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## ABUSIVE TAX PRACTICES: THE 100-YEAR ONSLAUGHT ON THE TAX CODE

Arthur Acevedo\*

[The tax evader is] in every respect, an excellent citizen, had not the laws of his country made that a crime which nature never meant to be so.

—Adam Smith<sup>1</sup>

I’ve not in my practice seen penalties be a deterrent factor on any action that’s being taken by a taxpayer.

—N. Jerold Cohen<sup>2</sup>

### I. INTRODUCTION

On January 26, 2011, forty-one federally elected officials<sup>3</sup> sponsored a bill in the House of Representatives to terminate the Income Tax Code. If passed, this bill, touted as the “Tax Code Termination Act,”<sup>4</sup> would have abolished income taxes “for any taxable year beginning after December 31, 2015.”<sup>5</sup> This bill was never passed.<sup>6</sup>

In 2013, the Internal Revenue Code (“Code”) will mark 100 years. Attacks on the tax policy generally, and on the Code specifically, have formed part of the income tax landscape since the enactment of the Code in 1913. For nearly 100 years, taxpayers have engaged in reasonable and unreasonable challenges to

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1. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 898 (R. H. Campbell & A. S. Skinner eds., 1981) (1776).

2. N. Jerold Cohen, *Remarks at Key Issues in Tax Policy: A 2008 Tax Analysts Conference, Tax Shelters & Penalties: Reasonable Cause, Opinion Letters, and Other Issues* (July 25, 2008) (transcript available at <http://www.taxanalysts.com/www/conferences.nsf/KeyLookup/GBRO-7G5KCF?OpenDocument&link=transcript>).

3. The bill had forty-one original co-sponsors, and twelve other Representatives have added their names as co-sponsors on various dates through May 23, 2011, for a total of fifty-three sponsors. Bill Tracking Report for H.R. 462, 112th Cong. (2011).

4. Tax Code Termination Act, H.R. 462, 112th Cong. § 1 (2011).

5. *Id.* § 2(a).

6. Bill Tracking Report H.R. 462, *supra* note 3.

Congress's power to tax. These challenges range from legitimate interpretational issues, to quasi-legitimate tax shelter issues, to illegitimate tax protester issues. Taxpayer challenges are motivated by any number of reasons. Some are based on a desire to equalize the perceived disparity of the income tax laws in relation to a particular tax position. Others on a desire to pursue aggressive positions in the absence of explicit authority. Still, some are based on a misplaced belief in the illegitimacy of the Code. A number of factors combine to create an environment ripe for taxpayer challenges and for self-executing equalization by taxpayers—voluntary tax assessments, varying tax preferences, fluctuating tax policies, and ambiguous language. These factors influence a faction of taxpayers, tax protesters, and aggressive tax participants to behave in a manner that is questionable and destructive to the tax policy goals of simplicity, fairness, efficiency, and revenue sufficiency.<sup>7</sup>

This article explores the actions taken by tax protesters and aggressive tax planners, and the response by Congress. It also examines whether Congress has taken sufficient action to curb abusive taxpayer practices. The thesis of the article is that Congress's faint-hearted responses to abusive taxpayer conduct are untimely, inefficient, and ineffective. Congress's weak responses since the inception of the Code have contributed to a culture of income tax avoidance and a growing sense of taxpayer frustration with income tax laws.<sup>8</sup> Part II examines the culture of tax avoidance in the U.S. and how this attitude has manifested itself in our tax jurisprudence. Abusive taxpayer practices are examined from two ostensibly diverse perspectives, the tax protester, and the aggressive tax planner. Part III examines the common law tax doctrines and their limited effectiveness in curbing aggressive tax planning. Part IV examines the relevant statutory responses by Congress to aggressive tax planning and identifies the limitations of each section. Part V concludes with two proposals to address abusive taxpayer practices and calls upon Congress to take affirmative and decisive steps to curb abusive taxpayer practices.<sup>9</sup>

During the first half of the twentieth century, Congress pursued a policy of restraint and tolerance when dealing with abusive taxpayer practices. Congress finally enacted a series of statutes in the 1980's aimed at curbing abusive taxpayer practices. Despite these statutory reforms, certain factions of taxpayers continued to engage in abusive behaviors.

The list of rebellious taxpayer behavior during the nearly 100 years of the Code's existence is not limited to the common taxpayer. Individuals of national prominence provide startling and unexpected examples of errant taxpayer behavior. Among "the most surprising cases on record is that of the tax specialist, a professor

7. JOSEPH J. MINARIK, CONCISE ENCYCLOPEDIA OF ECONOMICS: TAXATION (David R. Henderson ed., 2d ed. 2008) (1993), available at <http://www.econlib.org/library/Enc/Taxation.html>.

8. For a history of the Tea Party Movement and the evolution of its platform, see Scott Clement, *The Tea Party, Religion and Social Issues*, PEW RESEARCH CENTER (Feb. 23, 2011), <http://pewresearch.org/pubs/1903/tea-party-movement-religion-social-issues-conservative-christian>.

