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Interpretative Theory and Tax Shelter Regulation

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INTERPRETATIVE THEORY AND TAX SHELTER REGULATION

*Brian Galle**

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I. INTRODUCTION

The practice of tax law is fundamentally the practice of statutory interpretation. For the most part, though, the scholarly tax community has been relatively indifferent to the work of our colleagues who teach and write in the realm of interpretative theory.¹ One area in which this oversight is becoming increasingly apparent is in our efforts to grapple with the policy challenge offered by the tax shelter industry.

In recent years tax shelter regulation has been complicated by the fact that the government’s litigation tools for combating shelters derive from a different era in the intellectual history of the judicial interpretation of statutes.² The foremost of these tools, the “economic substance doctrine,” is a common law rule³ crafted by a Supreme Court⁴ that was entirely comfortable saying of another tax statute that “[l]ife in all its fullness must supply” the best interpretation.⁵ That is not our Court, and it often is not our lower federal courts, either. We live in an era in which textualism — loosely conceived as fidelity to

¹ For some notable exceptions, see Deborah A. Geier, *Textualism and Tax Cases*, 66 TEMP. L. REV. 445 (1993); Michael Livingston, *Practical Reason, “Purposivism,” and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677 (1996); Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Statutes*, 69 TEX. L. REV. 819 (1991); Edward J. McCaffery, *Tax’s Empire*, 85 GEO. L.J. 71 (1996); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986). There are only a few brief efforts in the tax shelter arena. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 11–14 (2000); Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 TAX LAW. 1, 14–20 (1999). Another important article, Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004), includes a discussion on the place of legislative history in tax interpretation, *id.* at 7–19, a subject I set to one side here, as a prelude to its insightful discussion of administrative law principles underlying the Internal Revenue Service’s (Service) partnership anti-abuse regulations, *id.* at 32–61.

² Cunningham & Repetti, *supra* note 1, at 2.

³ Bankman, *supra* note 1, at 7–11.

⁴ *Gregory v. Helvering*, 293 U.S. 465 (1935).

⁵ *Welch v. Helvering*, 290 U.S. 111, 114–15 (1933).

the words of the statute — now reigns over the more free-wheeling methods of Cardozo and Holmes.⁶

Thus, we now see decisions in which courts read the economic substance doctrine narrowly, if they are willing to apply it at all.⁷ We can only guess at what goes on in the minds of other tax planners, but this development almost certainly has to have made a difference in the way that lawyers and others think about how to arrange their affairs.⁸ In addition to the “audit lottery,” we now have a sort of “textualist lottery.”⁹ Even Knetsch, tax law’s most famous economic substance loser,¹⁰ might try his deal with the Sam Houston Company again in today’s climate; one never knows when a court will decide that the literal words of a statute are as far as it need go in deciding the tax treatment of any transaction. Early defense filings in the prosecution of the KPMG shelter promoters suggest that this exact dynamic may

⁶ See Nancy Staudt et al., *Judging Statutes: Interpretive Regimes*, 38 LOY. L.A. L. REV. 1909, 1911 (2005) (summarizing empirical study analyzing Supreme Court’s use of interpretive methods). For a study of the Supreme Court’s historical practices, see Nicholas S. Zeppos, *The Use of Authority in Statutory Interpretation: An Empirical Analysis*, 70 TEX. L. REV. 1073, 1091–113 (1992).

⁷ See *infra* note 26. Of course, the Government has also won in some cases in which taxpayers raised textualist arguments, most prominently in a recent case in the Federal Circuit. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006); *ACM P’ship v. Commissioner*, 157 F.3d 231, 247–63 (3d Cir. 1998). My claim here is not that textualism inevitably will prevail in all litigated cases, only that it is likely at least to succeed often enough to impact tax planning. For example, the occasional textualist opinion may reduce the potential downside to tax planning. A taxpayer is generally safe from both civil and criminal penalties if she relies upon tax advice with “substantial authority” to support it. See *Cheek v. United States*, 498 U.S. 192, 201 (1991) (holding that defendant cannot be guilty of tax offense unless he intentionally violates a known legal duty); *Treas. Reg. § 1.6662-4(a), (d)* (2005) (defining standard for civil penalties). Whether authority is “substantial” is a balancing test, and is “less stringent than the more likely than not standard,” *Treas. Reg. § 1.6662-4(d)(2), (3)*, such that, while a single textualist opinion might be insufficient authority, a series of them, might well be enough to encourage taxpayers to rely on a textualist position with the hopes of, at worst, a loss with no penalties.

⁸ Joseph Bankman, *Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs*, 31 OHIO N.U. L. REV. 1, 4 (2005); Cunningham & Repetti, *supra* note 1, at 4, 27–28; Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 361 (2002).

⁹ Cf. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1947 (2005) (arguing that, in addition to audit lottery, taxpayers also may gamble that they will prevail in court by denying applicability of economic substance doctrine).

¹⁰ *Knetsch v. United States*, 364 U.S. 361 (1960).

be at the heart of the defendants' case: how could they have "known" that the shelters they offered were contrary to a "legal duty," when it was possible that some textualist court would support their tax claims irrespective of their transactions' total lack of economic substance?¹¹

Other commentators have recognized the importance of the textualist revolution for the shelter problem.¹² Many have noted that judicial reluctance to invoke the common law methods of yore may oblige Congress to codify some of the doctrines, such as economic substance, that courts have in the past used to combat abusive tax avoidance (whatever "abusive" may mean).¹³ Indeed, both the Senate and the Joint Committee on Taxation (JCT) have proposed codified versions of the economic substance doctrine, although apparently Treasury is not enthusiastic.¹⁴ Textualism is an elephant in the room in an important scholarly alternative to the JCT's proposal, set out in a recent *Columbia Law Review* essay by Marvin Chirelstein and Larry Zelenak.¹⁵ Chirelstein and Zelenak urge us, in essence, to abandon hope in economic substance and instead to pursue a pair of bright-line rules designed to cut off what they see as the most damaging forms of modern shelters.¹⁶ All of these efforts are thorough, carefully considered, and draw on far more real-world tax experience than is available to this author.

¹¹ Memorandum of Law in Support of Certain Defendants' Motion To Dismiss the Charging Portions of the Indictment Involving FLIP, OPIS and BLIPS on the Ground that the Prosecutors Misled and Misinformed the Grand Jury Concerning the Applicable Law and Material Facts, *United States v. Stein*, No. 05-CR-0888 (S.D.N.Y. Jan. 12, 2006).

¹² Bankman, *supra* note 8, at 3–5; Cunningham & Repetti, *supra* note 1, at 27–29; Allen D. Madison, *The Tension Between Textualism and Substance-over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 747–48 (2003).

¹³ See Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9, 34 (2001); Martin J. McMahon Jr., *Beyond a GAAR: Retrofitting the Code To Rein in 21st Century Tax Shelters*, 98 TAX NOTES 1721, 1734–37 (Mar. 17, 2003); Lee A. Sheppard, *Drafting Economic Substance, Part 3*, 106 TAX NOTES 1020, 1025 (Feb. 28, 2005).

¹⁴ For the Joint Committee on Taxation (JCT) proposal, see STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., *OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES* (Joint Comm. Print 2005). For the Senate's bill, see, e.g., Tax Shelter and Tax Haven Reform Act of 2005, S. 1565, 109th Cong. § 301. On Treasury's coolness to these types of proposals, see, e.g., *Nomination of Pamela F. Olson: Hearing Before the Senate Committee on Finance*, 107th Cong. (2002); Sheryl Stratton, *Shelter Disclosure, Doctrine Codification Debated*, 99 TAX NOTES 25, 25 (Apr. 7, 2003) (reporting views of Treasury officials).

¹⁵ Chirelstein & Zelenak, *supra* note 9, at 1942.

¹⁶ *Id.*

I want humbly to suggest, however, that the proposals could be further improved by more extensive engagement with the theory behind the textualist outcomes we see from some courts. For example, I do not think it is by any means clear that the JCT's proposal, if enacted, would succeed in changing the result in a court with a voting majority of textualists.¹⁷ To make that prediction, we first have to understand what the textualists' objections are and then consider carefully whether the JCT's proposal really meets them. I argue here that it probably does not.

At the same time, Chirelstein and Zelenak may have decided that the elephant is bigger than it really is. As I will attempt to show, it is possible for a well-designed statute to overcome textualist arguments against judicial invocation of broad policy tools such as the economic substance doctrine. Indeed, such a statute could draw on many of the insights Chirelstein and Zelenak offer, while at the same time maintaining the flexibility to adapt to innovations in tax-sheltering that seems somewhat lacking (by design) in their current proposal.

Finally, understanding the theory of textualism helps us to see that many of the arguments against regulating tax shelters more generally are fairly weak when confronted with a carefully drafted statute. For example, critics of Professor Weisbach's powerful challenge to tax planning raise what prove to be textualist-flavored objections to any potential judicial solution.¹⁸ Those objections, I show, can be met relatively easily once we understand the actual content of their claims.

Thus, in this article I not only lay out and analyze the interpretative theory underlying textualist challenges to tax shelter regulation, but also suggest a possible new — or, really, hybrid — formulation of a codified economic substance doctrine. Many of the particulars were crafted by others. My main effort here is to show how the pieces can best be fit together to rebut textualist challenges.

The article proceeds in five parts. I begin the first part by reviewing briefly the economic substance doctrine (the doctrine) and its discontents. The part quickly moves on to discuss several suggestions to codify the doctrine, each of them aimed at shoring up one or more weaknesses in its current, common law incarnation. Part III.A explores the theoretical underpinnings of the textualist

¹⁷ Other commentators appear to have assumed that codification would oblige a court to adhere to the newly codified economic substance doctrine. See *infra* note 63. As I discuss here, that is not necessarily an obvious conclusion.

¹⁸ See *infra* text accompanying notes 157–58.

challenge to judicial invocation of the economic substance doctrine. Part III.B explains how the Chirelstein and Zelenak proposal sidesteps those challenges, but then elaborates on why no sidestep should be needed.

Part IV considers another textualist-inspired criticism of the doctrine. Critics point out that purposivist efforts to identify shelters are often paralyzed by the difficulty that Congress clearly does intend to tax-favor some transactions. Given that the plain text is often our best clue to congressional intent, it may be difficult to discern shelter from subsidy. By obliging Congress to identify its intended tax-favored transactions by a clear statement, we can remove any doubt that the remaining tax favors are accidents of drafting.

Part V applies these lessons. In particular, I argue that there remains no particularly convincing argument against Weisbach's view that the law should discourage all tax planning. Thus we might, for example, pursue a codified doctrine that would permit the Internal Revenue Service (Service) to disregard a taxpayer's characterization of a transaction if one of several main purposes for engaging in any part of the transaction is to realize a tax benefit or if no reasonable businessperson would have carried out the transaction in that way, but for the resulting tax benefits. Borrowing from Chirelstein and Zelenak, I suggest that Congress could also carve out specifically identified tax-favored transactions that would be exempt from re-characterization even if engaged in unreasonably or for tax avoidance purposes. Combining these two steps largely resolves the theoretical problems identified earlier.

I then conclude.

II. BACKGROUND

The economic substance doctrine is a set of judicially-crafted rules of interpretation for tax statutes.¹⁹ In general, the doctrine operates to disallow a taxpayer's characterization of a particular business transaction where, although the transaction in form meets the literal terms of the statute, in substance it "seeks to claim tax benefits, unintended by Congress."²⁰ In this context Congress is usually

¹⁹ Bankman, *supra* note 1, at 7–11; Alexandra M. Walsh, Note, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 STAN. L. REV. 1541, 1544 (2001).

²⁰ *ACM P'ship v. Commissioner*, 73 T.C.M. (CCH) 2189, 2215 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998). In this article I do not make any effort to sort out the various strands of common law doctrine, some of them occasionally appearing under other

understood to intend to give tax-favorable treatment only to a transaction that has a meaningful effect on the taxpayer's real economic situation or that was entered into with a real business purpose.²¹ Courts are divided on whether these standards must both be met in order for a transaction to pass muster,²² disagree about how to analyze the scope of a "transaction,"²³ and differ on how much risk or possibility of profit must exist in order to qualify a transaction as having economic substance.²⁴

While these variations can make for some complicated legal analysis, the greater concern among policy makers is that, increasingly, the economic substance doctrine is proving to have no substance at all.²⁵ Since the mid-1980s, as "textualist" theories of statutory interpretation have become more prevalent, courts have grown increasingly skeptical of judge-made tax policy, especially where that policy has the effect of negating the clear lexical meaning of the text.²⁶ It was only a matter of time before textualist courts began refusing to apply the economic substance doctrine at all.²⁷

In response to both sets of problems, the JCT has proposed codifying the economic substance doctrine.²⁸ The JCT's proposal is, in some senses, fairly limited. The proposal notes that it "only applies to cases in which a court determines that the economic substance doctrine is relevant" and expressly states that it is not intended to

names, that have similar effects as the economic substance doctrine. See Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 195 (2001) (describing differences among doctrines as "abstract" and "fairly gossamer").

²¹ STAFF OF JOINT COMM. ON TAXATION, *supra* note 14, at 14–16.

²² Bankman, *supra* note 1, at 26.

²³ See *id.* at 15; David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1, 30 (2003).

²⁴ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 14, at 14–16; Lee A. Sheppard, *Drafting Economic Substance, Continued*, 99 TAX NOTES 597, 598–99 (May 5, 2003).

²⁵ See Samuel C. Thompson Jr., *Despite Widespread Opposition, Congress Should Codify the ESD*, 110 TAX NOTES 781, 782 (Feb. 13, 2006).

²⁶ See, e.g., *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 784 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350, 356 (8th Cir. 2001); *ACM P'ship v. Commissioner*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting); *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716, 740–41 (2004).

