Part I.C.1.

67. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting) (“I can't help but suspect that the majority's conclusion to the contrary is, in its essence, something akin to a 'smell test.' If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to 'put one over.' . . . The fact that ACM may have 'put one over' in crafting these transactions ought not to influence our inquiry.”); Rector, *supra* note 65, at 134 (suggesting that the circuit differences are not

lends itself to subjectivity and inconsistent results.⁶⁸ Part I.C.1 further describes the reasons behind proposals to codify the ESD. Before returning to this issue, the next section of this Note explains that, once a court determines that a transaction lacks economic substance, the court can disallow the purported tax benefit and uphold IRS's assessment of penalties.⁶⁹

B. Tax Penalties for Noneconomic Substance Transactions Under the Internal Revenue Code

After a court holds that a transaction lacks economic substance and that the claimed tax deduction should be disallowed, the next question is whether IRS's assessment of penalties was proper. Part I.B illustrates how these penalties operate. Part I.B.1 explains accuracy-related penalties, and Part I.B.2 explains a defense to these penalties, the reasonable cause exception. Part I.B.3 demonstrates how these pieces fit together by way of two cases with opposite outcomes.

1. Accuracy-Related Penalties Under I.R.C. Section 6662

Under the I.R.C., various tax penalties are assessed for a taxpayer's failure to comply with the requirements of the Code.⁷⁰ One such penalty is identified in section 6662 as "accuracy-related penalties," which are assessed for underpayments of federal income tax.⁷¹ Accuracy-related penalties are assessed for underpayments arising from (1) the taxpayer's negligence, (2) a substantial understatement of the income tax, (3) a substantial valuation misstatement, (4) a substantial overstatement of pension liabilities, and (5) a substantial valuation understatement of estate or gift tax.⁷² For any underpayment of income tax under section 6662(b), the penalty is generally twenty percent of the underpayment amount.⁷³

The second of the five scenarios above, the substantial understatement of income tax, is used by IRS and courts to penalize underpayments arising from the disallowance of tax benefits in noneconomic substance transactions.⁷⁴ An "understatement" is defined as the difference in amount

determinative of the result but that courts are "informally deciding whether they 'like' a transaction" and then using their version of the test to justify the result). See generally Mark J. Silverman, Matthew D. Lerner & Gregory N. Kidder, *The Economic Substance Doctrine: Sorting Through the Federal Circuit's "We Know It When We See It" Ruling in Coltec*, 58 TAX EXECUTIVE 423 (2006) (interpreting the U.S. Court of Appeals for the Federal Circuit's ESD analysis as ambiguous, expansive, and, ultimately, equivalent to a "we know it when we see it" analysis).

68. See *infra* Part II.B.3.

69. See *infra* Part I.B.

70. See 47C C.J.S. *Internal Revenue* § 825 (2009).

71. I.R.C. § 6662 (2006); see 47C C.J.S., *supra* note 70, *Internal Revenue* § 825.

72. I.R.C. § 6662(b)(1)–(5).

73. *Id.* § 6662(a).

74. See *infra* Part I.B.3. There are cases in which IRS asserts that the disallowance of tax deductions in noneconomic substance transactions leads to a valuation misstatement

of the correct tax liability and a taxpayer's reported tax liability.⁷⁵ An understatement is "substantial" if it is greater than ten percent or \$5000 of the reported tax liability.⁷⁶ For corporations, that amount is the lesser of either (1) the amount that is greater between ten percent of the correct tax or \$10,000 or (2) ten million dollars.⁷⁷ The Treasury Regulations establish rules for adjusting the amount of understatement in certain circumstances.⁷⁸

2. The Reasonable Cause Exception Under I.R.C. Section 6664

I.R.C. section 6664 establishes exceptions to accuracy-related penalties imposed by section 6662.⁷⁹ Section 6664(c) serves as a defense to the assertion of underpayment penalties arising under section 6662 if the taxpayer can demonstrate reasonable cause and good faith (reasonable cause or reasonable cause exception).⁸⁰

In noneconomic substance transactions, reasonable cause is demonstrated by a facts and circumstances test, wherein the most important factor is the extent to which the taxpayer attempted to assess the proper tax liability.⁸¹ Where the taxpayer relies on a tax professional's opinion, such opinion must be based on all relevant laws and facts in the particular case, which requires full disclosure on the part of the taxpayer of all facts relevant to the proper tax treatment and the purpose for entering the transaction.⁸² Stated another way, the taxpayer cannot reasonably rely on a tax professional's opinion unless it is based on complete knowledge of the tax law and all relevant facts that the taxpayer knew or should have known.⁸³ The

penalty in addition to the understatement penalty. Circuit courts are split on this issue. The U.S. Courts of Appeals for the Fifth and Ninth Circuits hold that valuation misstatement does not apply in noneconomic substance transactions, while the U.S. Courts of Appeals for the Second, Third, Fourth, Sixth, and Eighth Circuits permit valuation misstatement penalties based on the disallowance of tax deductions as a result of noneconomic substance transactions. This circuit split is beyond the scope of this Note. Because the penalty standard debate is not differentiated by which of the two grounds is used to assert the accuracy-related penalty, this Note will limit its discussion to substantial understatements of income tax. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 60–61 & nn.187–90.

75. I.R.C. § 6662(d)(2)(A).

76. *Id.* § 6662(d)(1)(A).

77. *Id.* § 6662(d)(1)(B); see STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 54.

78. Treas. Reg. § 1.6664-4(c) (as amended in 2008). The calculation of the understatement amount may be adjusted in two situations: when the portion of understatement that is attributable to the treatment of an item is supported by substantial authority or when relevant facts surrounding the tax treatment of an item are adequately disclosed and substantiated by a reasonable basis. *Id.* In the case of tax shelters, the calculation of understatement is adjusted by the portion attributable to substantial authority and reasonable belief, which is covered in Part I.B.3. See *infra* note 128.

79. I.R.C. § 6664.

80. *Id.* § 6664(c).

81. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 54–55; *infra* note 130 and accompanying text.

82. See *infra* notes 129–33 and accompanying text.

83. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 55.

following section illustrates how the reasonable cause exception works in cases involving noneconomic substance transactions.⁸⁴

3. Case Law Applying I.R.C. Sections 6662 and 6664 in Noneconomic Substance Transactions

In this section of the Note, two cases help illustrate the function of the accuracy-related penalty and reasonable cause exception in cases involving noneconomic substance transactions. The first is *Klamath*, the Fifth Circuit case introduced earlier in the Note, wherein the taxpayer established reasonable cause by relying on the advice of tax accountants and tax lawyers regarding a complex loan transaction.⁸⁵ The second case is *Long Term Capital Holdings v. United States*,⁸⁶ a Second Circuit case in which the taxpayer failed to establish reasonable cause because the tax lawyers' advice was received long after the tax return was filed, the lawyers' opinion was based on minimal legal analysis lacking relevant legal authority, and the taxpayer lacked good faith.⁸⁷

a. *Klamath Strategic Investment Fund v. United States*

In *Klamath*, two law partners Patterson and Nix each claimed approximately twenty-five million dollars in tax deductions, which were disallowed because the transaction was deemed to lack economic substance by the IRS, whose decision was validated by the U.S. District Court for the Eastern District of Texas and then affirmed by the Fifth Circuit.⁸⁸ The transaction at issue was designed by Presidio Advisory Services (Presidio), which created a complex plan by which Patterson and Nix would invest in foreign currencies over a seven-year period in three stages.⁸⁹ The investments would be made through newly created limited liability companies named Klamath and Kinabalu, which would be treated as partnerships for tax purposes.⁹⁰ These partnerships each borrowed \$66.7 million from National Westminster Bank (Bank), with twenty-five million dollars of that amount being deemed a loan premium, which represented a high interest rate of 17.97% to be paid to the bank.⁹¹ To protect the bank's ability to collect this interest, the credit agreement between the Bank and the partnerships included a prepayment provision, requiring that in the event of early repayment of the loan by the partnerships, the bank would be entitled to a prepayment amount of twenty-five million dollars, which

84. See *infra* Part I.B.3.

85. See *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 546–48 (5th Cir. 2009).

86. 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005).

87. See *infra* notes 135–41 and accompanying text.

88. See *infra* notes 89–103 and accompanying text.

89. *Klamath*, 568 F.3d at 541.

90. *Id.*

91. *Id.*

would decrease over seven years.⁹² However, within the first sixty days of the seven-year investment period, Patterson and Nix withdrew from the partnerships.⁹³ They received cash and Euros in liquidation.⁹⁴ They subsequently sold the Euros, the proceeds of which were offset with over twenty-five million dollars in tax deductions arising from Klamath and Kinabalu activities.⁹⁵ Patterson and Nix achieved this result by treating the twenty-five million dollar loan premium as if it was money they had contributed into the partnership and then calculating the Euros received in liquidation using that basis.⁹⁶ Then when they sold the Euros at a market value much less than this amount, large artificial losses were created.⁹⁷

This transaction was held to lack economic substance for three reasons, all tending to show that the transaction was not entered to achieve economic profit but merely to generate large losses that can be used as tax deductions.⁹⁸ First, the transaction was structured to cause the investors to withdraw from the investment within sixty to seventy days rather than its purported seven-year term.⁹⁹ Second, a substantial portion of the purported investment was never intended to occur because the credit agreement provided that the Bank would hold all of the funds in collateral, with power to force the investors to withdraw within sixty to seventy days.¹⁰⁰ Third, Presidio's service fees were a function of losses generated by the investment, rather than as a function of profits generated.¹⁰¹ Therefore, the transaction lacked a reasonable expectation of generating a profit and failed the objective economic benefit prong of the test for economic substance.¹⁰² Even though the court held that Patterson and Nix possessed the subjective intent to enter the transaction for a nontax purpose, this was not enough to uphold the transaction because the Fifth Circuit uses a conjunctive test, requiring both objective economic benefit and subjective business purpose to validate a transaction.¹⁰³

In addition to disallowing the tax deductions for this noneconomic substance transaction, the IRS also assessed accuracy-related penalties for

92. *Id.*

93. *Id.*

94. *Id.*

95. *See id.* at 541–42 (containing an explanation of the itemized calculations giving rise to the twenty-five million dollar tax deduction).

96. *See id.*

97. *Id.* at 542 n.2.

98. *Klamath Strategic Inv. Fund v. United States*, 472 F. Supp. 2d 885, 896–98 (E.D. Tex. 2007).

99. This was done by requiring that the investors maintain collateral with the Bank in an amount that exceeded the total value of the amount owed to the bank. The Bank had discretion to determine whether the collateral was satisfied, or to declare a default and force the investor to withdraw from the partnership. *See id.* at 896–97.

100. *Id.* at 897.

101. *Id.*

102. *Id.* at 897–98.