9. For purposes of this article, "abusive taxpayer practice" includes tax protester activity and aggressive tax planning activity.

of taxation in a law school, who pleaded guilty in 1962, in the Federal District Court in Brooklyn, to failing to file his own tax returns.”<sup>10</sup> Another startling case involved the “former Commissioner of Internal Revenue, Joseph D. Nunan, Jr., who received a five-year sentence and a substantial fine for failing to report 160,000 dollars of income during taxable years, including time he served as chief tax collector of the United States.”<sup>11</sup> A recent example includes the appointment of Timothy Geithner as United States Secretary of the Treasury.<sup>12</sup> Geithner admitted that he did not pay for Medicare or Social Security while working for the IMF from 2001 to 2004.<sup>13</sup> He also admitted he improperly claimed tax deductions and tax credits.<sup>14</sup> Another example is former Senate majority leader Thomas A. Daschle, who failed to report \$340,000 in income over a three year period.<sup>15</sup> Taxpayer predisposition to neglect or abuse the Code carries a wide and varied constituency which includes ordinary citizens,<sup>16</sup> influential politicians,<sup>17</sup> and multi-national corporations.<sup>18</sup>

Our federally elected officials have undertaken a sworn duty to defend the Constitution.<sup>19</sup> By logical extension, this duty includes ensuring that the federal treasury is not deprived by unscrupulous taxpayer activity.<sup>20</sup> The collective behavior of tax protesters and aggressive tax planners undermines confidence in the tax laws, destabilizes the foundations of tax policy, and increases the burden on effective tax administration.<sup>21</sup> Moreover, aggressive tax planners’ conduct has cost the federal treasury billions of dollars in lost revenue. The risk of Congress taking a passive approach to dealing with abusive taxpayer activity include a decrease in taxpayers’ confidence in the tax system, increased administrative difficulties for the IRS, and the loss of legitimate tax revenues. The question therefore is, what

10. JEROME R. HELLERSTEIN, *TAXES, LOOPHOLES AND MORALS* 222 (1963).

11. Richard J. Kovach, *Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap*, 30 WHITTIER L. REV. 247, 272 (2008).

12. Jonathan Weisman, *Geithner’s Tax History Muddles Confirmation*, WALL ST. J., Jan. 14, 2009, <http://online.wsj.com/article/SB123187503629378119.html#articleTabs%3Darticle>.

13. *Id.*

14. See *id.* (Geithner improperly claimed a business deduction for personal use public utilities and improperly calculated the dependent care tax deduction. He blamed the incident on faulty advice from his advisor).

15. Janet Novack & Ashlea Ebeling, *Taxes: How To Cheat Like a Pro*, FORBES, Mar. 2, 2009, [http://www.forbes.com/forbes/2009/0302/030\\_taxes\\_cheat\\_pro.html](http://www.forbes.com/forbes/2009/0302/030_taxes_cheat_pro.html).

16. See *Kellems v. Comm’r*, 58 T.C. 556 (1972).

17. See Novack, *supra* note 15 (Thomas A. Daschle); Editorial, *Morality and Charlie Rangel’s Taxes*, WALL ST. J., July 27, 2009, at A14 (U.S. Representative Charlie Rangel); Margaret Shapiro & Ted Gup, *Taxes Paid, Agnew Says at Ocean City Home*, WASH. POST, June 27, 1979, at C1 (U.S. Vice President Spiro Agnew).

18. Jesse Drucker, *Google’s 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, BLOOMBERG, Oct. 21, 2010, <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>.

19. See 5 U.S.C. § 3331 (2011) (The Congressional Oath of Office states in relevant part “I . . . do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same . . .”).

20. Calling for an abolition of the Income Tax Code, as was done by the fifty-three elected representatives, borders on reckless and irresponsible action. See Bill Tracking Report H.R. 462, *supra* note 3.

21. See generally IRS RESPONSE TO THE ILLEGAL TAX PROTESTER MOVEMENT BEFORE THE H. SUBCOMM. ON THE GOV’T OPERATIONS, 97th Cong. (1981) (report by the Comptroller General), available at <http://archive.gao.gov/f0102/115485.pdf>.

additional actions, if any, should Congress consider in the face of continuing abusive practices?

## II. A CULTURE OF AVOIDANCE

Judge Learned Hand's position as one of the greatest jurist in American history is uncontested. His influence reigns supreme in the area of income tax. In 1934, Learned Hand penned his hallmark statement 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.<sup>22</sup>

This succinct, yet powerful statement has influenced taxpayer conduct and jurisprudence since its pronouncement.

This statement contributes to the enforcement and collection challenges faced by the IRS. Tax protesters and aggressive tax planners alike have cited to this language as a justification for their actions. Judge Hand's statement affirms a philosophy of minimal legal compliance. His statement cloaks tax avoidance behavior with a legal justification willingly embraced by taxpayers generally, and tax protesters and aggressive tax planners specifically. Although Judge Hand's statement rings loud, two issues present themselves. First, the statement is unnecessary in light of the Supreme Court's earlier decision in *United States v. Isham*.<sup>23</sup> Second, Congress and the IRS failed to recognize the influence this statement would have on taxpayer conduct throughout the twentieth century.