²⁷ See Cunningham & Repetti, *supra* note 1, at 4, 26.

²⁸ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 14, at 18 (explaining "reasons for change").

modify common law except as otherwise stated.²⁹ What the proposal would do is resolve a pair of circuit splits, by instructing that a valid transaction must have both economic substance and business purpose and by defining economic substance to require a “meaningful change in the taxpayer’s economic position.”³⁰ Even these provisions would apply only in the context of six “applicable transactions,” which the JCT finds to be most suspect, as well as in any others added by Treasury.³¹ Earlier, already enacted provisions provide for a forty percent penalty for undisclosed transactions failing the test, which drops to twenty percent if the transaction is disclosed.³²

There are a variety of other proposals. Some (especially tax practitioners) suggest adhering to the status quo, perhaps with some additional disclosure requirements.³³ Others tinker at the margins of (or anticipate, with slight variation) the JCT plan, offering improved wording of some of its provisions, a different resolution of the circuit splits, and the like.³⁴

More radically, Professors Chirelstein and Zelenak have suggested, in essence, giving up on efforts to write the economic substance doctrine into law. They argue that efforts to elevate economic substance will simply lead to tax shelters in which shelter participants will insert just enough risk or chance for gain to meet the minimum threshold for tax compliance.³⁵ They propose instead a bright-line regime, in which Congress would flatly disallow noneconomic losses, as well as noneconomic deferral of gain or acceleration of loss through the use of tax-indifferent parties.³⁶ However, they provide that Congress or Treasury may make exceptions for certain noneconomic losses intended by Congress.³⁷ Similarly, Professor Weisbach has noted that well-designed shelter

²⁹ *Id.* at 18, 20.

³⁰ *Id.* at 21–22.

³¹ *Id.* at 19–21, 28.

³² *Id.* at 17.

³³ See, e.g., Hebert N. Beller, *ABA Tax Section Offers Comments, Concerns Regarding CARE Act Provisions*, 2003 TNT 81-74 (Apr. 24, 2003); Michael P. Boyle, *TEI Opposes Revenue Raisers in Senate Tax Relief Bill*, 2006 TNT 7-19 (Jan. 10, 2006); Thomas J. Purcell, III, *AICPA Expresses Concerns over Some Tax Relief Act Provisions*, 2006 TNT 3-19 (Dec. 23, 2005); Bernard Wolfman, Letter to the Editor, *Why Economic Substance Is Better Left Uncodified*, 104 TAX NOTES 445, 445 (July 26, 2004) (arguing that codification would result in too much doctrinal rigidity).

³⁴ See, e.g., Hariton, *supra* note 23, at 30–31, 33; Sheppard, *supra* note 24, at 600.

³⁵ Chirelstein & Zelenak, *supra* note 9, at 1955, 1962.

³⁶ *Id.* at 1952–53.

³⁷ *Id.* at 1955–56.

legislation should “require Congress to specify all intentional subsidies and the manner in which they may be used.”³⁸

A key aspect of the Chirelstein and Zelenak proposal is its deliberate rigidity. Chirelstein and Zelenak, I suspect, would freely concede at least that they have chosen the less flexible approach to combating tax shelters; they are quite up front about their choice to use, in essence, a “rule” rather than a “standard.”³⁹ That is, they deliberately prefer to set out detailed prescriptions for dealing with certain forms of transactions, with no apparatus in their scheme for adjusting to subsequent efforts by taxpayers to achieve similar tax-avoiding results by other means.⁴⁰ One express rationale they offer for their choice is that, in their view, it better provides for an effective deterrent to would-be shelterers.⁴¹ I am somewhat skeptical of that claim, for reasons I will explain in detail in Part V.

Chirelstein and Zelenak also offer another rationale, although perhaps it is just slightly below the surface of their argument. Their article, as well as Professor Zelenak’s earlier writings, suggest skepticism about whether judge-made tax doctrines can succeed in doing anything other than replicating each individual judge’s tax-policy preferences.⁴² Thus, tax-shelter-friendly judges will remain friendly to shelters irrespective of codification of economic substance doctrines.⁴³ I want to suggest, in Part IV, that this worry is fundamentally a textualist one and that Chirelstein and Zelenak’s terrific solution in fact can resolve it equally well in a less-rigid scheme than the one they offer. First, though, I want to consider another possible strength of their proposal.

³⁸ David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 225 n.22 (2002).

³⁹ For a discussion of the basic concept of the rule/standard tradeoff, see Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687–88 (1976), and in tax law particularly, see Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673, 699–702 (1969).

Professor Zelenak had already put his cards on the table about his distrust of standards, and his search for a “silver-bullet” rule, four years earlier. Lawrence Zelenak, *Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. REV. 177, 185–86, 191–93 (2001).

⁴⁰ Chirelstein & Zelenak, *supra* note 9, at 1951. The duo argue, though, that their proposal is broad enough to prevent new shelters, *id.*, which seems fairly optimistic given the money at stake and talent available.

⁴¹ *Id.*

⁴² *See id.* at 1948, 1953.

⁴³ *See id.* at 1949; Zelenak, *supra* note 39, at 186–87.

III. DOES TEXTUALISM DOOM ANY EFFORT TO CODIFY ECONOMIC SUBSTANCE?

As I have mentioned, for many tax shelter commentators, the most significant challenge posed by the rise of modern textualism is not necessarily the force of its critique so much as the likelihood that the textualist judge will reject existing efforts to regulate shelters. As we will see in a moment, the textualist judge is likely to reject judge-made rules that supplement the actual words of a technical tax statute. In other words, the textualist would not apply the economic substance doctrine. Quite possibly, the textualist would hesitate to employ common law methods, such as economic substance analysis, even if strongly encouraged to do so by Congress. That would leave us, still, with the possibility that shelter participants could continue to play the “textualist lottery.”

It might be said in favor of Chirelstein and Zelenak that their proposal shortcuts this problem entirely. By substituting bright-line rules for any judicial conclusions about whether a transaction has economic substance, they sidestep the need to convince the textualist judge. While it is unclear whether that was one of their goals, it is undeniably a significant potential advantage of their approach.⁴⁴

As a result, in order to appraise our options, we first have to understand the nature of the problem to be solved. Is there a serious likelihood that textualists would resist even a codified economic substance doctrine? If so, Chirelstein and Zelenak’s offering looks much more appealing. To be sure one way or the other, we would have to understand better the reasons for the textualist’s reluctance to dabble in common law methods. Is the problem a lack of congressional authorization or is it something else, such as a general doubt about, or constitutional constraint on, judicial power? Surprisingly, there is no sustained consideration of that question, even in the interpretative theory literature. In this part, I argue that it is highly unlikely that textualists would in principle be able to refuse to implement a codified economic substance doctrine, leaving us free to look to other strengths and weaknesses of the competing codification proposals.

⁴⁴ There are some indications, though, that Chirelstein and Zelenak are concerned about the appeal to courts of the argument that “rules are rules” irrespective of economic substance. Chirelstein & Zelenak, *supra* note 9, at 1940, 1946–47.

A. The Textualist Challenge to Economic Substance

First, it is worth a paragraph or two to clarify what I mean by “textualist.” It is possible to describe a textualist broadly as any interpreter who claims that the primary authoritative source of meaning in a statute is its words.⁴⁵ But, in a modern era in which most interpreters place a very high degree of importance on the words of a statute,⁴⁶ this definition is not very helpful to us in pinpointing just those interpreters who tend to resist the economic substance doctrine. For instance, some writers who might fall within this very broad textualist umbrella claim that the import of words must be divined by the meaning those words would have held at the time of the statute’s enactment,⁴⁷ with some further disagreement about whether that entails their public meaning,⁴⁸ the meaning actually understood by the statute’s enactors,⁴⁹ or the meaning that should reasonably be imputed

⁴⁵ At first glance this definition might seem to include anyone who interprets statutes. However, there are significant differences in how various schools of interpretative thought believe the words of a statute relate to judicial applications of the statute. John Manning, for example, distinguishes textualists from those who would use legislative history as a way of authoritatively construing a statute’s meaning. John F. Manning, *Putting Legislative History to a Vote: A Response to Professor Siegel*, 53 VAND. L. REV. 1529, 1529 n.2 (2000) [hereinafter Manning, *Response to Siegel*]. For Manning a key difference between *authoritative* meaning and other meanings is that authoritative meaning compels a court’s reading, while other sources of information about how to read a statute might merely be guides or hints. *See id.* As I will explain shortly, this distinction is largely what divides those I describe as textualists from those I label purposivists. Purposivists, in my taxonomy, treat the words of the statute mostly as evidence about legislative purpose, rather than as authoritative boundaries on a court’s authority. Obviously, these are zones on a continuum rather than bright lines. As the degree of deference one gives to a source of evidence increases, it comes to look more and more like an authoritative source. And, as the occasions for straying from authority’s dictates grow in number, the authority begins to seem more like mere evidence. *Cf.* John Manning, *What Divides Textualists from Purposivists*, 106 COLUM. L. REV. 70, 75–76 (2006) [hereinafter Manning, *What Divides*] (noting that so-called textualists and purposivists both consider goals of legislation and context of statutes’ words in reaching a conclusion and that what divides them is what they “emphasize”).

⁴⁶ *See* Caleb Nelson, *What Is Textualism?*, 91 VA. L. REV. 347, 348 (2005) (stating that “no critic of textualism believes that statutory text is unimportant”).

⁴⁷ Frank H. Easterbrook, *The Role of Original Intent in Statutory Construction*, 11 HARV. J.L. & PUB. POL’Y 59, 61 (1988).

⁴⁸ *See* Vasani Kesavan & Michael Stokes Paulsen, *The Interpretive Force of the Constitution’s Secret Drafting History*, 91 GEO. L.J. 1113, 1132–33 (2003).

⁴⁹ Martin H. Redish & Theodore T. Chung, *Democratic Theory and the Legislative Process: Mourning the Death of Originalism in Statutory Interpretation*, 68

to the enactors.⁵⁰ Yet others we might call textualists assert that the meaning of words in a statute is dynamic and should depend on the understanding of the present-day audience or the judge who is interpreting them.⁵¹ In practice, some of these species — especially the dynamic interpreters — refuse to describe themselves as textualists, even while they ostensibly acknowledge the supremacy of the text.⁵² Not much is at stake for us in these terminological disputes.

With apologies, then, for overlooking what may be some important but fine-grained distinctions, I will generally lump judges into two categories: textualists and purposivists. Many of those whom I call purposivists meet the very broad “textualist” standard of assigning interpretive primacy to the text of a statute. But what I mean here by purposivists are those who would utilize the words of the text (and, conceivably, other sources, such as legislative history or their own view of what is “reasonable”) to construct a standard, rather than a rule.⁵³ They look at the words, ask “what is this statute intended to accomplish?” and construe the terms in light of that purpose.⁵⁴ At times they will place this purpose above the literal words of a particular provision. Against this I set “textualists.” In my usage, a textualist is an interpreter who assigns the highest

TUL. L. REV. 803, 808–10 (1994).

⁵⁰ See Caleb Nelson, *A Response to Professor Manning*, 91 VA. L. REV. 451, 464–66 (2005) (discussing role of canons as imputed meaning); Richard A. Posner, *Legal Formalism, Legal Realism, and the Interpretation of Statutes and the Constitution*, 37 CASE W. RES. L. REV. 179, 189–91 (1986); Richard A. Posner, *Statutory Interpretation — In the Classroom and in the Courtroom*, 50 U. CHI. L. REV. 800, 810, 817 (1983). But note that Posner describes himself in these pieces as quite receptive to nontextual sources of evidence of the words’ meaning, which would put his classification as a textualist somewhat in doubt; in my simple schema he is mostly a purposivist. See *infra* note 51.

⁵¹ See T. Alexander Aleinikoff, *Updating Statutory Interpretation*, 87 MICH. L. REV. 20, 23 (1988); William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479, 1497 (1987); William N. Eskridge, Jr. & Philip P. Frickey, *Foreword: Law as Equilibrium*, 108 HARV. L. REV. 26, 56–71 (1994); Daniel A. Farber, *Statutory Interpretation and Legislative Supremacy*, 78 GEO. L.J. 281, 309 (1989).

⁵² See Jonathan T. Molot, *The Rise and Fall of Textualism*, 106 COLUM. L. REV. 1, 3, 29–35 (2006).

⁵³ See Michael C. Dorf, *The Supreme Court 1997 Term — Foreword: The Limits of Socratic Deliberation*, 112 HARV. L. REV. 4, 19–20 n.74 (1998).

⁵⁴ For a classic example, see HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 1374 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994). For a leading tax scholar’s similar views, see Joseph Bankman, *Stanford Professor Rebuts Criticisms of Partnership Antiabuse Reg.*, 94 TNT 140-33 (July 20, 1994).

interpretive priority to the words of the statute, in their context.⁵⁵ The textualist will resort to “purpose” inquiries only rarely, and even then, usually only at a fairly low level of generality.⁵⁶

Textualists, as I have described them, are likely to be hostile to the economic substance doctrine.⁵⁷ The doctrine rejects literal taxpayer interpretations of the Internal Revenue Code’s (Code) rules that run counter to a broad standard disfavoring tax planning for its own sake.⁵⁸ The textualist is unwilling to replace clear textual rules with standards supposedly implicit in the statute. Unsurprisingly, then, as textualism has become more prevalent over the past two decades, the doctrine has been subjected to ever-increasing skepticism from textualist-minded courts. The Federal Court of Claims’ opinion in *Coltec Industries, Inc. v. United States*⁵⁹ is typical. There, the trial court found that the taxpayer satisfied the literal terms of the statute and it rejected the Government’s economic substance argument, noting that “under constitutional separation of powers, judges should determine congressional intent by the language of the Code, rather than deciding what tax policy should be.”⁶⁰ For good measure, the court added a brief disquisition on the evils of judicial lawmaking, emphasizing its effects on private planning — in effect, arguing that

⁵⁵ *E.g.*, *W. Va. Univ. Hosps., Inc. v. Casey*, 499 U.S. 83, 87–92, 99 (1991) (Scalia, J.); John F. Manning, *Textualism and Legislative Intent*, 91 VA. L. REV. 419, 424 (2005); Nelson, *supra* note 50, at 467–68. Textualists may disagree on how broadly they ought to look in locating the context of a phrase’s meaning, with very broad context perhaps tending towards purposivism. See George H. Taylor, *Structural Textualism*, 75 B.U. L. REV. 321, 347, 350 (1995); Adrian Vermeule, *Three Strategies of Interpretation*, 42 SAN DIEGO L. REV. 607, 618–22 (2005).