103. *See Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009); *supra* note 51 and accompanying text.

the partners' substantial understatement of tax liability.¹⁰⁴ Patterson and Nix argued against the penalties by asserting the reasonable cause defense.¹⁰⁵ The Fifth Circuit noted that the most important factor in establishing reasonable cause is the taxpayer's effort to assess the proper tax liability.¹⁰⁶ A professional tax advisor's opinion does not necessarily satisfy reasonable cause, but the court examines the validity of the taxpayer's reliance by looking to the quality and objectivity of the tax advisor's opinion.¹⁰⁷

Here, Patterson and Nix obtained legal advice from tax attorneys and accountants, who wrote detailed opinions based on reasonable interpretations of the tax law.¹⁰⁸ Patterson and Nix also provided all relevant facts to inform the tax opinion.¹⁰⁹ Therefore, the tax opinion was a sufficient basis upon which Patterson and Nix could rely.¹¹⁰ Patterson and Nix relied on this opinion in good faith, being unaware of the understanding between Presidio and the Bank that the transaction was designed solely to generate tax losses.¹¹¹ As a result, the Fifth Circuit affirmed the district court's holding that Patterson and Nix carried their burden of demonstrating reasonable cause and held that Patterson and Nix were not subject to the understatement penalties.¹¹²

b. Long Term Capital Holdings v. United States

Long Term is a Second Circuit case involving a five-step transaction designed to create a tax deductible loss of \$400 million.¹¹³ The Second Circuit affirmed the U.S. District Court for the District of Connecticut's holding that the transaction lacked economic substance.¹¹⁴ The transaction at issue in *Long Term* is complex and technical, but the salient facts are simplified as follows and involved the "creation and cloning of an artificial loss that was marketed at least twice and hidden on the tax return by

104. See *supra* notes 9–11 and accompanying text.

105. See *supra* note 12 and accompanying text.

106. See *Klamath*, 568 F.3d at 548.

107. See *id.*

108. *Id.*

109. *Id.*

110. See *id.*

111. See *Klamath Strategic Inv. Fund v. United States*, 472 F. Supp. 2d 885, 901 (E.D. Tex. 2007).

112. See *Klamath*, 568 F.3d at 548.

113. See *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 127–28 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005).

114. See *Long Term*, 150 F. App'x at 42. Henceforth, this Note will refer to the district court's opinion, which contains the details lacking in the circuit court opinion. The district court's opinion has been praised for its thorough analysis of the ESD. See Keinan, *It Is Time*, *supra* note 39, at 30. In addition, because the technical details surrounding the transaction are complex, Professor Alvin Warren's case analysis informs this Note's explication of the case. See Alvin C. Warren Jr., *Understanding Long Term Capital*, 106 TAX NOTES 681, 681 (2005).

taxpayers whose business was unrelated to the origin of the loss.”¹¹⁵ The first step involved the creation of a foreign entity, Onslow Trading Company (Onslow), which was to receive lease income from preexisting leases of computer hardware and trucks in exchange for making a \$400 million deposit to cover the exposure of the lease payments.¹¹⁶ This step had the purpose of assigning \$400 million in lease income to a foreign entity that would not be subject to U.S. income taxes.¹¹⁷ Step two was the creation of a controlled subsidiary to which Onslow contributed its \$400 million of lease deposits and exposure obligations.¹¹⁸ In exchange, Onslow received four million dollars of the subsidiary’s preferred stock.¹¹⁹ The subsidiary was essentially purchasing Onslow’s \$400 million in exposure obligations as a deductible loss.¹²⁰ In step three, Onslow sold its subsidiary preferred stock to Long Term Capital Portfolio.¹²¹ Long Term Capital Portfolio was traceable to individual principals who formed Long Term Capital Management, which had a partnership interest in Long Term Capital Partners, which in turn had a partnership interest in Long Term Capital Portfolio (collectively Long Term).¹²² This had the effect of giving Long Term four million dollars in the subsidiary’s preferred stock, which had a tax deductible base of \$400 million that had stayed with the subsidiary.¹²³ In step four, Long Term secured a fifty million dollar investment from investors through the bank UBS.¹²⁴ In step five, Long Term sold some of the preferred stock it had purchased from Onslow for one million dollars, which had a book value of \$107 million, resulting in an artificial loss of \$106 million that was allocated to the principal-partners of Long Term Capital Management.¹²⁵

The IRS disallowed the \$106 million in deductions claimed by the partners of Long Term Capital Management, and then assessed accuracy-related penalties for their understatement of taxes.¹²⁶ The district court agreed with IRS’s conclusion that the transaction lacked economic substance and validated the assessment of penalties.¹²⁷ Long Term asserted, *inter alia*, that the understatement penalty should not apply to it based on the reasonable cause exception.¹²⁸

115. See Warren, *supra* note 114, at 695; *infra* notes 116–25 and accompanying text.

116. See Warren, *supra* note 114, at 681–83.

117. See *id.*

118. See *id.* at 683.

119. See *id.*

120. See *id.*

121. See *id.* at 683–84.

122. See *id.*

123. See *id.* at 684–85.

124. See *id.* at 685.

125. See *id.* at 685–86.

126. See *id.* at 686–87.

127. See *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 128 (D. Conn. 2004), *aff’d*, 150 F. App’x 40 (2d Cir. 2005).

128. See Warren, *supra* note 114, at 692. Long Term also asserted the defense that its tax treatment was supported by substantial authority and reasonable belief, which would mean either that there was no understatement of tax liability or that its understatement amount

In analyzing Long Term's reasonable cause defense, the court noted that whether a taxpayer acted with reasonable cause requires a case by case analysis, considering all pertinent facts and circumstances.¹²⁹ Like the court in *Klamath*, the district court noted that the most important factor in determining whether the taxpayer acted with reasonable cause and good faith is the extent to which the taxpayer attempted to assess the proper tax liability.¹³⁰ Then, the court made an important distinction with regard to reliance on professional tax advice—reliance on professional tax advice alone does not establish reasonable cause and good faith but, rather, such reliance must be reasonable in light of all of the circumstances.¹³¹ Reasonability requires two elements: First, the professional tax advice must be based upon all pertinent facts and circumstances as well as laws relating to those facts, which requires that the taxpayer fully disclose all facts relevant to the proper tax treatment as well as the purpose for entering into the transaction.¹³² Second, the advice cannot be based on unreasonable factual and legal assumptions, including inaccurate assumptions about the taxpayer's purpose for entering into the transaction or for structuring it in a particular manner.¹³³

The district court then held that Long Term failed to establish reasonable cause and good faith for several reasons.¹³⁴ First, the legal tax opinion upon which Long Term claims to have relied was not received by Long Term until after Long Term filed its tax return.¹³⁵ Second, even if the legal opinion had been received in a timely manner, Long Term could not demonstrate that the legal opinion was based on all pertinent facts or that such opinion did not rely on unreasonable factual or legal assumptions.¹³⁶ The district court described the legal opinion as containing minimal legal analysis and only a brief discussion of basic facts, which amounted to "superficial pronouncements asking the Court to 'trust us.'"¹³⁷ Additionally, even if the legal opinion was substantively sufficient, the partners of Long Term Capital Management did not review it.¹³⁸ Lastly, Long Term failed to act in good faith by attempting to conceal the tax losses by reporting them under the line item "Net Unrealized Gains" and

would be reduced by the portion attributable to substantial authority and reasonable belief. *See id.* Substantial authority is an objective analysis of the law, which looks to whether the taxpayer had substantial legal authority supporting his tax treatment and, if so, reduces the understatement amount by the portion attributable to that substantial authority. Here, the district court held that Long Term lacked substantial authority because it could not demonstrate any authority that recognizes tax deductible losses arising from noneconomic substance transactions. *See Long Term*, 330 F. Supp. 2d at 201–05.

129. *See Long Term*, 330 F. Supp. 2d at 205.

130. *See id.* (citing Treas. Reg. § 1.6664-4(b)).

131. *See id.* at 205–06.

132. *See id.* at 206 (citing Treas. Reg. § 1.6664-4(c)(1)).

133. *See id.* (citing Treas. Reg. § 1.6664-4(c)(1)).

134. *See infra* notes 135–41 and accompanying text.

135. *See Long Term*, 330 F. Supp. 2d at 206–07; Warren, *supra* note 114, at 693.

136. *See Long Term*, 330 F. Supp. 2d at 209; Warren, *supra* note 114, at 693.

137. *Long Term*, 330 F. Supp. 2d at 210–11; *see* Warren, *supra* note 114, at 693.

138. *See Long Term*, 330 F. Supp. 2d at 211.

netting the tax losses against unrelated capital gains.¹³⁹ This was done to hide the large tax loss it attempted to claim, which could have triggered an IRS audit.¹⁴⁰ In sum, Long Term could not carry the burden of demonstrating that it had reasonable cause and good faith in relying on the professional tax advice, and the understatement penalty was upheld.¹⁴¹

C. Legislative Proposals To Codify the Economic Substance Doctrine

Part I.A discussed the ESD under common law and noted the unresolved circuit split regarding the varying forms of the doctrine. Part I.B described accuracy-related penalties assessed under the I.R.C. for noneconomic substance transactions. This section of the Note summarizes legislative attempts to codify the common-law ESD, which includes defining the penalty standard under the I.R.C. Part I.C.1 identifies the objectives sought by prior legislative proposals between 1999 and 2007. Part I.C.2 describes a 2009 proposal, H.R. 3200.

1. Reasons Behind Legislative Efforts To Codify the Economic Substance Doctrine Between 1999 and 2007

This section addresses the numerous legislative attempts to codify the ESD into the I.R.C., beginning in 1999. Three main reasons were purported to be the goals behind codification: (1) deter aggressive noneconomic substance transactions, (2) clarify the ESD by codifying one definition of the doctrine, and (3) raise federal revenue by assessing tax penalties for noneconomic substance transactions. This section elaborates on these reasons and gives examples of prior legislation between 1999 and 2007, which sought to achieve these aims.

a. Deter Noneconomic Substance Transactions and Tax Avoidance

As an initial policy matter, noneconomic substance transactions are seen as hurtful to the economy and to be dealt with in a manner that deters such transactions.¹⁴² Proponents argue that the strong need for deterrence justifies codification of the ESD.¹⁴³ The codified ESD is argued to be a more effective deterrent than the common-law doctrine, as demonstrated by

139. *See id.*; Warren, *supra* note 114, at 693.

140. *See Long Term*, 330 F. Supp. 2d at 212.

141. *See id.* at 211–12.

142. *See Corporate Tax Reform: Hearing Before Subcomm. on Select Revenue Measures of H. Comm. on Ways and Means*, 109th Cong. 33 (2006) [hereinafter *Hearing on Corporate Tax Reform*] (statement of Samuel C. Thompson, Jr., Professor, UCLA), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_house_hearings&docid=f:30445.pdf.