In *Isham*, a taxpayer sought to avoid the application of a stamp tax by structuring his transaction in the form of a draft instead of a promissory note.<sup>24</sup> The statute in effect at the time imposed a tax of two cents per \$100 on checks and drafts, and a tax of five cents per \$100 on promissory notes.<sup>25</sup> In form, *Isham*'s document was a draft, but in substance it was a promissory note.<sup>26</sup> The United

22. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). Apparently Learned Hand was no fan of the tax code. In an essay in the Yale Law Journal, he wrote:

In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.

Learned Hand, *Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947).

23. 84 U.S. 496 (1873).

24. *Id.* at 501.

25. *Id.*

26. *Id.* at 505.

States filed a criminal complaint “against E.B. Isham, for issuing [documents] without a stamp and with intent to evade the provisions of the [tax laws] . . . .”<sup>27</sup> The United States argued that the instruments were “in essence, promissory notes”<sup>28</sup> and therefore, subject to the higher tax rate.

The United States Supreme Court framed the issue as whether “a device to avoid the payment of a stamp duty, and . . . its operation is . . . a fraud upon the revenue.”<sup>29</sup> A majority of the Court responded “[t]hat if the device is carried out by the means of legal forms, it is subject to no legal censure.”<sup>30</sup> The Supreme Court held in favor of Isham and in the process, affirmed the principle of tax avoidance.<sup>31</sup>

Rather than rely on the precedential value of the Supreme Court’s opinion in *Isham*, Judge Hand took pen to paper and composed his now famous statement. Learned Hand’s powerful and persuasive statement continues to haunt tax administrators to this day. From a jurisprudential perspective, Learned Hand’s statement is a marginal addition in light of the Court’s earlier statement in *Isham*. However, supporters of this statement may argue that Judge Hand reaffirms the principle of tax avoidance in the post-Code enactment era. Supporters of this statement can also be expected to argue that the statement extends the principle of tax avoidance from a criminal context into a civil context. Be that as it may, Judge Hand’s statement is a leviathan for tax administrators. Learned Hand’s statement invites insolence instead of compliance, encourages circumvention instead of observation, and reinforces the psychology of minimal compliance with the law.<sup>32</sup> Learned Hand is not the only judge to endorse tax avoidance. However, no other judge has influenced tax law as has Learned Hand.<sup>33</sup>

Equally important, Congress and the IRS failed to reject Learned Hand’s endorsement of tax avoidance and minimal taxpayer compliance with the income tax laws. This inaction is due in part to the victory the IRS secured in the case.<sup>34</sup> The appropriate response by Congress or the IRS would have been to issue a statement of agreement with the conclusion of the case, along with a statement of disagreement over the rationale of the case. Today, the IRS issues a similar

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27. *Id.* at 496.

28. *Isham*, 84 U.S. at 496.

29. *Id.* at 506.

30. *Id.*

31. *Id.* at 507.

32. This is consistent with Justice Brandeis’ criticism of the Delaware corporate statutes as a race to the bottom. *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 557–60 (Brandeis, J., dissenting). Moreover, Hand’s statement that “there is not even a patriotic duty to increase one’s taxes” is troubling because of its potential to influence other areas of the law. *Helvering*, 69 F.2d at 810.

33. Judge Learned Hand’s dissenting opinion in *Comm’r v. Newman*, 159 F.2d 848, 850–51 (2d Cir. 1947), is a classic statement in tax lore:

Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

Judge Hand’s dissent has been often cited with approval. *See, e.g., United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 511 n.4 (1992); *Comm’r v. First Sec. Bank of Utah*, 405 U.S. 394, 398 n.4 (1972); *Atl. Coast Line R.R. v. Phillips*, 332 U.S. 168, 173 (1947).

34. *Newman*, 159 F.2d at 850.

statement known as an Action on Decision<sup>35</sup> to indicate its acquiescence or non-acquiescence in a particular case. The failure to act by the IRS leaves one wondering “why?”

U.S. courts have recognized that taxpayers are free to arrange their affairs to minimize their tax burden. The principle of minimizing tax also has roots in the United Kingdom.<sup>36</sup> The freedom to arrange one’s affairs traces to the principle of freedom from governmental intrusion. This idea has deep historical roots and can be traced to the early days of this country. In his 1791 book, *The Rights of Man*, Thomas Paine writes, “What is not prohibited by the law should not be hindered; nor should any one be compelled to that which the law does not require.”<sup>37</sup> The notion of minimal government intrusion in private affairs is a deeply held and cherished principle in United States jurisprudence. However, either Congress or the IRS should have taken the extraordinary measure of expressing disapproval with Learned Hand’s statement and reasserting the government’s right to budget, assess and collect tax revenues. Such action by either Congress or the IRS is not only warranted, but is legally justified by virtue of the enactment of the Sixteenth Amendment.<sup>38</sup> Judge Learned Hand’s dictum legitimizes the broader and accepted culture of tax avoidance and nominal tax compliance—two policies which corrode the foundations of tax policy and of an ordered society.