⁵⁶ In other words, the textualist looks at “purpose” primarily in order to understand the meaning of particular words used in the statute — for example, whether the word “rule” means “exert dominion over” or “demarcate with evenly spaced lines.” See, *e.g.*, *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 546 (1992) (Scalia, J., concurring and dissenting); Manning, *What Divides*, *supra* note 45, at 91–96 (explaining that textualists prioritize “semantic” context while purposivists put more weight on “policy” context); Nelson, *supra* note 50, at 463. The purposivist, in contrast, may look to the more general intentions of Congress regarding how to apply the statute in various contexts. For more thorough discussions, see, *e.g.*, William N. Eskridge, Jr., *The Circumstances of Politics and the Application of Statutes*, 100 COLUM. L. REV. 558, 572–74 (2000); Lon L. Fuller, *The Case of the Speluncean Explorers*, 62 HARV. L. REV. 616, 625–26 (1949).

⁵⁷ See Walsh, *supra* note 19, at 1545.

⁵⁸ Bankman, *supra* note 1, at 7–11.

⁵⁹ 62 Fed. Cl. 716 (2004).

⁶⁰ *Id.* at 753 (citing, *inter alia*, *Cipollone*, 505 U.S. at 544–45 (Scalia, J., concurring and dissenting)).

statutes should be treated as embodying rules, not standards.⁶¹

Interestingly, one other point the *Coltec* court mentions, without real explanation, is that Congress has repeatedly considered but not enacted a codification of the economic substance doctrine.⁶² Evidently the court's implication is that Congress has affirmatively chosen rules over standards. But that only begs a larger question: supposing Congress were to codify the doctrine, would the *Coltec* court, or any other textualist, give it any more heed?

This is a crucial question for would-be codifiers. Other commentators largely agree that, even if codification does little to improve the content of the doctrine, at a minimum it is worthwhile to the extent that it can force courts like the *Coltec* court to apply the doctrine at all. These writers, too, seemingly overlook the point that the rationale that drives courts to resist an uncodified doctrine might apply fully to the doctrine codified.⁶³ If so, we have to find a way to design a "fix" to the problem of unwanted tax planning that avoids that rationale.

B. The Chirelstein and Zelenak Solution and Why It May Be Unnecessary

This, then, is another potential appeal of the Chirelstein and Zelenak proposal. Again, rather than mandating that courts apply the economic substance doctrine, they have for the most part simply

⁶¹ *Id.* at 753–56. The Federal Circuit later reversed the Court of Claims, explaining that both its own precedent and Supreme Court precedent included cases applying the economic substance doctrine. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006). It is unclear how persuasive this second *Coltec* opinion will prove to textualist-minded courts elsewhere. For one thing, the Federal Circuit omits from its list of Supreme Court precedents one of the Court's most recent shelter cases, a Justice Thomas-authored opinion in which the Court applied a very literal reading of the statute and refused to consider purposive arguments arguably contrary to its reading of the putatively "plain" language of the applicable statute. *Gitlitz v. Commissioner*, 531 U.S. 206, 212–20 (2001). Second, the Supreme Court authority on which the Federal Circuit relies for the proposition that textualism is not required by the separation of powers in fact probably does not stand for that proposition. *See infra* note 77.

⁶² *Coltec*, 62 Fed. Cl. at 756.

⁶³ *See, e.g.*, Cunningham & Repetti, *supra* note 1, at 6 (claiming that there is "little doubt" Congress has the power to require that courts apply substance-over-form rules); Zachary Nahass, Comment, *Codifying the Economic Substance Doctrine: A Proposal on the Doorstep of Usefulness*, 58 ADMIN. L. REV. 247, 264 (2006); Weisbach, *supra* note 38, at 218–19 ("[S]tatutes and regulations can be changed in any imaginable manner.").

identified the most problematic transactions and set them off limits. To the extent that we think that judicial resistance to the economic substance doctrine, in any form, is a substantial obstacle, their approach leapfrogs the obstacle nicely. The catch here is that, in fact, there is no principled basis for extending the textualist opposition to the (putatively) uncodified economic substance doctrine to an encoded version. Whatever more pragmatic hesitation some courts may have will, I hope, be undermined by a careful demonstration that such hesitation cannot stand on principle. Thus, in this subsection I ask whether the principles underlying textualism would require the textualist to resist any legislative efforts to impose purposivist methodology, as the codification of the economic substance doctrine would do for all tax statutes.

Would Judge McKee or the *Coltec* trial court be obliged to apply a codified doctrine? It seems plain enough, on a policy level, why textualists would resist allowing textualist methods easily to be defeasible by Congress.⁶⁴ Some textualists have argued, frankly, that their goal is to limit the reach of government.⁶⁵ Textualism greatly reduces Congress' power, not only by reducing the sweep of individual statutes to their terms, but also by requiring frequent legislative reconsideration of old enactments, inducing more careful deliberation by Congress in anticipating how each enactment will be applied, and raising the stakes for parties to any compromise.⁶⁶ Bargaining becomes more extended and more intense because the outcome of the negotiation will be more difficult to modify later. The result is that more "space" is left for private ordering and market solutions.⁶⁷ Other textualists argue, relatedly, that textualism is more "majoritarian," in the sense that rules made by courts can be effected by a single litigant, while rules crafted by Congress, obviously, must command widespread political support.⁶⁸ Because of the difficulty of

⁶⁴ See Walsh, *supra* note 19, at 1566–67.

⁶⁵ E.g., Frank H. Easterbrook, *Text, History, and Structure in Statutory Interpretation*, 17 HARV. J.L. & PUB. POL'Y 61, 63 (1994).

⁶⁶ Manning, *Response to Siegel*, *supra* note 45, at 1529, 1540 n.47; Muriel Morisey Spence, *The Sleeping Giant: Textualism as Power Struggle*, 67 S. CAL. L. REV. 585, 593–615 (1994). At the same time, textualism may arguably increase the importance of Congress relative to courts. But the point here is simply that both courts and Congress generally can accomplish less under a textualist regime.

⁶⁷ Frank H. Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533, 549–50 (1983). But see Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 94–100 (1991) (arguing that background rules left in place by textualism are themselves legal rules, not market ordering).

⁶⁸ See Easterbrook, *supra* note 67, at 536; Easterbrook, *supra* note 47, at 61–62.

obtaining such broad agreement, many possible efforts at rulemaking will fail, so that majoritarianism overlaps somewhat with the first, libertarian purpose. But, in fairness, majoritarianism might have other virtues. Many commentators believe that courts, in forcing Congress to speak clearly to give effect to its dictates, also force Congress to be more “republican” — that is, to debate among many viewpoints, hopefully in a principled way — and to be more “transparent” — that is, to make more evident to its constituents the rules Congress has chosen for them.⁶⁹

Yet some of these same principles suggest that the textualist would have to accept the “anti-textualist” statute, or on a smaller scale, a codification of economic substance. If a goal of textualism is to elevate the policy choices reached after a deliberative and transparent process over those made by a small body of experts in an obscure courthouse, then the textualist has little ground to assert that her preference for textualism must prevail over the considered view of the legislature.⁷⁰ In a sense, the codified economic substance doctrine is nothing more than a sort of “dictionary act” for the Code. The doctrine defines — unobjectionably, one would think — what sorts of transactions are truly those Congress wants to provide with favorable tax treatment.⁷¹ The textualist should have to respect statutory text that tells her how to read the rest of the statute.

On the other hand, there are some forms of decisions that we generally think courts ought to make for themselves, even if contrary to Congress’ direction or definition. In other words, the textualist might say that the “dictionary” part of the statute she is reading is unconstitutional. While constitutional rights come quickly to mind, in practice the Court often defers matters of constitutional dimension to legislative determination — as, for example, with the scope of the “necessary and proper” clause.⁷² Therefore the textualist still would

⁶⁹ See Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 73 (1983). On the transparency argument, see *Finley v. United States*, 490 U.S. 545, 556 (1989) (Scalia, J.); Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 416 (1989) (describing this view).

⁷⁰ See Walsh, *supra* note 19, at 1567 (arguing that even Justice Scalia should have to accept that Congress can impose standards instead of rules).

⁷¹ Cf. Brian J. Arnold, *The Long, Slow, Steady Demise of the General Anti-Avoidance Rule*, 52 CAN. TAX. J. 488, 499 (2004) (making similar point with respect to Canadian efforts to codify an anti-abuse rule for tax statutes); Nicholas Quinn Rosenkranz, *Federal Rules of Statutory Interpretation*, 115 HARV. L. REV. 2085, 2103–09 (2002) (arguing that general interpretive rules supplied in statutes are theoretically unobjectionable because no different than dictionary definitions).

⁷² See Lawrence Gene Sager, *Fair Measure: The Legal Status of Underenforced*

have two theoretical challenges in resisting codification of the doctrine — first, to locate some source of constitutional authority for her textualist resistance to the “dictionary” text, and second, some additional ground for *enforcing* the Constitution — for elevating her choice of interpretive method above the legislature’s.

Professor Rosenkranz has suggested a similar analysis. He claims that, for any individual statute, there would be little argument that Congress cannot instruct a court how to read the terms of the statute.⁷³ He acknowledges that the Constitution will often suggest a background rule that will prevail in the absence of legislation, but for the most part he argues that Congress can displace these presumptions by statute in the same way it can displace any other common law.⁷⁴ However, he also notes that the Supreme Court’s cases seem to imply the existence of another category, which he terms “constitutional default rules,” in which the underlying constitutional norm can be displaced only one statute at a time.⁷⁵ He cites as an example the Court’s presumption that states cannot be sued in federal court, a presumption that could not be displaced by a generic definitional statute including “states” as “persons” for purposes of the entire Code.⁷⁶ Rather, Congress can only subject states to suit under a federal provision by expressly displacing state liability as to that individual provision. Thus, we really have two sets of questions about the constitutionality of any codification effort. First, whether it is constitutional even if applied only to a single statute. And, second, whether there is any sort of “constitutional default rule,” like the sovereign immunity clear statement rule, that would make it difficult to codify economic substance across the whole of the Code at a single stroke.

Turning first to whether codification could be permissible even in a single statute, one common constitutional argument for textualism is apparently that it is a necessary incident of the separation of powers. Congress, it is claimed, makes laws, while courts should only interpret them.⁷⁷ Put in a more sophisticated frame, the claim is that the text of

Constitutional Norms, 91 HARV. L. REV. 1212, 1217 (1978).

⁷³ Rosenkranz, *supra* note 71, at 2103–09.

⁷⁴ *Id.* at 2095–96.

⁷⁵ *Id.* at 2097.

⁷⁶ *Id.* at 2122–23.

⁷⁷ See *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716, 753–56 (2004); 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: FEDERAL COURTS AND THE LAW 3, 9–13, 34–35 (Amy Gutmann

a statute is the output of a negotiated legislative process and only by applying that text fairly formally, can courts remain faithful to the agreement embodied in the deal.⁷⁸ A group of negotiators, who may arrive at consensus for many different reasons, has no “intention” to which a court can be faithful, and so replacing the text with a meaning derived from an imputed “intention,” undermines legislative power.⁷⁹

It is not immediately apparent how this theory would rule out codification. As many critics have pointed out, legislative bodies can reach (or agree not to reach) consensus on many different levels of generality, so that the “deal” that is put into place can, in fact, be a deal to defer rule-making authority to courts (as in, for example, the Sherman Act).⁸⁰ A codified economic substance doctrine could be a similar type of high-level agreement. Moreover, all interpretation

ed., 1997); *see also* The Queen v. Canada Trustco Mortgage Co., [2005] 2 S.C.R. 601, at para. 41 (Can.); Arnold, *supra* note 71, at 499 (noting same arguments offered by Canadian courts).

The Federal Circuit rejected this argument in the *Coltec* appeal, citing to a Supreme Court opinion in which it claimed the Court had rejected a separation of powers challenge to a purposive reading of a statute. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006) (citing *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982)). I think the Federal Circuit probably somewhat misread the continuing significance of *Merrill Lynch*. That was a case in which the Court permitted suit under a so-called “implied” right of action — an authorization for suit that was not expressed in the clear words of the federal statute the plaintiffs were attempting to enforce. 456 U.S. at 375, 381. The modern rule for private suits in federal court, however, is that in fact a claim exists only where there is a clear statement authorizing a private suit. *Alexander v. Sandoval*, 532 U.S. 275, 286–87 (2001). The Court has explained *Merrill Lynch* as simply embodying the principle that, where Congress reenacts statutory language after a court (in retrospect, erroneously) has implied a right of action under that language, Congress in effect has expressly authorized suit. *Id.* at 288. The Court added that, when it comes to finding private rights of action, “[w]e have never accorded dispositive weight to context shorn of text” and that “legal context matters only to the extent it clarifies text.” *Id.* While perhaps this view of *Merrill Lynch* is a revisionist one, it is, obviously, authoritative. Indeed, the private right of action caselaw may have been a uniquely bad example for the *Coltec* court to have drawn on, since that area seems to reflect a strong textualist influence. *See* Brian D. Galle, *Can Federal Agencies Authorize Private Suits under Section 1983? A Theoretical Approach*, 69 *BROOK. L. REV.* 163, 185 (2003).