143. *See id.* at 36–37 (statement of Samuel C. Thompson, Jr., Professor, UCLA) (citing reports by the American Bar Association, American Institute of Certified Public Accountants, and Tax Executive Institute).

other targeted legislation that drove behavior and deterred misconduct.¹⁴⁴ The proposals throughout the years, discussed in greater detail in later sections of this Note, have had the overarching purpose of bolstering the federal government's ability to combat tax shelters.¹⁴⁵

b. *Codify One Definition of the Test for Economic Substance*

Another goal of the codification effort is to define one uniform application of the doctrine.¹⁴⁶ As demonstrated in Part I.A.2, the circuit courts are split on whether the two prongs of the ESD should be used conjunctively or disjunctively.¹⁴⁷ In addition, each of the two prongs is defined using various factors.¹⁴⁸ This lack of uniformity is a prominent reason behind legislative efforts to codify one definition of what constitutes a noneconomic substance transaction.¹⁴⁹

In 1999, the Treasury and the Joint Committee on Taxation first discussed the possibility of codifying the ESD as one approach to combat tax shelters.¹⁵⁰ The ESD would be codified as a one-prong test using the objective economic benefit prong.¹⁵¹ During the 2001–2002 congressional sessions, two House bills proposed that the ESD be codified into the I.R.C. as a two-prong conjunctive test.¹⁵² During the 2003–2004 congressional sessions, the Senate proposed three bills,¹⁵³ the notable one being S. 1637, the Jumpstart Our Business Strength Act (JOBS Act).¹⁵⁴

144. See *id.* at 33–34, 37 (statement of Samuel C. Thompson, Jr., Professor, UCLA) (noting that section 469 enacted a “passive loss provision,” which has been effective in deterring real estate and similar tax shelters, and that the forty percent penalty under the proposal will have greater “bite” than existing antishelter provisions).

145. See TREASURY DEP’T, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2010 REVENUE PROPOSALS 25 (2009) [hereinafter TREASURY DEP’T ON 2010 REVENUE PROPOSALS], available at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf> (explaining that the 2009 proposal to codify the ESD and increase the penalty will deter transactions intended for tax avoidance); TREASURY DEP’T, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2001 REVENUE PROPOSALS 125 (2000), available at <http://www.treas.gov/offices/tax-policy/library/grnbk00.pdf> (stating that the 1999 legislative proposal to codify the ESD was intended to strengthen the Treasury Department’s overall tax shelter strategy); Yoram Keinan, *The Economic Substance Doctrine*, 508-1 Tax Mgmt. Portfolio (BNA) § VIII(C)(1) (2007), available at TMFEDPORT No. 508 s VIII (Westlaw) (noting that the 2004 legislative proposal to codify the ESD under the Jumpstart Our Business Strength Act (JOBS Act) was intended to deter noneconomic substance transactions).

146. See *infra* notes 150–69 and accompanying text.

147. See *supra* Part I.A.2.

148. See *supra* Part I.A.2.

149. See Keinan, *supra* note 145, § VIII(A).

150. See *id.* § VIII(B)(1) & n.1225.

151. See *id.* § VIII(B)(1).

152. See *id.* § VIII(B)(2) & n.1230 (identifying two House bills, H.R. 2520 and H.R. 5095, that proposed codification of the ESD as part of I.R.C. § 7701).

153. See *id.* § VIII(B)(3) & nn.1231–32 (stating that the three Senate bills introduced in the 108th Congress, S. 476, S. 1054, and S. 1637, were substantively unchanged from the House bills submitted during the 107th Congress).

154. See *id.* § VIII(C) (noting that the JOBS Act passed the Senate by a 92-5 vote then became signed into law).

The 2004 JOBS Act acknowledged that circuit courts were applying the ESD inconsistently¹⁵⁵ and proposed to define the ESD as a two-prong conjunctive test.¹⁵⁶ Specifically, a transaction would have economic substance if it changes the taxpayer's economic position in a meaningful way, and the taxpayer has a substantial nontax purpose for entering into the transaction with a reasonable means of accomplishing such purpose.¹⁵⁷ The court would retain the discretion to determine if the ESD was relevant in a given case.¹⁵⁸ The JOBS Act passed into law on October 22, 2004,¹⁵⁹ but excluded the portions of the bill regarding the codification of the ESD and the accompanying penalty provision.¹⁶⁰

In 2005 during the 109th Congress, the Joint Committee on Taxation (JCT) proposed its version of a codification proposal, noting that the lack of clarity produces unfairness, which is compounded by the high tax penalty.¹⁶¹ The JCT's 2005 proposal differed from the JOBS Act of 2004 in three key aspects. First, the subjective prong would require that the business purpose of the transaction be substantial and "bear a reasonable relationship to the taxpayer's normal business operations or investment activities."¹⁶² This change was premised on the idea that a transaction that bears no relationship to the taxpayer's normal business activities may signal that it was entered into merely for tax purposes.¹⁶³ Second, courts would be able to invalidate an entire transaction that consists of portions seeking nontax purposes as well as portions seeking only tax avoidance.¹⁶⁴ Third, the ESD would be used by courts only for certain "applicable transactions," defining six such categories and giving the Treasury authority to add or

155. *See id.* § VIII(C)(1).

156. *See id.* § VIII(C)(2).

157. *See id.* § VIII(C)(3). There is criticism that this proposal purported to define the ESD in a manner inconsistent with common-law precedent. First, the objective economic benefit prong under the proposal would use a "change in economic position" test, which would be broader than the "reasonable expectation for profit" test applied by the courts. Second, the subjective business purpose prong under the proposal would require, on top of a nontax purpose, a reasonable means to achieve it, and, hence, would be more restrictive than the common-law standard. *See id.* § VIII(C)(3)–(4) & nn.1242–45.

158. *See id.* § VIII(C)(2) (noting that the proposed standard would apply only upon a court's determination that the ESD is relevant in a case, without which the legislation would have no effect).

159. Pub. L. No. 108-357, 118 Stat. 1418 (2004) (codified at 26 USC § 114 (2006)).

160. *See id.* § VIII(C)(7).

161. *See id.* § VIII(D)(1).

162. *See id.* § VIII(D)(4).

163. *See id.* § VIII(D)(4) n.1259.

164. *See id.* § VIII(D)(4). In its description of the 2007 proposal, S. 2242, the Senate Committee on Finance noted that courts would have the authority to bifurcate a transaction, such that the court could aggregate or disaggregate portions of the transaction and disallow it in its entirety or only those portions motivated by tax avoidance. *See* STAFF OF S. COMM. ON FIN., 110TH CONG., ECONOMIC SUBSTANCE DOCTRINE 5 (2007) [hereinafter STAFF OF S. COMM. ON FIN.], available at <http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20100407agamentment.pdf>.

delete from this list of applicable transactions.¹⁶⁵ Congress did not adopt the 2005 JCT proposal.¹⁶⁶

In 2007, a codification proposal came as part of the Heartland, Habitat, Harvest, and Horticulture Act of 2007.¹⁶⁷ This Senate proposal would also define the ESD using a two-prong conjunctive test, requiring the transaction to change the taxpayer's economic position in a meaningful way apart from federal income tax benefits and to have a substantial nontax purpose.¹⁶⁸ The 2007 proposal differed from prior proposals in that it excluded from the subjective prong the requirement of either a reasonable means of accomplishing the nontax purpose, as in the 2004 JOBS Act, or a reasonable relationship to the taxpayer's normal business activities, as in the 2005 proposal.¹⁶⁹ Like prior bills, Congress did not adopt the 2007 proposal.¹⁷⁰

c. Raise Federal Revenue Through Tax Penalties

Legislative proposals to codify the ESD began to include a penalty provision with the JOBS Act of 2004, which provided that tax penalties would be assessed for noneconomic substance transactions as an explicit category subject to accuracy-related penalties under the I.R.C.¹⁷¹ Penalties assessed for noneconomic substance transactions act as revenue offsets against federal spending.¹⁷² The assessment of this penalty as a revenue raiser for the federal government has been noted by some as one of the driving forces behind the codification effort.¹⁷³

165. See Keinan, *supra* note 145, § VIII(D)(6). The six categories of applicable transactions were the following: (1) "offsetting positions," or transactions by which the taxpayer can recognize a loss without recognizing an offsetting gain in the same period; (2) transactions that create or increase a loss or reduce a gain by way of a disparity between basis and fair market value; (3) transactions that create or increase a gain in an asset, which do not result in a recognizable loss if the asset is sold at fair market value; (4) transactions with tax-indifferent parties; (5) transactions in which the taxpayer disposes of property in less than a forty-five day holding period; and (6) transactions in which certain deductions are permitted for federal tax purposes but not for financial accounting purposes. See *id.*

166. See *id.* § VIII(A) (noting that Congress has not adopted any of the proposals to date).

167. S. 2242, 110th Cong. (2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_reports&docid=f:sr206.pdf.

168. See STAFF OF S. COMM. ON FIN., *supra* note 164, at 5.

169. See *id.*

170. See Govtrack.us, S. 2242: Heartland, Habitat, Harvest, and Horticulture Act of 2007, <http://www.govtrack.us/congress/bill.xpd?bill=s110-2242> (last visited Feb. 21, 2010).

171. See Keinan, *supra* note 145, § VIII(C)(7).

172. See TREASURY DEP'T ON 2010 REVENUE PROPOSALS, *supra* note 145, at i (listing the codification of ESD as a category of revenue changes in the President's 2010 budget); *Codifying the Economic Substance Doctrine*, FED. TAX ADVISORY (Alston Bird LLP, D.C.), Apr. 1, 2009, available at [http://www.alston.com/files/Publication/bc42675d-c232-40a5-af88-00b41f3ba394/Presentation/PublicationAttachment/1bc7cd19-d5ef-4bb5-9662-00f3d49c9e9a/FedTaxReport%204-1-09%20\(2\).pdf](http://www.alston.com/files/Publication/bc42675d-c232-40a5-af88-00b41f3ba394/Presentation/PublicationAttachment/1bc7cd19-d5ef-4bb5-9662-00f3d49c9e9a/FedTaxReport%204-1-09%20(2).pdf); Samuel C. Thompson Jr., *Despite Widespread Opposition, Congress Should Codify the ESD*, 110 TAX NOTES 781, 781 (2006).

173. See Dennis J. Ventry Jr., *Save the Economic Substance Doctrine from Congress*, 118 TAX NOTES 1405, 1410 (2008) (quoting commentators' observations on the role of the penalty provision as a revenue raiser).

