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## Textualism and Tax Shelters

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*Textualism and Tax Shelters*

By

Noël B. Cunningham\* &amp; James R. Repetti\*\*

*Introduction*

A substantial debate about the approaches employed by courts to interpret statutes and regulations has developed during the last decade. Some have argued that the search for a statute's meaning and purpose should focus on the text, itself, and should not include consulting legislative history.<sup>1</sup> In contrast, others have argued that it is difficult to determine the meaning of a statute without consulting legislative history to determine the legislature's purpose for the statute.<sup>2</sup>

The debate about the appropriate method for interpreting statutes underlies a crisis in the administration of tax law. The recent proliferation of tax shelters<sup>3</sup> has at least in part been facilitated by the ascendancy of textualism. Our conversations with practitioners indicate that tax advisors have become more aggressive in structuring

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<sup>1</sup> See, e.g., Antonin Scalia, *Common Law Courts in a Civil Law System: The Role of United States Federal Courts in Interpreting The Constitution and Laws*, in A MATTER OF INTERPRETATION 17 (Amy Gutman ed., 1997).

<sup>2</sup> See, e.g., HENRY M. HART, JR. & ALBERT SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 1374-76 (William N. Eskridge & Philip P. Frickey, eds., 1999).

<sup>3</sup> For various reports on the proliferation of tax shelters, see, e.g., DEPT. OF TREAS., *THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS*, 2-3 (July 1999), available at <http://www.ustreas.gov/offices/taxpolicy/library/ctswwhite.pdf>; David Cay Johnston, *Big Accounting Firm's Tax Plans Help the Wealthy Conceal Income*, N. Y. TIMES, June 22, 2002, at A1; Janet Novack & Laura Sanders, *The Hustling of X Rated Shelters*, FORBES MAGAZINE, Dec. 14, 1998, at 198.

transactions that comply with the form of the tax statutes even though the transactions may be highly questionable in light of the legislation's history or underlying purpose. The result has been a cottage industry where investment banks and accounting firms market tax shelters that triumph in form, but not substance, at the expense of the fisc. Because most tax shelter activity is hidden,<sup>4</sup> it is difficult to ascertain its revenue impact.<sup>5</sup> It is estimated that tax shelters reduced tax revenues by approximately \$10 to \$24 billion in 1999.<sup>6</sup> In addition, practitioners and government officials worry that the use of shelters is eroding confidence in the tax system.<sup>7</sup> The Department of Treasury has stated:

Corporate tax shelters breed disrespect for the tax system – both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a 'race to the bottom.' If unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue losses we currently are experiencing in the corporate tax base.<sup>8</sup>

Although the majority of courts have not adopted textualism, the legal community's acceptance of textualism as a plausible method of interpretation has

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<sup>4</sup> Most tax shelters are organized as partnerships that are not subject to tax, but instead flow-through their losses and income to partners. In 2002, the IRS audited only 0.39 percent of the tax returns for flow-through entities such as partnerships. STAFF OF JOINT COMMITTEE ON TAXATION, REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998 37 (JCX-53-03) (May 19, 2003).

<sup>5</sup> See Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply To Professor Weisbach*, 55 TAX L. REV. 325, 342–46 (2002) (noting that data about revenue losses from tax shelters is lacking and is difficult to obtain).

<sup>6</sup> See Martin Sullivan, *A Revenue Estimate for Corporate Tax Shelters*, 85 TAX NOTES TODAY 981 (Nov. 22, 1999) (estimating \$10 billion shortfall in 1999); Martin Sullivan, *Testimony Before House Ways and Means Committee on Corporate Tax Shelters*, Tax Notes Doc. 1999-3951 (Nov. 10, 1999) (Reporting shortfall in corporate tax revenues of between \$12 and \$24 billion). See generally Mihir Desai, *The Corporate Profit Base, Tax Sheltering Activity and the Changing Nature of Employer Compensation*, NBER Working Paper No. 8866 p. 3 (April, 2002) (noting that a difference of approximately \$154.4 billion between corporate income reported for tax purposes and book income reported on financial statements cannot be explained); DEPT. OF TREAS., *supra* note 3, at 31 (stating that one tax shelter uncovered by the IRS could reduce corporate tax receipts by \$13 billion over a five-year period).

<sup>7</sup> DEPT. OF TREAS., *supra* note 3, at 3.

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

dramatically affected the practice of tax law. As discussed in this article,<sup>9</sup> taxpayers often invest in tax shelters based upon the opinion of counsel assessing the probability that the desired tax results from the transaction, if challenged, will be sustained. These opinion letters are essential to attract investors because they protect taxpayers from various penalties that otherwise might be imposed if the Service successfully challenges the transaction. Under the textualist approach, it is much easier for an attorney to write a favorable opinion for transactions that are designed to comply with the letter of the law, but not its spirit, for at least two reasons. First, the attorney is permitted to ignore, or at least downplay, any legislative history that would argue against, or undercut, the desired tax results. Second, under a textualist approach, it is arguable that various well-accepted judicial doctrines, such as the business purpose doctrine, are suspect. At the extreme, a textualist might argue that these doctrines are the product of judicial activism and either should no longer be followed, or at a minimum should not be extended into new areas of the law.

Tax shelter promoters have exploited the move towards textualism by designing transactions that comply with the letter of the law, but that generate results clearly never contemplated by Congress or the Treasury. Some promoters believe that the more detailed and complex the underlying law is, the more likely it is that a transaction complying with the letter of the law will be respected. One area in tax law that is particularly detailed and complex is Subchapter K, the partnership tax provisions. Subchapter K also has several special rules not otherwise available in the Internal Revenue Code. It is, therefore, not surprising that Subchapter K has become the vehicle

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<sup>9</sup> See *infra* notes 122–144 and accompanying text.

of choice for a wide variety of abusive transactions.<sup>10</sup> Transactions are designed so that a partnership is created or joined just to take advantage of these special rules (“reverse engineered” transactions). In an attempt to stem the tide, the IRS adopted a general anti-abuse rule for Subchapter K.<sup>11</sup> This rule requires that the provisions of Subchapter K be interpreted consistent with “the intent of subchapter K.” Oversimplified, the regulations assert that there is an overall legislative intent underlying Subchapter K, and if a partnership is formed or availed of in connection with a transaction to substantially reduce federal taxes in a manner inconsistent with this intent, the transaction may be recast. The regulations make clear that for a transaction to pass muster, doctrines that originated with the judiciary, i.e., the requirements of a business purpose, economic substance, and substance over form, must be taken into account. In addition, the regulations require that the purposivist method of statutory interpretation be used to interpret Subchapter K.

The anti-abuse regulations caused an unprecedented furor within the tax bar.<sup>12</sup> They have been severely criticized by academics and practitioners alike on a variety of bases, the most damning of which is that Treasury lacked the authority to promulgate the rules and that therefore they are not valid.<sup>13</sup> Indeed, it is fair to say that there is a general consensus that the partnership anti-abuse regulations are an extreme example of administrative overreaching.

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<sup>10</sup> N.Y. State Bar Ass’n Tax Section, *Report on the Proposed Partnership Anti-Abuse Rule*, 64 TAX NOTES 233, 234 (1994).

<sup>11</sup> An anti-abuse regulation allows the government to “override the literal words of a statute . . . if the taxpayer enters into or structures a transaction with a principal purpose of reducing tax liability in a manner contrary to the purposes of the statute . . . .” David A. Weisbach, *Costs of Departures from Formalism: Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 860 (1999).

<sup>12</sup> See *infra* notes 151–153 and accompanying text.

<sup>13</sup> See *infra* note 171.

We disagree. Although we do not endorse all the policy choices in the anti-abuse regulations, we believe that they are not only valid, but suggest a way in which transactions that are the product of reverse engineering can and should be attacked, both within and without Subchapter K. Initially, it may seem inappropriate for Treasury to instruct the judiciary on how and when the courts should apply judicial doctrines and what tools they should use in interpreting statutes. After all, as every law student knows, “[i]t is emphatically the province and duty of the judicial department to say what the law is.”<sup>14</sup> Where does Treasury get the authority to instruct a court as to which method of interpretation it should use to interpret a tax statute? On reflection, however, we believe that Treasury acted well within its authority under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,<sup>15</sup> and was simply filling a gap in the statute left by Congress.

The judicial doctrines that are implicit in the “intent of subchapter K” were well-developed when Subchapter K was first enacted in 1954 and continue to be applied in a variety of contexts by the courts.<sup>16</sup> At that time, however, it was not clear exactly how and when these doctrines should be applied in the context of Subchapter K. There is little doubt Congress could have clarified this issue by statute.<sup>17</sup> It could have insisted that these doctrines (or variations thereof) be applied with full force, or it could have forbidden their application altogether. Congress, however, chose not to address this issue, leaving a gap in the statute. Under current administrative law principles, this

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<sup>14</sup> *Marbury v. Madison*, 5 U.S. 137, 177 (1803).

<sup>15</sup> 467 U.S. 837, 842 (1984). See *infra* notes 178–247 and accompanying text for a discussion of *Chevron*.

<sup>16</sup> See *infra* notes 238–241 and accompanying text.

<sup>17</sup> See *infra* notes 241–245 and accompanying text.

silence constitutes an implied delegation of authority by Congress to Treasury to fill that gap.<sup>18</sup>

In addition to being valid, we also believe that, as a general proposition, it is sound tax policy to use broad standards to administer the tax law.<sup>19</sup> Historically this had been accomplished by the courts through the use of these judicial doctrines. Although the ascendancy of textualism cast doubt on the continuing viability of the doctrines, Treasury eliminated that doubt by promulgating these regulations (if valid), and requiring lawyers and courts to consider the “intent of subchapter K.” This approach allows the IRS to use broad standards to administer the tax law in place of a collection of narrow rules that must be constantly changed in a hopeless attempt to keep pace with the latest tax gimmick. To assure proper consideration of these doctrines by tax advisors, we recommend that the IRS amend its standards for practice to require advisors opining on the validity of tax shelters to apply the doctrines to the specific economic facts of the tax shelter in their opinion letter. If the advisors are assuming economic facts based on the conclusions of experts, the advisors should have to explain the conclusions and any assumptions made by the experts in reaching their conclusions.

In Part I of this article, we describe how the historic willingness of courts in the United States to consider legislative intent resulted in the substance of a transaction, not its form, controlling the tax treatment of the transaction. We also describe the current debate about whether legislative intent should be considered or whether, instead, the focus should be solely on the statute’s text. We conclude that concerns about legislative intent are inappropriate in light of the tax legislative process. Part II describes the

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<sup>18</sup> See *infra* notes 242–248 and accompanying text.

<sup>19</sup> See *infra* notes 248–262 and accompanying text.

manner in which the textualist approach has spawned the recent development of attorneys willing to structure transactions based on a form that complies with the statute but likely conflicts with legislative intent. It also describes the role of an opinion of counsel in structuring tax shelters and the methods by which counsel exploit the uncertainty in statutory interpretation in rendering their opinions. Part III then analyzes the response by the IRS to this practice by adopting the partnership anti-abuse regulations and concludes that the regulations are valid. Part IV analyzes the wisdom of the regulations and recommends proposals for consideration by Treasury that will insure that tax advisors apply the anti-abuse regulations to tax shelters in their opinion letters.

### ***I. The Role of Legislative Intent and Legislative History in Interpreting Statutes.***

Scholars have identified four methods of statutory interpretation that have been employed by the courts: intentionalism, purposivism, textualism, and the practical reason (or dynamic) method. The first three of these methods have been termed “foundational”<sup>20</sup> because each identifies the primary source for interpreting a statute. In this Part, we describe the four types of statutory interpretation. We explain that courts have traditionally used the the intentionalist and purposivist methods of interpretation in the United States. We conclude that textualism is inappropriate for interpreting statutes in general, and is particularly inappropriate for interpreting tax statutes.

In vogue through the 1920’s, intentionalism seeks to determine what the legislature intended the statute to mean by examining committee reports and floor statements by sponsors. This method of interpretation reflects a view that in interpreting

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<sup>20</sup> William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321, 321 (1990).

a statute, a court acts as the agent of Congress.<sup>21</sup> Under this view, it is appropriate to consult legislative history, even where the statutory language is clear, to insure that the interpretation does not conflict with the legislature's intent.<sup>22</sup>

The purposivist, in contrast, does not inquire what the legislature intended the statute to mean, but rather asks what the statute's purpose was as the time of enactment in order to interpret the statute in a manner consistent with that purpose.<sup>23</sup> The intentionalist and purposivist methods are quite similar. Indeed, purposivism has been described as the fall back from the concept of legislative intent. The major theoretical difference between the two is that while the intentionalists try to determine what the legislature's intent actually was at the time of enactment, the purposivists try to determine what the statute would have meant at the time of enactment when read by a reasonably intelligent informed reader. To identify this purpose, the purposivist will also examine legislative history.

The textualist, in contrast, eschews all legislative history because she considers it highly suspect.<sup>24</sup> She looks instead to the statute's language and other sources to identify the text's meaning. Justice Scalia has stated that the textualist should seek "an objectified intent—that a person would gather from the text of the law, placed alongside the remainder of the *corpus juris*."<sup>25</sup> He elaborated:

The meaning of terms in the statute books ought to be determined, not on the basis of which meaning can be shown to have been understood by a larger handful of the Members of Congress, but rather on the basis of which meaning is (1) most in accord with

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<sup>21</sup> Maureen B. Cavanaugh, *Order in Multiplicity: Aristotle On Text, Context, and the Rule of Law*, 79 N.C. L. REV. 577, 587 n.30 (2001); William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 627 (1990).

<sup>22</sup> Cavanaugh, *supra* note 21, at 587 n.30; Eskridge, *supra* note 21, at 626.

<sup>23</sup> HART & SACKS, *supra* note 2, 1374–1376.

<sup>24</sup> Scalia, *supra* note 1, at 29–37.

<sup>25</sup> *Id.* at 17.

context and ordinary usage, and thus most likely to have been understood by the whole Congress which voted on the words of the statute (not to mention the citizens subject to it), and (2) most compatible with the surrounding body of law into which the provision must be integrated—a compatibility, which by a benign fiction, we assume that Congress always had in mind.<sup>26</sup>

Under the textualist method, an interpreter is not limited to examining the text of the statute, itself, and related statutes, but may also consult various textual authorities existing at the time of enactment (e.g., dictionaries, case law, possibly treatises).<sup>27</sup> In addition, the interpreter should apply “statutory clear statement rules” (i.e., strong canons of statutory interpretation setting forth policy presumption that may only be overcome by statutory text clearly to the contrary). As mentioned above, the one text not consulted is legislative history, except to determine the background context of the legislation where such background may be independently verified.<sup>28</sup>

The fourth method of statutory interpretation is the practical reasoning or dynamic interpretation. This method, which was developed by Eskridge & Frickey, holds that all three foundational methods are not only flawed, but also do not reflect what the courts actually do. The practical reasoning method does not reject the foundational methods *per se*, but rather “refuses to privilege intention, purpose or text as the sole touchstone for interpretation.”<sup>29</sup> An interpreter under this model looks “at a broad range of evidence—text, historical evidence, and the text’s evolution—and thus form[s] a preliminary view of the statute.”<sup>30</sup> The interpreter then develops that “preliminary” view by testing various

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<sup>26</sup> *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 528 (1989) (Scalia, J. concurring in the judgment).

<sup>27</sup> WILLIAM N. ESKRIDGE, JR., *DYNAMIC STATUTORY INTERPRETATION* 42 (1994).

<sup>28</sup> See John F. Manning, *Textualism as a Nondelegation Doctrine*, 97 COLUM. L. REV. 673, 731–34 (1997) (observing that Justice Scalia had referred to a Senate Report to determine circumstances surrounding the enactment of a statute in *United States v. Fausto*, 484 U.S. 439, 448 (1988), where such circumstances could be independently verified).

<sup>29</sup> Eskridge & Frickey, *supra* note 20, at 322.

<sup>30</sup> *Id.* at 352.

possible interpretations against the multiple criteria of fidelity to the text, historical accuracy, and conformity to circumstances and values.<sup>31</sup> Each criterion is relevant, yet none necessarily trumps the others.<sup>32</sup> What is most important for present purposes is the last aspect of this analysis, the “conformity to contemporary circumstances and values.”<sup>33</sup> In his book on dynamic interpretation, Professor Eskridge (quoting Arthur Phelps) states “the interpreter asks ‘not only what the statute means abstractly, or even on the basis of legislative history, but also what it ought to mean in terms of the needs and goals of our present day society.’”<sup>34</sup> He further states, “Sometimes the circumstances will be materially different from those contemplated by the statutory drafters, and in that event any application of the statute will be dynamic in the strong sense, going *against* the drafter’s expectations, which have been negated because important assumptions have been undone.”<sup>35</sup>

No matter what method of statutory interpretation is employed, the starting point is always the same: the text. Nevertheless, for over 100 years the courts have been willing to look at the legislative history of a statute to clarify ambiguities, and to avoid applying the law in ways that produce unintended results.<sup>36</sup> Frequently, the courts will use legislative history to limit the scope of a statute’s application in situations which literally fall within the statute’s language. This practice can be traced back to the Supreme Court’s decision in *Church of the Holy Trinity v. United States*.<sup>37</sup> In this case,

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 359–60.

<sup>34</sup> ESKRIDGE, *supra* note 27, at 50.

<sup>35</sup> *Id.*

<sup>36</sup> Cavanaugh, *supra* note 21, at 587 n.30; Eskridge, Jr., *supra* note 21, at 627.