⁷⁸ *See* Easterbrook, *supra* note 65, at 68; Nelson, *supra* note 50, at 460–63; Adrian Vermeule, *Interpretive Choice*, 75 *N.Y.U. L. REV.* 74, 129–39 (2000).

⁷⁹ *See* Molot, *supra* note 52, at 28.

⁸⁰ *See* Eskridge, *supra* note 56, at 572–74; Galle, *supra* note 77, at 183–86; Rosenkranz, *supra* note 71, at 2115–20. I am omitting here the possibility that there may be other limits on Congress’ authority to delegate decision making power to other actors, none of which seem to have much traction when it comes to delegations to courts. *See* Rosenkranz, *supra* note 71, at 2126–39.

includes some baseline assumptions about how text is to be interpreted, such as the rules of grammar. As we saw, textualists accept purposivism at this level — where it includes lexical context, if not policy context.⁸¹ Similarly, at least some textualists accept the “absurd results” doctrine, which holds that a court can ignore even the plain words of a text when the result is obviously not “right.”⁸² That necessarily includes a recognition that statutes have purposes from which the text can deviate. Once Congress has itself instructed a court to engage in purposive analysis, and we have acknowledged (as in the absurd results doctrine) that at least some contextual analysis is permissible, it is hard to see how legislative supremacy or faithfulness to the terms of a statutory “deal” can justify drawing a bright line on the continuum of context beyond which courts cannot cross. Thus, the separation of powers argument offered by the *Coltec* court does not appear to rule out congressional efforts to require purposive interpretation.

There may, though, be other constitutional bases on which the *Coltec* court could have drawn. Surprisingly, although much has been written about the constitutional provenance of textualism, there is almost no scholarly examination of whether textualism as a method can be displaced by Congress. The most extensive effort is a short reply article by John Manning.⁸³ Professor Manning argues that Congress could not enact a statute declaring that, for all future statutes, courts must consider legislative history to have been incorporated into the text of the statute.⁸⁴ His claim seems to be that this arrangement violates separation of powers just as much as the use of legislative history absent congressional authorization. In both situations, he maintains, Congress improperly delegates law-making power to a subsidiary within the legislative branch.⁸⁵ That argument seems a bit circular, but we do not need to probe it closely here. Manning states expressly that congressional delegations to other branches, because they necessarily invite checks on legislative will by the other governmental actors, are not constitutionally suspect in the

⁸¹ See *supra* note 56.

⁸² See *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 527–28 (1989) (Scalia, J., concurring); John Manning, *The Absurdity Doctrine*, 116 HARV. L. REV. 2387, 2391–92, 2419–20 (2003) (“[E]ven the staunchest modern textualists still embrace and apply, even if rarely, at least some version of the absurdity doctrine.”). But see Manning, *supra*, at 2391–92, 2419–20 (arguing that these other textualists are wrong).

⁸³ Manning, *Response to Siegel*, *supra* note 45.

⁸⁴ *Id.* at 1530–31.

⁸⁵ *Id.* at 1533–35.

way he condemns for legislative history.⁸⁶ That is the situation with codification of the economic substance doctrine: it is not self-delegation, but rather power-sharing between Congress and courts.

We can imagine, however, two more applicable approaches. Consider the claim that “the judicial power” granted by Article III itself does not include the authority to interpret federal statutes except with regard to meaning clearly implicit on the face of the statute.⁸⁷ If we thought that Article III was limited in this way, then codification could perhaps be unconstitutional.⁸⁸ John Manning has argued that the original meaning of Article III curtails courts’ interpretive power, preventing them from relying much on legislative history.⁸⁹ But Manning acknowledges that his originalist analysis does not do much else to confine courts. In his exchange with Professor Eskridge, he admits that his reading would largely permit the purposivist approach advocated by Eskridge, allowing judges to consider the objects of legislation in interpreting its literal language.⁹⁰

Another possible Article III argument might draw on the literature of “clear statement rules.” Scholars, in particular Larry Sager, have argued that a number of constitutional terms are not enforced directly by the courts, often out of deference to the superior

⁸⁶ That is, Manning argues that by giving authoritative force to legislative history, Congress would be, in effect, making law without bicameralism and presentment. *Id.* at 1538–40. This, he says, would be unconstitutional in much the same way that the single-house veto of administrative actions was unconstitutional in *INS v. Chadha*, 462 U.S. 919 (1983). Manning, *Response to Siegel*, *supra* note 45, at 1535–37.

⁸⁷ See Molot, *supra* note 52, at 7–9 (describing this argument).

⁸⁸ That is, we might conclude that courts cannot accept a delegation to them of authority to fill in gaps in the meaning or application of statutes. The Sherman Act, therefore, would be unconstitutional under this view. I say “perhaps” with respect to codification of economic substance because it is possible that our historical reading of Article III might be inconclusive with respect to dictionary-type definitions. Where the line demarcating acceptably “clear” statutory language from overly vague definitions resides would be a thorny problem, as I discuss in the text a few paragraphs from now.

⁸⁹ John F. Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 8–9 (2001).

⁹⁰ John F. Manning, *Deriving Rules of Statutory Interpretation from the Constitution*, 101 COLUM. L. REV. 1648, 1663 (2001); see William N. Eskridge, Jr., *No Frills Textualism*, 119 HARV. L. REV. 2041, 2051 (2006) (reviewing ADRIAN VERMEULE, *JUDGING UNDER UNCERTAINTY: AN INSTITUTIONAL THEORY OF LEGAL INTERPRETATION* (2006)); Molot, *supra* note 52, at 42, 45 (arguing that, other than differing views on the use of legislative history, there is not much ground between originalist constitutional claims by Manning and Eskridge).

political accountability and practical policy-making skills of the other branches.⁹¹ Instead, the courts demand that legislation that trenches somewhat on the edges of the under-enforced value must be stated “clearly” before it will be understood in fact to displace the constitutional norm. The goal, as with textualism more generally, is to make legislation more onerous to enact, but more deliberative and transparent when enacted.⁹² Moreover, the end result is a set of rights that is crafted not exclusively by courts, but by courts in cooperation with the political branches, so that the courts’ burden of rights-elaboration is lightened by the contribution of political and practical insight from the other branches.⁹³ For example, the Supreme Court has determined that for the most part it will not strike down federal legislation on the ground that it unduly expands federal power at the expense of state autonomy — largely, again, because the Court defers to the outcomes of the political process.⁹⁴ But the Court does demand that legislation affecting so-called “core” state functions must do so clearly.⁹⁵ And so, in theory, when legislation displaces core state functions, it does so after more elaborate consideration from both the courts and Congress.⁹⁶

One could make a similar case for textualism more generally, or at least, for textualism in the special context of tax legislation. Scholars such as Randy Barnett have argued for a libertarian originalist reading of the Constitution, in which the main goal of that document is to preserve individual liberty from outsized government.⁹⁷ Yet as Barnett’s critics point out, we have already walked that road in the *Lochner* era, with the result that courts often made haphazard, uninformed, and anti-democratic decisions that undermined, nearly fatally, their public support.⁹⁸ If we agree with Barnett (and this

⁹¹ See, e.g., Paul Brest, *Congress as Constitutional Decisionmaker and Its Power to Counter Judicial Doctrine*, 21 GA. L. REV. 57, 104–05 (1986); Sager, *supra* note 72, at 1217.

⁹² William N. Eskridge, Jr. & Philip P. Frickey, *Quasi-Constitutional Law: Clear Statement Rules as Constitutional Lawmaking*, 45 VAND. L. REV. 593, 631 (1992); William D. Popkin, *Law-Making Responsibility and Statutory Interpretation*, 68 IND. L.J. 865, 881 (1993).

⁹³ Popkin, *supra* note 92, at 881.

⁹⁴ E.g., *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528, 547–48 (1985).

⁹⁵ *Gregory v. Ashcroft*, 501 U.S. 452, 457–61 (1991).

⁹⁶ See Eskridge & Frickey, *supra* note 92, at 624.

⁹⁷ RANDY E. BARNETT, *RESTORING THE LOST CONSTITUTION: THE PRESUMPTION OF LIBERTY* (2004).

⁹⁸ E.g., Trevor W. Morrison, *Lamenting Lochner’s Loss: Randy Barnett’s Case for a Libertarian Constitution*, 90 CORNELL L. REV. 839 (2005) (reviewing BARNETT,

author does not) about his claims as a matter of constitutional interpretation, then his libertarian principle would seem to be a strong candidate for the sort of “under-enforced” legal norm that Sager discusses.⁹⁹ In this view, the libertarian principle would seem right as a matter of first-order constitutional interpretation, but unworkable in practice. And that, in turn, could lead us to textualism. By raising the cost of legislation, we could protect somewhat libertarian values without outright prohibiting government regulation to the degree of the *Lochner* Court. Alternatively, if this seems to paint with too broad a brush, we might agree with Learned Hand that there is a sort of tax exceptionalism¹⁰⁰ — that there is some basic right to tax planning, to preserve private assets against state claims, and therefore, that efforts to restrain tax planning should have to overcome the “clear statement” speedbump.

But even these theories, as radical as they may seem, would not of themselves bar codification of the economic substance doctrine. Codification, after all, is in a sense exactly the response that the theory of the clear statement rule hopes to produce. After courts have resisted implementing implicit legislative goals that seemed to approach a protected area, Congress responds by affirming more clearly that it intends to press on.

At most, then, these approaches might justify describing textualism as one of Professor Rosenkranz’s constitutional presumptions or default rules. Of course, whether textualism should be properly considered a presumption or a default rule is highly significant to our present debate. If textualism, or tax planning freedom, is only a presumption, then codification of the economic substance doctrine clearly satisfies its requirements.¹⁰¹ On the other

supra note 97).

⁹⁹ See Sager, *supra* note 72.

¹⁰⁰ *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934). The court stated:

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.

Id. at 810. Of course, the Second Circuit went on to conclude that, irrespective of any such right, Congress’ purpose in enacting a tax statute must prevail over its literal terms. *Id.* at 810–11.

¹⁰¹ See Rosenkranz, *supra* note 71, at 2096–98 (explaining that Congress may freely change a presumption or “constitutional starting point”).

hand, if it is a “default rule” which therefore can be displaced by Congress only on a statute-by-statute basis, we then have a very difficult determination. The codified doctrine, of course, applies not simply to one statute, but it is also not quite so broad as the entire Code. Just how narrowly or broadly can a default-displacing provision sweep at a single stroke?

Rosenkranz’s article, as thoughtful as it is, leaves these kinds of questions largely unanswered. He does not offer any normative theory of how to distinguish presumptions from defaults, instead only observing that the Supreme Court seems to have treated state liability to private suit as the latter. This is hardly a fault of Rosenkranz. What he is talking about, really, is the theory of under-enforced constitutional rights and the corresponding statutory rules of constitutional avoidance that go with them. But the Court itself has never developed any coherent theory addressing the extent of Congress’ power to deprive courts of the avoidance power. I have noted similar uncertainties about avoidance before. For example, no one knows whether state legislatures could order state courts not to employ avoidance when interpreting either state or federal law.¹⁰² And, on the question of how broad a default-displacing statute may be, I have described the Supreme Court’s own confusion over that question in the context of clear statement rules that protect state sovereign prerogatives.¹⁰³

These doctrinal uncertainties may well be deliberate. Fuzzy borders around our rules may keep potential trespassers — here, Congress — far from their edges.¹⁰⁴ And the very premise of the notion of avoidance is that it minimizes the Court’s need to confront Congress and strike down the enactments of the more politically responsive branch.¹⁰⁵ A very brightly demarcated definition of what Congress is permitted to do might oblige the Court to challenge Congress head-on much more often,¹⁰⁶ diminishing the Court’s own store of political capital and good will. And it removes some of the Court’s doctrinal flexibility. Right now, the Court can require more

¹⁰² Brian Galle, *Getting Spending: How to Replace Clear Statement Rules with Clear Thinking About Conditional Grants of Federal Funds*, 37 CONN. L. REV. 155, 210 (2004).

¹⁰³ *Id.* at 162–66.

¹⁰⁴ See Matthew D. Adler & Seth F. Kreimer, *The New Etiquette of Federalism*: New York, Printz, and Yeskey, 1998 SUP. CT. REV. 71, 137.

¹⁰⁵ Galle, *supra* note 102, at 204–05.

¹⁰⁶ See Molot, *supra* note 52, at 54–55 (arguing that consistent application of strong textualist methods tends to greatly expand judicial power).

or less narrow default-removing legislation, depending on its own sense of how important the underlying right is, how likely Congress is to respect the right, the Court's own present capacity for resisting encroachments, and other similar factors.¹⁰⁷ A hard and fast rule would likely make those adjustments either very difficult or, at least, much closer to the surface of the Court's opinions than it seems presently to want to make them.¹⁰⁸ So the space between default and presumption may well never be clearly set out — by design.

For our present purposes, then, the certainty of uncertainty may be all we need. It may be enough to say simply that it would take a dramatic new advance in the law of clear statement rules to invalidate codification of the economic substance doctrine and no such dramatic advance is likely to be forthcoming. It therefore seems, at most, a very small advantage in favor of Chirelstein and Zelenak that their proposal would avoid this possible problem. Further, even if there were a rule that very broad anti-clear-statement-rule statutes are impermissible, it is unclear where the line would fall dividing those that would be permissible and those that would not be. The economic substance doctrine is fairly broad, but corporate tax planning is a small piece of the legislative world as a whole. So, in short, there appears to be very little reason to fear that textualists would have any constitutional hook for resisting codification.