The JOBS Act proposed that a penalty be assessed at forty percent of the understatement amount resulting from the disallowance of a tax deduction, which would be reduced to twenty percent with adequate disclosure of all relevant facts surrounding the transaction.¹⁷⁴ These penalties, along with the purported heightened deterrent effect of the codified ESD, were estimated to generate over thirteen billion dollars in federal revenue over a ten-year period between 2004 and 2013.¹⁷⁵ The penalty provision in the JOBS Act was excluded from the version of the bill signed into law on October 22, 2004.¹⁷⁶

The 2005 proposals were substantially similar to the 2004 JOBS Act except that they proposed a major change to administer the penalty on a strict liability basis.¹⁷⁷ The strict liability standard, which is discussed further in Part I.C.2.b, meant that the taxpayer's reliance on the advice of a tax professional could not serve as a defense to the penalty.¹⁷⁸ One of the 2005 proposals, S. 2020, was estimated to generate fifteen billion dollars from codifying the ESD.¹⁷⁹

In the 2007 proposal,¹⁸⁰ the penalty was adjusted to thirty percent, which would be reduced to twenty percent if the taxpayer adequately disclosed the facts surrounding the transaction.¹⁸¹ Like the 2005 proposals, the 2007 proposal would administer the penalty on a strict liability basis, precluding the taxpayer from asserting a defense to the penalty based on outside tax opinions or in-house analyses tending to demonstrate reasonable cause.¹⁸² Estimates of the revenue to be generated by the several 2007 proposals, including S. 2242, ranged between \$3.5 billion and \$10 billion.¹⁸³

174. See Keinan, *supra* note 145, § VIII(C)(7).

175. See STAFF OF J. COMM. ON TAXATION, 108TH CONG., ESTIMATED REVENUE EFFECTS OF THE CHAIRMAN'S MARK OF S. 1637, THE "JUMPSTART OUR BUSINESS STRENGTH ('JOBS') ACT" (Comm. Print 2003), available at <http://finance.senate.gov/sitepages/leg/leg092603revtble.pdf>.

176. See Pub. L. No. 108-357, 118 Stat. 1418 (2004); Keinan, *supra* note 145, § VIII(C)(7).

177. See *id.* § VIII(D).

178. See *id.*; *infra* Part I.C.2.b.

179. See Thompson, *supra* note 172, at 781 (citing STAFF OF J. COMM. ON TAXATION, 109TH CONG., ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN S. 2020, "THE TAX RELIEF ACT OF 2005" AS PASSED BY THE SENATE ON NOVEMBER 18, 2005 (Comm. Print 2005), available at <http://www.jct.gov/x-82-05r.pdf>).

180. Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242, 110th Cong. (2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_reports&docid=f:sr206.pdf.

181. See STAFF OF S. COMM. ON FIN., *supra* note 164, at 13.

182. See *id.*

183. See Donald L. Korb, *Codification of the Judicial Economic Substance Doctrine*, in TAX LAW AND ESTATE PLANNING 2008, at 379, 382-87 (PLI Tax Law & Practice, Course Handbook Series No. 852, 2008).

2. 2009 Proposal by the 111th Congress: H.R. 3200

One of the 2009 proposals for codification of the ESD was part of America's Affordable Health Choices Act of 2009, or H.R. 3200.¹⁸⁴ H.R. 3200 contained sections 452 and 453, respectively entitled "Codification of Economic Substance Doctrine" and "Penalties for Underpayments."¹⁸⁵ The former section defined how the ESD should be codified, and the latter section specified how the penalty provision should be incorporated into the I.R.C.¹⁸⁶

a. *Section 452: Codification of Economic Substance Doctrine*

H.R. 3200 proposed to codify ESD into the I.R.C. as an amendment to section 7701, which covers procedural and administrative definitions under the I.R.C.¹⁸⁷ The ESD would be codified as a two-prong conjunctive test, requiring that (1) the transaction change the taxpayer's economic position in a meaningful way apart from reducing federal tax and that (2) the taxpayer have a substantial nontax business purpose for entering into the transaction.¹⁸⁸ The nontax business purpose prong is not satisfied by the taxpayer's purpose to achieve a financial accounting benefit if such financial accounting benefit is intended to achieve a reduction of tax.¹⁸⁹

The proposal included a "special rule where taxpayer relies on profit potential," which stated that a profit potential must have a "present value of the reasonably expected pre-tax profit [that is] substantial in relation to the present value of the expected net tax benefits" arising from the transaction.¹⁹⁰ Courts would retain the discretion to determine when the ESD applies in a particular case.¹⁹¹ In addition, the proposal stated that other common-law doctrines would not be affected by the proposal.¹⁹² Lastly, the Treasury Department would have authority to publish regulations to carry out the purpose of the proposal.¹⁹³

184. See America's Affordable Health Choices Act of 2009, H.R. 3200, 111th Cong. (2009). This Note analyzes the proposal to adopt a strict liability penalty standard for noneconomic substance transactions under the framework of H.R. 3200. On October 29, 2009, H.R. 3200 was superseded by a similar bill, H.R. 3962. This change does not impact this Note's analysis for two reasons: First, the new bill contains a penalty provision identical to that in H.R. 3200. Second, this Note's discussion of the penalty standard does not rely on the particulars of any one bill but addresses the broader policy considerations of any legislation that proposes to adopt a strict liability penalty standard for noneconomic substance transactions. See *supra* note 20 and accompanying text.

185. See H.R. 3200 §§ 452–453.

186. See *id.*

187. I.R.C. § 7701 (2006); see H.R. 3200 § 452(a).

188. H.R. 3200 § 452(a)(1).

189. *Id.* § 452(a)(4).

190. *Id.* § 452(a)(2).

191. See *id.* § 452(a)(5)(D).

192. *Id.* § 452(a)(5)(C).

193. *Id.* § 452(a)(6).

b. *Section 453: Penalties for Underpayments*

H.R. 3200 section 453 was the penalty provision, which was an important component of the proposal and fit into the goal of deterring tax shelters.¹⁹⁴ The penalty provision proposed to enact three important amendments to existing accuracy-related penalties and the reasonable cause exception, to be discussed below.¹⁹⁵ The penalty provision was estimated to raise \$3.6 billion of federal revenue over a ten-year period between 2010 and 2019.¹⁹⁶

The first provision in section 453 was to amend I.R.C. section 6662(b) to add noneconomic substance transactions as a sixth category of underpayments giving rise to a penalty.¹⁹⁷ A twenty percent penalty would be imposed, calculated as a percent of the understatement amount resulting from the disallowance of the claimed tax deduction.¹⁹⁸ The second provision of section 453 proposed a heightened penalty of forty percent where a taxpayer failed to adequately disclose all relevant facts surrounding the tax treatment of an item at issue.¹⁹⁹

The third change proposed by H.R. 3200 is the source of the conflict addressed in this Note. The proposal would amend section 6664, which currently provides that no penalty shall apply to underpayments for which reasonable cause and good faith can be shown on the part of the taxpayer.²⁰⁰ Under the proposal, the reasonable cause exception would be inapplicable to noneconomic substance transactions,²⁰¹ which means that as long as the transaction is deemed to lack economic substance, the section 6662 understatement penalty would apply, and the taxpayer would be precluded from asserting the reasonable cause exception as a defense to the penalty.²⁰² Hence, the taxpayer has no opportunity to demonstrate that his tax position is substantiated by professional tax opinions or in-house analyses.²⁰³ The penalty cannot be abated unless the underlying understatement amount is recalculated under a different set of rules.²⁰⁴ Stated another way, the penalty can only be abated in proportion to an

194. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 48 (stating that the penalty was intended to deter aggressive tax positions by increasing the cost of entering noneconomic substance transactions).

195. See *infra* notes 197–206 and accompanying text.

196. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 40 n.104 (noting that for its budgetary estimate, the JCT has made the same assumptions on the penalty and interest disallowances as H.R. 2419 and S. 2242); STAFF OF J. COMM. ON TAXATION, 111TH CONG., ESTIMATED EFFECTS OF THE REVENUE PROVISIONS OF H.R. 3200, THE “AMERICA’S AFFORDABLE HEALTH CHOICES ACT OF 2009,” at 2 (Comm. Print 2009).

197. H.R. 3200 § 453(a)(1).

198. I.R.C. § 6662(a) (2006); H.R. 3200 § 453(a)(1).

199. H.R. 3200 § 453(a)(2).

200. I.R.C. § 6664(c); see also *supra* Part I.B.2.

201. H.R. 3200 § 453(b).

202. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 63; STAFF OF J. COMM. ON TAXATION ON H.R. 3200, *supra* note 18, at 49.

203. See STAFF OF J. COMM. ON TAXATION ON H.R. 3200, *supra* note 18, at 49.

204. See *supra* note 78 and accompanying text.

abatement of the underlying tax liability.²⁰⁵ The changes proposed by section 453 would effectively make the penalty standard one of strict liability.²⁰⁶

In summary, H.R. 3200's penalty provision would have imposed a twenty percent penalty for underpayment of income tax that results from the disallowance of a tax benefit claimed by a taxpayer in a noneconomic substance transaction.²⁰⁷ Should the taxpayer fail to disclose all relevant facts surrounding the tax treatment of an item in the transaction, he is subject to a forty percent penalty of the underpayment.²⁰⁸ The taxpayer would no longer have the opportunity to avoid the penalty by asserting the reasonable cause exception but would be penalized under the strict liability standard.²⁰⁹ This last provision, which proposed to change the penalty standard from reasonable cause to strict liability, is the focus of the debate in Part II, where this Note explores the question of whether the strict liability penalty standard is appropriate for application with the ESD.

II. THE DEBATE REGARDING THE TAX PENALTY STANDARD: ARGUMENTS FOR AND AGAINST STRICT LIABILITY

Part II examines arguments for and against the use of strict liability to assess penalties for noneconomic substance transactions. The debate regarding the strict liability penalty takes place within the larger context of the debate around codification of the ESD generally, in which the arguments for and against codification necessarily implicate the propriety of the penalty provisions contained therein.²¹⁰ Part II.A examines the arguments in favor of strict liability as espoused by its proponents. Part II.B examines arguments against strict liability as espoused by its opponents.

A. *Proponents' Arguments in Favor of the Strict Liability Penalty Standard*

This section of the Note considers arguments proffered by those who favor the strict liability standard. Proponents of strict liability argue that strict liability should be adopted in order to (1) better deter noneconomic substance transactions, (2) raise revenue for the federal government through the assessment of penalties, and (3) curtail the promotion of these tax evasion tools by tax professionals.

205. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 63–64.

206. See *id.*; STAFF OF J. COMM. ON TAXATION ON H.R. 3200, *supra* note 18, at 49; *supra* notes 201–05 and accompanying text.

207. See *supra* note 198 and accompanying text.

208. See *supra* note 199 and accompanying text.

209. See *supra* notes 200–06 and accompanying text.

210. See Clinton Stretch, Matthew Lay & John Galotto, *Economic Substance and Strict Liability Do Not Mix*, 123 TAX NOTES 1357, 1357 & nn.2–5 (2009).