<sup>37</sup> 143 U.S. 457, 472 (1892). For a thorough discussion of this case, see Carol Chomsky, *Unlocking the Mysteries of Holy Trinity: Spirit, Letter and History in Legislative Interpretation*, 100 COLUM. L. REV. 901 (2000).

the Court was called upon to interpret a statute that forbade anyone “. . . to prepay the transportation . . . of . . . any foreigner into the United States . . . under contract or agreement . . . to perform labor or services of any kind in the United States. . . .”<sup>38</sup> The defendant, an Episcopal Church located in New York City, hired an English minister living in England to be its new pastor. The church paid the new pastor’s transportation to the United States. As the Court noted, if one were to look solely at the text of the statute, the defendant clearly violated the law. The Court, however, using the intentionalist approach, looked beyond the text and found that the “title of the Act, the evil which was intended to be remedied, the circumstances surrounding the appeal to Congress, the reports of the committee of each house, all concur in affirming that the intent of Congress was simply to stay the influx of . . . cheap unskilled labor . . .”,<sup>39</sup> not of ministers. The Court further observed that it is the “duty of courts . . . to say that however broad the language of the statute may be, the act, although within the letter, is not within the intention of the legislature, and therefore cannot be within the statute.”<sup>40</sup>

Since its decision in *Holy Trinity*, the Supreme Court has repeatedly declared that there are “rare and exceptional circumstances” under which the courts must depart from the letter of the law. Although exactly what those circumstances must be is not entirely clear.<sup>41</sup> Until recently the Court has invariably used the statute’s legislative history to make that determination.

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<sup>38</sup> *Holy Trinity*, 143 U.S. at 472.

<sup>39</sup> *Id.* at 458.

<sup>40</sup> *Id.* at 472.

<sup>41</sup> For example, in *Crooks v. Harrelson*, the Court stated:

[T]o justify a departure from the letter of the law . . . the absurdity must be so gross as to shock the general moral or common sense . . . . And there must be something to make plain the intent of Congress that the letter of the statute is not to prevail.  
282 U.S. 55, 60 (1930).

Legislative history has played an important role in the development of the tax law. Over the past several decades, the Supreme Court’s usual practice in analyzing a tax provision has been to start with the statute’s words and then place those words in the context of the Code and the provision’s legislative history.<sup>42</sup> The Court has stated that “the words of statutes – including revenue acts – should be interpreted when possible in their ordinary, everyday senses.”<sup>43</sup> But it has tempered this statement by observing:

We have noted that “[t]he true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related

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Shortly after *Harrelson*, however, the Court retreated from the requirement that the “absurdity . . . be so gross as to shock the general moral or common sense . . .” In *United States v. American Trucking Association*, the Court limited the scope of the power of the Interstate Commerce Commission to regulate the hours of employees only to employees who affect the safety of operation. 310 U.S. 534, 553 (1940). The Court stated:

There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one “plainly at variance with the policy of the legislation as a whole” this Court has followed that purpose, rather than the literal words.

*Id.* at 543–44 (quoting *Ozawa v. United States*, 260 U.S. 178, 194 (1922)).

The Court has not resolved the tension between *Harrelson* and *American Trucking*. The Court has often cited *Harrelson* and quoted the “rare and exceptional circumstances” language without also quoting the phrase that the “absurdity must be so gross as to shock the general moral or common sense.” See Lawrence Zelenak, *Thinking About Nonliteral Interpretation of the Internal Revenue Code*, 64 N.C. L. REV. 623, 633 n.76 (1986) (listing cases through 1984). Since 1984, the Court has only once referred to the requirement that a literal interpretation produce a “gross” absurdity. In *Barnhart v. Sigmon Coal Company, Inc.*, a case involving the Coal Act, the Court quoted the lower court’s statement that the lower court could not ignore unambiguous language because the language did not produce a result “so gross as to shock the general moral or common sense” in summarizing the lower court’s prior action on the case. 534 U.S. 438, 450 (2002) The Court did not quote the language in its own analysis of the statute. In all other cases since 1984, the Court has quoted only the “rare and exceptional circumstance” language. See *Salinas v. United States*, 522 U.S. 52, 57–58 (1997); *King v. St. Vincent’s Hospital*, 502 U.S. 215, 222 n.14 (1991); *Ardestani v. INS*, 502 U.S. 129, 135–36 (1991); *Freytag v. Commissioner*, 501 U.S. 868, 873 (1991); *Int’l Primate Prot. League v. Admr’s of Tulane Educ. Fund*, 500 U.S. 72, 84–85 (1991); *Demarest v. James*, 498 U.S. 184, 190 (1991); *Crandon v. United States*, 494 U.S. 152, 168 (1990); *Pub. Citizen v. United States*, 491 U.S. 440, 454 (1989); *Burlington N. R.R. Co. v. Okla. Tax Comm’n*, 481 U.S. 454, 461 (1987); *United States v. James*, 478 U.S. 597, 606 (1986); *Garcia v. United States*, 469 U.S. 70, 75 (1984).

<sup>42</sup> See, e.g., *Commissioner v. Clark*, 489 U.S. 726, 737–44 (1989); *Ark. Best Corp. v. Commissioner*, 485 U.S. 212, 215–22 (1988); *Commissioner v. Tufts*, 461 U.S. 300, 304–17 (1983); *Hillsboro Nat’l Bank v. Commissioner*, 460 U.S. 370, 391–95 (1983).

<sup>43</sup> *Malat v. Riddell*, 323 U.S. 569, 571 (1966) (quoting *Crane v. Commissioner*, 331 U.S. 1, 6 (1947)).

sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.”<sup>44</sup>

The Court has used legislative history to limit the literal language of tax provisions. For example, in *United States v. Correll*, at issue was the Internal Revenue Service’s interpretation of the statutory rule under § 162(a)(2) that permits a deduction for the cost of meals incurred while “traveling . . . away from home in the pursuit of a trade or business.”<sup>45</sup> Literally read, one might argue that a commuter should be able to deduct all of her meals while she is at work. Only those who work at home would not be entitled to deduct their meals. The legislative history of this provision makes it clear that this is not what was intended.<sup>46</sup> The provision was meant to apply to those traveling expenses incurred in excess of those ordinarily required.<sup>47</sup> To implement this rule, the Service established the so-called overnight rule, i.e., to be entitled to a deduction under this provision, the business trip must require the taxpayer to stop for sleep or rest. It is hard to justify the overnight rule simply by looking at the text of the statute; the statute appears to be written in terms of geography, not time. Nevertheless, with extensive use of its legislative history, the Supreme Court held the overnight rule to be valid.

Legislative history has also played a very important role in the development of various judicial doctrines. In the seminal case of *Gregory v. Helvering*,<sup>48</sup> the taxpayer, Mrs. Gregory, wished to dispose of stock held by her wholly-owned corporation in the most tax-efficient way. To accomplish this, she created a new corporation, which would allow her to exploit favorable tax provisions by structuring the sale as part of a corporate

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<sup>44</sup> *Commissioner v. Engle*, 464 U.S. 206, 223 (1984) (quoting *Helvering v. Morgan’s, Inc.*, 293 U.S. 121, 126 (1934)).

<sup>45</sup> 389 U.S. 299, 300 (1967).

<sup>46</sup> *Id.* at 305 n.20 (quoting, S. REP. NO. 83-1622, at 9 (1954)).

<sup>47</sup> *Id.*

<sup>48</sup> 27 B.T.A. 223 (1932), *rev’d*, 69 F.2d 809 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

reorganization. The corporate reorganization served no purpose other than to reduce her tax liability and, after the reorganization, the new corporation was dissolved.

The IRS challenged the applicability of the reorganization provisions to the transaction. At the trial court, the IRS asserted that the favorable tax provisions for reorganizations should not apply because the new corporation was transitory.<sup>49</sup> The trial court rejected this argument because the structure of the transaction satisfied the literal requirements for a reorganization. The court observed that a “statute so meticulously drafted must be interpreted as a literal expression of the taxing policy . . .”<sup>50</sup> The Court of Appeals reversed.<sup>51</sup> It determined that Congress intended the favorable reorganization provisions to apply only to real business transactions because both the House and Senate Reports stated that their purpose was to favor “exchanges made in connection with a reorganization in order that ordinary business transactions will not be prevented.”<sup>52</sup> As a result, the Court of Appeals determined that the provision should not apply to a transaction that was not part of the conduct of business, but rather part of a plan to reduce an individual’s tax liability. The court was very careful to note that it was not saying that the steps taken by the taxpayer and her corporations had failed to occur. Rather, it emphasized that it was concluding that Congress did not intend the statute to apply to non-business transactions such as that devised by the taxpayer. The court stated:

We do not indeed agree fully with the way in which the Commissioner treated the transaction; we cannot treat as inoperative the . . . [actions of taxpayer]. The [new] Corporation had a juristic personality, whatever the purpose of its organization. . . . All these steps were real, and their only defect was that they were not what the statute means by a “reorganization,” because the transactions were not part of the conduct of

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<sup>49</sup> 27 B.T.A. at 225.

<sup>50</sup> *Id.* at 225.

<sup>51</sup> *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

<sup>52</sup> *Id.* at 811.

the business of either or both companies; so viewed were a sham, though all the proceedings had their usual effect.<sup>53</sup>

In a very short opinion, the Supreme Court affirmed the Court of Appeals, finding that the transaction served “no business or corporate purpose.”<sup>54</sup> Although the Supreme Court did not explicitly refer to any legislative history, it clearly affirmed the Court of Appeals decision. The Court stated: “. . .[T]he question for determination is whether what was done . . . was the thing which the statute intended. The reasoning of the court below in . . . a negative answer leaves little to be said.”<sup>55</sup>

With the advent of the textualist movement, the Supreme Court in recent years has become more circumscribed in its initial determination of whether the language is unambiguous. Rather than look to legislative history as a guide to confirm its view about the meaning of the statute, the Court in several non-tax cases has sometimes relied solely on the language.<sup>56</sup> For example, Professor Merrill has observed that while the Court referred to legislative history in three quarters of the cases involving statutory interpretation during the 1988 term, during the 1992 term the Court only referred to legislative history in 26 out of 66 such cases.<sup>57</sup>

In general, we find application of the textualist approach highly problematic. We believe that ignoring the legislative history surrounding the enactment of a particular

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

<sup>54</sup> *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

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

<sup>56</sup> *See, e.g.,* *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 109–21 (2001); Michael Koby, *The Supreme Court's Declining Reliance on Legislative History: The Impact of Justice Scalia's Critique*, 36 HARV. J. ON LEGIS. 369, 384–91 (1999) (summarizing statistics that show declining reliance on legislative history); Gregory E. Maggs, *The Secret Decline of Legislative History: Has Someone Heard A Voice Crying In The Wilderness?* 1994 PUB. INT. L. REV. 57 (documenting decreased use of legislative history by Supreme Court in 1992-1993 Term); Thomas Merrill, *Textualism and the Future of the Chevron Doctrine*, 72 WASH. U. L.Q. 351, 351 (1994) (finding significant increase in use of textualism by the Supreme Court during the period 1981-1992).

<sup>57</sup> Merrill, *supra* note 56, at 356.

provision can only make the task of interpreting that provision more difficult and the ultimate interpretation more arbitrary. Ambiguity is often not obvious; one normally needs a frame of reference. Usually, there must be something else present to serve as a basis for comparison before the existence of ambiguity can be ascertained. For example, reconsider the *Correll* case, discussed above, interpreting the provision that permits a deduction for the cost of one's meals while traveling "away from home in pursuit of a trade or business." On the first reading this phrase does not appear to be ambiguous. However, when applied in various factual contexts, its ambiguity becomes apparent. For example, should all meals consumed during working hours be deductible except for those eaten at home?

When the Supreme Court has applied the textualist approach, it refers to canons of construction,<sup>58</sup> the dictionary,<sup>59</sup> the relationship of the provision to the statute as a whole,<sup>60</sup> to other legislative enactments,<sup>61</sup> and case law existing at the time the statute was adopted.<sup>62</sup> Two of these sources are rarely helpful. Canons of construction are not helpful because they are often contradictory. Half a century ago, Professor Llewellyn observed that for every canon of statutory construction used by the courts there is a

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<sup>58</sup> See, e.g., *Cleveland v. United States*, 531 U.S. 12, 25 (2000); *Hughey v. United States*, 495 U.S. 411, 422 (1990); *Pub. Citizen*, 491 U.S. at 465, 466; *Nat'l R.R. Passenger Corp. v. Nat'l Assoc. of R.R. Passengers*, 414 U.S. 453, 458 (1974); see also Mary L. Heen, *Plain Meaning, the Tax Code, and Doctrinal Incoherence*, 48 HASTINGS L.J. 771, 778 (1997) (describing Court's use of canons of construction).

<sup>59</sup> See, e.g., *Muscarello v. United States*, 524 U.S. 125, 128 (1998); *Smith v. United States*, 508 U.S. 223, 229 (1993); *Commissioner v. Soliman*, 506 U.S. 168, 174 (1993); *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 383 (1992); *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 97 (1983); Heen, *supra* note 58, at 778.

<sup>60</sup> See, e.g., *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341 (1997); *Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 477 (1992); *McCarthy v. Bronson*, 500 U.S. 136, 139 (1991); *Crandon v. United States*, 494 U.S. 152, 158 (1990); Heen, *supra* note 58, at 778.

<sup>61</sup> See, e.g., *J.E.M. AG Supply, Inc. v. Pioneer Hi-Bred Int'l, Inc.*, 534 U.S. 124, 145 (2001); *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 511, 513 (1989); *Pierce v. Underwood*, 487 U.S. 552, 564 (1988); Heen *supra* note 58, at 778.

<sup>62</sup> See, e.g., *Chisom v. Roemer*, 501 U.S. 380, 405–06 (Scalia, J., dissenting).

contradictory canon that has also been used.<sup>63</sup> Similarly, the dictionary usually does not provide one definition for a word, but several alternative definitions.<sup>64</sup> Reference to the statute as a whole and to other statutory enactments may also not be helpful in many situations because the ambiguity may only be apparent in a particular application by reference to legislative history.<sup>65</sup> It is hard to see, for example, how any of the textualist's tools would have been of much use in *Correll*. The word “home” has 16 definitions in Webster's New International Dictionary. The canons of statutory interpretation fail to provide guidance about which should be used.

The difficulties in applying textualism to tax statutes is well-illustrated by the recent Supreme Court decision in *Gitlitz v. Commissioner*<sup>66</sup> where the Court failed to consider what most tax lawyers thought was a critical ambiguity in the statute.<sup>67</sup> The

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<sup>63</sup> Karl Llewellyn, *Remarks on the Theory of Appellate Decisions and the Rules or Canons About How Statutes Are To Be Construed*, 3 VAND. L. REV. 395, 401–06 (1950).

<sup>64</sup> Ellen P. Aprill, *The Law of the Word: Dictionary Shopping In the Supreme Court*, 30 ARIZ. ST. L.J. 275, 317–18 (1998).

<sup>65</sup> Heen, *supra* note 58, at 776 (“An acontextual determination by the Court of the threshold question of whether a statute is ambiguous presents the possibility that a complex statute may be misinterpreted by the Court.”).

<sup>66</sup> 531 U.S. 206 (2001).

<sup>67</sup> Critics of the use of legislative history have sought to diminish its contribution to statutory interpretation by arguing that Congress does not approve legislative history in adopting a statute and legislative history is not signed by the President. *See, e.g.*, *Schwegman Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 396 (1951); R. DICKERSON, *THE INTERPRETATION AND APPLICATION OF STATUTES*, 137–97 (1975); Kenneth W. Starr, *Observations About The Use of Legislative History*, 1987 DUKE L.J. 371, 375–79 (1987). While this is true, it is also true that Article III judges are not elected officials and are not empowered by the Constitution to adopt legislation. The issue is, in an imperfect world, which is the better choice? Is it preferable to look to committee reports considered by those constitutionally charged with drafting legislation to determine what the legislation means or is it better to ignore such reports and instead allow the judiciary to use their copies of Webster's Dictionary and their own unique life experiences to tell us what the legislation means? *See generally*, Aprill, *supra* note 64 (arguing that use of dictionaries provides significant discretion to judiciaries); Muriel Morrissey Spense, *The Sleeping Giant: Textualism as Power Struggle*, 67 S. CAL. L. REV. 585, 593 (1994) (asserting that textualism pits the judiciary against the legislature); Nicholas S. Zeppos, *Judicial Candor and Statutory Interpretation*, 78 GEO. L.J. 353, 411 (1989) (arguing that textualism is judicial activism).

In our view, resorting to legislative history is preferable. *See* Chomsky, *supra* note 37, 951–52. Resorting to legislative history limits judicial activism and preserves majority rule in situations not involving constitutional rights. *See* Jerry L. Mashaw, *Textualism, Constitutionalism, and the Interpretation of Federal Statutes*, 32 WM. & MARY L. REV. 827, 836 (1991) (observing that “. . . the exclusion of legislative history is more likely to increase the flexibility of statutes than to render them static or rigid”).

issue before the Court was to determine how the rules of § 108 operate in the context of S corporations. Under § 108(a),<sup>68</sup> a taxpayer generally is permitted to exclude from gross income the amount of any debt discharged when the taxpayer is insolvent.<sup>69</sup> The amount excluded under § 108(a) is deferred for later taxation under § 108(b) by reducing certain of the taxpayer's tax attributes. Under §§ 1366(a)(1) and 1367, the shareholders of an S corporation are permitted to increase the basis in their stock by their pro rata share of the S corporation's items of income (including tax exempt income) for the year.<sup>70</sup> The issue in *Gitlitz* was whether income of an insolvent S Corporation, which was excluded under § 108(a), should increase the basis of the S corporation's solvent stockholders.<sup>71</sup> The resolution of that issue depended on how one interprets a special rule for S corporations found in § 108(d)(7)(A): "In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level . . . ."<sup>72</sup> Should this provision be read as mandating that the impact of the excluded income be confined to the corporate level, or should it be read as permitting the excluded income to increase the basis of the stockholders in their stock?