### III. ABUSIVE TAX PRACTICES

The IRS is contending with two ostensibly distinct, but related, factions at the same time: tax protesters and aggressive tax planners. Each one creates a unique administrative challenge, each one is a drain on the government’s limited resources,<sup>39</sup> and each one has increased in sophistication over time. Although they apply to radically different taxpayer segments, they both have the common effect of undermining the confidence, efficiency and effectiveness in the administration of the internal revenue laws.

35. “An Action on Decision (AOD) is a formal memorandum prepared by the IRS Office of Chief Counsel that announces the future litigation position the IRS will take with regard to the court decision addressed by the AOD.” Actions on Decisions, IRS.gov, <http://www.irs.gov/app/picklist/list/actionsOnDecisions.html> (last visited Feb. 17, 2012).

36. See, e.g., *Ayrshire Pullman Motor Serv. v. The Comm’rs of Inland Revenue*, (1929) 14 T.C. 754, 763 (Scot.) (Lord President Clyde) (“No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores.”).

37. THOMAS PAINE, *THE RIGHTS OF MAN* 117 (2d ed. 1791).

38. U.S. CONST. amend. XVI.

39. *United States v. Martin*, 19 F. App’x 345, 346 (6th Cir. 2001) (“The United States has presented evidence that it costs an average of \$4,900—in attorney salaries and other expenses incurred by the Tax Division of the Department of Justice—to defend frivolous appeals.”).

### A. The Tax Protester Movement<sup>40</sup>

One continuing and beleaguering challenge facing Congress is the tax protester movement. The tax protester movement has a long and worrisome history in the United States. Tax protesters are defined as “person[s] who oppose[ ] tax laws and seek[ ] or employ[ ] ways, often illegal, to avoid the [tax] laws’ effects . . . .”<sup>41</sup> The thrust of the tax protesters’ argument is that the IRS has no authority to tax. They file frivolous income tax returns with the IRS, or file a frivolous tax petition with the Tax Court. An income tax return is frivolous if it “does not contain information on which the substantial correctness of the self-assessment may be judged, or contains information that on its face indicates that the self-assessment is substantially incorrect . . . .”<sup>42</sup> “A petition to the Tax Court . . . is frivolous if it is contrary to established law and unsupported by a reasoned, colorable argument for change in the law.”<sup>43</sup> Tax protester arguments include recurring and settled arguments such as the Sixteenth Amendment was not properly ratified,<sup>44</sup> payment of income tax is voluntary,<sup>45</sup> returns filed but filled with zeros,<sup>46</sup> citizenship exemption claims,<sup>47</sup> signature omissions,<sup>48</sup> slavery,<sup>49</sup> war tax deductions,<sup>50</sup> and gold standard exclusions.<sup>51</sup>

Tax protesters have challenged the IRS’s authority to impose a tax or a penalty since the enactment of the Code in 1913. In 1924, Congress added a new section to the income tax law which was designed to address the filing of frivolous appeals by taxpayers to the Tax Board.<sup>52</sup> This new statute was amended in 1926 and provided that “[w]hensoever it appears to the [Tax] Board that proceedings before it have been instituted by the taxpayer merely for delay, damages in an amount not in excess of \$500 shall be awarded to the United States by the Board in its decision.”<sup>53</sup>

40. INTERNAL REVENUE MANUAL § 9.9.4.8.1(2)(g) (2011) (instructing IRS personnel to “[r]efrain from the use of the terms ‘illegal tax protester’, ‘constitutionally challenged’, or similar language when referring to taxpayers. When in doubt describe the action, such as, ‘the taxpayer has filed frivolous returns’ or ‘the taxpayer adamantly refuses to file required returns.’”).

41. BLACK’S LAW DICTIONARY 1600 (9th ed. 2009). Illegal tax protesters denotes “[t]he name once used by the IRS to designate a person believed to have used illegal means to avoid or reduce tax liability. In the Internal Revenue Service Restructuring and Reform Act of 1998, Congress forbade the IRS to continue using the label. Today the term *nonfiler* is typically used instead.” *Id.* (emphasis in original).

42. 26 U.S.C. § 6702(a) (2012).

43. *Coleman v. Comm’r*, 791 F.2d 68, 71 (7th Cir. 1986).

44. *United States v. Thomas*, 788 F.2d 1250, 1253–54 (7th Cir. 1986).

45. *United States v. Tedder*, 787 F.2d 540, 542 (10th Cir. 1986).

46. *See generally* *United States v. Schiff*, 379 F.3d 621 (9th Cir. 2004).

47. *United States v. Hilgeford*, 7 F.3d 1340, 1342 (7th Cir. 1993).

48. *Selgas v. Comm’r*, 475 F.3d 697, 700 (5th Cir. 2007).

49. I.R.S. Service Center Advisory 200120035 (April 12, 2001).

50. *United States v. Snider*, 502 F.2d 645, 647–48 (4th Cir. 1974). For information on peace tax advocacy, see National Campaign for a Peace Tax Fund, <http://www.peacetaxfund.org> (last visited Feb. 17, 2012) (outlining a proposal to create a non-military trust fund for conscientious objector taxpayers).