1. Strict Liability Is a Stronger Deterrent to Noneconomic Substance Transactions Relative to Existing Law

The proposed penalty standard imposes a strict liability penalty for noneconomic substance transactions.²¹¹ There is argument that a higher and stricter penalty is needed to better deter noneconomic substance transactions,²¹² based on the observation that the current tax penalty regime does not sufficiently deter aggressive tax shelter transactions.²¹³ A taxpayer can gamble, in a sense, on a tax shelter transaction with the upside of obtaining the tax benefit and the downside of losing the tax benefit he attempted to realize.²¹⁴ This leaves him in a position that is no worse than the one he would be in without the tax shelter transaction.²¹⁵ Similarly, current IRS guidelines for settling tax shelter cases are said to be ineffective at deterring tax shelters because the taxpayer does not stand to be sufficiently disadvantaged from a finding that the transaction lacked economic substance.²¹⁶ These observations lead the proponents of strict liability to argue that the reasonable cause exception leaves too much “wiggle room” for the sophisticated taxpayer and too many opportunities to convince IRS or a court to validate a purely tax-motivated transaction.²¹⁷ Thus, the proponents advocate a strict liability standard, which alters the cost-benefit analysis of these taxpayers and increases the stakes should their transactions be deemed to lack economic substance.²¹⁸ This gives the taxpayer incentive to avoid tax shelter transactions, thereby “level[ing] the

211. See *supra* note 206 and accompanying text.

212. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 63–65.

213. See *Hearing on Corporate Tax Reform*, *supra* note 142, at 33–34, 37 (statement of Samuel C. Thompson, Jr., Professor, UCLA).

214. See *Hearing on Corporate Tax Shelters*, *supra* note 30, at 39–40 (statement of Lindy Paull, Chief of Staff, J. Comm. on Taxation); Zachary Nahass, Comment, *Codifying the Economic Substance Doctrine: A Proposal on the Doorstep of Usefulness*, 58 ADMIN. L. REV. 247, 267 (2006); Lawrence M. Hill & Alexandra Minkovich, *Tax Policy Gone Wild: Harsh Penalties as Revenue Raisers*, 115 TAX NOTES 79, 81 (2007) (arguing that the strict liability penalty encourages taxpayers to take their chances of being audited rather than voluntarily disclosing the transaction because their disclosure and good-faith attempt at compliance does not mitigate their chances of being penalized).

215. See Hill & Minkovich, *supra* note 214, at 81.

216. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 63–64 & n.203.

217. See *Hearing on Corporate Tax Reform*, *supra* note 142, at 34–36 (statement of Samuel C. Thompson, Jr., Professor, UCLA); I.R.S. Notice CC-2004-036 (Sept. 22, 2004), available at <http://www.irs.gov/pub/irs-ccdm/cc-2004-036.pdf> (pronouncing that tax penalties should not be bargained away if they are to deter tax shelter transactions).

218. See *Hearing on Corporate Tax Reform*, *supra* note 142, at 34–36 (statement of Samuel C. Thompson, Jr., Professor, UCLA); *Hearing on Corporate Tax Shelters*, *supra* note 30, at 39–40 (statement of Lindy Paull, Chief of Staff, J. Comm. on Taxation) (suggesting that the existing tax penalty regime does not sufficiently deter tax shelter transactions because the underpayment penalty is relative to the tax benefit attempted to be realized by the taxpayer); STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 63–64 & n.204 (noting that proponents say tax advisors will look to existing case law to advise their clients that a tax penalty will apply if the transaction fails on ESD).

playing field between more aggressive and more conservative practitioners and their clients.”²¹⁹

2. Strict Liability Helps Raise Revenue for the Federal Government

The federal tax gap is the difference between what taxpayers actually owe in taxes and what they actually pay.²²⁰ The largest portion of the tax gap is a result of underreporting,²²¹ with a 2008 estimate approximating that eighty-three percent of the tax gap, or \$285 billion, is attributable to underreporting.²²² Abusive tax shelters contribute to the underreporting that produces the federal tax gap.²²³ This is seen as evidence that the penalty system is not effectively deterring tax shelters.²²⁴ Based on the argument that reducing the complexity of the Code alleviates underreporting,²²⁵ strict liability would help close the tax gap because it can be administered simply as a bright-line rule by eliminating opportunities for taxpayers to explain away violations using the reasonable cause exception.²²⁶

3. Strict Liability Discourages Tax Professionals from Promoting Tax Evasion Tools Such as Noneconomic Substance Transactions

Scholars have criticized tax professionals’ marketing of legal opinions or accounting tools, which are used to validate tax shelter transactions.²²⁷

219. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 63 (citing *Hearing on Corporate Tax Reform*, *supra* note 142, at 33 (statement of Samuel C. Thompson, Jr., Professor, UCLA)).

220. See *Uncollected Taxes: Can We Reduce the \$300 Billion Tax Gap?: Hearing Before the Subcomm. on Fed. Financial Management, Government Information, and International Security of the S. Comm. on Homeland Security and Governmental Affairs*, 109th Cong. 95 (2005) [hereinafter *Hearing on the Tax Gap*], available at <http://bulk.resource.org/gpo.gov/hearings/109s/24444.pdf> (statement of J. Russell George, Treasury Inspector General for Tax Administration). The tax gap is composed primarily of (1) unfiled tax returns, (2) underreported income on filed returns, and (3) underpaid taxes on filed returns. See *id.*

221. See *id.* at 96 fig.1. For a discussion of the federal tax gap and information reporting as a means to reduce it, see generally Leandra Lederman, *Reducing Information Gaps To Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733 (2010).

222. 2 TAXPAYER ADVOCATE SERV., 2008 ANNUAL REPORT TO CONGRESS 12 (2008), available at http://www.irs.gov/pub/irs-utl/08_tas_arc_vol2.pdf.

223. See William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. (forthcoming Summer 2010), available at http://www.law.siu.edu/fac_staff/Drennan/Drennan-forthcoming%20Okla%20LR%20article%205-09.pdf.

224. See *id.*

225. See *Hearing on the Tax Gap*, *supra* note 220, at 100–03 (statement of J. Russell George, Treasury Inspector General for Tax Administration).

226. See *id.* at 101–03 (statement of J. Russell George, Treasury Inspector General for Tax Administration) (arguing that complex tax laws permit taxpayers to exploit “angles” such as tax shelters but simultaneously require greater IRS resources to fight such abusive behavior).

227. See Warren, *supra* note 114, at 695 (stating that tax professionals have marketed tax shelter transactions as tax products, and such behavior will only change if courts uphold

Akin to the argument that the current penalty regime is insufficient to deter noneconomic substance transactions, a similar argument is that tax professionals have become promoters of these noneconomic substance transactions and that this problem should be curtailed by penalizing the taxpayer on a strict liability basis.²²⁸ The strict liability penalty for taxpayers would work in conjunction with penalties assessed on tax professionals for failing to comply with requirements of disclosure and confidence levels in issuing tax opinions that serve as substantial bases for taxpayers' tax positions.²²⁹

B. Opponents' Arguments Against the Strict Liability Penalty Standard

Opponents of strict liability argue that the strict liability penalty standard is not appropriate for noneconomic substance transactions.²³⁰ At least one commentator has suggested that the strict liability penalty is the most flawed aspect of the proposed codification of ESD.²³¹ Strict liability penalties are rarely used in federal tax law.²³² In fact, it is reported that of the \$29.5 billion in tax penalties assessed by the IRS in 2007, 37.6% were abated in whole or in part, illustrating the significant role of IRS's ability to abate tax penalties.²³³ Opponents of the proposed strict liability standard espouse four main arguments: (1) strict liability contravenes broader tax penalty policies and is unfair to the taxpayer, (2) strict liability penalties should not be imposed as revenue raisers, (3) strict liability should not be

penalties); Federal Tax Crimes, <http://federaltaxcrimes.blogspot.com/2009/07/other-players-in-abusive-tax-shelters.html> (July 24, 2009, 12:14 CST) (commenting on Marvin Chirelstein's Letter to the Editor in *Tax Notes* expressing alarm about law firms promoting tax shelters and selling legal opinions validating tax shelters).

228. See *Hearing on Corporate Tax Reform*, *supra* note 142, at 37 (statement of Samuel C. Thompson, Jr., Professor, UCLA) (supporting the proposed penalty provision and arguing against organizations that say current laws sufficiently address the problem of tax professionals who promote tax shelter transactions).

229. See Memorandum from the A.B.A. Tax Section to Chairmen and Ranking Members of the House and Senate, Statement of Policy Favoring Reform of Federal Civil Tax Penalties (Apr. 21, 2009) [hereinafter A.B.A. Tax Section on Civil Tax Penalty Reform], available at <http://www.abanet.org/tax/pubpolicy/2009/090421statemntciviltaxpenalties.pdf>. For the tax professional's standard of conduct, see 31 C.F.R. pt. 10 (2008), available at http://www.irs.gov/pub/irs-utl/circular_230.pdf.

230. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 64–65; VanderWolk, *supra* note 64, at 548, 552; Memorandum from the A.B.A. Tax Section to Chairman Baucus and Ranking Member Grassley, Proposed Codification of the Economic Substance Doctrine 11–12 (Apr. 12, 2007) [hereinafter A.B.A. Tax Section on ESD Codification], available at <http://www.abanet.org/tax/pubpolicy/2007/070412codificationeconsubdoc.pdf>; AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, PENALTY REFORM TASK FORCE, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM 4 (2009) [hereinafter AICPA], available at <http://www.aicpa.org/download/news/2009/AICPA-report-civil-tax-penalty-reform.pdf>.

231. See Stretch et al., *supra* note 210, at 1357.

232. See *id.* at 1357–58 (noting that the 6600 and 6700 series of the I.R.C. contain seven strict liability penalties compared to approximately fifty-five provisions with the reasonable cause exception).

233. See U.S. GOV'T ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: IRS SHOULD EVALUATE PENALTIES AND DEVELOP A PLAN TO FOCUS ITS EFFORTS 1 (2009), available at <http://www.gao.gov/new.items/d09567.pdf>.

used with a fluid and complex doctrine such as the ESD, and (4) strict liability may produce unintended consequences.

1. Strict Liability Contravenes Broader Tax Penalty Policies and Is Unfair to the Taxpayer

A basic premise of the I.R.C. is to encourage taxpayers' voluntary compliance to the Code.²³⁴ That premise was enacted through the Improved Penalty and Compliance Tax Act (IMPACT) twenty years ago, which established that civil tax penalties should encourage taxpayers to voluntarily comply with the Code.²³⁵ IMPACT was heavily influenced by recommendations from the IRS Task Force, which was composed of members of the IRS and Treasury Department who conducted an in-depth study in collaboration with government officials, taxpayers, private practitioners, and professional organizations to examine civil tax penalties.²³⁶ The IRS Task Force concluded that four factors are crucial to encourage compliance to the Code: fairness, understandability, effectiveness, and ease of administration.²³⁷ Similarly, the U.S. Government Accountability Office's (GAO) 2009 report to the Senate Finance Committee maintained that fairness and voluntary compliance are essential to the administration of the I.R.C., based on its extensive study involving review of key IRS policy documents and academic studies, interviews with four IRS divisions and representatives of twenty-five states, and collaboration with the Federation of Tax Administrators, IRS Office of Tax Shelter Analysis, the Treasury Department, and others.²³⁸

The above studies established that tax penalties should be administered in a fair and equitable manner, which means penalties should distinguish taxpayers who commit culpable conduct from those who in good faith attempt to comply with the Code.²³⁹ In order to be fair, penalty rules should be flexible to differentiate factual circumstances in each case and should distinguish willful from negligent misconduct.²⁴⁰ Strict liability by

234. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 3; TAXPAYER ADVOCATE SERV., *supra* note 222, at 4; AICPA, *supra* note 230, at 16–17 (citing I.R.S. Policy Statement 20-1, Internal Revenue Manual pt. 1.2.20.1.1, ¶¶ 1–2, http://www.irs.gov/irm/part1/irm_01-002-020.html (last visited Feb. 21, 2010)); Stretch et al., *supra* note 210, at 1360.