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Dictionaries and perceptions of common usage are unbounded. An examination of Webster's Dictionary, which often provides more than one meaning to a word because meaning is contextual, allows a judge to substitute her or his judgment for the legislature's judgment. *But see*, Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 881 (1982) (arguing that resorting to legislative purpose by courts provides courts an opportunity for "creative" jurisprudence). In contrast, a statement in a legislative committee report is bounded; it applies specifically to the statute under consideration.

<sup>68</sup> I.R.C. 108(a) (Thompson 2004) provides that "Gross income does not include . . . income by reason of the discharge of indebtedness . . . if . . . the discharge occurs when the taxpayer is insolvent."

<sup>69</sup> Under I.R.C. § 108(a)(3) (Thompson 2004), the amount excluded is limited to the amount by which the taxpayer is insolvent.

<sup>70</sup> I.R.C. § 1367(a)(1) (Thompson 2004).

<sup>71</sup> Under I.R.C. § 1366 (Thompson 2004), income of an S corporation flows out to its stockholders. Such income increases the stockholders' basis under § 1367 (Thompson 2004).

<sup>72</sup> I.R.C. § 108(d)(7)(A) (Thompson 2004).

Writing for the majority, and without the aid of legislative history, Justice Thomas determined that the “plain text”<sup>73</sup> of the statute required the latter interpretation. He argued that sections 1366(a)(1) and 1367 clearly permit an increase in basis for each shareholder’s pro rata portion of tax exempt income. The amount excluded under § 108(a) is tax exempt and there is nothing stated or implied in § 108(d)(7)(A) that suspends this rule.<sup>74</sup> Thomas acknowledged that his interpretation results in a “double windfall” for the stockholders: they would not have to pay a tax on the income from cancellation of debt, but could use the income to increase their basis. He also acknowledged that he knew of no other instance where § 108 directly benefits a solvent entity.<sup>75</sup> Nevertheless, even with these misgivings, he felt constrained by the statute.

Writing in dissent, and with the aid of legislative history, Justice Breyer argued that the language of § 108(d)(7)(A) was not nearly as unambiguous as the majority had held. A House Committee Report, which accompanied an amendment to § 108 after § 108(d)(7)(A) was enacted, stated that “[t]he exclusion and basis reduction are both made at the S corporation level (§ 108(d)(7)). The shareholders’ basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level.”<sup>76</sup> Although this statement was made after the enactment of § 108(d)(7)(A), it suggests that Congress did not intend for the shareholders to increase their basis. With this in mind, Breyer asserted that if one were to read the text of § 108(d)(7)(A) “...literally as exclusive, both the COD exclusion (§ 108(a)) and the tax attribute reduction (§ 108(b)) would apply only ‘at the corporate level.’ Hence the COD income

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<sup>73</sup> *Gitlitz*, 531 U.S. at 219.

<sup>74</sup> *Id.* at 214 n.6.

<sup>75</sup> *Id.* at 220 n.10.

<sup>76</sup> *Id.* at 221 (citing H.R. Rep. No. 103-111, at 624–25 (1993)).

would not flow through to S corporation shareholders.”<sup>77</sup> He suggested that not only was this interpretation plausible, but it was also the “best reading of § 108 as a whole.”<sup>78</sup>

*Gitlitz* is an excellent example of how the majority’s failure to consult legislative history caused the Court to miss an important ambiguity in the statute. The majority’s analysis would have been more complete had the majority consulted the legislative history. In our view, Justice Breyer poignantly summarized what’s at stake with the shift towards textualism when he stated in another case:

Language, dictionaries, and canons, unilluminated by purpose, can lead courts into blind alleys, producing rigid interpretations that can harm those whom the statute affects. If generalized, the approach, bit by bit, will divorce law from the needs, lives, and values of those whom it is meant to serve. . . .<sup>79</sup>

Even if one is still skeptical about the usefulness of legislative history in interpreting statutes in general, there is an additional compelling reason for why legislative history is particularly relevant to understanding *tax* statutes. As Professor Livingston has observed, the very process by which tax legislation is formulated belies the notion that the meaning of the statute can be based solely on its text. Members of the House Ways and Means Committee and Senate Finance Committee “rarely consider statutory language when discussing a tax bill.”<sup>80</sup> Professor Livingston states:

Instead the staff presents members with a list of proposals in summary, “conceptual” form, frequently accompanied by the estimated revenue effect of each proposal. The proposals may be based on the Administration’s recommendations . . . , [or] on the preferences of the chairman and other committee members . . . . The committee members make decisions based on these summaries, only later does the staff reduce

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<sup>77</sup> *Id.* at 221.

<sup>78</sup> *Gitlitz*, 531 U.S. at 224.

<sup>79</sup> *Duncan v. Walker*, 533 U.S. 167, 192 (2001) (Breyer, J., dissenting).

<sup>80</sup> Michael Livingston, *Congress, the Courts and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 833 (1991); see Bernard Bell, *R-E-S-P-E-C-T: Respecting Legislative Judgments In Interpretive Theory*, 78 N.C. L. REV. 1254, 1270 (2000) (stating that members of Congress appear to support the continued use of legislative history in interpreting statutes).

these decisions to statutory language. In contrast, the members of many [non-tax] congressional committees consider actual statutory language when discussing a bill.<sup>81</sup>

This approach to drafting tax legislation clearly supports consulting committee reports when interpreting tax provisions. The committee reports describe the “conceptual” form selected by the committee members and relied upon by staff to draft the statutes. Thus, the reports convey the essence of what Congress thought it was accomplishing when it enacted the statutes.

## ***II. Textualism Legitimizes Tax Shelters***

The ascendancy of textualism has had its greatest impact by facilitating the promotion and sale of “abusive” tax shelters. An “abusive” tax transaction, from the perspective of the Treasury, is a transaction, which is designed to technically comply with the letter of the law, but which produces tax savings that are inappropriate to the underlying purposes of the statutory scheme and inconsistent with the economic reality of the transaction.<sup>82</sup> It is in the nature of abusive transactions that the statute in question is inadequate to address the abuse. Thus, the courts, using the intentionalist and purposivist approaches, have crafted, additional doctrines that permit the reviewing agency or court to go beyond the literal wording of the statute in order to effectuate its purpose. The use of textualism, however, challenges the legitimacy of these doctrines and supports literal interpretations that are the keystone of tax shelters.

In Part II, we will first briefly describe the doctrines that the courts developed to combat abusive tax transactions using the purposivist and intentionalist methods of

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<sup>81</sup> Livingston, *supra* note 80, at 833.

<sup>82</sup> Treas. Reg. § 1.701-2 (as amended in 1995); see Alan Gunn, *The Use and Misuse of Antiabuse Regulations: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 163 (2001) (defining abusive transactions).

interpretation. We will then discuss the manner in which tax advisors have utilized the textualist approach to avoid the judicial doctrines in structuring and rendering legal opinions about tax shelters. The most important of the doctrines, business purpose and economic substance, could not have been developed under textualism and are, therefore, vulnerable to attack.

**A. *Judicially Crafted Doctrines***

**1. *The Business Purpose Doctrine***

Using the purposivist and intentionalist methods of statutory interpretation, the courts developed two broad doctrines to curb abusive transactions – the business purpose doctrine and substance-over-form doctrine. The business purpose doctrine provides that a tax statute will not be applied to a transaction unless the transaction serves some business purpose, other than tax avoidance.<sup>83</sup> Although the courts created the business purpose doctrine based on legislative history that accompanied the adoption of the corporate reorganization tax provisions,<sup>84</sup> they readily applied the doctrine in other tax contexts,<sup>85</sup> including partnerships.<sup>86</sup> In 1949, Judge Learned Hand explained the scope of the doctrine in circumstances other than reorganizations:

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<sup>83</sup> BORIS BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS*, 4–46 (3d ed., 1999).

<sup>84</sup> See *supra* notes 48 to 55 and accompanying text.

<sup>85</sup> See, e.g., *Moline Props., Inc. v. Commissioner*, 319 U.S. 436, 438–39 (1943) (holding that a business purpose or business activity had to be present before the existence of a corporation separate from its stockholders would be respected). See generally BITTKER & LOKKEN, *supra* note 83, at 4–46 (discussing cases).

<sup>86</sup> The courts have applied the business purpose doctrine to tax shelters that employ partnerships in two ways. One has been to disregard the existence of the partnership when it lacked a business purpose. For example, in *Merryman v. Commissioner*, the Court of Appeals affirmed the Tax Court’s disregard of the existence of a partnership among a corporation and its controlling stockholders where the Tax Court had determined that the partnership lacked business purpose and served no purpose other than to allow the shareholders to claim investment credits with respect to assets the partnership had purchased from the corporation. See 873 F.2d 879 (5th Cir. 1989). See also *ASA Investing P’ships v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) and *Andantech L.L.C. v. Commissioner*, 331 F.3d 972 (D.C. Cir. 2003) where the court disregarded the partnership.

The doctrine . . . means that in construing . . . a tax statute which describes commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered for no other motive but to escape taxation.<sup>87</sup>

Where the tax benefit claimed does not relate to a commercial transaction, the business purpose doctrine cannot easily be applied. Consequently, the courts have modified application of the doctrine in these settings. In *Goldstein v. Commissioner*,<sup>88</sup> the court reshaped the business purpose doctrine to apply to non-business transactions by requiring the taxpayer to engage in an activity for a purpose other than to save taxes.<sup>89</sup> The taxpayer in *Goldstein* had borrowed funds to invest in Treasury notes that paid less interest than the interest expense she incurred on the borrowing. She prepaid the interest and claimed a large tax deduction in the year of prepayment. The court denied the deduction, stating:

Section 163 (a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. . . . On the other hand, and notwithstanding Section 163 (a)'s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to

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Another approach has been to disregard the transaction entered into by the partnership where the transaction lacked a business purpose. In *ACM v. Commissioner*, for example, the court disallowed a loss allocated to a U.S. corporation by a partnership that arose from the partnership's exploitation of an "anomaly" in the installment sales rules. 157 F.3d 231, 252 (3d Cir. 1998). The court denied the loss deduction to the U.S. corporation on the basis that no business purpose existed for entering into the installment sale other than the generation of the tax loss. *See id.*

<sup>87</sup> *Commissioner v. Transp. Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950).

<sup>88</sup> 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

<sup>89</sup> *See BITTKER & LOKKEN, supra note 83, at 4-47.*

obtain the benefit of a tax deduction; and a good example of such purposeless activity is the borrowing of funds, at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential.<sup>90</sup>

The courts have also applied the *Goldstein* variation of the business purpose doctrine to partnerships.<sup>91</sup>

It is likely that these doctrines would never have been developed by textualists. No statutory language authorized the business purpose doctrine or its subsequent expansion in *Goldstein*. Rather, the doctrines resulted from the application of the intentionalist and purposivist methods of statutory interpretation by the Court of Appeals in *Gregory v. Helvering*.<sup>92</sup>

## **2. The Substance-Over-Form Doctrine**

The substance-over-form doctrine also originated in the context of corporate taxation.<sup>93</sup> In contrast to the business purpose doctrine, the substance-over-form doctrine is rather amorphous and applies differently in different contexts and is sometimes known by different names. In general, under this doctrine, courts seek to tax a transaction pursuant to its economic effect, rather than its form. For example, the ‘step transaction’ doctrine disregards steps in a transaction that lack independent economic significance.<sup>94</sup> Similarly, under the ‘sham transaction’ doctrine, where a transaction involves a circular flow of cash or property such that each party does not change its legal or economic

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<sup>90</sup> *Goldstein v. Commissioner*, 364 F.2d 734,741–42 (2d Cir. 1966).

<sup>91</sup> The Tax Court subsequently applied this approach to a similar transaction engaged in by a partnership in *Sheldon v. Commissioner*, 94 T.C. 738 (1990). There, the court disallowed interest deductions where the taxpayer’s borrowing lacked “tax-independent purpose.” The taxpayer, a partnership, purchased Treasury bills using borrowed proceeds. Observing that the interest expense incurred by the partnership exceeded the interest income from the bills, the court concluded that the transactions lacked a purposive activity.

<sup>92</sup> See 69 F.2d at 811.

<sup>93</sup> See *Commissioner v. Court Holding Co.*, 324 U.S. 331, 332 (1945).

<sup>94</sup> See, e.g., *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521-22 (10th Cir. 1991); *True v. United States*, 190 F.3d 1165, 1174-77 (10th Cir. 1999).

position, the transaction will be disregarded.<sup>95</sup> It is likely that a textualist would have developed the step-transaction and sham-transaction doctrines because they seek to characterize facts, not to interpret statutes.

This is not true, however for the most important variation of the substance-over-form doctrine, the ‘economic substance’ doctrine. Under this doctrine, the courts will deny tax benefits if the purported pre-tax economic profit is insubstantial in relation to the value the expected tax benefits from the transaction. The economic substance doctrine is a supplement to the business purpose doctrine. The Court of Appeals for the Fourth Circuit has stated that both a business purpose and economic substance must be lacking before it will disregard a transaction.<sup>96</sup> In other words, the presence of either a business purpose or profit motive will suffice to respect the transaction.<sup>97</sup> Consistent with this suggestion, most courts apply the economic substance doctrine only after concluding that the transaction does not serve a non-tax business purpose other than generating a profit.<sup>98</sup> One commentator explained:

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<sup>95</sup> See, e.g., *Higgins v. Smith*, 308 U.S. 473, 477-78 (1940); *Griffiths v. Commissioner*, 308 U.S. 355, 356-58 (1939); Rev. Rul. 78-397, 1978-2 C.B. 150.

<sup>96</sup> *Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) (court stated that it will disregard a transaction if it finds that “that the taxpayer was motivated by no business purposes other than obtaining tax benefits . . . and that the transaction has no economic substance because no reasonable possibility of a profit exists”) (emphasis added).

<sup>97</sup> See *Horn v. Commissioner*, 968 F.2d 1229, 37–38 (Fed. Cir. 1992); *Gilman v. Commissioner*, 933 F.2d 143, 148 (2d Cir. 1991). *But see*, *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) (concluding that it could disregard a transaction when it determined that the transaction’s sole function was to produce the deductions regardless of the taxpayer’s motive). Compare *IES Indus., Inc. v. United States*, 253 F.3d 350, 353–54 (8th Cir. 2001) (court declined to decide whether the presence of one would suffice because it found both present). Other courts have concluded that the test is not intended to be a rigid two-step analysis. See, e.g., *Casebeer v. Commissioner*, 909 F.2d, 1360, 1363 (9th Cir. 1990).

<sup>98</sup> John P. Warner, *Statutory, Regulatory and Common Law Anti-Abuse Weapons*, PLI Tax Law and Estate Planning Handbook Series, 52 TAX LAW AND PRACTICE, 885, 904 (Oct.-Nov. 2000); David Hariton, *Sorting Out The Tangle of Economic Substance*, 52 TAX LAWYER 237, 241 (Winter 1999); Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 670 (1989). This approach is consistent with the language the courts have used to explain the test. The courts will often state that they may disregard the transaction if they “find that the taxpayer was motivated by no business purposes other than obtaining tax benefits. . . and that the

At least implicitly, the courts appear to apply ... [the economic substance] test only after first finding that the transactions cannot serve any non-tax business purpose other than the generation of an economic profit. In reaching such a finding, the courts apply a “strict scrutiny” standard to any such purported business purpose; i.e. the purported business must not be contradicted by any other information that comes to light about the taxpayer, the transaction must be a reasonably efficient means of fulfilling the purported business purpose in light of reasonably available alternatives and the transaction or arrangement as carried out must further such business purpose.<sup>99</sup>

In evaluating the profit motive, some courts (but not all) will compare the magnitude of the profit potential to the tax benefits. *Sheldon v. Commissioner*<sup>100</sup> is a good example of the approach. There, the court found that no business purpose was present, and concluded that the possibility of only an “incidental” profit for a preplanned transaction could not justify the tax benefits.<sup>101</sup> The Tax Court,<sup>102</sup> and the Courts of Appeal for the Third, Sixth and Tenth Circuits have similarly employed this balancing test.<sup>103</sup> Other courts, however, have not engaged in such an explicit balancing test.<sup>104</sup>

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transaction has no economic substance because no reasonable possibility of a profit exists.” *Rice’s Toyota World*, 752 F.2d at 91–92 (emphasis added).

<sup>99</sup> Warner, *supra* note 98, at 904.

<sup>100</sup> See 94 T.C. 738 (1990).

<sup>101</sup> See Kenneth W. Gideon, *Mrs. Gregory’s Grandchildren: Judicial Restriction of Tax Shelters*, 5 VA. TAX REV. 825, 835–39 (1986) (discussing early cases that address this issue).

<sup>102</sup> See, e.g., *Salina P’ship LP, FPL Group, Inc. v. Commissioner*, 80 T.C.M. 686 (2000).

<sup>103</sup> *ACM P’ship v. Commissioner*, 157 F.3d 231, 257–58 (3d Cir. 1998); *Pasternak v. Commissioner*, 990 F.2d 893, 904 (6th Cir. 1993); *Keeler v. Commissioner*, 243 F.3d 1212, 1220–21 (10th Cir. 2001).