51. *See* I.R.S. Notice 2008-14 (identifying forty-three positions that have been deemed frivolous by courts or have no basis for validity in existing law), available at [www.irs.gov/pub/irs-drop/n-08-14.pdf](http://www.irs.gov/pub/irs-drop/n-08-14.pdf).

52. Revenue Act of 1924, ch. 234, § 1000, 44 Stat. 109 (1924) (current version at 26 U.S.C. § 6673 (2012)).

53. Revenue Act of 1926, ch. 27, § 911, 44 Stat. 9 (1926) (current version at 26 U.S.C. § 6673 (2012)). The Tax Court is currently authorized to assess a penalty up to \$25,000. *Id.* § 6673(a)(1).



Although the new statute was available to prosecute protester claims, it was seldom invoked by the courts.<sup>54</sup>

A second legislative effort to discourage frivolous appeals resulted from an American Bar Association recommendation which advocated authorizing the Board to impose costs of up to \$100 on either party if the appeal was found to be without merit. . . . Congress was apparently hesitant, however, to impose costs against the Government. As a consequence, the Board was only authorized to penalize taxpayers “whenever it . . . [appeared] to the Board that proceedings before it . . . [had] been instituted by the taxpayer merely for delay.”<sup>55</sup>

Regrettably, early attempts to address frivolous taxpayer claims met with limited success. The IRS itself is partly to blame. “The [Tax] Bureau occasionally issued groundless deficiency notices which also had the effect of increasing the number of petitions filed. Furthermore, the Bureau was not always willing to negotiate settlements in good faith which meant more cases had to go to trial.”<sup>56</sup> As a result, courts “used [their] power sparingly”<sup>57</sup> to restrain frivolous appeals by taxpayers.

One noteworthy tax protester case that has garnered the attention and the admiration of the tax protester community<sup>58</sup> is *Kellems v. Commissioner of Internal Revenue*.<sup>59</sup> The taxpayer, Vivien Kellems, challenged the assessment of income tax by the IRS as unconstitutional. Specifically, Kellems argued “that the amount of tax paid by her in excess of that which would be payable if [the lower] joint return rates were applied to her income is not an income tax [but rather a penalty].”<sup>60</sup> She also asserted that the excess amount “is not a tax which is apportioned among the States.”<sup>61</sup> The court summarily rejected the taxpayer’s argument stating “[t]his argument, predicated on the assertion that the ‘excess’ is a penalty for remaining single, and not an income tax, is without merit.”<sup>62</sup> The court reasoned that “Congress was within the bounds of its constitutional role [of allocating tax burdens between married taxpayers and individual taxpayers] since it is conceivable Congress believed that married persons generally have greater

54. *Coombs v. Comm’r*, 28 B.T.A. 1216, 1217 (1933); *Bateman v. Comm’r*, 34 B.T.A. 351, 370–71 (1936); *Hatfield v. Comm’r*, 68 T.C. 895, 900 (1977) (commenting on a filing “if tax protestors continue to bring such frivolous cases, serious consideration should be given to imposing such damages”).

55. Joseph R. Cook & Harold Dubroff, *The United States Tax Court: An Historical Analysis*, 41 ALB. L. REV. 639, 662 (1977) (quoting Revenue Act of 1926, ch. 27, § 1000).

56. *Id.* at 660–61.

57. *Wilkinson v. Comm’r*, 71 T.C. 633, 641 (1979).

58. See *Preface to Jury Instructions from Vivian Kellems’ Tax Withholding Trial*, WE THE PEOPLE, <http://www.givemeliberty.org/NoRedress/STOP/VivianKellemsTrial.htm> (last visited Feb. 17, 2012); see also WE WON’T PAY!: A TAX RESISTANCE READER 419–29 (David M. Gross ed.) (2008).

59. 58 T.C. at 556.

60. *Id.* at 558.

61. *Id.*

62. *Id.*

financial burdens than single persons.”<sup>63</sup> The court concluded that “[t]he degree of recognition given by Congress to the problem of greater financial burdens on the part of the married taxpayers was also within the discretion of Congress since it does not appear arbitrary or unreasonable.”<sup>64</sup>

Early tax protester cases were styled as constitutional attacks on the Code. Another interesting case involved a constitutional challenge to Congress’s power to tax by a federal judge. In *O’Malley v. Woodrough*, the United States Supreme Court considered the “question . . . [i]s [the income tax law] constitutional insofar as it include[s] in . . . ‘gross income’ . . . the compensation of ‘judges of courts of the United States . . . .’”<sup>65</sup> The taxpayer, Joseph W. Woodrough, “was appointed a United States circuit judge . . . .”<sup>66</sup> He filed a joint income tax return for the calendar year 1936 “disclos[ing] his judicial salary of \$12,500, but claim[ing] to be constitutionally immune from taxation.”<sup>67</sup> The taxpayer argued that the income tax as applied to him amounted to a constitutionally prohibited diminution in salary.