235. See AICPA, *supra* note 230, at 1.

236. See *id.* at 2.

237. See TAXPAYER ADVOCATE SERV., *supra* note 222, at 7. These four principles mean that tax penalties should be easily understood, avoid assessing multiple penalties for the same misconduct, and treat all taxpayers in a fair and equitable manner. See AICPA, *supra* note 230, at 3.

238. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 1–3. The ABA Tax Section also believes that the guiding principles have not changed in the last twenty years. See A.B.A. Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 5.

239. See AICPA, *supra* note 230, at 3.

240. See *id.* (positing that penalties should encourage voluntary compliance by differentiating between taxpayers who attempt good-faith compliance with the tax law and those who deliberately violate the laws); Stretch et al., *supra* note 210, at 1359–60; A.B.A.

definition imposes the penalty regardless of whether the taxpayer substantially complied with the Code or made a good-faith attempt to do so.²⁴¹ Hence, opponents of the strict liability standard argue that strict liability is unfair to the taxpayer, particularly given the higher penalty of forty percent, and would discourage voluntary compliance as well as violate the basic tenets of the Code.²⁴² Particularly with regard to noneconomic substance transactions, the argument is that strict liability is not appropriate because it precludes the ability of courts to analyze the facts and circumstances of each case.²⁴³

In its 2008 report to Congress, the National Taxpayer Advocate (NTA) observed the lack of fairness in penalties that are imposed without determining whether the taxpayer's conduct warrants a penalty or whether the penalty is proportional to the misconduct.²⁴⁴ The Tax Section of the American Bar Association (ABA) shares the NTA's concern regarding penalties that are imposed without giving the taxpayer the opportunity to demonstrate that penalties should not be imposed in his case.²⁴⁵ Hence, the ABA Tax Section recommends that all tax penalties should include a reasonable cause and good-faith defense.²⁴⁶ Similarly, NTA advocates that reasonable cause exceptions should take priority over harsh penalties.²⁴⁷ Along the same lines, the IRS Policy Statement vows to provide the taxpayer a "reasonable opportunity to provide evidence that the penalty should not apply" and to fully consider any evidence that excuses the penalty even if the IRS initially intended to impose the penalty.²⁴⁸

Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 4 (recommending that "[i]nadvertent or excusable error should not be punished to the same degree (if at all) as willful misconduct").

241. See Stretch et al., *supra* note 210, at 1359.

242. See *infra* notes 244–56 and accompanying text.

243. See A.B.A. Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 10 (citing A.B.A. Tax Section on ESD Codification, *supra* note 230). The ABA Tax Section would recommend that instead of adopting a strict liability penalty, IRS resources should be increased to allow the IRS to enforce its existing tools and penalties to combat tax shelters. See *id.* The ABA Tax Section is supportive of penalty regimes that are based on disclosure, rather than penalty regimes based on punishment and increased complexity. See *id.* at 4, 7–10.

244. See *id.* at 8 (citing TAXPAYER ADVOCATE SERV., *supra* note 222, at 7–9). The National Taxpayer Advocate report cites studies, including the IRS Task Force Reports, that identify three components of perceived fairness in tax penalties: horizontal fairness, proportionality, and procedural fairness. Horizontal equity requires that tax penalties be administered in a manner that treats similarly situated taxpayers similarly, rather than applying the same penalty to everyone regardless of a given taxpayer's effort to comply with the tax code. To treat similarly situated taxpayers similarly, the IRS should inquire into the taxpayer's level of sophistication, prior compliance history, and other factual circumstances. See TAXPAYER ADVOCATE SERV., *supra* note 222, at 7–9.

245. See A.B.A. Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 8.

246. See *id.* at 9.

247. See TAXPAYER ADVOCATE SERV., *supra* note 222, at 8.

248. See I.R.S. Policy Statement 20-1, Internal Revenue Manual pt. 1.2.20.1.1, ¶ 9, http://www.irs.gov/irm/part1/irm_01-002-020.html (last visited Feb. 21, 2010).

The criticism is that under the strict liability penalty standard, a taxpayer would have no such opportunity to provide evidence to show that the penalty should not be imposed.²⁴⁹ The taxpayer gets no opportunity for procedural due process prior to the assessment of penalties,²⁵⁰ which is said to preclude a fair application of penalties.²⁵¹ In addition, there is no substantive due process because the proposed penalty does not define the proper standard by which to administer the penalty.²⁵² After the penalty is assessed, the taxpayer retains no meaningful opportunity for postassessment relief²⁵³ because, while the IRS Commissioner may abate the penalty in certain circumstances, such circumstances are not defined and the Commissioner's decision is not subject to judicial review.²⁵⁴ Hence, taxpayers with genuine mitigating circumstances would have no opportunity to challenge the assessment of a penalty against him at any stage of the penalty process.²⁵⁵ The ABA Tax Section has recommended that the taxpayer be given the opportunity to challenge noneconomic substance transaction penalties both at the IRS Office of Appeals level and in the courts.²⁵⁶

2. Strict Liability Penalties Should Not Be Imposed as Revenue Raisers

There is opposition to the use of penalties as revenue raisers for the federal government.²⁵⁷ Specifically, the penalty provisions contained in the codification proposals are seen as attempting to raise revenue by imposing high penalties designed to offset costs of other tax changes.²⁵⁸ The American Institute of Certified Public Accountants (AICPA) voiced its concern about the recent trend of tax penalties being assessed as revenue raisers.²⁵⁹ The AICPA also noted that the 2004 IRS Penalty Policy Statement²⁶⁰ shifted away from focusing on voluntary compliance in the 1980s toward a preference for assessing penalties.²⁶¹ The GAO also

249. See Stretch et al., *supra* note 210, at 1359.

250. See Hill & Minkovich, *supra* note 214, at 82; Stretch et al., *supra* note 210, at 1359.

251. See Stretch et al., *supra* note 210, at 1359–60.

252. See *id.* at 1359.

253. See *id.*

254. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 66; Jackel, *supra* note 50, at 75; A.B.A. Tax Section on ESD Codification, *supra* note 230, at 10 & n.24 (referencing 2007 proposal).

255. See Stretch et al., *supra* note 210, at 1359.

256. See A.B.A. Tax Section on ESD Codification, *supra* note 230, at 13.

257. See Hill & Minkovich, *supra* note 214, at 79.

258. See Ventry, *supra* note 173, at 1410. The ABA Tax Section also opposes using penalties to offset tax expenditures because that incentivizes IRS to impose penalties at the expense of evaluating whether the penalty is justified in each case. See A.B.A. Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 11.

259. See AICPA, *supra* note 230, at 4.

260. I.R.S. Policy Statement 20-1, Internal Revenue Manual pt. 1.2.20.1.1, http://www.irs.gov/irm/part1/irm_01-002-020.html (last visited Feb. 21, 2010).

261. See AICPA, *supra* note 230, at 17 (“While these policies appear reasonable on their face, together, and with no ability for the agent to exercise discretion, they create an unfair bias in favor of assertion of penalties which undermines the appearance of impartiality.”).

inferred that penalties are assessed on a cost-benefit basis from the trend that certain small penalties are not assessed because the cost of developing and asserting the penalty outweighs the penalty collected.²⁶²

The 2008 NTA report and the ABA Tax Section recommend that penalties should aim to drive taxpayer behavior rather than to raise government revenues.²⁶³ The NTA report concluded that strict liability does not comport with this objective because strict liability precludes IRS's ability to reward taxpayers' good-faith attempts to comply with the Code with an abatement of the penalty.²⁶⁴ As a corollary, there is the additional argument that strict liability penalties encourage the IRS to aggressively assess penalties because the taxpayer has no opportunity to defend his tax position through the use of a reasonable cause exception.²⁶⁵ Hence, the use of strict liability penalties to raise revenue is seen as unfair to the taxpayer and detrimental to the tax policy of encouraging voluntary compliance with the Code.²⁶⁶

3. Strict Liability Should Not Be Used with a Fluid and Complex Doctrine Such as the Economic Substance Doctrine

Opponents of the strict liability standard note that the ESD is a doctrine that remains complex and unclear under the proposal and that it is, therefore, unsuitable for use with strict liability.²⁶⁷ Because it is administered as a bright-line rule, strict liability is seen as useful and appropriate only in areas of the law where the rules are simple and clear.²⁶⁸ The New York State Bar Association, despite supporting strict liability penalties for tax-shelter-related understatements, opposed the use of strict liability in the ESD, noting that the proposal leaves so much uncertainty that using a strict liability standard in this context would be unfair to the taxpayer.²⁶⁹ For reasons discussed below, opponents note that the codified

262. *See id.* at 4 (citing U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 9).

263. *See* AICPA, *supra* note 230, at 3; A.B.A. Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 11. Treasury Regulation section 1.6694-2(d) identifies some factors that the taxpayer can demonstrate to show reasonable cause, and these factors are aligned with behavior that the Treasury and IRS want to encourage, such as employing tax professionals' advice and performing due diligence to calculate the correct tax liability. *See* Stretch et al., *supra* note 210, at 1359.

264. *See* Stretch et al., *supra* note 210, at 1359–60.

265. *See* Hill & Minkovich, *supra* note 214, at 79–80.

266. *See id.* at 79 (“The bottom line is that revenue raising through the use of strict liability penalties is poor tax policy and an unsatisfactory rationale for harming our tax system, which is built on the solid underpinnings of due process and voluntary compliance.”).

267. *See* Stretch et al., *supra* note 210, at 1360; *infra* notes 271–85 and accompanying text.

268. *See* TAXPAYER ADVOCATE SERV., *supra* note 222, at 10 n.26; Stretch et al., *supra* note 210, at 1360.

269. *See* Stretch et al., *supra* note 210, at 1361 & n.32; A.B.A. Tax Section on Civil Tax Penalty Reform, *supra* note 229, at 8.