<sup>104</sup> See, e.g., *IES Indus., Inc. v. Alliant Energy Corp.*, 253 F.3d 350, 351–56 (8th Cir. 2001), where the Eighth Circuit allowed the taxpayer to claim a capital loss and a foreign tax credit in the following transaction. The taxpayer, IES, purchased foreign stock with the right to receive a dividend that would be subject to a 15 percent foreign withholding tax. The purchase price for the stock was market value plus 85 percent of the expected gross dividend. IES sold the stock shortly thereafter for the price it had paid, less the dividend, since it retained the right to receive the dividend. The subsequent receipt of the dividend by IES, less the 15% withholding, allowed IES to fully recover its investment. When the dust had settled, IES had incurred no pre-tax economic gain or loss, but was able to claim a foreign tax credit for the amount withheld on the dividend and a capital loss from the stock sale. The IRS sought to disallow the foreign tax credit and capital loss, arguing that the transaction was a sham since there was no economic benefit. The Court of Appeals concluded that the transaction was not a sham because an economic profit existed. The court reasoned that the profit was 100 percent of the gross dividend amount, less the 85 percent amount

The courts would not have developed the economic substance doctrine if they had been using the textualist method of statutory interpretation. The economic substance doctrine, like the business purpose doctrine, is the result of a purposivist or intentionalist method of interpretation. It imposes an additional requirement that is not explicitly expressed in the statutory language. It is based on the judiciary's view that a transaction must have some purpose other than tax avoidance before it may benefit from the provisions of the tax statute.

### ***B. Textualism and Purposive Activity***

Despite the potentially wide application of these doctrines, tax advisors have frequently diminished their significance in structuring abusive transactions.<sup>105</sup> Textualism is a major contributor to the problem for two reasons. First, textualism undermines the legitimacy of the business purpose and economic substance doctrines, since it is likely that a textualist would never have formulated the doctrines. The textualist would not have consulted the legislative history that the lower court in *Gregory v. Helvering* examined to determine that Congress intended the reorganization provisions to apply to

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attributable to the dividend that the taxpayer paid on acquiring the stock. Although IES never received the 15 percent of the dividend that was withheld, the court treated such amount as profit because it provided a benefit to the taxpayer; *i.e.*, it satisfied its tax liability. The court made no attempt to balance this "profit" with the tax benefits the taxpayer obtained from the transaction. *See Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 779–88 (5th Cir. 2001) (engaging in the same analysis for an identical transaction).

<sup>105</sup> The advisors' willingness to do so can be attributed to a number of factors, some of which are not related to textualism. First, the audit lottery heavily favors taxpayers investing in tax shelters organized as partnerships because there is a low audit rate for partnerships. Many practitioners we spoke to in Boston and New York have never had a tax shelter partnership client audited by the IRS other than family limited partnerships used in estate planning. In 2002, the IRS only audited 0.39 percent of the tax returns for flow-through entities such as partnerships. STAFF OF JOINT COMMITTEE ON TAXATION, REPORT OF THE JOINT COMMITTEE ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998 37 (JCX-53-03) (May 19, 2003).

Consequently, most abusive transactions are not even identified as such, much less litigated. Second, because of the complexity of the abusive transactions, it is likely that, even if audited, the examining IRS agents will lack the sophistication to identify the abuse. Practitioners have frequently told us of the complexity of tax shelter structures where several layers of partnerships and other entities are used to obfuscate the transaction.

bona fide business transactions. Moreover, a textualist would not have reshaped the business purpose requirement into a general requirement of purposive activity without express statutory support.

Second, textualism limits the sources that a court may consult in interpreting a statute. The elimination of legislative history as a tool to determine a statute's purpose makes it less likely that the court will find authority to limit application of the statute's literal text.<sup>106</sup> This is illustrated by the experience of Great Britain. Until relatively recently, British courts used a form of textualism that would not consider a statute's purpose unless the words used in the statute had no "determinate ordinary meaning and ... [were] unclear on their face."<sup>107</sup> The result of this approach to statutory interpretation was that the courts accorded favorable tax treatment to a transaction that complied with the statute's formal requirements even if it conflicted with the statute's purpose.<sup>108</sup> Until British courts started look to a statute's purpose<sup>109</sup> and legislative history<sup>110</sup>, the form of the transaction, not its legislative purpose, controlled the outcome. A similar experience is reported to have occurred in Canada. Brian Arnold, a leading authority on Canadian

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<sup>106</sup> Senator Grassley has expressed concern about the recent approach of courts to interpreting tax statutes and the rise in tax shelters. He stated, "... I'm worried about the Tax Court blessing highly artful interpretations of the code." David Cay Johnston, *Tax Moves By Enron Said to Mystify the I.R.S.*, N.Y. TIMES, Feb. 13, 2003, at C1.

<sup>107</sup> P.S. ATIYAH & ROBERT S. SUMMERS, FORM AND SUBSTANCE IN ANGLO-AMERICAN LAW 101 (1987) (stating "... the accepted doctrine in English law is that courts are not entitled to consider the statutory purpose unless the words used in the statutes have no determinate ordinary meaning and are ... unclear on their face ...")

<sup>108</sup> See, e.g., *Commissioner of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1 (1935); William Popkin, *Judicial Anti-Tax Avoidance Doctrine In England: A United States Perspective*, 8 BRIT. TAX REV. 283, 283 (1991) (observing that until the 1980's, English courts "were reluctant to use statutory purpose to interpret statutes, preferring to stick closely to the text").

<sup>109</sup> *W.T. Ramsay Ltd. v. I.R.C.*, [1981] 1 All E.R. 865; *McGuckian v. I.R.C.*, [1997] STC 918 (House of Lords favors purposivist approach to interpreting tax statutes).

<sup>110</sup> *Pepper v. Hart*, [1992] STC 898, 922-923 (House of Lords reversing centuries of precedent and ruling that courts may consult legislative history). But see JOHN TILEY, REVENUE LAW 49 (4th ed. 2000) (arguing that in cases subsequent to *Pepper v. Hart*, the ability to consult legislative history has not affected the court's interpretation of the statute).

law, has suggested that a similar literalist approach by the Canadian courts, which seeks the plain meaning of a statute's language, has resulted in the courts failure to strike down "several blatant tax-avoidance schemes."<sup>111</sup>

The challenges posed by textualism embolden tax shelter advisors to push the limits. The highly respected New York State Bar Association has stated that "a taxpayer may have a respectable argument that the common law doctrines do not apply to . . . a transaction that literally complies with subchapter K."<sup>112</sup> Moreover, a practitioner has argued in a recent law review article that the assent of textualism means that economic substance and business purpose doctrines are invalid.<sup>113</sup> Some lawyers believe that the IRS, itself, is concerned that textualism will undermine the doctrines. For example, some have asserted that if an IRS agent identifies a particular transaction as abusive, the government is likely to settle rather than apply the business purpose and economic substance doctrines to transactions that literally comply with Subchapter K.<sup>114</sup> Those lawyers believe that the IRS is concerned that the courts would reject application of the doctrines to complex statutes and that the deterrent effect of the doctrines would be lost.<sup>115</sup> Even legislators have expressed concern that the Tax Court is "blessing highly

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<sup>111</sup> Brian J. Arnold, *Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance*, 49 CAN. TAX J. 1, 12–22 (2001).

<sup>112</sup> N.Y. State Bar Ass'n Tax Section, *supra* note 10, at 235.

<sup>113</sup> Allen D. Madison, *The Tension Between Textualism and Substance-over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 749–50 (2003)

<sup>114</sup> N.Y. State Bar Ass'n Tax Section, *supra* note 10, at 235.

<sup>115</sup> *Id.*

artful interpretations of the tax code”<sup>116</sup> and bills have been proposed that would codify the economic substance doctrine.<sup>117</sup>

The magnitude of the actual threat is difficult to access. We believe that a court, using the textualist approach, might disregard principles that were developed based upon legislative intent, but that such disregard would be highly inappropriate. Although textualism disregards legislative history, it should not disregard decades of established judicial precedent that has established the manner in which tax statutes should be applied.<sup>118</sup> Justice Scalia’s statement that textualism selects a meaning that is “most compatible with the surrounding body of law into which provision must be integrated”<sup>119</sup> should take into account existing case law and *stare decisis*.<sup>120</sup> Nevertheless, the concern ascribed to the IRS may be legitimate. There is evidence that the staunchest advocates of textualism will often disregard long-established precedent where textualism leads them to a different conclusion.<sup>121</sup>

In any event, textualism makes it easier for lawyers to render favorable tax shelter opinions that aid in selling tax shelters.<sup>122</sup> Some attorneys assert that textualism places such significant weight on the language of the statute that it is not necessary that the activity being taxed have a non-tax avoidance purpose so long as the activity actually

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<sup>116</sup> David Cay Johnston, *Tax Moves By Enron Said to Mystify the I.R.S.*, N. Y. TIMES, Feb. 13, 2003, at C1 (reporting that Senator Grassley has expressed concern about the recent approach of courts to interpreting tax statutes and the rise in tax shelters and quoting him as stating, “. . . I’m worried about the Tax Court blessing highly artful interpretations of the code.”).

<sup>117</sup> S. 1637 (2003)

<sup>118</sup> *Square D Co. v. Niagara Frontier Tariff Bureau*, 476 U.S. 409, 424 n.34 (1986).

<sup>119</sup> Scalia, *supra* note 1, at 17.

<sup>120</sup> See Jerry L. Mashaw, *Textualism, Constitutionalism, and the Interpretation of Federal Statutes*, 32 WM. & MARY L. REV. 827, 831 (1991).

<sup>121</sup> See *Dickerson v. United States*, 530 U.S. 428, 451–60 (2000) (Scalia, J., dissenting) (arguing for rejection of the *Miranda* doctrine); Aviam Soifer, *Courting Anarchy*, 82 B.U. L. REV. 699, 701, 727 (2002) (observing that the Supreme Court has recently tended to disregard precedent).

<sup>122</sup> For an account of the important role of attorney opinions in selling tax shelters, see David Cay Johnston, *Costly Opinions Arise on Legal Opinions For Tax Shelters*, N.Y. TIMES, Feb. 9, 2003, § 1, at 25.

occurred.<sup>123</sup> In *ACM*, the taxpayer’s attorney argued that the allocation of the loss to the U.S. taxpayer should be respected because the transaction satisfied the literal requirements of the statutes.<sup>124</sup> Indeed, in his dissent, Judge McKee harshly criticized the majority’s application of the economic substance test. He stated:

I can’t help but suspect that the majority’s conclusion . . . is . . . akin to a “smell test,” . . . If the scheme . . . smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to “put one over.”<sup>125</sup>

Most advisors will not ignore entirely the judicially crafted doctrines in their opinions. Even where the tax shelter’s form complies with the text of the statute, some opinions on tax shelters still present some argument for why the tax shelter also possesses a business purpose or economic substance. The judicial trend toward textualism, however, encourages lawyers to diminish the importance of these doctrines. Their opinions will frequently state that the determination of the presence of business purpose or economic substance is inherently factual and difficult to predict. They do not compare the magnitude of profit potential to tax benefits. Often, they simply assume the problem away. For example, in a highly publicized tax shelter case (*Long-Term Capital Holdings v. United States*<sup>126</sup>), an opinion issued by a prominent New York law firm assumed that the tax shelter in question would generate a “meaningful pre-tax profit” and provided no analysis of the economic substance issue.<sup>127</sup> During the trial of that tax shelter, the

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<sup>123</sup> See N.Y. State Bar Ass’n, *supra* note 10, 235–36 (stating “the common law authority is very general in nature, and there is little case law involving the application of such doctrines in the partnership context. As a result, a taxpayer may have a respectable argument that the common law doctrines do not apply to . . . transaction that literally complies with Subchapter K . . . .”); Deborah Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 453–54 (1993) (arguing that textualism prevents consideration of “general policy arguments” in interpreting tax statutes).

<sup>124</sup> 157 F.3d at 245.

<sup>125</sup> *Id.* at 265.

<sup>126</sup> Case No. 3:01cv1290 (JBA) (D Conn.).

<sup>127</sup> Letter by Shearman & Sterling, dated October 4, 1994 (admitted into evidence in *Long-Term Capital Holdings v. United States*, Case No. 3:01cv 1290 (JBA) (D. Conn. 2003) [hereinafter Shearman Letter].

attorney who had drafted the opinion testified that he had failed to “check out” the economic assumptions upon which he had based his opinion letter.<sup>128</sup>

Although these opinions make short shrift of business purpose and economic substance, they are effective marketing tools because they clearly allow taxpayers to avoid the fraud penalty of § 6663.<sup>129</sup> Early in the history of the fraud penalty, the courts concluded that a taxpayer has not acted fraudulently if he or she is acting upon the advice of an accountant or lawyer.<sup>130</sup> Indeed, it appears that the IRS has not been asserting the fraud penalty in tax shelter cases.<sup>131</sup>

Such opinions, although deficient in their analysis of business purpose and economic substance, may also allow a taxpayer to avoid the penalties under § 6662, or at least present an argument for why they should not apply. Section 6662, in general, imposes a civil penalty of 20 percent for understatements of tax liability on an individual’s tax return that are attributable to negligence or lack of “substantial authority.”<sup>132</sup> Taxpayers who are individuals may avoid the penalties if they have a “reasonable cause” for their position and they acted in good faith.<sup>133</sup> Regulations define what constitutes “reasonable cause” where the taxpayer relies on the opinion of an advisor.<sup>134</sup> The regulations require that the advice be based on “all pertinent facts and

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<sup>128</sup> See David Cay Johnston, *Partner Testifies That Tax Shelter of Hedge Fund Was Legitimate*, N.Y. TIMES, July 9, 2003, at C1, Col. 5 (Late Ed.). (Reporting testimony of tax attorney that he had failed to “check out” the economic assumptions upon which he had based his opinion letter for a tax shelter).

<sup>129</sup> Section 6663 imposes a civil penalty equal to 75 percent of the portion of a tax underpayment that is attributable to fraud. I.R.C. § 6663 (Thompson 2004).

<sup>130</sup> See, e.g., *Jamison v. Commissioner*, 45 F.2d 4 (5th Cir. 1930); *Durovic v. Commissioner*, 54 T.C. 1364, 1398 (1970), *aff’d*, 487 F.2d 36 (7th Cir. 1974).

<sup>131</sup> See Mark Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 260 n.26 (2002).

<sup>132</sup> I.R.C. § 6662(a) and (d)(2)(B) (Thompson 2004).

<sup>133</sup> I.R.C. § 6664 (Thompson 2004).

<sup>134</sup> Treas. Reg. § 1.6664-4(c)(1) (as amended in 2003).

circumstances and the law as it relates to those facts and circumstances.”<sup>135</sup> The regulations also require that the advice not be based on “unreasonable factual or legal assumptions.”<sup>136</sup> It is possible that the IRS could argue that the attorneys’ assumptions about business purpose and economic substance are unreasonable, but the IRS has reportedly not done so.<sup>137</sup> An inquiry into “unreasonableness” would likely require a detailed inquiry into the applicability of the doctrines themselves. Indeed, the New York State Bar Association has stated:

. . . [T]axpayers know that penalties are unlikely because of their literal compliance with the statute and regulations, and as a result believe (often with considerable justification) that even with an unfavorable settlement they will generally end up better off than if they had not engaged in the abusive transaction.<sup>138</sup>

Corporate taxpayers have a greater burden to bear in order to avoid the § 6662 penalties. In the case of tax shelters,<sup>139</sup> corporate taxpayers must have “reasonably believed that the tax treatment . . . was more likely than not the proper treatment” and must also have “substantial authority” for their position.<sup>140</sup> Textualism helps corporate taxpayers construct an argument that these requirements are satisfied. Taxpayers use opinions of counsel, which were discussed above,<sup>141</sup> to support their assertion that they reasonably believed that the shelter’s treatment of a tax item was more likely than not correct. Moreover, the regulations state that a “. . . taxpayer may have substantial

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<sup>135</sup> Treas. Reg. § 1.6664-4(c)(1)(i) (as amended in 2003).

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

<sup>137</sup> See Lee Sheppard, *Tax Shelter Opponents Turn Practical*, 22 *INS. TAX REV.* 989, 991 (June 2002).

<sup>138</sup> N.Y. State Bar Ass’n Tax Section, *supra* note 10, at 235–36.

<sup>139</sup> The term “tax shelter” is defined as:

(I) a partnership or other entity,  
(II) any investment plan or arrangement, or  
(III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.”

<sup>140</sup> I.R.C. § 6662(d)(2)(C)(i) (Thompson 2004); Treas. Reg. § 1.6664-4(e)(2)(A) and (B) (as amended 2003).

<sup>141</sup> See *supra* notes 122–137 and accompanying text.

authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.”<sup>142</sup> Some practitioners argue that this language suggests that the text of the statute can constitute substantial authority, even though it might be applied in a transaction that lacks business purpose or economic substance. We find this argument to be extremely weak because it ignores the additional requirement in the regulations that contrary authorities must be considered.<sup>143</sup> It is quite likely, for example, that the text of tax statutes relating to business activities would not constitute substantial authority where the transaction to which the statute is applied lacks a business purpose.<sup>144</sup> Nevertheless, the availability of the argument emboldens taxpayers to play the audit lottery.

### ***III. The Anti-Abuse Regulations***

#### ***A. The Advantage of Anti-Abuse Regulations***

The ascendancy of textualism and the proliferation of tax shelters have created an enormous problem for Treasury. Historically, Treasury had responded to abusive transactions in two ways, one involving rules and the other standards. If the Service identified a particular abusive transaction, it would adopt a rule, or request Congress to adopt a rule, that specifically targeted that transaction.<sup>145</sup> Treasury would also attack abusive transactions that it discovered on audit by litigation, asking the courts to apply their judicially created doctrines or standards to deny the sought-after tax benefits.

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<sup>142</sup> Treas. Reg. § 1.6662-4(d)(3)(ii) (as amended in 2003).

<sup>143</sup> The regulations state that there is “substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. . . .” Treas. Reg. 1.6662-4(d)(3)(i) (as amended in 2003).

<sup>144</sup> *See generally* Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001) (imposing § 6662 penalty and stating that the “participation of highly paid professionals provides petitioner no protection, excuse, justification or immunity . . .”).

<sup>145</sup> For example, in response to transactions that used partnerships to disguise sales and shift gains, Congress enacted I.R.C. §§ 707 (a)(2)(B), 704 (c)(1)(B), 737 (Thompson 2004).