Writing for the majority, Justice Frankfurter rejected the taxpayer’s claim of unconstitutionality reasoning that “Congress has committed itself to the position that a non-discriminatory tax laid generally on net income is not, when applied to the income of a federal judge, a diminution of his salary within the prohibition of Article III, § 1, of the Constitution.”<sup>68</sup>

During the first half of the nineteenth century, the protester movement was comparatively unsophisticated and generally involved one taxpayer. However, a noticeable trend in tax protester activity began in the decade of the 1950’s as these cases gained both in number and sophistication.<sup>69</sup> Tax protesters also seized on Learned Hand’s statement and cited to it as a justification for their actions.<sup>70</sup> For example, in *Pfluger v. Commissioner of Internal Revenue*, the tax protester cited to Learned Hand’s statement in support of his actions.<sup>71</sup> Additionally, organizers of the tax protester movement cite to Learned Hand as both a source of legitimacy and

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63. *Id.* at 559.

64. *Id.*

65. 307 U.S. 277, 278–79 (1939). Specifically, the Court considered whether “the provision of § 22 of the Revenue Act of 1932 (47 Stat. 169, 178) re-enacted by Section 22(a) of the Revenue Act of 1936 (49 Stat. 1648, 1657)” is constitutional. *Id.*

66. *Id.* at 279.

67. *Id.*

68. *Id.* at 282. Justice Frankfurter added “To subject [judges] to a general tax is merely to recognize that judges are also citizens, and that their particular function in government does not generate an immunity from sharing with their fellow citizens the material burden of the government whose Constitution and laws they are charged with administering.” *Id.*

69. IRS RESPONSE, *supra* note 21, at 24. This Report stated that “Over the years, illegal tax protesters have developed various complex and sophisticated schemes to evade or reduce their taxes, and the courts have denied the legality of many schemes.” *Id.*

70. WE WON’T PAY!, *supra* note 58, at 397; see also DAVID KING, A GUIDE TO THE PHILOSOPHY OF OBJECTIVISM (1998), available at <http://mol.redbam.org/objectivism/Writing/DavidKing/GuideToObjectivism/CHAPTR14.HTM#175> (last visited Sept. 26, 2011).

71. 51 T.C.M. (CCH) 503 (1986). The taxpayers argued unsuccessfully “that the Federal income tax is unconstitutional because it acts as a societal ‘leveling’ device by transferring resources from the nonpoor to the poor.” *Id.*

authority.<sup>72</sup> By the 1970's and 1980's, the tax protester movement became more sophisticated as tax protesters organized and began conducting seminars and conferences on tax minimization and tax avoidance.<sup>73</sup> Books, tapes, and seminars on tax avoidance were increasingly popular with this faction. Tax protester cases spiked and were negatively affecting the effective administration of the income tax laws.

In 1982, Congress responded to the surge in tax protester activity by adding frivolous return penalties to the Code.<sup>74</sup> The new rule assessed a penalty for filing a frivolous income tax return with the IRS.<sup>75</sup> The frivolous return penalty is assessed upon a person who "files what purports to be a return . . . but which does not contain information on which the substantial correctness of the assessment may be judged, or contains information that on its face indicates that the self-assessment is substantially incorrect . . . ."<sup>76</sup>

Congress originally provided that "[t]he [frivolous return] penalty would apply only on documents purporting to be returns that are patently improper and not in cases involving valid disputes with the Secretary, or in cases involving purely inadvertent mathematical or clerical errors."<sup>77</sup> In response, taxpayers began to request administrative conferences with IRS personnel claiming a valid dispute existed with the objective of delaying the final resolution of the tax matter under consideration. As a result of this taxpayer conduct, Congress amended the frivolous return penalty in 2006 by increasing the penalty to \$5,000 on any person who submits a "specified frivolous return,"<sup>78</sup> defined as "submissions . . . that are intended to delay or impede tax administration . . . requests for a collection due process hearing, installment agreements, and offers-in-compromise."<sup>79</sup>

However, a review of the history of the tax protester movement shows that tax protester activity has not waned over the years. Prior to 1982, the year that TEFRA<sup>80</sup> imposed the tax protester penalty to the Code, there were seventy-eight reported tax protester decisions.<sup>81</sup> After the enactment of section 6702 frivolous return rules in 1982, there were 1,209 reported decisions, among which, about

72. Jeff Jacoby, *Taxpayers Have Reason to Rebel*, POST & COURIER (April 13, 1998), available at <http://news.google.com/newspapers?nid=2482&dat=19980413&id=2ZhIAAAAIBAJ&sjid=ZAoNAAAAIBAJ&p=1400,5385983>.

73. IRS RESPONSE, *supra* note 21, at 3; *Income Tax Protester All Out of Evasions*, N.Y. TIMES (Nov. 16, 1997), <http://www.nytimes.com/1997/11/16/us/income-tax-protester-all-out-of-evasions.html>.

74. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 248, § 326(a), 96 Stat. 617 (codified as amended at 26 U.S.C. § 6702).

75. This section is distinct from the earlier adopted section which prohibited frivolous filings with the Tax Court.

76. 27 U.S.C. § 6702(a).

77. S. REP. No. 97-248 (1982), reprinted in 1982 U.S.C.C.A.N. 781, 1024.

78. IRS Notice 2010-33 defines a "specified submission" as "a request for a collection due process hearing or an application for an installment agreement, offer-in-compromise, or taxpayer assistance order." I.R.S. Notice 2010-33, 2010-17 I.R.B.

79. Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 407(a), 120 Stat. 2960 (codified as amended at 26 U.S.C. § 6702 (2006)).

80. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 [hereinafter TEFRA].

81. Data on file with author.

1,196 decisions involving tax returns filed after the date of September 3, 1982.<sup>82</sup> From 2006, the effective date of the most recent amendment to the frivolous return rules through August 2011, there were thirty decisions.<sup>83</sup> No doubt, additional protester cases will follow.

Tax protester cases expose a colorful and imaginative facet of tax law. Tax protester arguments range from the mundane to the inane and are frequently cloaked as constitutional, substantive, or procedural arguments.<sup>84</sup> One creative taxpayer went so far as to argue that imposing the frivolous return penalty was a “cruel and unusual punishment.”<sup>85</sup> This argument was rejected.<sup>86</sup> Tax protesters continue advancing well-settled arguments to challenge the authority of Congress and of the IRS to assess, impose and collect income taxes adding strain to the tax administration process. The financial cost of protester cases is estimated at \$4,900 per case.<sup>87</sup> Nonfinancial costs, such as the negative influence on taxpayer attitudes and confidence in tax administration, must also be weighed. Ultimately, financial and nonfinancial costs are “borne by all of the citizens who honestly and fairly participate in our tax collection system.”<sup>88</sup>

The United States system of self-assessment produces an environment where taxpayers have the opportunity to engage in self-help to adjust their tax liability whenever they perceive the tax system to be unfair. With an audit percentage of less than two percent, some taxpayers may not be able to resist the urge to favorably adjust their tax liability.<sup>89</sup> Not surprisingly, tax protesters have seized upon the self-assessment characterization of the U.S. tax system to justify their act of non-compliance with the tax law.<sup>90</sup>

Arguments advanced by tax protesters are, by now, all too familiar and demonstrably unfounded. Admittedly, the dollars of tax protester cases may not reach into the billions of the tax shelter cases. Nonetheless what the frivolous return faction lacks in financial depth, it makes up in breadth because of its virulent ability to reach a vast number of taxpayers through its network of websites, books, and seminars.

In 2006, the IRS began publishing taxpayer positions that have been identified by the IRS as frivolous taxpayer arguments. IRS Notice 2010-33<sup>91</sup> contains forty frivolous arguments. The law involving tax protester challenges is categorically settled. Still, tax protesters continue unabated, straining valuable administrative and judicial resources. Judge Kanne’s expression regarding tax protesters is both an instructive and illuminating insight into the psychology of a tax protester. He notes,

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82. *Id.*

83. *Id.*

84. Tax-Freedom.com, *Perfect Tax Avoidance*, <http://www.tax-freedom.com> (last visited June 26, 2012).

85. *Milazzo v. United States*, 578 F. Supp. 248, 253 (S.D. Cal. 1984).

86. *Id.*; see also *Bearden v. Comm’r*, 575 F. Supp. 1459, 1462 (D. Utah 1983) (rejecting a similar argument).

87. See WE WON’T PAY!, *supra* note 58.

88. *Hunt v. Comm’r*, 60 T.C.M. (CCH) 31 (1990).

89. The overall audit rate for 2010 was just 1.1%. I.R.S., ENFORCEMENT AND SERVICE RESULTS FOR FY 2010, at 2, available at <http://www.irs.gov/newsroom/article/0,,id=232430,00.html>.

90. *Tedder*, 787 F.2d at 542.

91. I.R.S. Notice 2010-33, I.R.B. 2010-17.

“[L]ike moths to a flame, some people find themselves irresistibly drawn to the tax protestor movement’s illusory claim that there is no legal requirement to pay federal income tax.”<sup>92</sup>

## **B. Aggressive Tax Planning, the Presumption of Permissiveness and the Problem of the Unprescribed Tax Benefit**

The other challenge facing Congress concerns aggressive tax planning. These transactions manifest themselves primarily as tax shelters, but are not necessarily limited to tax shelter activity.<sup>93</sup> For purposes of this article, “aggressive tax planning” means using any entity, device, or arrangement that lacks a material non-tax benefit in combination with any domestic or foreign law to significantly reduce the income tax liability of the taxpayer in the absence of authority<sup>94</sup> for such tax position. Aggressive tax planning transactions exploit the Code by injecting a presumption of permissiveness into the subject transaction.

Tax law is based both on prescribed provisions and to a degree, on a presumption of permissiveness. Prescribed tax benefits are characterized by Congressional debate and approval, statutory enactment, and budgetary appropriation. In contrast, unprescribed tax benefits fail to satisfy these three fundamental requirements. Congress expresses assent to intended tax benefits when there is debate, enactment, and acknowledgement of “the cost to the public treasury.”<sup>95</sup> In this regard, some transactions reflect express congressional policy. Other transactions, however, are nothing more than a contortion of agreements, hollow entities, and pointless undertakings designed to give the appearance of substance to an otherwise insubstantial arrangement.