ESD does not resolve the points of ambiguity in the doctrine and, therefore, should not be used with strict liability.²⁷⁰

The ESD has been characterized as an inherently subjective analysis involving a case by case review of the facts and circumstances.²⁷¹ According to the JCT, the codified ESD does not become a more objective analysis but remains an inherently subjective test.²⁷² The JCT notes a number of cases in which the lower and appeals courts have reached opposite outcomes on the same facts,²⁷³ or different jurisdictions have reached varying outcomes on cases with similar facts.²⁷⁴ The proposal does not address whether existing case law should be reversed on any particular point.²⁷⁵ In addition, the codified ESD provides that a court will use its discretion to decide if the ESD is even relevant to a given case, but does not specify the circumstances under which the court should apply the ESD.²⁷⁶

Opponents of strict liability also point out that the proposed statutory language leaves many crucial elements undefined.²⁷⁷ For example, in order for a transaction to be valid under the proposal, the transaction must change the taxpayer's economic position in a "meaningful way," and the taxpayer must have a "substantial purpose" for entering into the transaction.²⁷⁸ Yet, what constitutes a "meaningful" change or a "substantial purpose" is not defined in the proposal.²⁷⁹ Similarly, where a taxpayer relies on profit potential to justify the transaction, the proposal requires a "substantial" amount of pretax profit potential relative to the net tax benefit.²⁸⁰ Yet, the proposal does not define what level of profit potential is sufficient to pass

270. See *infra* notes 271–85 and accompanying text.

271. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 41; Korb, *supra* note 23, at 13–15; see also Christopher M. Pietruszkiewicz, *Economic Substance and the Standard of Review*, 60 ALA. L. REV. 339, 342 (2009) (characterizing the economic substance analysis as a factual, case by case analysis and arguing that the appellate courts should use a clearly erroneous standard of review); Hill & Minkovich, *supra* note 214, at 81 (stating that courts have reached inconsistent rulings in recent decisions and "reasonable minds could reach different conclusions"); *supra* note 67 and accompanying text (suggesting that the ESD may involve a "smell test").

272. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 41.

273. See *id.* at 41 & n.106 (collecting cases).

274. See *id.* at 41 & n.107 (collecting cases).

275. See *id.* at 42 & n.108.

276. See America's Affordable Health Choices Act of 2009, H.R. 3200, 111th Cong. § 452(a)(5)(D) (2009); A.B.A. Tax Section on ESD Codification, *supra* note 230, at 10 (noting that one of the several ambiguities of the codified ESD is whether the statute would apply at all to a given transaction).

277. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 45; Stretch et al., *supra* note 210, at 1360.

278. See H.R. 3200 § 452(a)(1)(A)–(B).

279. See Hill & Minkovich, *supra* note 214, at 82; Stretch et al., *supra* note 210, at 1360.

280. H.R. 3200 § 452(a)(2).

the test, or what happens when profit potential is not readily measurable.²⁸¹ These terms have been used in different ways by different courts.²⁸²

One commentator characterized the codification as “replacing judicial uncertainty with statutory uncertainty.”²⁸³ The argument is that a taxpayer’s good-faith effort to calculate the correct tax liability should be considered in the assessment of penalties for noneconomic substance transactions.²⁸⁴ If instead taxpayers are penalized as a result of inconsistent rulings, the legitimacy of the tax system could potentially be undermined.²⁸⁵

4. Strict Liability May Produce Unintended Consequences

Opponents of the strict liability standard predict unintended consequences from the codification of the ESD and the accompanying strict liability penalty.²⁸⁶ The Senate Report to the predecessor of H.R. 3200²⁸⁷ admittedly recognized that a strictly rule-based system, which cannot provide for every conceivable transaction, is not able to prevent all unintended consequences.²⁸⁸ Opponents note at least two unintended consequences, one being increased litigation accompanied by decreased taxpayer cooperation and disclosure, and the other being the possibility that courts may hesitate to use the ESD.²⁸⁹

Opponents expect increased litigation by taxpayers, especially with the higher penalty.²⁹⁰ Former IRS Chief Counsel Korb characterizes the codified ESD as the “seeds of the next tax shelter problem,” which would make litigation more complex and eliminate taxpayers’ incentive to cooperate with the IRS because cooperation will not mitigate the penalty.²⁹¹ Opponents argue that IRS resources would be deflected to fight litigation or

281. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 45; Bankman, *supra* note 36, at 23–26.

282. See Stretch et al., *supra* note 210, at 1360 (calling the elements an “amalgamation of elements that . . . do not reflect an economic substance test applied by any one court or any one jurisdiction”).

283. See *id.* at 1361.

284. See Jackel, *supra* note 50, at 75.

285. See TAXPAYER ADVOCATE SERV., *supra* note 222, at 20–21; Hill & Minkovich, *supra* note 214, at 81 (suspecting that where strict liability penalties are assessed regardless of legitimate grounds for disagreement between IRS and the taxpayer, such a penalty policy could “erode faith in our voluntary compliance system”).

286. See *infra* notes 287–97 and accompanying text.

287. See S. REP. NO. 109-336, at 138 (2006) (report of the Senate Committee on Finance accompanying the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, S. 1321).

288. See *id.*

289. See *infra* notes 290–97 and accompanying text.

290. See Stretch et al., *supra* note 210, at 1359.

291. See Crystal Tandon, *Economic Substance Codification Would Create More Problems Than It Solves, Says Korb*, 118 TAX NOTES 777, 777 (2008); see also Hill & Minkovich, *supra* note 214, at 81 (predicting that the strict liability penalty will produce less disclosure, not more, because the taxpayer does not benefit by disclosure or good-faith attempt at complying with the Code).

clarify the doctrine's application, based on evidence suggesting that defending on the ESD requires greater IRS resources than defending on other grounds.²⁹² There is even a question as to whether IRS agents will be disinclined to assert penalties under the ESD because of the doctrine's resource intensive nature.²⁹³

Another unintended consequence predicted by opponents of the strict liability standard is that courts may hesitate to use the doctrine to invalidate a tax benefit or recharacterize a transaction because the penalties are higher and cannot be abated.²⁹⁴ The strict liability penalty creates an anomaly by imposing a high penalty for noneconomic substance transactions, whereas the failure of the same transaction on other tax shelter doctrines would impose no or smaller penalties.²⁹⁵ This is especially salient because the proposal does not define how the ESD will interact with other similar doctrines such as the "sham transaction" doctrine.²⁹⁶ Hence, the ABA suggests that IRS should focus on pursuing cases on technical rules rather than on the ESD.²⁹⁷

In conclusion, opponents of the strict liability standard argue that strict liability should not be used in the context of the ESD because it contravenes tax policies such as fairness to the taxpayer, is not proper as a revenue raiser, is unsuitable for use with a fluid and complex doctrine such as the ESD, and may produce unintended consequences.²⁹⁸ Addressing the proponents' deterrence argument, opponents argue that the new penalty regime will not produce additional deterrence of tax shelters²⁹⁹ but that the

292. See *Hearing on Corporate Tax Reform*, *supra* note 142, at 34 (statement of Samuel C. Thompson, Jr., Professor, UCLA) (arguing that legislation adds to the complexity of enforcing tax penalties because the statute is another issue to consider and resolve); *Hearing on the Tax Gap*, *supra* note 220, at 103 (statement of J. Russell George, Treasury Inspector General for Tax Administration) (noting that time spent on examinations per tax return has increased in 2004, and this is partially attributable to the types of cases being handled); STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 64–65 & nn.206–208 (giving examples of resources needed for the IRS to win its cases, such as extensive expert testimony on foreign currency options markets, or on whether transferring asbestos liability to a subsidiary limits the transferor's liability); A.B.A. Tax Section on ESD Codification, *supra* note 230, at 11 (asserting that economic substance cases are resource intensive for both the IRS and the taxpayer).

293. Compare Jeremiah Coder, *Korb Continues PR Battle Against Economic Substance Codification*, 117 TAX NOTES 578, 578 (2007) (arguing that IRS agents may avoid using the ESD due to the extra administrative steps required to assert the penalty, such as obtaining approval from the Chief Counsel or his delegate), and Nahass, *supra* note 214, at 267, with A.B.A. Tax Section on ESD Codification, *supra* note 230, at 11 (suggesting that the high strict liability penalty amount may make ESD attractive over other doctrines).

294. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 65; Hill & Minkovich, *supra* note 214, at 80; Stretch et al., *supra* note 210, at 1359.

295. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 68.

296. See Korb, *supra* note 183, at 395.

297. See A.B.A. Tax Section on ESD Codification, *supra* note 230, at 11–12 n.32 (collecting cases).

298. See *supra* Part II.B.

299. See Hill & Minkovich, *supra* note 214, at 80 (referring to Assistant Treasury Secretary Eric Solomon, who believes that codification of the ESD will not produce additional deterrence because (1) the Treasury and IRS are already focused on fighting tax

current tax laws sufficiently target the tax shelter problem, as evidenced by IRS winning many tax shelter cases.³⁰⁰ At the same time, the higher penalty is believed to restrain legitimate transactions or tax planning because of the risk that the penalty will be improperly imposed on these legitimate activities, without the opportunity for abatement.³⁰¹ Ultimately, opponents of strict liability see it as a deviation from the traditional reasonable cause exception, the reasons for which are not sufficiently justified.³⁰²

III. REJECTING THE STRICT LIABILITY PENALTY STANDARD: RETAIN THE CURRENT PENALTY REGIME OR DEVELOP ALTERNATIVE SOLUTIONS CONTAINING THE REASONABLE CAUSE EXCEPTION

Part II explored the reasons for and against adopting a strict liability standard for penalizing noneconomic substance transactions. Part III.A argues against the adoption of the strict liability standard. Part III.B advocates that the current penalty regime containing the reasonable cause exception should be retained, or, alternatively, new solutions should be developed to address the tax shelter problem.

A. *The Arguments Weigh Against Adopting the Strict Liability Penalty Standard*

Admittedly, tax shelters are against public policy, and the ESD and its associated understatement penalty contribute to IRS's overall strategy in eradicating tax shelters.³⁰³ The argument that harsh penalties are justified in tax shelters is a compelling one.³⁰⁴ Notwithstanding the validity of the concern regarding tax shelters, the penalty regime can maintain its efficacy without changing the penalty standard from reasonable cause to strict liability. On balance of the arguments espoused by proponents and opponents of strict liability, the arguments weigh against adopting the strict liability standard.

The strongest argument for adopting the strict liability standard is deterrence of tax shelters.³⁰⁵ While the proponents of strict liability criticize the current regime as failing to impose sufficient punitive

shelters and (2) courts may hesitate to use the ESD because of the harsh strict liability penalty).

300. See Korb, *supra* note 183, at 395; Ventry, *supra* note 173, at 1408–10.

301. See STAFF OF J. COMM. ON TAXATION, *supra* note 20, at 65; AICPA, *supra* note 230, at 5–6 (expressing concern that transaction categories subject to penalty are too broad and could inhibit legitimate transactions, especially in light of the strict liability penalty); Korb, *supra* note 183, at 393; Jeremiah Coder, *Administration Still Opposes Economic Substance Codification*, 115 TAX NOTES 813, 813 (2007); Hill & Minkovich, *supra* note 214, at 81–82 (predicting that the penalty may have a “chilling effect” on risk averse taxpayers); A.B.A. Tax Section on ESD Codification, *supra* note 230, at 8.