Neither strategy proved sufficiently effective for the current wave of tax shelters. Treasury seemed reluctant to pursue litigation and to request the courts to apply the judicial doctrines. One explanation for this may be a fear that, with the advent of textualism, the courts will not apply or extend these doctrines to novel transactions, especially if the transactions involve the detailed partnership statutes.<sup>146</sup> Another explanation may be concerns about political fallout from vigorously pursuing tax shelter cases.<sup>147</sup>

Adopting rules designed to close down specific transactions also did not work very well because, in most cases, Treasury had no clue as to how these transactions were being structured. In contrast with the tax shelters of the 1970's and early 1980's that were syndicated, widely marketed and well known, many of the abusive transactions that Treasury was most concerned with were being individually tailored, and sold to, particular taxpayers. A promoter of these deals often required prospective clients to swear to secrecy (by signing a confidentiality agreement) before the deal was explained to prevent competitors and the government from getting wind of it.<sup>148</sup> Unless a Good Samaritan informed Treasury about a particular deal, the only way it would be discovered was on audit. However, audits were ineffective because only a small percentage of

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<sup>146</sup> See *supra* notes 112–121 and accompanying text.

<sup>147</sup> See Schler, *supra* note 5, at 346 (suggesting that the failure to collect data about the loss of revenues from tax shelters is politically motivated); David Cay Johnston, *A Tax Break for the Rich Who Can Keep A Secret*, N. Y. TIMES, Sept. 10, 2002, at C1 (Late Ed.) (reporting statement of Mark Weinberger, former Treasury official under President Bush, that the Treasury was not attacking a particular tax shelter that allowed taxpayers to avoid capital gains because “we are against taxes on capital gains in general . . .”).

<sup>148</sup> Tax shelter promoters no longer require that taxpayers sign confidentiality agreements because such agreements will trigger an obligation to register the shelter with the IRS. See I.R.C. § 6111(d) and (a) (Thompson 2004). However, the investors in tax shelters are usually highly sophisticated and unlikely to discuss the shelter in public.

returns are reviewed and the abusive transactions are buried in piles of paperwork.<sup>149</sup> Finally, if a particular transaction was identified and addressed by a new rule, the rule would only apply prospectively. This has been especially true for legislative responses.<sup>150</sup> In addition, once the new rule became effective, promoters could easily concoct new abusive transactions that literally complied with the rule.

Treasury determined that it needed a new strategy, one that reasserted the validity of the judicial doctrines as well as one that recognized that Treasury could not keep pace with the tax shelter industry. By promulgating the partnership anti-abuse regulations, Treasury chose to impose an overarching standard on the specific rules of Subchapter K. In doing so, it sought to put all parties on notice that the standards that had originated in the courts applied with full force to transactions involving partnerships. In addition, Treasury sought to require that the purposivist method of statutory interpretation be used to interpret Subchapter K.

Treasury's approach was both novel and aggressive. Treasury had never been this assertive before, especially in the absence of a specific legislative mandate. The tax bar was taken completely off guard. Its reaction was immediate and vociferous, denouncing the regulations as administrative overreaching.<sup>151</sup> A few former government officials called for their immediate withdrawal and several

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<sup>149</sup> See, e.g., Johnston, *supra* note 116, at C1 (stating that the "I.R.S. has stepped up efforts to find tax shelters, but the agency lacks the resources to address the problem fully . . ."); Novack & Saunders, *supra* note 3, at 202 (stating that the "IRS is not equipped to find most shelters").

<sup>150</sup> See, e.g., the legislative responses listed *supra* note 145.

<sup>151</sup> See, e.g., William S. McKee & Mark A. Kuller, *Issues Relating to Choice of Entity, "Entity Characterization and Partnership Anti-Abuse Rules,"* in TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES AND OTHER STRATEGIC ALLIANCES (PLI, June 2000); William S. McKee, William F. Nelson, Robert L. Whitmire, *Subchapter K Anti-Abuse Rule: Final Regulation,* in TAX PLANNING FOR CORPORATE JOINT VENTURES, PARTNERSHIPS AND OTHER STRATEGIC ALLIANCES 1995 (PLI, July 1995); James A. Gouwar, *The Proposed Anti-Abuse Regulation: Treasury Oversteps Its Authority*, 11 J. PARTNERSHIP TAX'N 287 (1995); Letter from the Tax Section of the Philadelphia Bar Association, (June 30, 1994), *reprinted in* 94 TNT 140-31; Letter from Charles Levin, Chair of the Federal Taxation Committee of the Chicago Bar Association, (June 30, 1994), *reprinted in* 94 TNT 139-61.

bar associations issued reports declaring the new rules invalid.<sup>152</sup> Even those few who lent support to the rules did so in a qualified manner.<sup>153</sup> The pressure became so great that Treasury issued a statement that the anti-abuse rules would not be asserted without the approval of the National Office.

When all the dust settled, the anti-abuse regulations have not been an effective tool against abusive tax shelters for at least two reasons. First, many members of the bar remain skeptical of their validity. Second, Treasury continues to require a field agent to receive approval from the National Office before asserting the regulations.<sup>154</sup> This policy may have the perverse effect of making it more difficult for an agent to assert judicial doctrine after the promulgation of the regulations than before.

We regret the reactions of both the bar and Treasury to the anti-abuse regulations. As we demonstrate below, Treasury acted well within its authority when it promulgated these regulations and, if taken seriously, they could provide several potential benefits. The regulations would require attorneys to analyze the judicial doctrines in opining on reverse-engineered transactions rather than relying solely on the statutory language.<sup>155</sup> This analysis would put potential investors on notice that the tax shelter's tax benefit is suspect. Furthermore, reassertion of the applicability of the doctrines would relieve some of the strain on the IRS, if tax advisors consider the doctrines in advising clients on tax shelters. The IRS would be able to reduce the number of, and complexity in, its regulations and notices, since it would not be

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<sup>152</sup> See, e.g., Letter from Donald C. Alexander, *et al* to the Assistant Secretary for Tax Policy, (Aug. 18, 1995), *reprinted in* 95 TNT 125-28; Letter from the Tax Section of the Philadelphia Bar Association, (June 30, 1994), *reprinted in* 94 TNT 140-31; Letter from Charles Levin, Chair of the Federal Taxation Committee of the Chicago Bar Ass'n, (June 30 1994), *reprinted in* 94 TNT 139-61.

<sup>153</sup> See, e.g., N.Y. State Bar Association Tax Section, *supra* note 10.

<sup>154</sup> Ann. 94-87, 1994-27 I.R.B. 124 (1994).

<sup>155</sup> To deal with lawyers who may not be so careful, we recommend in Part IV that the standards of practice be amended to require lawyers to analyze the applicability of the doctrines to the specific facts of the tax shelter in their opinion letters. We also recommend that if the lawyer's opinion relies on experts as to the profit potential of the tax shelter, the lawyer's opinion should explain the manner in which the expert formulated her conclusion about the shelter's profit potential and the assumptions upon which she relied.

necessary to address every potentially abusive situation in which a tax provision might be applied.<sup>156</sup>

We believe that Treasury should rescind its order that requires National Office approval before the regulations be asserted, and do so in a very public way. Treasury should state clearly that it believes the promulgation of these regulations was well within its administrative authority and grounded in sound tax policy. By doing so, the tax bar would have to take these regulations seriously. It is undoubtedly true that many members of the bar will continue to believe these regulations will ultimately be found invalid. Nevertheless they will also be on notice that Treasury is more than willing to litigate the issue. In sum, the regulations will once again have teeth and will be able to serve the prophylactic role for which they were designed.

### ***B. Brief Summary of the Anti-Abuse Regulations***

To understand the partnership anti-abuse regulations, it is helpful to observe that there are two particular aspects of Subchapter K that make it susceptible to abuse. First, Subchapter K contains a number of very specific rules that dictate tax consequences that do not adequately follow economic consequences. These rules provide taxpayers with opportunities to generate tax results that deviate from economic reality. One example of such a transaction would be the income stripping partnership where partnership income is allocated to a nontaxable partner in order to generate artificial losses that are then allocated to taxable partners.<sup>157</sup> A second characteristic of Subchapter K that makes it ripe for abuse is that it takes a schizophrenic view of partnerships; it treats partnerships as entities for certain purposes and as an aggregate of its members for other purposes. Transactions taking advantage of this aspect of Subchapter K focus on the interaction of Subchapter K with general provisions found outside of the partnership arena. In such interactions, the question often arises whether the partnership should be treated as an entity distinct from its partners or whether the partnership's activities should be treated as

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<sup>156</sup> See, e.g., Stanley Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L & CONTEMP. PROBS. 673, 707 n.31 (1969) (noting that the use of standards allow less lengthy rules to be adopted); David A. Weisbach, *Costs of Departures From Formalism: Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 861–62 (1999) (same).

<sup>157</sup> The *ACM* case, discussed *supra* in the text accompanying notes 123 to 124, is a good example of an income stripping transaction.

engaged in individually by each partner.<sup>158</sup> Since there is no principled basis to determine which treatment should apply, taxpayers select whichever is more favorable for that transaction.

In its final form, the regulations contain two separate rules: the “abuse of subchapter K rule,”<sup>159</sup> which targets perceived abuses of the rules contained in subchapter K, and the “abuse of entity rule,”<sup>160</sup> which deals with how Subchapter K interfaces with Code provisions outside of Subchapter K.<sup>161</sup>

The abuse of Subchapter K rule states that:

... if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner which is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes....<sup>162</sup>

The rule requires the Service to make two subjective determinations: (1) the taxpayer’s motivation to reduce tax liability and (2) the intent of Subchapter K. Since well-advised taxpayers generally try to plan their transactions to reduce their federal tax liability, the key will be to determine whether the structure of the transaction and the resulting tax consequences are consistent with the “intent of subchapter K.”

The regulation provides a working definition of “the intent of subchapter K.”

According to the regulation, Subchapter K is intended “to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement

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<sup>158</sup> See *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), where the Court of Appeals reversed the Tax Court’s holding that the activities of a partnership should be treated as though engaged in directly by its partners for purposes of applying the controlled foreign corporation rules of Subpart F.

<sup>159</sup> Treas. Reg. § 1.702-2(b) (as amended in 1995).

<sup>160</sup> Treas. Reg. § 1.702-2(e) (as amended in 1995).

<sup>161</sup> These terms were coined in MCKEE, NELSON & WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.05[1] (3d ed. 1997).

<sup>162</sup> Treas. Reg. § 1.701-2(b) (as amended in 1995). If the rule is triggered, the Commissioner can, among other things, disregard the partnership, adjust the accounting methods of both the partnership and the partners, and reallocate the partnership’s items of income and loss.

without incurring an entity level tax.”<sup>163</sup> This general statement of intent is not particularly controversial, nor is it particularly helpful in identifying abuse. Therefore, the regulation goes on to state that *implicit* in this intent are the following three requirements:

1. The partnership must be *bona fide* and each transaction, or series of transactions must be entered into for a *substantial* business purpose,
2. The form of the transaction must be respected under the substance over form principles, and
3. The tax consequences to each partner and the partnership must accurately reflect their economic agreement and clearly reflect the partner’s income. This third requirement is referred to as the “proper reflection of income” requirement.

Recognizing that not all statutory and regulatory provisions in Subchapter K have been adopted to properly measure income,<sup>164</sup> the regulation states that if the first two implicit requirements are met, the proper reflection of income requirement is also considered met *as long as* the manner in which the particular provision is applied to the transaction and the “ultimate” tax results are “clearly contemplated by the provision.”<sup>165</sup> Note that this provision of the regulation in effect requires that the purposivist method of statutory interpretation be used in analyzing Subchapter K.

Ultimately, whether a particular transaction runs afoul of the abuse of Subchapter K rule, is a question of facts and circumstances. The regulation lists several factors to consider, the most important of which is a comparison of the purported

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<sup>163</sup> Treas. Reg. § 1.701-2(b) (as amended in 1995).

<sup>164</sup> Other goals include simplicity, certainty and flexibility.

<sup>165</sup> Treas. Reg. § 1.701-2(a)(3) (as amended in 1995).

business purpose for the transaction and the claimed tax benefits resulting therefrom.<sup>166</sup>

In Treasury's view, apparently, even if one has a *bona fide* business purpose for planning a transaction in a certain way, if the claimed tax consequences are too favorable, the transaction may not be respected. To make this determination, one must compare the magnitude of the business purpose (measured in whatever units are appropriate) to the amount of the anticipated tax savings (presumably measured in dollars).

The abuse of entity rule is somewhat narrower than the abuse of Subchapter K rule. It states “[t]he Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code (“IRC”) and the regulations there under.”<sup>167</sup> This rule also imposes the purposivist method of interpretation and vests the Commissioner with discretion to determine when it is appropriate to treat a partnership as an aggregate of its partners instead of as an entity. The only explicit limitation on this discretion is that it does not apply if two conditions are met: First the Code or regulations specifically prescribes

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<sup>166</sup> Treas. Reg. § 1.701-2(c) (as amended in 1995). The seven other listed factors are:

1. The present value of the partners' aggregate federal tax liability is substantially less than it would have been if the partners had owned the partnership's assets directly.
2. The present value of the partners' aggregate federal tax liability is substantially less than it would have been if purportedly separate transactions are integrated into a single transaction.
3. One or more partners who are necessary to achieve the desired tax results are substantially protected from loss and have little or no participation in the profits of the partnership.
4. Substantially all partners are related to one another.
5. Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to special allocations to partners who are effectively in the zero bracket.
6. The benefits and burdens of ownership of partnership property nominally contributed to a partnership are substantially retained by the contributor.
7. The benefits and burdens of ownership of partnership property are substantially shifted to the distributee partner before or after the property is actually distributed.

<sup>167</sup> Treas. Reg. § 1.701-2(e)(1) (as amended in 1995).

entity treatment and, second, the ultimate tax results of that treatment “are clearly contemplated.”<sup>168</sup>

### C. *Validity of the Anti-Abuse Regulations*

Most of the literature that has discussed the partnership anti-abuse regulations has been very critical. Indeed, two former commissioners of the IRS, Donald C. Alexander<sup>169</sup> and Lawrence B. Gibbs,<sup>170</sup> asked the IRS to withdraw the regulations. Although the criticisms take various forms,<sup>171</sup> their underlying theme is the same: In the absence of a specific legislative mandate, Treasury does not have the authority to impose overarching standards on Subchapter K that have the effect of overriding specific statutory provisions.

These criticisms are well-illustrated by Example 8 of the regulations. In this example, A owns land with a fair market value of \$60 in which he has a basis of \$100. Rather than selling the land and realizing a \$40 loss, A entered into the following transaction, which, if respected, would have the effect of doubling the amount of the loss:

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<sup>168</sup> Treas. Reg. § 1.701-2(e)(2) (as amended in 1995).

<sup>169</sup> Letter, from Donald C. Alexander, *et al*, to the Assistant Secretary of Tax Policy (August 18, 1995), *reprinted in* 95 TNT 175-28. *See* Samuel C. Thompson Jr., *Ex-Government Official, Challenge Partnership Anti-Abuse Reg: An Analysis*, 69 TAX NOTES 1395 (1995) (summarizing letters).

<sup>170</sup> Letter from Lawrence B. Gibbs, *et al* to the Assistant Secretary of Tax Policy (August 23, 1995), *reprinted in* 95 TNT 175-27.

<sup>171</sup> These criticisms primarily take five forms. First, critics argue that the language of Subchapter K, the legal context of its adoption in 1954, and its subsequent development all indicate that the existence of a tax avoidance motive is irrelevant to the determination of “whether a partnership is *bona fide*, whether a transaction has sufficient business purpose, and whether the form of the transaction is respected for tax purposes.” *See, e.g.*, McKee & Kuller, *supra* note 151; McKee, Nelson, and Whitmire, *supra* note 151, at 7. Second, the critics assert that the proper reflection-of-income standard finds “no support in the statute, the legislative history, or the case law.” Gouwar, *supra* note 151, at 287; McKee & Kuller, *supra* note 151. Third, the critics state that to the extent that there is uncertainty in the statutory scheme of Subchapter K about the role of business purpose, economic substance and the proper reflection of income, the regulation is not a reasonable interpretation of Congressional intent. *Id.*; Letter from Donald C. Alexander, *et al*, to the Assistant Secretary for Tax Policy (August 18, 1995), *reprinted in* 95 TNT 125-28. Fourth, some have suggested that it is inappropriate for a regulatory agency, like the IRS, to adopt formally judicial standards. Letter from the Tax Section of the Philadelphia Bar Ass’n (June 30, 1994), *reprinted in* 94 TNT 140-31. Fifth, the critics argue that the regulations are invalid to the extent they purport to overrule the literal application of several specific provisions of Subchapter K. Letter from Charles Levin, Chair of the Federal Taxation Committee of the Chicago Bar Ass’n (June 30, 1994), *reprinted in* 94 TNT 139-61.

A and two family members form a partnership to which A contributes the land and the family members each contribute \$30 of cash. Under the partnership provisions, A's basis in his partnership interest and partnership's basis in the land are both \$100.<sup>172</sup> The partnership invests the total cash of \$60 in an investment asset, which is not a marketable security. The partnership leases the land to B, an unrelated party, and gives B an option to purchase the land at the end of year 3 for its then fair market value. In year 3, the partnership liquidates A's interest by distributing the investment asset (which still has a value of \$60) to A. Under Subchapter K, A takes a basis in the asset of \$100<sup>173</sup> to preserve his \$40 loss. At the end of year 3, the partnership sells the land to B for \$60, recognizing an additional \$40 loss, which is allocated equally between the two family members. Note that, in effect, the original \$40 built-in loss in the land has been duplicated.<sup>174</sup> The example concludes that the IRS may "recast" the transaction to deny the duplicate losses, in part, because "... any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for Federal tax purposes."<sup>175</sup>

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<sup>172</sup> I.R.C. §§ 722, 723 (Thompson 2004).