IV. TEXTUALISM AND THE PROBLEM OF INTENDED TAX SUBSIDIES

I do not say any of this in order to criticize Chirelstein and Zelenak. Indeed, as I mentioned, my argument here relies on their powerful insight: that an express listing of approved or disapproved transactions has the potential to solve one of the largest conceptual challenges for the economic substance doctrine.¹⁰⁹ In particular, a

¹⁰⁷ Cf. Popkin, *supra* note 92, at 882–84 (pointing out that constitutionally-inspired clear-statement rules leave to judges additional decisions about how broadly to apply underlying constitutional principle).

¹⁰⁸ In addition, for reasons that are too complex to be worth getting into here, the Court likely has strong institutional reasons for wanting, rhetorically, to describe its interpretation of statutes, even under the aegis of a constitutional “default rule,” as something other than constitutional deliberations. See Brian Galle, *The Justice of Administration: Judicial Responses to Executive Claims of Independent Authority to Interpret the Constitution*, 33 FLA. ST. U. L. REV. 157, 194–208 (2005). But describing its work as constitutional interpretation is precisely what the Court would likely have to do in order to enunciate any clear theory of constitutional default rules. Thus, I think we are unlikely to ever see such a theory, at least from the Court.

¹⁰⁹ Cf. Chirelstein & Zelenak, *supra* note 9, at 1955–56.

major flaw in the doctrine is and has been that some tax benefits in fact are intended by Congress. Leaving to courts the task of sorting tax shelter from tax subsidy exposes the whole enterprise to precisely the most trenchant criticisms of textualism. In this part, I explain those criticisms and discuss how (I hope) incorporating this piece of the Chirelstein and Zelenak proposal into any codification effort blunts them. At the same time, we see that, if an unfettered judiciary is our largest concern, this opt-in or opt-out scheme is enough on its own to solve the problem without resorting to outright abandonment of economic substance.

A. A Clear Statement Rule for Tax Benefits or Detriments

Despite the possible downsides of tax planning, it is obvious that Congress sometimes intends to encourage it.¹¹⁰ Tax subsidies may correct a defective market, as where individual actors fail to internalize fully the benefits of a societal good.¹¹¹ Or the tax system may simply provide an easily administered delivery vehicle for redistributive spending of various forms (not all of them laudable).¹¹² Yet Congress does not have infinite time and energy to write every tax statute in a way that perfectly exemplifies the policy tradeoffs Congress wants to achieve.¹¹³ And, of course, Congress cannot always foresee what effect a statutory text will have when mixed with real-world financial transactions, some unimagined at the time of drafting.¹¹⁴ Ideally, then, Congress would like a shortcut, a way to enable courts readily to identify what portions of their statutes are designed to create subsidies and what portions are not.¹¹⁵

¹¹⁰ See Bankman, *supra* note 1, at 13; Beller, *supra* note 33, at 5–6; see also *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 S.C.R. 601, at paras. 16, 32 (Can.) (making same arguments with respect to Canadian Parliament).

¹¹¹ See Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1398 (1988).

¹¹² PHILIP D. OLIVER, *TAX POLICY: READINGS AND MATERIALS* 569–84 (2d ed. 2004).

¹¹³ See Cunningham & Repetti, *supra* note 1, at 55–56; David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 861–62 (1999).

¹¹⁴ See James S. Eustice, *Abusive Corporate Tax Shelters: Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 141 (2002); David P. Hariton, *Response to “Old ‘Brine’ in New Bottles” (New Brine in Old Bottles)*, 55 TAX L. REV. 397, 397–98 (2002).

¹¹⁵ Louis Kaplow has argued that, in choosing between statutes whose details will be filled out primarily at the time of enactment (rules) and those whose content will largely be created in litigation afterwards (standards), the tax law should choose rules because the costs of many repeated instances of litigation will exceed the costs of one

This reality poses a particular problem for those who wish to control tax sheltering activity in a textualist era. Remember, again, that the textualists' primary complaint is with the effect of shifting decision-making authority from legislatures to courts.¹¹⁶ That shift, they say, means that rules may be made largely out of public sight and insulated from public influence.¹¹⁷ Changes can be initiated by a single litigant with an agreeable court. And rules may reflect, not widespread consensus by representatives of various social interests, but instead the preferences of an elite and entrenched group of judges whose preferences may be either eclectic or not fully informed.¹¹⁸ The textualist might, conceivably, be willing to accept a statutory scheme that stated, flatly, that tax planning is prohibited. That would leave little play for judicial discretion. What most present codification proposals instead present is a mixed landscape, in which a court is

burst of legislative energy. Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 577 (1992). Thus, Kaplow would likely say that Congress, if it is interested in efficiency, should not prefer "shortcuts," as I have called them. One could argue with Kaplow's assessment of the welfare effects of rules. For instance, he is largely comparing apples and oranges, treating legislative decision making resources as equivalent to the resources we spend in litigation. But one of those — litigation resources — is relatively limitless, while legislative resources may be significantly constrained by the Constitution. We can only have so many legislators and there may be serious negative effects on the quality of legislative outputs if we cut back on the time legislators themselves (as opposed to their staffs) devote to each statute. A complete welfarist analysis would have to consider whether Congress could create net positive welfare by conserving its own time and allocating budget authority for more judges.

My point here, though, is a bit different. I am claiming that congressmen themselves are likely to want to conserve their own time. For instance, they will only partly internalize any of the inefficiency effects predicted by Kaplow (largely through the medium of voter discontent with the job they are doing), while more fully realizing the benefits of having time to raise money, provide constituent services, and enact legislation that serves their own ideological and political interests. That preference has significant implications for interpretative theory. If our goal is fidelity to congressional intent, however self-serving, then we likely have to follow Congress' preference for standards in some instances. If our goal, on the other hand, is to reform a misguided Congress and chasten it to better internalize what may be harmful effects of its preferences, then we have to understand the basis for those preferences. Either way, the basic point that Congress likely wants shortcuts is important.

¹¹⁶ See Easterbrook, *supra* note 67, at 536; Easterbrook, *supra* note 47, at 61–62.

¹¹⁷ *Finley v. United States*, 490 U.S. 545, 556 (1989) (Scalia, J.); Sunstein, *supra* note 69, at 416 (describing this view).

¹¹⁸ See *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 S.C.R. 601, at paras. 31, 41 (Can.); JEREMY WALDRON, *LAW AND DISAGREEMENT* 79–80, 105–18, 136–38, 141 (1999).

expected to sort between encouraged tax subsidies, discouraged tax planning, and tax shelters, which are to be singled out for special penalties. All of this sorting is to be done based on the court's own view of what a Congress, which on the face of the Code has given few clues, must have wanted. The result is an obvious invitation to give free play to the courts' own views about what conduct is desirable and whether revenue is to be given priority over private autonomy. Therefore the textualist likely is unsurprised that individual circuit courts show distinct, ideologically predictable tendencies in their treatment of alleged tax shelters.¹¹⁹

Even if we are unmoved by these criticisms, their appeal to some judges remains a practical problem, as the experiences of our Canadian neighbors have demonstrated.¹²⁰ The JCT's proposal includes an exception for tax benefits intended by Congress.¹²¹ The textualist response, in the Canadian example, is logical: the textualist exploits this language to upend the enterprise, reading intended by Congress to mean any benefit described by the literal language of the Code.¹²² The exception swallows the rule and the textualist need worry no longer about judicial discretion.¹²³

Chirelstein and Zelenak themselves seem to make much the same point. They worry that any effort to leave "economic substance" or more general anti-abuse rules to judges will simply reproduce the judge's policy preferences, rather than reflect a rational nationwide tax policy.¹²⁴ They thus appear to share with textualists some skepticism about the capacity for individual judges to fill statutory "gaps" in a way that is principled and faithful to abstract congressional policy aims not embodied specifically in the lexical dimension of a statute. This is, of course, not an undisputed position in interpretative

¹¹⁹ See Hariton, *supra* note 23, at 23–24; Nahass, *supra* note 63, at 257–61; Sheppard, *supra* note 13, at 1022.

¹²⁰ In essence, the Canadian experience was that enactment of a statutory rule aimed at abusive tax shelters did almost nothing to change judicial outcomes. Canadian courts essentially ignored the new statute and continued to read tax laws as they always had — as textualists. See *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 S.C.R. 601, at paras. 60–76 (Can.); Arnold, *supra* note 71, at 491–92, 497.

¹²¹ STAFF OF JOINT COMM. ON TAXATION, *supra* note 14, at 14–15.

¹²² *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 S.C.R. 601, at paras. 60–76 (Can.).

¹²³ See Schler, *supra* note 8, at 386–87.

¹²⁴ See Chirelstein & Zelenak, *supra* note 9, at 1949, 1953; Zelenak, *supra* note 39, at 185–87.

circles. Professor Dworkin, among many others, would be anxious to disagree.¹²⁵

But, again, our goal is to build a statute that will prove effective no matter the interpretative theory of the court in which it lands. Dworkin's Hercules, and his brethren, will have no trouble sorting congressionally intended subsidies from tax sheltering and will trust their fellow principled judges to do the same.¹²⁶ That achieves nicely the "shortcut" I mentioned at the outset of this section, conserving Congress' tax statute drafting efforts and freeing more time for other problems. Unfortunately, for those who are unpersuaded by purposivism, we have some more work to do. "Do what Congress intends" will not be a satisfactory shortcut, and a Congress that relies on that rule alone, may see unintended and unappealing results, such as allowance of many tax shelters.

Evidently, then, we need a more precise way of describing the difference between tax subsidy and tax shelter. This is as much a conceptual challenge as a linguistic one. Consider, for instance, the participation by nonprofit entities in many "shelters" in exchange for a modest accommodation fee. The tax exemption is obviously "intended" by Congress to benefit the exempt entity. Here, the accommodation fee does, indeed, leverage exemption to the entity's gain. But that gain is achieved at a disproportionately large social cost. To us, it may seem irrational to spend \$100 to give the exempt entity \$1. The textualist might say, however, that to allow courts to make that judgment is to open the door to saying that many other congressional subsidies are just as foolish.

Once this door is open, the textualist claims, it is hard to make certain that only the "right" subsidies step through. In this view, the difficulty in describing the limits of what it means to subsidize is that the societal tradeoffs that go into a political decision to subsidize are often necessarily implicit or incompletely theorized. We have little language, and not much more theory, about what it means for a collective body, be it a legislature or a society, to "intend" something.¹²⁷ Judicial efforts to fill in these gaps may be subjective

¹²⁵ RONALD DWORKIN, *LAW'S EMPIRE* 87, 176–275, 353–54 (1986).

¹²⁶ Hercules is Professor Dworkin's imaginary judge, whose considerable knowledge and analytical powers allow him to reach right answers even to difficult legal questions. *Id.* at 239.

¹²⁷ See Easterbrook, *supra* note 67, at 547; Manning, *supra* note 55, at 427; Molot, *supra* note 52, at 28; Nelson, *supra* note 46, at 370; Nicholas S. Zeppos, *Legislative History and the Interpretation of Statutes: Toward a Fact-Finding Model of Statutory Interpretation*, 76 VA. L. REV. 1295, 1300–01 (1990).

guesswork.¹²⁸ Inevitably, then, some decisions will permit tax benefits to flow to transactions that many or most legislators would have agreed should not receive them, but which perhaps are viewed more sanguinely by a judge.¹²⁹ As a result, it is difficult to describe “intended subsidy” in a way that rules out shelter hitchhikers, unless we think words can have only one plausible lexical meaning and we limit statutory “intent” to that meaning.

Chirelstein and Zelenak helpfully suggest a way to short-circuit these problems. If we simply make a list of *expressly* approved tax subsidies, or of disapproved shelters, then we can greatly reduce our need to describe congressional intent on the level of grand theory.¹³⁰ That is, in this scheme any tax benefit can be recognized only if described on the face of a statute (or, perhaps, a regulation) as an intended tax benefit; intention could not be inferred from context, implication, or analogy. We then would have only the more manageable and more familiar task of making the lines demarcating each carve-out as bright as we want them. Obviously there will still be debate around the edges. But we greatly reduce the room for the play of judicial value preferences, which greatly appeases textualist resistors.¹³¹

Now, as I noted earlier, this approach has costs, at least from the legislative perspective. It consumes large chunks of legislative time

¹²⁸ See Easterbrook, *supra* note 65, at 68; Nelson, *supra* note 46, at 370.

¹²⁹ See Schler, *supra* note 8, at 340–41; Walsh, *supra* note 19, at 1562–63; *cf.* ADRIAN VERMEULE, *JUDGING UNDER UNCERTAINTY: AN INSTITUTIONAL THEORY OF LEGAL INTERPRETATION* 175–76 (2006) (arguing that error costs of judicial interpretation exceed any benefits); Smith, *supra* note 1, at 12–13 (noting difficulty of sorting benefits intended by Congress from those that resemble benefits intended by Congress).

¹³⁰ See Chirelstein & Zelenak, *supra* note 9, at 1955–56.

¹³¹ *Cf.* Weisbach, *supra* note 113, at 877 (observing that it might be possible to obtain benefits of both rules and standards by “provid[ing] a standard with safe harbors”). As Ethan Yale points out in correspondence, this standard arguably does raise a second set of difficulties in identifying what is a tax “benefit” that must be staked out expressly by Congress and what is simply an ordinary application of tax principles. For instance, we might dispute whether a “beneficial” treatment of basis in fact is a “benefit” that must be stated clearly by Congress or just a necessary component of determining a taxpayer’s income. *Cf.* George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 659–60 (1985) (observing difficult baseline questions in defining tax avoidance). To avoid these difficulties, I would suggest that we might define our baseline from which departures are a “benefit” not as “income,” or any other concept that might involve questions of tax policy, but rather simply as any determination that would reduce taxable income below gross revenues in the applicable tax accounting period.

that could be devoted to other efforts, as Congress must determine each item individually, and craft and agree on language that reflects its assumptions. For example, Congress would have to state whether tax exemption applies only to income generated by engaging in exempt activities, and not to the profits passed through by a partnership created by a shelter promoter.¹³² It must reach consensus on these questions and cannot simply punt them to courts.¹³³ Some of these negotiations will entail not only time but also political pain, as it becomes more obvious to those whose oxes are gored who has done the goring. Many efforts will initially be over- or under-inclusive and demand repeated revisions, especially as underlying facts in the world change.¹³⁴ To the textualist, of course, these are not costs at all, but gains. They are precisely what textualism is supposed to produce — more deliberation, more transparency, and less legislation.