302. See Stretch et al., *supra* note 210, at 1361.

303. See generally *supra* Parts I.A.1, I.C.1.a, II.A.1.

304. See *supra* notes 212–19 and accompanying text.

305. See *supra* Part II.A.1.

consequences relative to the potential benefit of noneconomic substance transactions, they do not clearly establish how strict liability will produce additional deterrence simply by making noneconomic substance transactions more onerous.³⁰⁶ If the current understatement penalty of twenty percent is insufficient to deter tax shelters, it does not necessarily follow that a forty percent penalty will effectively deter tax shelters, even if the taxpayer is precluded from asserting the reasonable cause defense, as the taxpayer may still hedge his bets of winning on the claim that his transaction has economic substance.³⁰⁷ This premise is augmented when considering the criticism that the codified ESD will remain an uncertain doctrine that may be applied by courts in an inconsistent manner.³⁰⁸ As critics of strict liability point out, the strict liability penalty may be counterproductive to deterrence and instead drive taxpayers to resist disclosure to, and cooperation with, IRS because such disclosure or cooperation will not afford them any abatement of penalty.³⁰⁹

The other arguments espoused by proponents of strict liability appear unrelated to the merits of the strict liability standard. First, the argument that strict liability penalties should be used to raise federal revenue appears to bear little connection to the merits of adopting a new standard by which to assess understatement penalties. Tax penalties as revenue raisers at best involve mixed motives and at worst become arbitrary punishment of the taxpayer, which is not within the role of tax penalties.³¹⁰ Notwithstanding the need to close the tax gap, which owes its existence largely to understatement of tax liability,³¹¹ adopting a rule that unilaterally penalizes the taxpayer without regard to his good-faith attempt to report the correct tax liability can hardly be an ideal way to close the tax gap. Second, the argument that tax professionals must be deterred from promoting tax shelters appears misplaced because tax professionals should be, and are, regulated under standards of professional responsibility rather than through understatement tax penalties.³¹² Penalizing the taxpayer for his tax advisor's misconduct amounts to unwarranted punishment of the taxpayer, who should be able to rely on the advice of his tax professional.

The strongest argument proffered by opponents of strict liability is the unfairness brought upon the taxpayer.³¹³ In eliminating the taxpayer's opportunity to justify his tax position before IRS or the court, at least two important interests are at stake. First, it undermines voluntary compliance by precluding the taxpayer from demonstrating his good-faith compliance with the Code, thereby reducing his incentive to voluntarily comply with

306. See *supra* notes 212–26 and accompanying text.

307. See *supra* notes 214–19 and accompanying text.

308. See *supra* Part II.B.3.

309. See *supra* note 291 and accompanying text.

310. See *supra* Part II.B.2.

311. See *supra* Part II.A.2.

312. See *supra* Part II.A.3.

313. See *supra* Part II.B.1.

the Code.³¹⁴ It is voluntary compliance, or the over eighty percent of taxes being reported on a voluntary basis, that permits IRS to allocate its resources to target truly culpable conduct.³¹⁵ Should voluntary compliance be compromised, IRS would need to disperse its resources across a wider range of noncompliance rather than focusing its efforts on its most pressing needs.³¹⁶ This result is the opposite of what is needed to fight tax shelters, as evidence suggests that using the ESD to litigate tax shelter cases requires extensive resources.³¹⁷ One suggested remedy to the tax shelter problem called for IRS to increase its resources in order to fully implement the existing tools at IRS's disposal.³¹⁸ Decreasing voluntary compliance could ultimately debilitate IRS's efforts to combat tax shelters.

The second interest at stake in eliminating the reasonable cause exception is the due process that is denied to the taxpayer.³¹⁹ A taxpayer with genuine mitigating circumstances has no venue, either at the IRS level or at the federal court level, upon which to challenge the validity of the penalty assessed against him.³²⁰ Such lack of due process does not advance any interest claimed by proponents of the strict liability standard, despite their efforts to characterize the reasonable cause exception as "wiggle room" to slither out of a penalty.³²¹ Rather, the taxpayer's inability to appeal the penalty is highly problematic, especially considering that the ESD is a fluid and uncertain doctrine that is unsuitable for statutory definition.³²² Not only is the split among the circuit courts unsettled, the codified ESD does not achieve a satisfactory resolution because it does not reconcile itself to existing case law and leaves many critical elements of the doctrine undefined.³²³ A vague doctrine cannot serve as the basis for a bright-line strict liability penalty, but that is the curious result that would be reached by the codification proposal.³²⁴ This context increases the need to permit the taxpayer to raise the reasonable cause exception, which may serve as a backstop in the event that inconsistent holdings result from the confusing legislation.

Balancing the arguments on either side of the debate surrounding the strict liability penalty, strict liability should not be adopted. On the one

314. See *supra* notes 239–46 and accompanying text.

315. The National Taxpayer Advocate's 2008 Annual Report to Congress reports that eighty-four percent of taxes are reported and paid voluntarily, but unfair tax penalty administration could undermine voluntary compliance. See TAXPAYER ADVOCATE SERV., *supra* note 222, at 4.

316. See generally U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233 (recommending that IRS focus its efforts in administering tax penalties to drive voluntary compliance).

317. See *supra* notes 292–93 and accompanying text.

318. See *supra* note 243.

319. See *supra* notes 249–55 and accompanying text.

320. See *supra* note 255 and accompanying text.

321. See *supra* note 217 and accompanying text.

322. See Bernard Wolfman, *Why Economic Substance Is Better Left Uncodified*, 104 TAX NOTES 445, 445 (2004) (positing that the ESD would lose its usefulness if reduced to a "formulaic legislative Rx").

323. See *supra* notes 275, 277–85 and accompanying text.

324. See *supra* Part II.B.3.

hand, the strict liability standard is not demonstrably connected to superior deterrence of tax shelters, while on the other hand it carries the risk of producing profound unfairness to the taxpayer.³²⁵ Furthermore, strict liability carries potential unintended consequences, which may span beyond increased litigation between IRS and the taxpayer or lead to disuse of the ESD itself.³²⁶ Without a full understanding of the consequences of adopting the strict liability standard, it would be premature at best to enact it under the ESD codification proposal. A comprehensive assessment of workable alternatives must be considered before the strict liability penalty standard can be justifiably adopted, if at all.

B. The Reasonable Cause Exception Should Remain a Feature of the Penalty Regime

Having resolved that the strict liability standard should not be adopted, this section suggests two possible alternatives. One is to retain the current penalty regime, which can be viewed as sufficiently addressing the tax shelter problem.³²⁷ The other is to develop an alternative solution altogether that does not rely on a pure strict liability standard. In either of these two scenarios, the reasonable cause exception should be a feature of the penalty regime to avoid the pitfalls of the strict liability standard.

Should the current penalty regime be retained, understatement penalties will continue to be assessed for noneconomic substance transactions, but the reasonable cause exception will remain available.³²⁸ This preserves the taxpayer's interests in asserting the reasonable cause defense while also preserving IRS's interest, as courts can declare that reasonable cause is lacking in a given case and uphold the penalty.³²⁹ While proponents of strict liability may characterize the status quo as failing to increase the stakes in the tax shelter battle, the counterargument is that the current penalty regime appears to be working, as IRS continues to win its cases in the courts under existing laws.³³⁰ Thus, the current penalty regime does not appear to be in urgent need of a deviation to the strict liability standard. Moreover, the argument can be made that the current penalty regime should be preferred over the codified version because one of the merits of the ESD is its flexibility to identify and invalidate varying forms of tax shelter transactions, which cannot be as aptly accomplished with one statutory definition of economic substance.³³¹

Should an alternative solution be developed, it must avoid the pitfalls of a pure strict liability standard. One alternative that deserves support is the approach suggested by Lawrence Hill and Alexandra Minkovich, which

325. See *supra* notes 298–99 and accompanying text.

326. See *supra* Part II.B.4.

327. See *supra* note 300 and accompanying text.

328. See *supra* Part I.B.

329. See *supra* Part I.B.

330. See *supra* note 300 and accompanying text.

331. See Keinan, *supra* note 145, § VIII(D)(7) & n.1283.

provides for two levels of penalties, with the level of penalty turning on disclosure.³³² If the taxpayer adequately discloses the transaction at issue, the penalty would be twenty percent, and the taxpayer would have the opportunity to assert the reasonable cause exception.³³³ Judicial review would be available for the penalty that was assessed.³³⁴ If the taxpayer does not adequately disclose the transaction, then a higher forty percent penalty would apply on a strict liability basis, but the IRS Commissioner would have discretion to rescind the penalty according to published criteria.³³⁵ The Commissioner's refusal to rescind the penalty would be reviewable by a court for abuse of discretion.³³⁶ As Hill and Minkovich point out, this approach reaches a compromise by effectuating more serious consequences for noneconomic substance transactions while retaining the reasonable cause exception, hence avoiding at least some of the problems with due process or voluntary disclosure.³³⁷ This approach, or others like it, would comport with the views of those who advocate a higher penalty to deter tax shelters but still oppose codification for its shortcomings.³³⁸ Whatever the solution, it cannot come at the expense of fairness to the taxpayer, and IRS may need to conduct a comprehensive assessment of its penalty administration before a suitable solution can be developed.³³⁹

CONCLUSION

It is undoubtedly important to curb abusive tax shelters and noneconomic substance transactions. In pursuing this goal, the competing interests of deterrence on one side and fairness to the taxpayer on the other must be carefully balanced. The proposed strict liability standard for penalizing noneconomic substance transactions represents a significant change from the reasonable cause exception used in existing tax law. Notwithstanding the merits of the arguments on each side of the debate, arguments weigh

332. See Hill & Minkovich, *supra* note 214, at 82.

333. See *id.*

334. See *id.*

335. See *id.*

336. See *id.*

337. See *id.*

338. See, e.g., *Hearing on Corporate Tax Shelters*, *supra* note 30, at 40, 46–47 (statement of Lindy Paull, Chief of Staff, J. Comm. on Taxation); Jackel, *supra* note 50, at 76; VanderWolk, *supra* note 64, at 547; Ventry, *supra* note 173, at 1411; Wolfman, *supra* note 322, at 445. In analyzing individual income tax understatement penalties, Professor William A. Drennan advocates an alternative solution that features varying levels of penalty based on the taxpayer's level of disclosure. He first argues that tax avoidance cannot adequately be addressed by either a fault-based system that permits exceptions or a purely strict liability system that undermines compliance. Rather, he suggests an alternative solution in which a taxpayer making full and conspicuous disclosure is excused from the penalty or assessed graduated penalty rates for small mistakes. See Drennan, *supra* note 223.

339. The U.S. Government Accountability Office, in its 2008 report to the U.S. Senate Finance Committee, pointed out that IRS is not meeting its expectation of conducting continuous and comprehensive assessment of its penalty administration to ensure effective and fair penalties that encourage voluntary compliance. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 18.

against adopting the strict liability standard. The current penalty regime should be retained or alternative solutions developed. At the very least, it is necessary to conduct a comprehensive and critical assessment of the implications of any change to the tax penalty regime before such change can be justifiably enacted under a plan to codify the ESD. By adopting the approach suggested in this Note, tax penalties can help drive correct taxpayer behavior without compromising the interests essential to an effective and fair tax penalty system.