<sup>173</sup> I.R.C. § 732(b) (Thompson 2004).

<sup>174</sup> B and C will enjoy the duplicated loss until they sell or liquidate the partnership. The outside basis of B and C has been reduced to \$10 (\$30 original basis less the \$20 allocated loss), while the partnership holds \$60 cash. If B or C was to sell or liquidate her partnership interest, she would recognize \$20 of gain (\$30 cash received less \$10 basis).

It is important to note that the tax benefit claimed by B and C in the example is not dependent on the value of the contributed property (the land) remaining unchanged. The critical factor for duplicating the tax benefit is that the partnership avoid selling or distributing the land while A is a partner. If the partnership continues to hold the land after A's exit, the remaining partners will be entitled to a tax benefit of \$40 in the form of a deduction or exclusion regardless of what happens to the land's value. To illustrate, suppose both the land and the investment asset both go up in value to \$100 at the time of A's liquidation. Economically, the partnership's assets have appreciated \$80 in value since formation, \$40 of which is allocable to A and \$40 of which is allocable to the two family members. After A's interest is liquidated in exchange for the investment asset, the partnership continues to hold the land, its only asset, with a value and a basis of \$100. The partnership does not have any unrealized tax appreciation in its assets, even though the two family members have an aggregate economic gain of \$40.

<sup>175</sup> Treas. Reg. § 1.701-2(d), Ex. (8) (as amended in 1995).

In the absence of the anti-abuse rule, the Service could have attacked this transaction using one or more of the existing judicial doctrines (e.g., business purpose doctrine or economic substance).<sup>176</sup> Nevertheless, the critics of the rule insist that it is improper for the Treasury to impose these judicial doctrines (or variations thereof) by regulation and that the rule is an abuse of administrative power. In this part, we evaluate the critics' position. Although the critics have been strident (sometimes even shrill) in stating their positions, their arguments have not been made in the normal framework used to determine the validity of regulations. We identify the appropriate standard of review for assessing the validity of tax regulations by exploring two unsettled issues. The first is whether regulations issued under § 7805 are legislative regulations, entitled to significant deference, or interpretative regulations, entitled to less deference. Historically, both the tax bar and the courts have referred to § 7805 regulations as "interpretive." Nevertheless, we argue that if properly analyzed, these regulations are legislative in nature. The second issue is whether the same standard that has been developed for non-tax regulations should apply to § 7805 regulations, or whether a different standard developed exclusively for tax regulations should apply. The Supreme Court has created quite a bit of needless confusion concerning this second issue. Nevertheless, we believe that the resolution of this issue is not meaningful and the differences between the two standards are not substantive, but semantic. Finally, we analyze the anti-abuse rule under these standards and determine that they are valid.

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<sup>176</sup> For example, the IRS could argue that the partnership should be disregarded in this transaction because it served no business purpose. *See Merryman v. Commissioner*, 873 F.2d 879, 881–83 (5th Cir. 1989) (court disregarded partnership because it lacked economic substance).

## 1. *Standards of Review of Regulations – In General*

Judicial review of the validity of administrative regulations is complex since courts owe varying degrees of deference to the different types of administrative regulations. Courts generally classify regulations as “legislative” or “interpretive,” but, as discussed below, the classification of tax regulations issued under § 7805, such as the partnership anti-abuse regulation, is not certain.<sup>177</sup> In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,<sup>178</sup> the Supreme Court ruled that a significant degree of judicial deference is required in reviewing legislative regulations. As long as the regulation is a permissible construction of the statute, the regulation must be sustained. On the other hand, significantly less deference – so-called Skidmore deference – is granted to interpretive regulations.<sup>179</sup> In *Chevron*, the Court created a two-part test to describe its limited role in reviewing legislative regulations:<sup>180</sup>

When a court reviews an agency’s construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the

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<sup>177</sup> As discussed *infra* in the text accompanying notes 186 to 194, the definition of a “legislative” or “administrative” regulation depends upon the context.

<sup>178</sup> 467 U.S. 837, 842-44 (1984). The *Chevron* case involved a legislative regulation that the Environmental Protection Agency (“EPA”) had first promulgated in 1980 and that had adopted the prior rulings of two Courts of Appeals. In 1981, however, a new administration adopted a modified version of the regulation, which rejected the prior judicial pronouncements. In upholding the new regulations, the Court articulated a new two-part test, which is described *infra* at the text accompanying note 180.

<sup>179</sup> *Skidmore v. Swift*, 323 U.S. 134 (1944).

<sup>180</sup> 467 U.S. at 842.

agency's answer is based on a permissible construction of the statute.

In contrast, the Court described its much less deferential role in reviewing interpretive regulations in *Skidmore v. Swift* when it stated, “We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance.”<sup>181</sup>

A leading treatise on administrative law and law review article state that *Chevron* applies to regulations promulgated under § 7805, such as the partnership anti-abuse regulation.<sup>182</sup> Although we agree that *Chevron should* apply, its application remains in some doubt for two reasons. First, it is not clear whether § 7805 regulations are in fact legislative regulations. Indeed, Treasury and the courts routinely refer to these regulations as “interpretive.” Second, prior to the *Chevron* decision, a separate body of law had developed evaluating § 7805 regulations and it is not clear how this body of law relates to *Chevron*. Although there is a unanimous Supreme Court opinion directly on point,<sup>183</sup> which applies *Chevron* to a § 7805 regulation, a subsequent Supreme Court opinion ignored its existence<sup>184</sup> and the lower courts remain split.<sup>185</sup> These issues are discussed below.

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<sup>181</sup> 323 U.S. at 140. This position was recently reaffirmed in *United States v. Mead*. 533 U.S. 218, 221 (2001).

<sup>182</sup> RICHARD J. PIERCE, ADMINISTRATIVE LAW TREATISE § 3.05 (2002); Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731, 751 (Winter 2002).

<sup>183</sup> *Atlantic Mut. Ins. Co. v. Commissioner*, 523 U.S. 382, 387 (1996).

<sup>184</sup> *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 218–29 (2001).

<sup>185</sup> See *infra* notes 200–213 and accompanying text.

## ***2. Legislative and Interpretive Regulations***

### ***a. Non-Tax Cases***

Distinguishing between legislative and interpretive<sup>186</sup> regulations is one of the most fundamental and litigious issues in administrative law outside the tax area. Although conceptually these rules are quite different, it is often very difficult to distinguish between them in practice. A legislative regulation is one that is based on a congressional delegation to fill in the gaps of an incomplete statute. It creates new duties or obligations that are binding on all parties.<sup>187</sup> Because legislative regulations have the force of law, they are subject to the notice and comment procedure of the Administrative Procedure Act [“APA”]. Failure to follow these procedures will result in the rule being invalidated.

Interpretive regulations, on the other hand, do not create new law; they merely interpret existing law. These rules do not bind either the agency or other parties and are merely a statement of what the agency believes is the proper interpretation. If an issue involving the interpretive rule is litigated, a court will interpret the underlying statute, not the regulation, and is not bound by the agency’s interpretation. The courts, however, typically have given to interpretive rules so-called “Skidmore deference,” which was described above.

As a practical matter, distinguishing between legislative and interpretive regulations has been extremely problematic. “The prevailing approach is to treat a rule as legislative if either the purpose or the effect of the rule is legislative. Thus, a rule is

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<sup>186</sup> The APA speaks in terms of “interpretative.” 5 U.S.C.A. § 553 (2004); *see* *Clarry v. United States*, 85 F.3d 1041, 1048–49 (2d Cir. 1996).

<sup>187</sup> *See* *Christensen v. Harris County*, 529 U.S. 576, 587 (2000) (opinion letter not subject to *Chevron* deference because it lacked the “force of law,” *i.e.*, it was not binding on all parties).

legislative if the agency's purpose was to use its legislative rulemaking power. A rule is also legislative if it has a legislative effect—if it is a self-executing change in the law—regardless of the agency's intention.”<sup>188</sup> The difficulty in drawing this distinction is a function of at least two factors. First, a rule that simply interprets a statute is not necessarily an interpretive rule; legislative rules also interpret statutes. Second, the presence of a legislative delegation to provide for rules does not necessarily mean that an agency must use that delegation to interpret the underlying statute.<sup>189</sup> “Thus, the presence of a delegated power is a necessary, but not sufficient, condition to establish that a rule is legislative.”<sup>190</sup>

The delegated power need not be a specific legislative mandate. It is not unusual in other areas of administrative law to have provisions similar to § 7805(a) that confer general rule making authority to the relevant agency to implement the statute.<sup>191</sup> Although it was not always the case, it is now generally accepted that legislative rules may be promulgated under these general provisions.<sup>192</sup> The issue is whether the purpose or the effect of the rule in question is legislative.

In recent years the tendency of the courts in hard cases has been to classify a questionable rule as legislative. For example, consider the following:

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<sup>188</sup> Michael Asimow, *Public Participation in the Adoption of Temporary Tax Regulations*, 44 TAX LAW 343, 353–54 (1991).

<sup>189</sup> An example of this in the tax area are the regulations issued under I.R.C. § 469 (Thompson 2004). Section 469(l) specifically delegates to the Secretary of Treasury the power to promulgate regulations to implement § 469. Nevertheless, when the Treasury issued regulations under this provision, it insisted that they were interpretive. These issues and these regulations are discussed extensively in Asimow, *supra* note 188, at 350–61.

<sup>190</sup> *Id.*

<sup>191</sup> See Thomas W. Merrill & Kathryn Tongue Watts, *Agency Rules With The Force of Law: The Original Convention*, 116 HARV. L. REV. 467, 575 (2002).

<sup>192</sup> See, e.g., *United States v. Mead Corp.*, 533 U.S. 218, 231–32 (2001) (observing that general rule making authority can result in legislative regulations); Merrill & Watts, *supra* note 191, at 575.

Accordingly, insofar as our cases can be reconciled at all, we think it almost exclusively on the basis of whether the purported interpretive rule has ‘legal effect,’ which in turn is best ascertained by asking (1) whether in the absence of the rule there would not be an adequate legislative basis for . . . enforcement . . .; (2) whether the agency has published the rule in the Code of Federal Regulations, (3) whether the agency has explicitly invoked its general legislative authority, or (4) whether the rule effectively amends a prior legislative rule. If the answer to any of these questions is affirmative, we have a legislative, not an interpretive rule.<sup>193</sup>

Of these four factors, the Supreme Court emphasized the importance of notice and an opportunity for public comment in determining whether a regulation is legislative in nature and entitled to *Chevron* deference.<sup>194</sup>

***b. Tax Cases***

Under the general standard developed above, § 7805 regulations would be classified as legislative: At a minimum they are promulgated under a legislative mandate, issued for notice and comment, and published in the Code of Federal Regulations. Moreover, the grant of authority in § 7805 is very similar to authority granted to other agencies whose regulations receive *Chevron* deference.<sup>195</sup> The tax law, however, to date has not used the traditional distinction between legislative and interpretive rules. Treasury has always characterized the regulations that it promulgates under the general authority of § 7805(a) as “interpretive” regulations; only those regulations promulgated pursuant to a specific legislative mandate are classified as “legislative.” This distinction is widely accepted by both the tax bar and the courts.

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<sup>193</sup> *Truckers United for Safety v. FHA*, 139 F.3d 934, 938 (D.C. Cir. 1998).

<sup>194</sup> *Christensen*, 529 U.S. at 587; *see Reno v. Koray*, 515 U.S. 50, 61 (1995) (agency guideline not entitled to *Chevron* deference because it was not “subject to the rigors of the Administrative Procedures Act, including public notice and comment”).

<sup>195</sup> *Merrill & Watts*, *supra* note 191, at 575.

Even though Treasury refers to § 7805 regulations as “interpretive,” the courts have not applied the low-level deference of *Skidmore*. In contrast to non-tax interpretive regulations, tax regulations have always commanded significant deference from the courts. In 1979, five years before *Chevron* was decided, the Supreme Court held in *National Muffler Dealers Ass’n v. United States*,<sup>196</sup> that courts should defer to a regulation issued under § 7805 if it “implements the Congressional mandate in some reasonable manner.”<sup>197</sup> The Court said this determination is made by asking “whether the regulation harmonizes with the plain language of the statute, its origin and purpose.”<sup>198</sup> To make clear that *National Muffler* requires a great deal of deference for § 7805 regulations, the Court emphasized that the “choice among reasonable interpretations is for the Commissioner, not the courts.”<sup>199</sup>

The Supreme Court has never clarified how *National Muffler* should be applied after *Chevron*, although it has had several opportunities.<sup>200</sup> When it analyzes regulations issued under § 7805, it often cites *National Muffler* without mentioning *Chevron*, leaving some with the impression that *Chevron* does not apply to these tax regulations.<sup>201</sup> Finally, in 1999, the Supreme Court in a unanimous opinion, *Atlantic Mutual Insurance Co. v. Commissioner*, applied *Chevron* to a § 7805 regulation.<sup>202</sup> However, it did so without even mentioning *National Muffler* or acknowledging the confused state of the

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<sup>196</sup> 440 U.S. 472, 476 (1979).

<sup>197</sup> *Id.* (quoting *United States v. Cartwright*, 411 U.S. 546, 550 (1973)).

<sup>198</sup> Relevant considerations include “the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner’s interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent enactments of the statute.” *Id.* at 477.

<sup>199</sup> *Id.* at 488.

<sup>200</sup> See Ellen Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 75 (1996); John F. Coverdale, *Court Review of Tax Regulations and Revenue Rulings in the Chevron Era*, 64 GEO. WASH. L. REV. 35, 57–63 (1995).

<sup>201</sup> See, e.g., *Commissioner v. Estate of Hubert*, 520 U.S. 93, 120 (1996); *Cottage Sav. Ass’n v. Commissioner*, 499 U.S. 554, 560–61 (1991); *Commissioner v. Engle*, 464 U.S. 206, 224–25 (1984).

<sup>202</sup> 523 U.S. 382, 387 (1999).

law.<sup>203</sup> The resolution of this issue became even murkier when, in 2001, the Supreme Court had another § 7805 regulation before it. This time, however, it applied *National Muffler* without mentioning *Chevron*.<sup>204</sup> Subsequently, in 2003, the Supreme Court appeared to apply the *Chevron* standard to a § 7805 regulation, but without citing either *Chevron* or *National Muffler*.<sup>205</sup> The result has been confusion as the various courts of appeal and Tax Court have sought to address the impact of developments in administrative law to the tax law.<sup>206</sup> The Sixth Circuit has held that *Chevron* applies to § 7805 regulations<sup>207</sup> and that *Chevron* requires greater deference than *National Muffler*.<sup>208</sup> In contrast, the Seventh Circuit<sup>209</sup> and the Tax Court<sup>210</sup> have explicitly stated that there is no substantive difference between the *Chevron* and *National Muffler* standard. The Ninth Circuit has declined to rule on the issue, but has continued to apply *National Muffler*.<sup>211</sup> The Fifth Circuit has determined that *Chevron* does not apply to regulations issued under § 7805.<sup>212</sup>

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<sup>203</sup> It is possible that the Court believed that the regulation at issue was based upon a specific legislative mandate and not under § 7805.

<sup>204</sup> *Cleveland Indians Baseball Co.*, 532 U.S. at 218–19. Adding to the confusion, in the same year, the Court approvingly cited *Atlantic Mutual* in *United States v. Mead Corp.*, 533 U.S. at 231 n.12, as an example of the proper application of *Chevron*.

<sup>205</sup> *Boeing Co. v. United States*, 537 U.S. 437, 451 (2003). The Sixth Circuit has interpreted Boeing as applying the *Chevron* standard. *Hosp. Corp. of Am. v. Commissioner*, 348 F.3d 136, 140–41 (6th Cir. 2003).

<sup>206</sup> For a succinct summary of this confusion, see *Gen. Elec. Co. v. Commissioner*, 245 F.3d 149, 154 n.8 (2d Cir. 2001); Aprill, *supra* note 200, at 75–77.

<sup>207</sup> *Hosp. Corp. of Am.* 348 F.3d at 140–41.

<sup>208</sup> *Peoples Fed. Sav. & Loan Ass’n v. Commissioner*, 948 F.2d 289 (6th Cir. 1991). The Sixth Circuit, however, applies *Chevron* to § 7805 regulations. *Nichols v. United States*, 260 F.3d 237 (6th Cir. 2001).

<sup>209</sup> *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 981–82 (7th Cir. 1999).

<sup>210</sup> *Cent. Pa. Sav. Ass’n v. Commissioner*, 104 T.C. 384 (1995).

<sup>211</sup> *Pac. First Fed. Sav. Bank v. Commissioner*, 961 F.2d 800, 803 (9th Cir. 1992) (stating “We need not decide whether *Chevron* applies to the regulations in this case, however, because the traditional rule of deference . . . supports our decision to uphold the challenged regulations.”).

<sup>212</sup> *Nalle v. Commissioner*, 997 F.2d 1134, 1138 (5th Cir. 1993).

We agree with those who have concluded that there is no significant difference between the standards set forth in *Chevron* and *National Muffler*.<sup>213</sup> *Chevron*'s two-stepped analysis is really a detailed restatement of *National Muffler*'s analytic approach.<sup>214</sup> The Court in *Chevron* held that the first step is to ask whether Congress has specifically addressed the subject of the regulation. It explained that, in that situation, neither the courts nor an administrative agency should alter the expressed intent of Congress since Congress is the repository of all legislative authority within Constitutional constraints. Even though a court or the agency might strongly disagree with the policy choice expressed in the statute, they must interpret and apply the law as written. As a practical matter, however, a statute never addresses all the possible policy issues that might arise.<sup>215</sup> *Chevron*'s holding interprets a statute's silence as an implied delegation by Congress to an agency to address issues not addressed in the statute.<sup>216</sup> In the absence of any administrative action, a court may be called upon to resolve a policy issue in a case that is brought before it. If, however, the administrative agency resolves a policy issue through a legislative rule, the courts must defer to the agency judgment because administrative agencies are more politically accountable than courts:<sup>217</sup>

[The Judiciary is] not part of either political branch of government. In contrast, an agency to which Congress has delegated policymaking responsibility may, within the limits of that delegation, properly rely upon the incumbent

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<sup>213</sup> See, e.g., David Brennan, *Treasury Regulations and Judicial Deference in the Post-Chevron Era*, 13 GA. ST. U. L. REV. 387, 389 (1997).