In sum, Chirelstein and Zelenak, although they do not frame their plan in quite this way, offer us a solution to what would otherwise be a crippling problem. Many views of interpretative theory would force the interpreter to balk at allowing judges to sort shelter from subsidy. Yet, unless Congress is to write every line of the Code with the utmost care and inhuman foresight, judges will be called upon to sort. The default rule device lifts much of the weight of those sorting decisions from the court — although, of course, not all of it.¹³⁵ Congress then can conserve its efforts, giving ordinary attention to most tax statutes and devoting heightened thought and deliberation to the rules affecting “opt-in” or “opt-out” provisions that are especially important to it. And these default provisions, by virtue of being interpretatively palatable to many different judges, are more likely to be heeded.

B. Why Stop There?

A key aspect of the analysis in the last section is that it does not seem to depend on the structure of the background anti-shelter rule.

¹³² See Surrey, *supra* note 39, at 707 n.31.

¹³³ See WALDRON, *supra* note 118, at 80.

¹³⁴ I note that a classic solution for many of these problems is to allow agencies to fill in the gaps and make the fine-grained adjustments that better implement an imperfect statute. This solution would reduce error costs, but arguably also reduce transparency. This article is agnostic about whether the Service would have the power to alter or authoritatively interpret the list of intended tax subsidies.

¹³⁵ See Einer Elhauge, *Preference-Estimating Statutory Default Rules*, 102 COLUM. L. REV. 2040–48 (2002).

Chirelstein and Zelenak deploy their opt-in/opt-out idea as a way to permit some but not all transactions with no real economic loss to get beneficial tax treatment, without having to retreat from their stance that courts should not be obliged to guess at congressional intent. But there is no obvious reason why the same idea would not work even in the absence of their suggested bright-line rule prohibiting deductions in the absence of real economic losses.

Indeed, the opt-in/opt-out plan might make the economic substance doctrine, or other broad anti-abuse rules, more appealing than the Chirelstein and Zelenak proposal as a whole. Suppose our primary concerns about the economic substance doctrine were tied to judicial reluctance to employ it, rather than to any doubts about its content.¹³⁶ We might then enact a codified doctrine that directs courts to disallow tax benefits for a transaction that lacks economic substance, unless that transaction was specifically identified by Congress as one that should receive favorable treatment. For courts that would be reluctant to punish shelter activity, that rule — the opt-in rule — deprives them of the argument that the literal text of the statute (text that does not contain an express declaration that this form of transaction is intended for subsidy) exemplifies an *implicit* congressional “intention” to allow the taxpayer a deduction or other benefit. And, perhaps more importantly, we have enacted an economic substance “standard” in a way that is intellectually satisfying to judges across the spectrum of interpretative theory.

Thus, assuming that the economic substance doctrine itself is fairly determinate, the result is to remove much of the wiggle room for importing judicial notions of good tax policy. That was one of the central goals we identified for Chirelstein and Zelenak’s proposal. But we have achieved it across a much wider, and more malleable, range of possible abusive transactions. Our only remaining challenge is to find a formulation of the economic substance doctrine that justifies our assumption. I return to that problem in a moment.

V. IMPLICATIONS FOR THE CONTENT OF A CODIFIED DOCTRINE

My analysis so far has two main implications. First, interpretative theory shows us that there are good reasons for codifying the

¹³⁶ In other words, in this hypothetical, we are reasonably confident that it will usually be obvious when a transaction has economic substance and when it does not. I use the subjunctive voice in the text here because I recognize that this is an assumption contrary to fact; one of our big worries about the doctrine is that its content is sometimes hard to predict. I return to this problem shortly.

economic substance doctrine. Codification could overcome the reservations of textualist judges. It would also allow Congress the opportunity to enact a default rule that would deal with some of the policy objections of textualists, while preserving Congress' flexibility in drafting most portions of the Code. In this part, I want to develop another implication: there is a good argument that the preceding suggests not only a form for the economic substance doctrine but also its content. In particular, by using clear statement rules, we can remove what is probably the most persuasive argument against David Weisbach's suggestion that shelter regulation should aim to curtail all tax planning.¹³⁷ That, in turn, suggests that any codified doctrine should likely target transactions subjectively motivated in significant part by tax considerations.

A. In Favor of a Strong Conjunctive Test

A continuing source of debate among courts is whether the economic substance test has both objective and subjective components. That is, while some courts say that the test can be satisfied either by the presence of objective economic substance or a subjective business purpose for engaging in the transaction, others require both.¹³⁸ The most recent codification proposals from both the Senate and the JCT would require a "conjunctive" test — that is, they would require both.¹³⁹ What is unclear is why. Our discussion in Part IV, in combination with important work by others, suggests a strong reason for requiring that taxpayers receive favorable tax treatment only for transactions in which their main objective is a nontax purpose.

As I said, I believe my analysis in Part IV fills a hole in what otherwise is a highly convincing set of claims by David Weisbach about the ideal content of tax shelter regulations.¹⁴⁰ Since he has already laid his argument out in detail, I only summarize it here. Weisbach's argument, as I read it, proceeds from the fairly uncontroversial premise that the content of any shelter strategy should follow from its purposes.¹⁴¹ From a purely welfarist perspective, the primary goals of the tax system are to raise revenue for government while incurring a minimum of economic distortions

¹³⁷ Weisbach, *supra* note 38, at 222–25.

¹³⁸ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 14, at 6–7.

¹³⁹ See *supra* note 13.

¹⁴⁰ Weisbach, *supra* note 38.

¹⁴¹ *Id.* at 222.

that reduce society's productivity.¹⁴² Both of these goals are best served by a tax system that discourages "tax planning" — that is, arranging one's affairs so as to minimize tax burdens.¹⁴³

While the effects of tax planning on revenue are obvious, its downside for social welfare perhaps bears a bit more examination. Most obviously, tax incentives distort efficient market behavior and tax planning distracts the planners from doing something more productive with their time.¹⁴⁴ I would add that inefficient tax distortions can be magnified by social norms and QWERTY effects. That is, sometimes we act the way we do because that is how we conclude we are expected to behave¹⁴⁵ or because we have invested in a way that depends on existing arrangements.¹⁴⁶ So distortions caused initially by a tax effect can influence behavior even generations later or in industries not affected directly by the tax. The costs of these distortions are almost literally incalculable.

It follows from these premises that at least the ideal goal of anti-shelter regulations should be to curtail tax planning.¹⁴⁷ That is, we should not simply aim to prevent revenue losses. We also should

¹⁴² *Id.* at 234, 241; Weisbach, *supra* note 113, at 870. I put aside fairness considerations here mostly because in the shelter context they often are question-begging. For instance, we all probably agree that similarly situated taxpayers should have comparable duties to pay tax, but that simply frames a further debate about whether merely technical compliance with the Internal Revenue Code (Code) puts a taxpayer in the same position as one who complies in both the technical and some other sense.

¹⁴³ Weisbach, *supra* note 38, at 223–25. My analysis here presumes that Congress, as an entity that more nearly internalizes society-wide costs and benefits than any individual private actor, will be a better judge of efficient or fairly distributive rules than potential tax avoiders. In other words, I assume that it is unlikely that tax rules will themselves be inefficient in a way that could be mitigated by tax planning.

¹⁴⁴ *See id.* at 222–23, 232, 236; Thompson, *supra* note 25, at 782.

¹⁴⁵ *See, e.g.,* Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 539–40 (1998); Jon Elster, *Social Norms and Economic Theory*, J. ECON. PERSP., Fall 1989, at 99, 99–100.

¹⁴⁶ *See* W. Brian Arthur, *Positive Feedbacks in the Economy*, SCI. AM., Feb. 1990, at 92, 95; Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332, 332 (1985); Paul Krugman, *History and Industry Location: The Case of the Manufacturing Belt*, 81 AM. ECON. REV. 80, 80 (1991). This effect may be increased by cognitive biases in favor of existing arrangements. *See* James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1360 (2001).

¹⁴⁷ Except, of course, for tax planning that would in fact increase revenue, social welfare, or both. More on this in a moment.

attempt to discourage socially wasteful efforts to minimize tax.¹⁴⁸ Because of a long tradition of rhetoric in favor of a taxpayer's "right" to engage in tax planning,¹⁴⁹ it perhaps is fair to say that most anti-shelter efforts have focused on the revenue side, with at most only incidental attention to whether they will also affect tax planning.

Taking this analysis one step further, we might conclude that any codification of the economic substance doctrine should prohibit favorable treatment for transactions motivated in any large part by tax considerations.¹⁵⁰ That rule aims most directly at both of the problems we want to prevent and reaches them in ways that a purely objective test might not. For example, markets improve and react through experimentation, and there may be many objectively reasonable ways to do business. If businesses select among what look at present to be relatively interchangeable options based on tax considerations rather than out of an effort to improve, we lose much of the motor that drives business experimentation and reduce market adaptability.

There are two main sets of arguments against this reasoning. The first is that there are putatively insurmountable evidentiary problems in establishing subjective motivation.¹⁵¹ In many respects, though, requiring subjective business purpose in every case will make the Government's life easier. Evidence that a taxpayer bought a promoted tax shelter will likely amount to conclusive proof that the tax benefit should be disallowed — because, among other reasons, most fact-finders probably will conclude it is unlikely that the promoted tax shelter happened to be just the kind of investment vehicle for which the taxpayer was looking.¹⁵² While some taxpayers may invent documents to support bogus business purposes, the possibility of "smoking gun" e-mails that will foreclose any business purpose argument (plus the threat of convictions for obstruction of justice) may outweigh this danger in the long run.¹⁵³ And making taxpayer motive relevant in every case will give taxpayers a strong

¹⁴⁸ See Weisbach, *supra* note 38, at 252.

¹⁴⁹ See Hariton, *supra* note 23, at 7; Weisbach, *supra* note 38, at 220 (describing the tradition).

¹⁵⁰ See Weisbach, *supra* note 38, at 251–53.

¹⁵¹ Cf. Bankman, *supra* note 1, at 27–28 (considering whether it is difficult for taxpayers to create fake evidence of nontax subjective intent); Weisbach, *supra* note 38, at 236–37, 253 (noting that determining motive may be costly).

¹⁵² Cf. Weisbach, *supra* note 38, at 253 (arguing that it is obvious that several famous shelters were tax-motivated).

¹⁵³ See I.R.C. § 7212(a) (making any corrupt effort to "impede[] the due administration of" the Code a felony).

incentive to be as transparent as possible with the Service about their tax position, because any evidence of concealment could easily be read by a finder of fact as evidence of tax planning.¹⁵⁴ In any event, the burden of proof critique is, at most, an argument for the Service and the Justice Department to be choosy about in which cases they elect to proceed. The law has both norming and deterrence effects¹⁵⁵ and may thereby curb subjectively motivated shelter activity even if enforced as such only rarely.¹⁵⁶

The more potent critique, then, is that some tax planning is desirable. Michael Schler and others, in their various responses to Weisbach and elsewhere, raise what is for us now a familiar problem: there are some tax rules designed specifically to encourage behavior that might not result from an unregulated market.¹⁵⁷ But that is no reason to welcome *all* tax planning. The challenge is to find a reliable and administrable tool for sorting desirable from undesirable planning. As we have seen, the challenge is substantial; the price of failure is a potential for highly over- or under-inclusive enforcement. However, as we have also seen, a clear statement rule for intended tax benefits could well be the tool we need to mitigate those problems.¹⁵⁸

¹⁵⁴ See *Spies v. United States*, 317 U.S. 492, 499–500 (1943).

¹⁵⁵ See Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 361–65 (1997); Tracey L. Meares et al., *Updating the Study of Punishment*, 56 STAN. L. REV. 1171, 1182–83 (2004). *But cf.* Robert Weisberg, *Norms and Criminal Law, and the Norms of Criminal Law Scholarship*, 93 J. CRIM. L. & CRIMINOLOGY 467 (2003) (critiquing strong predictive claims of other analyses of effect of law and punishment on social norms).

¹⁵⁶ See Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 FORDHAM L. REV. 957 (2006); Weisbach, *supra* note 38, at 245.

¹⁵⁷ See Beller, *supra* note 33, at 5; Hariton, *supra* note 23, at 15, 20; Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 876 (1982); McMahon, *supra* note 20, at 205–06; James M. Peaslee, *More Thoughts on Proposed Economic Substance Clarification*, 99 TAX NOTES 747 (May 5, 2003); Schler, *supra* note 8, at 329, 340, 385–86 (arguing that Weisbach overlooks that some tax planning is encouraged by Congress); *see also* Bankman, *supra* note 1, at 13 (observing that the economic substance doctrine cannot logically be applied to subsidies intended by Congress); Daniel N. Shaviro, *Evaluating the Social Costs of Corporate Tax Shelters*, 55 TAX L. REV. 445, 450–51 (2002) (positing that tax planning to comply even with arbitrary tax rules may have some societal usefulness).

¹⁵⁸ See *supra* text accompanying notes 134–37.