<sup>214</sup> If *National Muffler* has independent significance after *Chevron*, it is that it identifies various historical considerations that are relevant in determining whether a regulation implements a congressional mandate in a proper manner.

<sup>215</sup> Some of the reasons for this include lack of time, foresight, or the process of collective decision making. PIERCE, *supra* note 182, § 3.3.

<sup>216</sup> Thomas W. Merrill & Kristen Hickman, *Chevron's Domain*, 89 GEO. L. J. 833, 870–71 (2001).

<sup>217</sup> See Nicholas Quinn Rosenkranz, *Federal Rules of Statutory Interpretation*, 115 HARV. L. REV. 2086, 2130 (2002); Cass Sunstein, *Law and Administration after Chevron*, 90 COLUM. L. REV. 2071, 2075 (1990).

administration's views of wise policy to inform its judgments. While agencies are not directly accountable to the people, the Chief Executive is, and it is entirely appropriate for this political branch of Government to make such policy choices."<sup>218</sup>

*Chevron's* step one has little application to tax regulations promulgated under § 7805(a), if the regulation does not conflict with the statute's language. Section 7805(a) mandates that the Treasury prescribe "all needful rules... for the enforcement" of the Code. "[N]eedful" is obviously not self-defining, and we know of no case where a court has struck down a regulation on the basis of being "unneedful." For this reason, it is not surprising that the Supreme Court in *National Muffler* did not provide the detail contained in step one of the *Chevron* test. Nevertheless, by asking "whether the regulation harmonizes with the plain language of the statute, its origin and purpose," the *National Muffler* standard requires a determination of whether the statute speaks to the subject matter of the regulation.

*Chevron's* step two asks whether the rule adopted by the administrative agency is a "permissible construction" of the statute.<sup>219</sup> The court in *Chevron* elaborated that a "permissible" interpretation is one that is "reasonable."<sup>220</sup> To be reasonable, the regulation need not be "the reading the Court would have reached if the question initially had arisen in a judicial proceeding."<sup>221</sup> The nature of the test for "reasonableness" is not clear.<sup>222</sup> The Supreme Court has only used *Chevron's* step two to strike down regulations

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<sup>218</sup> *Chevron*, 467 U.S. at 865–66.

<sup>219</sup> *Id.* at 842.

<sup>220</sup> *Id.* at 845.

<sup>221</sup> *Id.* at 843 n.11.

<sup>222</sup> *See, e.g.*, Michael Abramowicz, *Regulatory Law: Toward A Jurisprudence of Cost-Benefit Analysis*, 100 MICH. L. REV. 1708, 1730–31 (2002).

in two cases.<sup>223</sup> Both cases suggest that a regulation is unreasonable where the regulation extends beyond the scope of Congress’ implied delegation of authority.<sup>224</sup> Some commentators and lower courts have also suggested that reasonableness occurs when a regulation is not arbitrary and capricious.<sup>225</sup> In a recent dissent, Justice Breyer has suggested that the standard requires a showing of a “rational connection” between the regulation and the statute’s purpose.<sup>226</sup>

Using language almost identical to that of *Chevron*, the Court in *National Muffler* made clear that the regulation must interpret the statute in “some reasonable manner” and that the interpretation need not be one that the court would have reached.<sup>227</sup> Even in those cases where a particular regulation has been in potential conflict with the literal language of the statute, the Court has granted Treasury’s interpretation a great deal of deference under *National Muffler*.<sup>228</sup> Since 1980, the Court had found tax regulations to be unreasonable in only two cases.<sup>229</sup> In both, the Court determined that regulations

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<sup>223</sup> *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 391-92 (1999); *Whitman v. American Trucking Ass’n*, 431 U.S. 457, 484–85 (2001).

<sup>224</sup> In *AT&T*, the Court held that an FCC regulation was not reasonable because the FCC had misunderstood the scope of authority delegated to it. *See* 525 U.S. at 391-92. In *Whitman v. American Trucking Ass’n*, the Court struck down a regulation as unreasonable because, although it addressed ambiguities in the statute, it also contradicted a part of the statute that was quite clear. 431 U.S. at 484–85.

<sup>225</sup> *See, e.g.*, *PIERCE*, *supra* note 182, § 3.6; *Animal League Def. Fund v. Glickman*, 204 F.3d 229, 234 (D.C. Cir. 2000). Richard Pierce states that a regulation is arbitrary and capricious:

if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important part of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

*PIERCE*, *supra* note 182, § 3.6.

<sup>226</sup> *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 540–42 (2002) (Breyer, J., dissenting).

<sup>227</sup> *Nat’l Muffler*, 440 U.S. at 488.

<sup>228</sup> *See, e.g.*, *United States v. Correll*, 389 U.S. 299, 302–04 (1967) (“overnight rule” found to be a reasonable interpretation of “away from home”).

<sup>229</sup> *See Commissioner v. Engle*, 464 U.S. 206, 224–26 (1984); *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981).

clearly contradicted Congressional purpose.<sup>230</sup> Such a finding is consistent with a determination that the regulation was outside of the agency’s delegated authority, the same determination that the Court has made in invalidating regulations under step two of *Chevron*.

### ***3. Application of Chevron and National Muffler to the Anti-Abuse Regulations***

The critics argue that Treasury does not have the authority to impose overarching standards on Subchapter K that override specific statutory provisions. Indeed, the anti-abuse regulations are not typical. Although the IRS has incorporated common law anti-abuse doctrines in other regulations, including corporate tax regulations,<sup>231</sup> the partnership anti-abuse regulations expand the judicial doctrines and impose a purposivist method of statutory interpretation. With apparently no statutory authority, the abuse of Subchapter K rule not only requires that there be a business purpose, but also that it be “substantial.”<sup>232</sup> In addition, it requires a “proper” reflection of income in a transaction. Income is properly reflected when application of the statute to the transaction and the “ultimate” tax result is “clearly contemplated by the provision.”<sup>233</sup> Also, the abuse of

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<sup>230</sup> In *Engle*, the Court struck down the Service’s application of a proposed regulation that denied a depletion allowance for advance royalty payments. 464 U.S. at 224–26. The Court reasoned that such application “unreasonably denies . . . [the taxpayer] a subsidy Congress expressly contemplated it should receive.” *Id.* at 226. In *Rowan*, the Court invalidated regulations that treated employer-provided housing as wages subject to withholding for FICA and FUTA where the “plain language and legislative histories of the relevant Acts indicate that Congress intended” otherwise. *See* 452 U.S. at 263.

<sup>231</sup> *See, e.g.*, Treas. Reg. §§ 1.301-1(l)(as amended in 2003), 1.351-1(b)(1)(as amended in 1996), 1.355-2(b)(as amended in 1989), 1.368-1(b)(as amended in 2001), 1.368-2(a)(as amended in 2003) and 1.446-3(i)(as amended in 1994); *see also* Pamela Olson, *Some Thoughts on Anti-Abuse Rules*, 48 TAX LAW. 817, 820 (1995) (listing additional regulations).

<sup>232</sup> Whether or not a business purpose is substantial is determined by comparing the magnitude of the business purpose to the tax benefits of the transaction. Treas. Reg. §1.701-2(d) Ex. (2) (as amended in 1995).

<sup>233</sup> Treas. Reg. §1.701-2(a)(3) (as amended in 1995).

entity regulation allows the Service to disregard a partnership if “appropriate to carry out the purpose of any provision of the Internal Revenue Code . . . .”<sup>234</sup>

Although the critics do not refer to *Chevron* or *National Muffler*, as discussed above, it is necessary that an analysis of the regulation’s validity consider these cases. Thus, the analysis has to determine whether the statute addresses the subject matter of the regulation and whether the regulation is a reasonable interpretation of the statute. The outcome of these determinations may depend on the method of statutory interpretation employed. As noted earlier, intentionalists, purposivists and those who subscribe to dynamic interpretation are willing to look at legislative history to interpret a statute. Textualists are not, except to determine the background context of the legislation where such background may be independently verified.<sup>235</sup> In *Chevron*, itself, the Court said that all the traditional tools of statutory interpretation should be used<sup>236</sup> and proceeded to examine the statute’s legislative history. The ascendancy of textualism, however, currently creates doubt about the role of legislative history.<sup>237</sup>

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<sup>234</sup> Treas. Reg. 1.701-2(e)(1) (as amended in 1995).

<sup>235</sup> See *supra* note 28 and accompanying text.

<sup>236</sup> *Chevron*, U.S.A., Inc. v. Nat’l Res. Def. Council, Inc., 467 U.S. 837, 843 n.9 (1984).

<sup>237</sup> Not surprisingly, courts have employed different interpretive methods in determining whether tax regulations are valid. For example, the Sixth Circuit has examined both the language and legislative history of a Code provision to determine whether it addresses the subject of regulations. *Peoples Fed. Sav. & Loan v. United States*, 948 F.2d 289, 294–300 (6th Cir. 1991). In contrast, the Seventh Circuit does not examine legislative history in determining whether the statute speaks to regulations in *Chevron* step one. *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 983 (7th Cir. 1998). Instead, it will only examine legislative history in step two after it determines that the statutory provision is silent or ambiguous. *Id.* Similarly the Tax Court in recent decisions has used the textualist method, looking to the ordinary usage and settled meaning of the words, to interpret code provisions. *Tutor-Saliba v. Commissioner*, 115 T.C. 1, 8 (2000). If the Tax Court finds the provision to be ambiguous or silent about the subject of the regulation, it then examines the provision’s legislative history to determine whether the regulation is consistent with the provision’s origin and purpose. *Id.* at 9. For an insightful analysis of the different approaches of the courts, see *Aprill*, *supra* note 200, at 81–87.

Textualists agree that authorities existing at the time of enactment (such as case law and possibly treatises) are an important interpretive aid.<sup>238</sup> The case law that existed at the time Subchapter K was enacted clearly shows that Congress left some gaping holes in the statute. At the time of the statute's adoption, the business purpose, substance-over-form and step transaction doctrines were already well-developed and part of the tax landscape. *Gregory v. Helvering*, the seminal case, which established that the business purpose and substance-over-form doctrine could override express corporate tax provision, had been on the books for 20 years. Similarly, the step transaction doctrines had existed for 11 years.<sup>239</sup> Although these doctrines had emerged in the context of corporate reorganizations, their application was far broader. Several courts had applied the doctrines to transactions involving partnerships prior to the adoption of Subchapter K with the result that they would often disregard the partnership as an entity separate from its partners.<sup>240</sup> None of the tax statutes existing at that time expressly authorized these doctrines, but the courts applied them to override express statutory provisions by employing the purposivist method of statutory interpretation. Commentators were well aware of these developments. Randolph Paul, a well-known tax lawyer and author during that period, was clearly troubled when he stated in 1954:

... [The courts'] fear of usurping the legislative function diminished as judicial legislation became more and more recognized as one of the facts

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<sup>238</sup> See *supra* note 28 and accompanying text.

<sup>239</sup> The Supreme Court applied the step transaction doctrine to corporate tax in *Commissioner v. Court Holding Co.* 324 U.S. 331 (1945).

<sup>240</sup> See, e.g., *Commissioner v. Tower*, 327 U.S. 280, 286–88 (1946) (partnership disregarded where taxpayers did not intend to carry on a business as partners); *Kocin v. United States*, 187 F.2d 707, 708 (2d Cir. 1951) (per curiam) (partnership disregarded because it lacked business purpose); *Shaffer Terminals v. Commissioner*, 16 T.C. 356, 363–64 (1951) (partnership formed by corporation's shareholders to lease equipment to corporation was not treated as tax owner of the equipment under the substance-over-form doctrine).

of legal life, and not something for which apology must be made at bar association conventions.<sup>241</sup>

The existence of these doctrines and the use of the purposivist method of statutory interpretation at the time of Subchapter K's adoption are key because they squarely confronted Congress with the issue whether, as a policy matter, the doctrines should apply when interpreting the partnership tax provisions. Congress had the authority to direct the courts to use a specific method of statutory interpretation in analyzing a statute<sup>242</sup> and to codify judicial doctrines, but it didn't.<sup>243</sup> Congress also clearly contemplated that it might become necessary for the IRS to delineate the circumstances in which a partnership should be disregarded, but Congress did not address that concern in the statutes. The 1954 Conference Committee Report, which accompanied the enactment of Subchapter K, stated:

No inference is intended . . . that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.<sup>244</sup>

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<sup>241</sup> RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 660 (1954).

<sup>242</sup> Nicholas Quinn Rosenkranz, *Federal Rules of Statutory Interpretation*, 115 HARV. L. REV. 2086, 2103–10 (2002) (arguing that definitional and statute specific methods of interpretation may be constitutionally mandated by Congress).

<sup>243</sup> Indeed, Congress did make the call in another part of the same legislation in which it adopted Subchapter K. In § 671, Congress specifically reversed the Supreme Court's application of the substance-over-form doctrine in *Helvering v. Clifford*, 309 U.S. 331, 335–36 (1940), where the Court had treated a taxpayer who controlled a trust as the owner of the trust assets. S. Rep. No. 1622, 83d Cong. 2d Sess. 86–87, 364–72 (1954); H.R. Rep. No. 2543, 83d Cong. 2d Sess. 65–57 (1954). Section 671 rejected the Court's holding in *Clifford*, stating in part:

No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust . . . .

<sup>244</sup> H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). Textualists will look to legislative history to determine the background context of the legislation where such background may be independently verified. *See supra* note 28 and accompanying text. The case law that disregarded the partnership as a separate entity independently verifies that Congress was aware that an issue existed about when it was appropriate to disregard the partnership.

By remaining silent, Congress impliedly delegated the authority to Treasury to make these calls.<sup>245</sup>

Having established that the statute does not address the subject matter of the regulations, step two asks whether the regulations interpret the statute in a reasonable manner. Is the expansion of the business purpose doctrine reasonable? Is the designation of purposivism as the method to interpret Subchapter K and to determine when a partnership should be disregarded reasonable? We believe the answer to all these questions is yes. The implied delegation from Congress necessarily included the ability to modify and adapt judicial doctrines existing in 1954 to changed circumstances. In 1954, the courts, themselves, were refining the judicial doctrines of business purpose and substance-over-form. This evolution has continued in the past decade as some courts have started to compare the profit potential in a transaction to the tax benefits to ascertain whether a tax shelter has economic substance.<sup>246</sup> Moreover, as discussed earlier, courts traditionally used the purposivist method of interpretation and frequently employed it to disregard partnerships.<sup>247</sup> Although one might disagree with the correctness of these judicial actions,<sup>248</sup> the courts' actions strongly support the conclusion that the regulations' designation of these tools is a reasonable choice among several options.<sup>249</sup>

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<sup>245</sup> Purposivists and intentionalists would also look to the legislative history and observe that Congress was thinking about corporations, as well as partnerships when it adopted Subchapter K. The committee reports make clear that Subchapter K was intended to be a flexible, simple set of provisions designed for business enterprises, especially those run by small entrepreneurs and farmers. H. Rep. No. 1337, 83d Cong. 2d Sess. 4091 (1954); Sen. Rep. No. 8300, 83d Cong. 2d Sess. 4721-4722 (1954). There is nothing in the reports to suggest that partnerships should be exempt from well-established judicial doctrines. This legislative history is very similar to that relied upon by the Court of Appeals in *Gregory v. Helvering* in formulating the business purpose and substance-over-form doctrines. See *supra* notes 48-55 and accompanying text.

<sup>246</sup> See *supra* notes 99 to 104 and accompanying text.

<sup>247</sup> See *supra* note 240 and accompanying text.

<sup>248</sup> It is important to recognize that the validity of the regulations is not dependent on one's views as to whether cases such as *Gregory v. Helvering* were properly decided. See 293 U.S. 465, 469 (1935).

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*Gregory v. Helvering* was an aggressive judicial opinion. Neither the statute nor the legislative history directly imposed a ‘business purpose requirement.’ Nevertheless, the Court used the legislative history to create one, and the debate continues today as to whether the Supreme Court properly decided this case. See generally David Harriton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law 235 (1999). Of course, if one agrees with the decision in *Gregory v. Helvering*, then *a fortiori*, one must sustain the regulations. Treasury has at least as much authority (possibly more) to interpret (construct) statutes as the courts. If the courts have the authority to craft a business purpose doctrine, so does Treasury. On the other hand, even if one disagrees with the decision in *Gregory v. Helvering* and believes that the Court exceeded its authority, one should still sustain these regulations. Even if wrongly decided, by 1954 these doctrines had been well-developed by the Courts and had become part of the context that existed when Congress enacted Subchapter K.

<sup>249</sup> The regulation’s directive to use the purposivist method of interpretation does not violate separation of powers. Any agency’s interpretation of a statute inevitably involves determining which method of interpretation will be weighed most heavily. Since Congress has the authority to dictate the method of interpretation to be used to interpret a statute, see Rosenkranz, *supra* note 242, Congress can delegate that authority. Such delegation occurs every time Congress asks an agency to interpret statutes. Bernard W. Bell, *Using Statutory Interpretation to Improve the Legislative Process: Can It Be Done in the Post-Chevron Era*, 13 J.L. & POL. 105, 141 (1997).

#### *IV. The Wisdom of the Anti-abuse Regulations*

In the previous section, we argued that the Treasury had the delegated power to promulgate the anti-abuse regulations. In this section we examine whether the decision to exercise that power was wise. On balance, we support Treasury's decision to promulgate these regulations and believe that this technique might be used in other areas of the tax law. We do, however, believe that the partnership anti-abuse regulations could be more effective and offer two recommendations towards that end.

As discussed earlier, with the ascendancy of textualism, doubt arose as to whether (and how) the judicial doctrines would be applied to the partnership provisions. The doubt resulted in a flurry of tax shelters, which in turn led Treasury to adopt the anti-abuse regulations. Anti-abuse regulations that reassert and expand the judicially created standards can be an effective way to counter textualism's threat to the applicability of judicial doctrines to detailed statutory schemes. Treasury's adoption of the anti-abuse regulations reflects its determination that reasserting and expanding the judicial standards was preferable to issuing a never-ending-stream of rules that address specific abuses.

Rules and standards are generally viewed as alternative approaches. The principal difference between the two is that the substantive content of the law is known before an individual acts in the case of rules, while the content of the law becomes known only after the individual acts in the case of standards.<sup>250</sup> Depending on the circumstances, one approach may be preferable to, and more efficient than, the other. The initial cost of employing rules is generally higher than that of standards, because the rule-maker must

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<sup>250</sup> See, e.g., Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559–60 (1992).

identify those transactions that fall within a rule and those that do not. Once a rule has been created, however, it offers citizens more certainty and is generally less costly to interpret and to apply than a standard. Standards, on the other hand, are relatively inexpensive to implement, but much more costly to interpret and apply. If a law addresses everyday behavior or a common transaction, a rule is generally preferable to a standard. For example, when setting a speed limit for a particular highway, one might adopt a rule (e.g., 55 miles per hour) or a standard (“not too fast for conditions”). Given the number of people who drive on the highway, and the range of weather conditions, it may be better to adopt the rule. Under this regime, drivers, police and judges all know with certainty what the law is and it can be applied easily. In contrast, the standard would be costly to interpret and adjudicate because there may be a whole range of views as to what “too fast for conditions” means. If, however, the behavior or the transaction that is being regulated might arise in a variety of different factual circumstances, it would be difficult and expensive to create rules for each of those circumstances and a standard might be preferable. The law of negligence is a good example: It is hard to imagine drafting a specific set of rules for every possible circumstance in which a person might be negligent. At any rate it certainly would be wasteful to spend all of that energy thinking about possible negligent acts, no one of which is ever likely to occur. Although one might want to develop rules for specific types of transactions that occur often (e.g., product liability), for those that are “uncommon” imposing a standard such as “the duty of reasonable care” would be more efficient.

Anti-abuse standards are sometimes adopted as a back-stop for a set of simple rules. What is unusual about the partnership anti-abuse regulations is that they impose a

standard on top of a set of extremely complex rules. Although this is generally thought to be a poor idea because it increases complexity,<sup>251</sup> this approach is justified in the context of tax shelter transactions. The Internal Revenue Code (including Subchapter K) has been, and undoubtedly will continue to be, primarily a rule-based statute. It is important that the “millions of taxpayers who engage in billions of transactions”<sup>252</sup> be able to file annual tax returns with some degree of certainty without incurring huge compliance costs. Nevertheless, there are situations in which standards can be usefully and efficiently employed to augment rules. Many rules under the income tax create bright lines; tax consequences depend entirely on which side of the line the transaction falls. Although the rule may not track economic reality, the benefit derived from certainty is considered sufficiently important as long as the rule is applied to a real business transaction.<sup>253</sup> Such rules, however, offer tax planners the opportunity to design transactions for which there is no purpose whatsoever except to take advantage of the tax benefits.<sup>254</sup> Historically, the rule-maker did not worry about these tax-driven transactions because such transactions would not have passed muster under one or more of the existing judicial doctrines that imposed the standards of business purpose and economic substance.<sup>255</sup> These judicial standards historically had applied in a variety of different circumstances and allowed the rule-based system to be less complex than it would

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<sup>251</sup> For example, Professor Weisbach, using the partnership anti-abuse regulations as an example, states that “it is not appropriate to add an anti-abuse rule on top of complex rules.” David A. Weisbach, *Cost Departures from Formalism: Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 882 (1999).

<sup>252</sup> Kaplow, *supra* note 250, at 573.

<sup>253</sup> See Weisbach, *supra* note 251, at 876–77.

<sup>254</sup> *Id.* at 874–75.

<sup>255</sup> Of course, if the tax consequences of such a transaction are respected, the transaction will become common.

otherwise have to be.<sup>256</sup> Reassertion of the judicial standards, therefore, is merely restoring the safety net necessary to insure that rules operate effectively.

To evaluate further the wisdom of Treasury's decision to reassert and expand the judicial standards, we consider four criteria proposed by Professor Weisbach for determining when an anti-abuse standard is preferable to rules.<sup>257</sup> First, the problems addressed by the standard should be serious.<sup>258</sup> Second, the anti-abuse standard should permit the underlying rules to be simplified. Third, the uncertainty created by the standard should not be so great as to outweigh its expected benefits. And finally, the anti-abuse standard should be effective.

The first factor is the strongest one in favor of the partnership anti-abuse regulations: the problems created by the (not-so) simple rules of Subchapter K were very serious and had to be addressed. As discussed in detail above, Subchapter K was the vehicle of choice for abusive transactions that Treasury was unable to address by adopting more rules. These transactions were extremely harmful to the system in a variety of ways. Not only were they draining revenue, but also they had the effect of undermining the general population's faith in the system. Repeated reports of the shelters in the media created an environment where taxpayers began to view the income tax as optional.

The second factor, whether the standard simplifies the rules of Subchapter K, is achieved in at least two ways. First, the anti-abuse regulations lessen the need of the Service to react to every abusive tax shelter it uncovers with yet another administrative

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<sup>256</sup> Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L. & CONTEMP. PROBS. 673, 707 n.31 (1969)

<sup>257</sup> See Weisbach, *supra* note 251, at 882.

<sup>258</sup> Professor Weisbach uses as examples of simple rules that do not create serious problems the depreciation classes for assets and the rules to determine if someone is married. *Id.* at 883.

rule or legislative proposal to shut it down. Furthermore, over time, it will enable Treasury to simplify the existing complex rules to allow simpler rules. Indeed, this strategy was argued by the New York State Bar Association, the strongest proponent of a general anti-abuse standard.<sup>259</sup> The underlying thought is that the presence of a standard to back up specific rules allows the rules to be less detailed.<sup>260</sup> To the extent that this is done, it would be a clear benefit to the system.

As to the third factor, anti-abuse standards create uncertainty by casting doubt on certain transactions that literally comply with the terms of the statute, and the partnership anti-abuse regulations are no exception. In addition to the reverse engineered transactions that Treasury targeted, some legitimate transactions have been placed in jeopardy. The uncertainty is only partially mitigated by the elimination of any doubt about the applicability of the business purpose and economic substance doctrines to Subchapter K. In our view, however, the net increase in uncertainty is a price worth paying in order to reassert the applicability of the judicial doctrines as a backstop to the abuse of complex rules.

The fourth factor addresses the standard's effectiveness. At this time, the anti-abuse regulations are not effective. The vitriolic outcry of the tax bar against the regulations, coupled with the Service's statement that its agents will not assert the regulations without the approval of the National Office,<sup>261</sup> left the lasting impression that the regulations were not valid. It is our understanding that many practitioners do not take

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<sup>259</sup> N.Y. State Bar Ass'n Tax Section, *supra* note 10, at 236; *see* Weisbach, *supra* note 251, at 882 ("A better approach would have been to propose the partnership anti-abuse rule in exchange for the repeal of the many complex rules.")

<sup>260</sup> Indeed, this was precisely the strategy taken by Treasury when it promulgated the final regulations under I.R.C. § 752 (Thompson 2004).

<sup>261</sup> Ann. 94-87, 1994-27 I.R.B. 124 (1994).

these regulations as seriously as we believe they should. In drafting tax shelter opinion letters, for example, tax advisors have not included a thoughtful application of the regulations or even the judicial doctrines to transactions involving tax shelters.<sup>262</sup>

Although we have demonstrated that the anti-abuse regulations are valid, this article may not change the perception of the entire tax bar. Treasury needs to focus the attention of the bar once again on these regulations and declare its intention to apply them.<sup>263</sup> It also needs to change immediately the standards of practice for tax advisors engaged in rendering tax shelter advice. The IRS should require tax advisors to explicitly take into account the regulations as well as the various judicial doctrines in the legal analysis provided to tax shelter investors.

We have two recommendations. First, the IRS should not permit tax advisors to assume that a business purpose or economic substance exists in opinions that they render

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<sup>262</sup> See Johnston, *supra* note 128 (describing testimony of tax shelter attorney that his opinion letter assumed underlying economics of the transaction); Shearman Letter, *supra* note 127 (assuming economic substance and concluding the validity of the tax shelter with no legal analysis).

<sup>263</sup> Since the regulations are not artfully drafted, the IRS should also consider a significant redraft. For example, one of the most glaring deficiencies is the regulations' failure to provide more guidance on the abuse-of-entity standard. The abuse of entity regulation allows the Service to disregard a partnership if "appropriate to carry out the purpose of any provision of the Internal Revenue Code . . ." Treas. Reg. 1.701-2(e)(1) (as amended in 1995). This does not offer a clear standard to determine whether, for a particular provision, a partnership should be treated as an aggregate or an entity. As Professor Gunn has noted, the "rule [is] expressed in terms of what the Commissioner can do, rather than of what the right rule should be." Alan Gunn, *Business Purpose, Economic Substance, and Corporate Tax Shelters: The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 172 (2001). If one were to extract a general standard from these regulations, at least two possibilities suggest themselves. First, one might discern that there is a strong bias in favor of aggregate treatment and that entity treatment should be restricted to only those situations where it would clearly more appropriate. This is the position of Alfred D. Youngblood and Deborah B. Weiss, *Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K*, 48 TAX LAW. 39, 39 (Fall 1994) and AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER K 5, 523–32 (1984). Second, since the only explicit power the Commissioner is granted is to require aggregate treatment when appropriate, one might discern that the default rule is that of entity treatment. This would be a disaster because it would allow taxpayers to use partnerships to reverse-engineer transactions. We believe that the IRS should explicitly adopt the first approach.

for tax shelters.<sup>264</sup> This is a common practice by tax advisors that allows them to obscure the threat to the shelter raised by the judicial doctrines and anti-abuse regulations in their letter opinions.<sup>265</sup> The IRS should require tax advisors to apply the judicial doctrines and the anti-abuse regulations to the transaction's economic facts and predict a court's likely conclusion about the outcome of such application.<sup>266</sup> That is, rather than assume economic substance, the regulations should require the advisor to review the economics of the transaction, including all fees that will be paid, to explain why the transaction has economic substance under existing judicial doctrines and applicable anti-abuse regulations. If the advisors are assuming economic facts, such as profit potential, based on the conclusions of experts, the advisors should have to explain the conclusions and any assumptions made by the experts in reaching the conclusions.

Adopting this first recommendation would provide several benefits. An analysis that applies the judicial doctrines to the economic facts of the tax shelter will alert

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<sup>264</sup> For this purpose, we would use the current definition in I.R.C. § 6662(d)(2)(C)(iii) (Thompson 2004), which defines a tax shelter as:

- (I) a partnership or other entity,
- (II) any investment plan or arrangement, or
- (III) any other plan or arrangement,

if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.

<sup>265</sup> See Johnston, *supra* note 127; Shearman Letter, *supra* note 127.

<sup>266</sup> In 2000, the IRS considered imposing such a requirement in certain circumstances in Circular 230, but postponed action on the proposal. 2002 T.D. 4011 (July 26, 2002). The postponement was well advised because the proposal was too narrow. The proposed amendment to Circular 230 (the regulations that control the standard of practice before the IRS) would have required analysis of the judicial doctrines only in opinions that would be used by someone other than the advisor to promote tax shelters (Prop. Reg.-111835-99 §10.33(b)(4)), and that concluded that favorable tax treatment was not likely. Prop. Reg.-111835-99 §10.33(a). If the advisor concluded that favorable tax treatment was likely, the advisor would not have to provide analysis of the judicial doctrines. Given the importance of the advisor's opinion in marketing a tax shelter, the Proposed Regulation had the unintended effect of increasing the pressure on advisors to render favorable opinions.

On December 30, 2003, the IRS proposed new amendments to Circular 230 that would require a tax advisor to avoid making unreasonable factual assumptions and to "relate the law (including potentially applicable judicial doctrines) to the relevant facts." Prop. Reg. 122379-02 §§ 10.33 and 10.55 (Dec. 30, 2003). The proposed amendment would also require the advisor to avoid relying on factual representations that the advisor knew or should have known was incorrect or incomplete. *Id.* As discussed in note 270, *infra*, we believe that the proposed amendment can be improved.

taxpayers more fully to the tax risks posed by the tax shelter and may deter them from participating in it. Such an analysis may also make it more difficult for corporate taxpayers to argue that they reasonably believed the tax treatment to be correct because application of law to the facts would necessarily involve a discussion of arguments against favorable tax treatment.

Similarly, requiring the tax opinion to describe the conclusions and assumptions of experts upon which the opinion is relying will help to expose weaknesses in the opinion. For example in the *Long-Term Capital Holdings v. United States* case, discussed above,<sup>267</sup> the tax shelter opinion assumed that the transaction had “meaningful pre-tax profit” without even a cursory discussion of the economic substance doctrine.<sup>268</sup> The tax opinion referred to the conclusion of an expert that computers leased in the tax shelter to third parties would have a significant residual value at the end of the lease term. The opinion did not, however, mention that the expert had assumed that the value of the computers would depreciate in value at a rate of only 25 percent per year, a rate that the IRS argued was significantly lower than the decline in value of 50 percent per year that normally occurred.<sup>269</sup> Had the lawyers been required to explain the expert’s assumptions, it is likely that they would have structured the transaction so that it clearly possessed economic substance.<sup>270</sup>

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<sup>267</sup> See *supra* notes 126–128 and accompanying text.

<sup>268</sup> Shearman Letter, *supra* note 127 (admitted into evidence in *Long-Term Capital Holdings v. United States*, Case No. 3:01cv 1290 (JBA) (D. Conn. 2003)).

<sup>269</sup> United States Trial Memorandum 110-111 for *Long-Term Capital Holdings v. United States*, Case No. 3:01cv 1290 (JBA) (D. Conn. 2003).

<sup>270</sup> We believe that our approach of requiring the advisor to describe the expert’s analysis and assumptions is preferable to the amendment to Circular 230 that the IRS proposed on December 30, 2003. See *supra* note 266. The proposed amendment suggests that the advisor can rely on the representations of experts unless they have reason to know or should have known that they are unreasonable. Our approach of requiring the advisor to explain the expert’s conclusions and the assumptions that underlie those conclusions in the tax shelter opinion will make it much more likely that the advisor will discover

Second, the IRS should clarify the definition of substantial authority for purposes of the tax penalty under § 6662.<sup>271</sup> Recall that the regulations state that a “. . . taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.”<sup>272</sup> The IRS should change the regulation to make clear that such “well-reasoned” construction requires that the transaction satisfy the judicial doctrines (business purpose, economic substance and the other substance-over-form doctrines) and applicable anti-abuse regulations. If the transaction does not satisfy the judicial doctrines, literal compliance with the statute should not, by itself, stand as substantial authority. This recommendation, like the first, will require an advisor to apply the judicial doctrines to the economic facts of the transaction and, as a result, provide benefits similar to the first recommendation.

## *V. Conclusion*

In this article, we determine that the ascendancy of textualism has affected the practice of tax law and has contributed to the recent tax shelter crisis. The textualist method of statutory interpretation makes it much easier for an attorney to write a favorable legal opinion that will be used to market a tax shelter for two reasons. First, textualism permits the attorney to ignore or reduce the importance of legislative history that would argue against the desired tax results. Second, textualism challenges the validity of applying various judicial doctrines to complex statutory provisions.

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weaknesses in the expert’s conclusions. Moreover, such disclosure will enable the taxpayer to formulate its own view as to whether the expert’s conclusions are reasonable. This will in turn impair the ability of corporate taxpayers to avoid the penalty under § 6662 by arguing that they reasonably believed the tax treatment to be correct.

<sup>271</sup> See *supra* notes 131–143 and accompanying text for a discussion of I.R.C. § 6662 (Thompson 2004).

<sup>272</sup> Treas. Reg. § 1.6662-4(d)(3)(ii) (as amended in 2003). See *supra* notes 131–143 and accompanying text for a discussion of the penalty provisions.

Tax shelter promoters have used textualism to exploit the particularly detailed and complex provisions of Subchapter K. The partnership anti-abuse regulations responded to this challenge by reasserting the application of the judicial doctrines, expanding the doctrines' scope, and designating that the purposivist method be used to interpret partnership tax provisions. The regulations triggered an unprecedented furor within the tax bar, however. Critics claimed the regulations were inappropriate and invalid. To the contrary, we conclude that the regulations are an appropriate response to textualism. They allow Treasury to use broad standards to administer the tax law rather than rely solely on a collection of narrow rules that must be constantly changed in a hopeless attempt to keep pace with the latest tax gimmick. Moreover, we believe that the regulations are a valid exercise of Treasury's administrative authority.

We suggest that adoption of the anti-abuse regulations, by itself, however, will not solve the tax shelter problem. Treasury needs to refocus the bar's attention on the regulations by declaring its intention to apply them to all questionable transactions. In addition, we believe that Treasury should require advisors in tax shelter opinions to apply the anti-abuse regulations as well as the judicial doctrines to the actual economic facts of the transaction. Where the advisor is assuming economic facts, such as profit potential, based on the conclusions of experts, the advisor should have to describe the expert's conclusions and any assumptions that underlie those conclusions.