David Hariton also argues that Weisbach confuses the tax shelter issue by failing to suggest a yardstick for distinguishing between unwanted tax planning and truly egregious planning meriting some additional penalty. Hariton, *supra* note 23, at 6–8, 32. In a sense, this is true. Once we are willing to say that we should resist all tax

For example, Congress could carve out a list of expressly specified tax-favored transactions that would be exempt from re-characterization even if engaged in unreasonably or for tax-avoidance purposes.

Thus, with the addition of a clear-statement rule addendum, there seems to be no strong argument against a codified doctrine that condemns subjectively tax-motivated transactions.

B. In or Out? An Aside

This presents the additional question whether the default setting for our clear statement rule should be subsidy or no subsidy. The logic of clear statement rules suggests that we should put the burden of overcoming legislative inertia on the position we think presently is over-produced, or at least under-deliberated, in the legislative process.¹⁵⁹ For the most part, I have argued, tax planning is societally wasteful. Yet there are few checks on tax subsidies, especially largely hidden subsidies, such as special rules for accelerated depreciation and deferred or equity-based compensation. Interest groups may use the tax system, which is arcane and largely obscure from public sight to begin with, as a way to hide from voters at large the benefits for which they lobby and reap for themselves.¹⁶⁰ Public choice theory predicts that, in situations like that, the interest group will win more often than the political marketplace would otherwise dictate; information costs and other collective action barriers, magnified by manipulation of obscure tax provisions, result in rents for the interest group.¹⁶¹

This is not to say that tax subsidies are always pernicious and inefficient. But there does seem to be a plausible case that they are over-produced and would greatly benefit from a rule that makes their production not only more difficult, but also more transparent, so that the political market can operate itself to check them more effectively.

planning, it becomes difficult to single out some subset of it that we find especially worthy of condemnation. That problem is easy to avoid, simply by exposing all tax planning to the same risks.

¹⁵⁹ Galle, *supra* note 102, at 184–85.

¹⁶⁰ See Elizabeth Garrett, *Accountability and Restraint: The Federal Budget Process and the Line Item Veto Act*, 20 CARDOZO L. REV. 871, 930–31 (1999).

¹⁶¹ See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 21, 35 (1971); Jonathan R. Macy, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 229 (1986).

The “opt-in” default rule I have described helps us to move in that direction.

C. Back to Standards

We are left with one loose end, albeit a very significant one. It is one thing, in theory, to recognize that we ought to target subjective tax planning motivations. It is another to determine whether as a practical matter any judicially-administered system with that goal can be consistent and predictable enough to be worth its costs. For example, as I have noted, one major reason Chirelstein and Zelenak are disenchanted with the economic substance doctrine is that they do not think that it can deter determined tax avoiders.¹⁶² If we agreed with that view, we might prefer their bright-line technique as a second-best method for reaching inefficient tax planning. As I explain here, though, the evidence for their claim is, at best, uncertain.

More or less everyone who has ever written about the economic substance doctrine has a different view about its deterrent effects on taxpayers. Chirelstein and Zelenak, as I said, believe that very aggressive tax planners, and especially their clients, can be dissuaded from their enterprise only by a bright-line rule that leaves essentially no doubt that the transaction available to them will not work.¹⁶³ At

¹⁶² See Chirelstein & Zelenak, *supra* note 9, at 1948, 1953.

¹⁶³ See *id.* It would be interesting to know whether Chirelstein and Zelenak agree with the Government that the KPMG shelter promoters are criminally liable for promoting their “FLIP” and “BLIPS.” The Government’s theory of the case, according to the indictment, appears to be that the economic substance doctrine made it so obvious that these shelters would not work that the individual KPMG defendants had to have known for certain that their efforts to sell them would violate a “known legal duty.” Superseding Indictment at 17, 25–26, *United States v. Stein*, No. 05-CR-0888 (S.D.N.Y. Oct. 17, 2005) (alleging that defendants’ internal communications revealed that they knew shelters would not survive court challenges and were “close to frivolous”); see *Cheek v. United States*, 498 U.S. 192, 201 (1991) (holding that proof of a “voluntary, intentional violation of a known legal duty” is an element of tax evasion); *United States v. Gurary*, 860 F.2d 521, 525 (2d Cir. 1988) (holding that tax willfulness is an element of the crime of conspiracy to evade tax). Yet Chirelstein and Zelenak appear to posit that the economic substance doctrine cannot produce that level of certainty about a tax transaction. In correspondence, Professor Zelenak noted that the Government also alleges that some of the promoted shelters were truly shams — that is, the transactions that should have provided tax relief were not genuinely as represented. *E.g.*, Superseding Indictment, *supra*, at 16, 21–23 (alleging that defendants in fact controlled supposedly “unrelated” parties to some transactions, misrepresented independence of other participants in transactions and

the same time, a number of other commentators — mostly practitioners, it should be noted — claim that the uncertainty of the doctrine *overdeters* innocent conduct, producing more social costs than it saves.¹⁶⁴ Professor Weisbach observes, aptly, that which of these views is right is ultimately an empirical question for which we have no current data.¹⁶⁵ Notwithstanding his warning, I will hazard here a few additional thoughts.

First, it is not quite true that we have no data. For one thing, we have the lessons of history, although I agree that in the end they are inconclusive. Our early experiences with the law of corporate reorganizations presented an experience very similar to Chirelstein and Zelenak's proposal. On first enactment, the reorganization provisions were fairly sketchy.¹⁶⁶ Business taxpayers took advantage of Congress' imprecise drafting and inexperience to pay very little tax.¹⁶⁷ Congress responded with, in essence, a super-detailed code, attempting to deal with every possible situation that might arise.¹⁶⁸ It was an enormous failure; tax revenues from the affected industries barely moved.¹⁶⁹ It was only Learned Hand, and later the Supreme Court, whose early invocations of the economic substance doctrine convinced taxpayers that they would have to pay or risk serious penalties.¹⁷⁰ But we have to be careful with our history.¹⁷¹ Is our lesson that detailed rules can never work and standards do? Or is our lesson that the particular code that Congress wrote in the 1920s failed,

claimed falsely that some transactions had a potential for profit). That would provide an alternative ground for conviction whatever one's view of the legal determinacy of the economic substance doctrine.

¹⁶⁴ See Beller, *supra* note 33, at 3, 5 (summarizing American Bar Association Section of Taxation comments); Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159 (2001); David P. Hariton, *How to Fix Economic Substance*, 2003 TNT 82-33, 539-40 (Apr. 29, 2003).

¹⁶⁵ Weisbach, *supra* note 38, at 248; see also Aprill, *supra* note 13, at 34.

¹⁶⁶ "Sketchy," of course, is a highly scientific interpretative term. I derive this discussion of the history from Steven A. Bank, *Codifying Judicial Doctrines: No Cure for Rules but More Rules?*, 54 SMU L. REV. 37 (2001).

¹⁶⁷ *Id.* at 42.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 44.

¹⁷¹ Cf. Martin S. Flaherty, *History "Lite" in Modern American Constitutionalism*, 95 COLUM. L. REV. 523, 526 (1995) (warning of what the author perceives as lawyers' misuses of historical analysis).

perhaps despite a level of detail that would otherwise be a virtue? With our one data point, we do not really know.

Another important source of data, though, is our reports from other commentators about who is likely to respond to the incentive effects of the doctrine in the manner they predict. Professor Zelenak says that very aggressive shelter promoters and their customers need bright-line rules.¹⁷² Schler, Hariton, and others predict that sober and careful members of the tax bar (like themselves) might be scared off of good transactions by overly broad judicial doctrines.¹⁷³ Both camps could easily be right, and neither seems to be making strong predictions about the group described by the other camp. Quite possibly, the same set of rules will have different effects on different planners.

Supposing that both sets of predictions were right, what would be the net outcome for society as a whole? Here, again, we have Weisbach's point that we do not know the relative size of either group or the magnitude of the costs or benefits that we could produce by designing a rule aimed at them.¹⁷⁴ We would like to think that there are more thoughtful and careful tax planners, and we suspect that many aggressive planners will do what they do regardless of what the rules are, bright or otherwise.¹⁷⁵ But we still do not know the magnitude of the costs on either side. Neither group is likely to tell us honestly and the "gap" between tax due and tax actually collected is hard to measure.¹⁷⁶

In the best tradition of nonempiricist law professors everywhere, though, I am going to guess, or rather, predict, that the net societal effects of a flexible economic substance doctrine will be positive. I

¹⁷² Zelenak, *supra* note 39, at 187.

¹⁷³ See Beller, *supra* note 33, at 3; Boyle, *supra* note 33, at 10; Kenneth W. Gideon, *Tax Law Works Best when the Rules Are Clear*, 81 TAX NOTES 999, 1001 (Nov. 23, 1998); Kenneth J. Kies, *A Critical Look at "Corporate Tax Shelter" Proposals*, 83 TAX NOTES 1463 (June 7, 1999); Schler, *supra* note 8, at 383.

¹⁷⁴ Weisbach, *supra* note 38, at 249. I assume here that it would be impractical, at the very least from a political perspective, to design a rule that on its face treated transactions by the two groups differently. We should keep in mind, though, that reputational effects for repeat-player tax advisors might permit the Service to, in effect, apply a different standard to aggressive lawyers. And, importantly, the lawyers might well know that fact in advance. Thus, we could mitigate a rule written to deter aggressive planning by treating careful advisors generously on audit, reducing the danger of over-deterrence for their clients. I am grateful to Ethan Yale for making this point.

¹⁷⁵ See Eustice, *supra* note 114, at 136; Hariton, *supra* note 114, at 402.

¹⁷⁶ See McMahon, *supra* note 20, at 207–08; Weisbach, *supra* note 38, at 243–44.

think it is true that a flexible doctrine will have a deterrent effect on careful advisors, but will not over-deter. I frankly do not understand the claims of over-deterrence, given that the Service offers private letter rulings in advance of a proposed transaction.¹⁷⁷ So the doctrine will prevent many borderline transactions the Service says it believes do not “work.”¹⁷⁸ My guess is that the revenue and anti-distortionary benefits from that effect will swamp any losses that we might see from the doctrine’s failure to present aggressive planners with a big enough stop sign. Planners who are attentive to rules are more sensitive to the rules’ deterrent effects.¹⁷⁹ Further, the Service is likely to discover on audit “abusive” transactions by both groups at about the same rate,¹⁸⁰ but the thoughtful planners will win in litigation much more often — because, after all, they are a lot more thoughtful and their transactions will not be as clearly wrong.¹⁸¹ Thus, if I am right that there are more careful planners, the revenue savings from preventing careful planners from recommending these transactions in the first place ought to exceed the costs from generating more such transactions from aggressive planners.¹⁸²

Another factor we have to consider is the likelihood that not all economic substance doctrines are created equal. Although it is true that the doctrine’s performance in the past has been uneven,¹⁸³ future

¹⁷⁷ Cf. Chirelstein & Zelenak, *supra* note 9, at 1960 (noting that Congress could mitigate over-deterrence problems by expanding advance ruling programs). In addition, as I described, *see supra* note 174, the Service can easily give either explicit or implicit assurances to reputable counsel that their clients will not face the harshest penalties for good faith but invalid transactions.

¹⁷⁸ See Eustice, *supra* note 114, at 165; Thompson, *supra* note 25, at 782; Weisbach, *supra* note 38, at 249–50.

¹⁷⁹ See Schler, *supra* note 8, at 385–86; Thompson, *supra* note 25, at 782.

¹⁸⁰ This seems a dubious presumption, considering that careful planners, one might think, would be more likely to disclose their transactions to the Service rather than hide them. The game theory of disclosure, however, is very complicated. If an aggressive planner believes that disclosed transactions receive less scrutiny, she may well advise her client to disclose. The Service may respond to this tactic by shifting more scrutiny back to disclosed transactions, and so on. My prediction therefore assumes that there will likely be an equilibrium point at which disclosed and undisclosed transactions are discovered on audit at roughly the same rate.

¹⁸¹ Cf. George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 223 (2001) (noting “comparative resource advantage” large corporate taxpayers have over government).

¹⁸² See Schler, *supra* note 8, at 384. It is also worth keeping in mind here that a subjective intent standard will be fairly fatal to mass-marketed shelters, so that each transaction is likely to apply only to one or a small number of taxpayers.

¹⁸³ See Sheppard, *supra* note 13, at 7–8; Thompson, *supra* note 25, at 782. For an

results might well be much better. For one thing, we will have fixed a major hole in the “subjective,” business-purpose half of the test. Before, courts struggled to define business purpose against a backdrop of repeated claims that there is a “right” to tax planning.¹⁸⁴ We now can dispense with that difficulty by the expedient of making clear that there is no such right.

On the objective end, we can probably do better than the welter of existing rules, most of which seem to require some element of market risk.¹⁸⁵ As others have shrewdly observed, this simply leads to ever-more difficult questions about just how much “risk” a transaction must include to have objective “substance.”¹⁸⁶ Since the only real purpose for requiring risk is to make it somewhat harder to create a shelter,¹⁸⁷ the test inherently was undefinable. Whether a given amount of risk was “enough” depended on our view of just how difficult it should be to engage in tax avoidance, a question that necessarily varied from judge to judge.¹⁸⁸ The Senate’s recent formulation, in my view, is much better. The Senate would find economic substance only if:

(I) the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer’s economic position, and (II) the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.¹⁸⁹

impressive torturing of one respected iteration of the rule, see Hariton, *supra* note 23, at 17–20.

¹⁸⁴ See Weisbach, *supra* note 113, at 869–70 n.25 (describing “the culture of tax compliance”).

¹⁸⁵ See *Dow Chem. Co. v. United States*, 435 F.3d 594, 604–05 (6th Cir. 2006); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 787 (5th Cir. 2001); *UPS of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1018–19 (11th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350, 355 (8th Cir. 2001); *ACM P’ship v. Commissioner*, 157 F.3d 231, 248–50 (3d Cir. 1998); *Gilman v. Commissioner*, 933 F.2d 143, 147 (2d Cir. 1991); *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 94–95 (4th Cir. 1985); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 284–85 (1999), *aff’d per curiam*, 254 F.3d 1313 (11th Cir. 2001); see also *Frank Lyon Co. v. United States*, 435 U.S. 561, 577, 583 (1978) (pointing to risk borne by taxpayer as one element supporting its claim that transaction possessed economic substance).

¹⁸⁶ Beller, *supra* note 33, at 3, 5; Chirelstein & Zelenak, *supra* note 9, at 1949–50.

¹⁸⁷ See Bankman, *supra* note 1, at 18–20; Hariton, *supra* note 23, at 31–32.

¹⁸⁸ Cf. *Dow Chem.*, 435 F.3d at 602 n.13 (rejecting dissenting opinion’s proposed approach to possibility-of-profit test because it would have been “too easily met”).

¹⁸⁹ S. 3777, 109th Cong. § 201(a) (2006).

Prong two here in fact covers not only the taxpayer's subjective motivation. To tell the truth, prong two is a bit weak on that front; it would be better to target *any* substantial tax planning motivation, for the reasons I have already given. The objective form of the transaction also matters. It could, for example, prevent tax benefits for a transaction in which a reasonable businessperson would not have engaged if not for tax reasons.¹⁹⁰

This version improves dramatically over the old attempts by setting out a standard that actually has a single answer, albeit one that may sometimes be hard to measure.¹⁹¹ More significantly, unlike the old tests, taxpayers know the answer before they engage in the transaction, because they know whether they, as reasonable people, would do the deal if not for the tax component.¹⁹² That means the results of the test will be much more predictable for the people it is aimed at deterring. Putting the objective and subjective improvements together, the revised doctrine may well be rather more

¹⁹⁰ This prong of the proposal apparently aims at codifying David Hariton's reading of the *ACM* holding, in which "[a] complicated way of investing cash lacks economic substance — even though it obviously produces a profit — if it leaves the taxpayer in substantially the same position as if the cash had been left in the bank." David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 *TAX LAW.* 235, 235–36 (1999).

¹⁹¹ Professor Zelenak is skeptical of this approach, arguing that we cannot determine whether a taxpayer's use of its funds is reasonable, because we do not know what its alternative investment opportunities were. Zelenak, *supra* note 39, at 182. Perhaps. But most shelters require at least one other party, who rarely is unaware of the tax benefits its cooperation is furnishing to the counterparty. This means the tax benefits must be shared. As a result, the test would allow us in many cases to show that a taxpayer incurred very large administrative costs (read: fees to the shelter facilitator) relative to other investments of similar risk and expected return. And, costs aside, it will often be easy to show that there were many investment vehicles of similar return that were not nearly as complex in their structure. Part of the test, as I read it, is whether a reasonable businessperson would have undertaken the same investment in the same (complicated, but tax-favored) way. Maybe creative tax planners will invent new shelters that are simple and cheap. But if there were many of those around today, we would not be taking in much tax revenue.

Michael Schler also attacks the idea of a standard in which favorable tax treatment would be denied to "a normal business transaction carried on in a peculiar manner solely for tax savings." Schler, *supra* note 8, at 340–42. Schler's main argument is that such a rule would unfairly infringe on ordinary tax planning. *Id.* at 384–85. I have already dealt with those claims.

¹⁹² *Cf.* Weisbach, *supra* note 113, at 882 ("A transaction entered into without regard for the tax system, for a true business purpose, is not likely to face any significant uncertainty because of anti-abuse rules.").

predictable than previous commentators have assumed in drawing their conclusions.

For example, this version of the economic substance doctrine would have dealt readily with the facts in *Frank Lyon Co. v. United States*.¹⁹³ In that case, the taxpayer, the Frank Lyon Company, was an intermediary (after winning a bidding competition) in a financing arrangement between a bank and another lender to build a new branch for the bank, where the bank was prohibited by regulations from engaging the financing directly.¹⁹⁴ Frank Lyon Company made a down payment of \$500,000, took nominal ownership of the branch and received depreciation deductions.¹⁹⁵ The bank paid “rent” to Frank Lyon exactly equal to Frank Lyon’s interest and principal mortgage payments, which the bank was able to deduct in full. The bank had the option to purchase the building by paying off the remaining mortgage, repaying the \$500,000 down payment, and paying Frank Lyon six percent interest on the \$500,000.¹⁹⁶ As Justice Stevens observed in dissent, in effect the bank had simply taken out first and second mortgages and received from Frank Lyon a costless put option.¹⁹⁷ Frank Lyon also gave the bank at least \$100,000 in other benefits.¹⁹⁸ The Court apparently found this transaction deeply difficult to unravel, citing some twenty-six separate factors that went into its holding.¹⁹⁹ Just how these twenty-six factors play out in other cases is, to put it mildly, not self-evident.²⁰⁰

But under the standard I propose here, or one like it, we can stop once we conclude that what happened, in essence, was that several parties bid on the opportunity to put the bank’s depreciation deductions to better use than the bank. That this may have had limited effects on the Treasury, as the Court noted,²⁰¹ matters little to us; we are concerned that we may have generated a deal that would not likely have occurred — at least with Frank Lyon as the counterparty — if not for the tax considerations. Even aside from the subjective evidence — for example, the bidding war and Frank Lyon’s

¹⁹³ 435 U.S. 561 (1978).

¹⁹⁴ *Id.* at 563–65.

¹⁹⁵ *Id.* at 565–66.

¹⁹⁶ *Id.* at 566–68.

¹⁹⁷ *Id.* at 585, 587 n.7 (Steven, J., dissenting).

¹⁹⁸ *Id.* at 565.

¹⁹⁹ *Id.* at 582–83.

²⁰⁰ For one of many efforts at deciphering *Frank Lyon*, see Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 433–39 (1988).

²⁰¹ *Frank Lyon Co.*, 435 U.S. at 580 n.15.

past history of having never engaged in this sort of investment — the evidence on the objective side that this was not a transaction in which an ordinary businessperson would engage, but for tax, was quite strong. For one thing, there was the \$100,000 sweetener Frank Lyon threw in — an awfully large sum to get a six percent return on \$500,000. Then there was the cost, unquantified by the Court, of the put option Frank Lyon granted the bank. Taken together, those look not like ordinary investment costs, but instead like disproportionately outsized transaction costs of just the kind our method would target: those that evidence a slicing of the tax-benefit pie, rather than a pure market-motivated investment. *Frank Lyon*, and other complex cases like it, can become simple and predictable under a well-drawn statute.

Finally, we also have some methods for softening any over-deterrence costs. One way that comes to mind would be to give the Service some authority to grant in advance broad exemptions at least from shelter-related penalties. No tax rule will ever be entirely clear, including our proposed economic substance codification.²⁰² There may be some danger that businesses will hesitate to engage even in subjectively *tax-neutral* transactions for fear that the Service will characterize them as penalizable tax planning.²⁰³ Thus, I would also propose giving the Service regulatory authority to define safe harbors, transactions that fall within a defined congressional tax subsidy. Good faith efforts to qualify for a congressionally-intended benefit, or for a Service-defined version of those benefits, would not be subject to penalties, although the Service would have the power to re-characterize the transaction if it in fact failed to qualify. Again, though, I freely concede that even with this mitigating rule my prediction is largely guess-work.

Even if I am wrong (as seems reasonably likely) and we have no particularly good information about the deterrent effects of any particular form of shelter regulation, there are some reasons to put the burden of proof on Chirelstein and Zelenak to show that bright-line rules are clearly better than judge-enforced standards. As I suggested before, their approach, although innovative and tremendously insightful, has some costs not associated with a more flexible doctrine.

First, the economic substance doctrine is rather broader in its coverage than the set of Chirelstein and Zelenak rules, in that it could

²⁰² Cf. Bankman, *supra* note 1, at 19 (“The tax rules are not self-executing; that is, the rules do not provide a single, apparent result for every economic transaction.”).

²⁰³ See Canellos, *supra* note 164, at 50–51.

also by its terms cover pure timing manipulations.²⁰⁴ It could, in other words, have the effect of reversing *Cottage Savings Ass'n v. Commissioner*,²⁰⁵ so that transactions designed to accelerate the realization of real losses could still be disallowed. Chirelstein and Zelenak note that, in their view, mis-timing is not a significant problem, and perhaps it is right that the possible dollar costs to the Treasury are smaller in each transaction.²⁰⁶ But the timing of losses is not only about the time value of money; it also often incorporates significant administrative concerns. For example, consider the rules prohibiting the recognition of built-in losses on boot²⁰⁷ received from or property contributed to a controlled corporation,²⁰⁸ where in the absence of a genuine arm's length transaction, valuation problems become very significant.²⁰⁹ In a deeper sense, questions of timing may reflect not simply matters of practical administration but rather fundamental views about the proper temporal frame of reference for questions of distributive justice.²¹⁰

The other modest weakness of Chirelstein and Zelenak's proposal is that it is, like a flu vaccine, effective for this generation of virus only. Its relatively bright-line rules seem to me to be fairly stable targets for would-be tax planners to avoid. Whatever it gains in certainty and ease of administration, it loses in its capacity to adapt to innovative forms of shelter planning.²¹¹ But that, of course, is the tradeoff in any

²⁰⁴ Chirelstein & Zelenak, *supra* note 9, at 1960–61.

²⁰⁵ 499 U.S. 554 (1991).

²⁰⁶ Chirelstein & Zelenak, *supra* note 9, at 1960–61; *see also* Bankman, *supra* note 1, at 21–22 (predicting that courts will be less troubled by timing shelters). *But cf.* Eustice, *supra* note 114, at 142, 156 (describing harms of timing shelters); Charlene Davis Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 144–65 (2005) (describing deferral value of "wraparound" insurance shelters).

²⁰⁷ "Boot," for those with only a passing acquaintance with colorful tax jargon, is a term for any property other than stock (usually cash) provided to shareholders in an otherwise tax-free exchange of shareholder property for stock in the controlled company (or, in various forms of corporate reorganizations, nonstock property provided to shareholders of the acquired or divided company). *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 3.05, 11.10, 12.42[1][b] (7th ed. 2004).

²⁰⁸ I.R.C. § 351(a), (b)(2).

²⁰⁹ *See* Fred B. Brown, "Complete" Accrual Taxation, 33 SAN DIEGO L. REV. 1559, 1603–04 (1996); Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 407, 409 (1987).

²¹⁰ Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 920–36 (2005).

²¹¹ *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 14, at 18; Eustice, *supra*

choice of a rule over a standard.²¹²

In the face of these costs, I think we should expect some showing that tax shelter rules in fact produce more social welfare than tax shelter standards. And I do not think the data are there to make that claim. As of now, it looks likely that a flexible, judicially-interpreted economic substance doctrine, strengthened by some elements of the Chirelstein and Zelenak proposal, is superior to relying on bright-line silver bullets.

VI. CONCLUSION

The tax shelter problem is a large beast. No single paper, and certainly not one of this size, can do it justice. But several worthwhile points emerge in the analysis here. Most significantly, I think, this discussion makes clear that textualism is likely not an inevitable barrier for codification efforts. If our preference is for standards, rather than rules that can ultimately be gamed by crafty counsel, we should not give up the fight out of fear of the recalcitrant textualist. Another point is that sometimes the best way to answer a big question is to make it bigger. While commentators fret about the challenges in distinguishing shelters from other tax planning, and how to describe that difference in an administrable statute, the answer may be that there is no reason even to try to draw the distinction.

I have just explained, in the last part of the preceding section, the most concrete policy implications of our wrestling match with textualist theory. I mentioned favorably there a version of a codified economic substance doctrine proposed by the Senate but not enacted. I have left largely untouched the parallel proposal by the JCT.²¹³ Others have already pointed out the likely flaws in that version.²¹⁴ Our analysis here confirms those judgments. The JCT's plan would oblige a court to apply the JCT's version of the doctrine only where a court first concludes that the doctrine applies. That leaves textualist courts hostile to purposive interpretation free to ignore the doctrine.²¹⁵

note 114, at 141, 147–48.

²¹² Cunningham & Repetti, *supra* note 1, at 55–56; Kennedy, *supra* note 39, at 1687–88; Weisbach, *supra* note 38, at 247–48.

²¹³ See STAFF OF JOINT COMM. ON TAXATION, *supra* note 14.

²¹⁴ E.g., Chirelstein & Zelenak, *supra* note 9, at 1948–49; Sheppard, *supra* note 13, at 1025–26.

²¹⁵ Chirelstein & Zelenak, *supra* note 9, at 1949; Sheppard, *supra* note 13, at 1025–26. Unfortunately, the Senate's proposal has this flaw, as well. See Senate Finance Committee, *Finance Committee Releases Summary of Tax Bill*, 2005 TNT

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At the same time, it continues — and probably adds to — existing doctrinal uncertainty about the applicability of the doctrine, which can only undermine any deterrence value Congress hopes to gain from codification. And it leaves unresolved the problem that incomplete compliance with economic substance principles leaves other taxpayers demoralized.²¹⁶

Finally, it is worth noting a few areas I have not addressed at all. For one thing, I have examined only the “demand” side of the tax planning business. Certainly there is much that could be said and done about complementary rules for professional responsibility and attorney or other tax preparer disclosure.²¹⁷ And my examination of penalty provisions, and the problems of the audit lottery generally, has been fairly cursory. Thus, the reader should not infer that, in advocating for one formulation of the doctrine, I mean that there is nothing else to be done.

221-23 (Nov. 17, 2005).

²¹⁶ Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289, 294 (2002).

²¹⁷ See, e.g., Eustice, *supra* note 114, at 150–51, 163.