When Congress intends to bestow tax benefits, it clearly and expressly indicates its willingness to benefit taxpayers whom it wants to permit access to prescribed tax benefits.<sup>96</sup> The corporate reorganization provisions, tax-exempt rules, or capital gain requirements all reflect congressional intent. In this manner, Congress enacts legislation making it desirable for taxpayers to engage in tax reducing activities.<sup>97</sup>

92. United States v. Sloan, 939 F.2d 499, 499 (7th Cir. 1991).

93. It also bears noting that not all tax shelter activity is necessarily abusive.

94. Examples of transactions where authority has been indicated include statutorily intended transactions (section 338, 351, 368, etc.) which satisfy the underlying objective of the statute, transactions to which the IRS has acquiesced, and transactions substantially similar to examples indicated in the income tax regulations or a revenue ruling.

95. For example, “The tax-free treatment of employer-paid health insurance will cost the government \$160 billion this year, according to the Treasury Department. The tax break for mortgage interest will cost \$92 billion. And deductions for state and local taxes will take \$34 billion from federal coffers.” Edmund L. Andrews & Lori Montgomery, *Tax breaks and loopholes that cost us \$1 trillion a year have staunch defenders*, WASH. POST., May 2, 2010, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/05/01/AR2010050100243.html>.

96. A tax expenditure is defined in 2 U.S.C.A. § 622(3) as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; and the term “tax expenditures budget” means an enumeration of such tax expenditures.

97. No area of the Code has been left untouched, whether individual, partnership, corporate, international, or procedural matters.

Congress also recognizes that it cannot regulate every single variant of taxation conceived in the mind of taxpayers or their advisors. As a result and in the interest of administrative efficiency, Congress enacts general rules governing the treatment of certain items. The general rules governing routine business deductions,<sup>98</sup> miscellaneous deductions,<sup>99</sup> and charitable contributions<sup>100</sup> serve as illustrative examples. These general rules are designed to provide taxpayers with a framework and the statutory authority to justify reasonable tax positions implemented by taxpayers.

However, there is arguably another area in tax law where savvy taxpayers access tax benefits, albeit without the express consent of Congress—the unprescribed benefit. It is here where Congress must act. The benefits provided by this area are frequently vague, uncertain and ambitious. Taxpayers have seized upon ambiguities in the Code, and a presumption of permissiveness, to implement tax strategies that maximize their returns at public expense. Taxpayers accomplish this result by accessing the imprecision of the income tax law and by structuring transactions that are ambitious and elaborate, with authority that is ambiguous and doubtful.<sup>101</sup> The unprescribed tax benefit is derived not from any authority or precedent, but from uncertainty, ambiguity, and opportunity. It has produced tax shelters, many of which have been described as abusive.<sup>102</sup>

The S-Corporation Charitable Contribution Strategy (SC2) is an illustrative example. The strategy of a SC2 involves making a donation of S-corporation stock by the donor S-corporate shareholder, to a donee tax-exempt entity pursuant to the terms of a redemption agreement.<sup>103</sup> The “SC2 is directed [toward] individuals who own profitable corporations organized under [Sub]Chapter S of the [Code].”<sup>104</sup> Under Subchapter S rules, “the corporation’s income is attributed directly to the corporate owners and taxable as personal income”<sup>105</sup> in the year the income is earned regardless of whether the income is distributed. The objective of the SC2 is to allocate paper profits to the tax exempt entity for the period it held the S-corporation stock. These profits, however, are never distributed to the tax-exempt shareholder.<sup>106</sup> Instead, the profits are eventually distributed to the original

98. Section 162 of the Internal Revenue Code (the “Code”) provides in relevant part that a taxpayer may deduct “ordinary and necessary” expenses. 26 U.S.C. § 162 (2006).

99. Section 212 of the Code provides in relevant part that a taxpayer may deduct “all the ordinary and necessary expenses . . . for the production or collection of income . . . .” 26 U.S.C. § 212 (2006).

100. 26 U.S.C. § 170 (2006).

101. See *Taxation with Representation of Washington v. Regan*, 676 F.2d 715, 731, (D.C. Cir. 1982) (“this case is of doubtful authority in view of *Speiser v. Randall*, which was decided four years later”).

102. See e.g., Rev. Rul. 89-74, 1989-1 C.B. 311 (discussing taxpayer attempts to channel their income through “churches” the taxpayers themselves have set up to avoid taxes). A change in lexicon of the dialogue from “tax shelter” to “unprescribed tax benefit” may sharpen the debate. “Shelter” carries both positive and negative connotations and distracts meaningful analysis from the core issue, whether the tax benefit has been prescribed by Congress.

103. Christopher R. Hoyt, *Charitable Gifts by S Corporations and their Shareholders: Two Worlds of Law Collide*, 36 ACTEC L.J. 693 (2011).

104. COMM. ON HOMELAND SECURITY & GOV’T AFFAIRS, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY, S. REP. NO. 109-54, at 10 (2005) [hereinafter U.S. TAX SHELTER INDUSTRY].

105. *Id.*

106. “[The] SC2 was intended to generate a tax deductible charitable donation for the corporate owner and, more importantly, to defer and reduce taxation of a substantial portion of the income produced by the S

donating shareholder after it exercises its rights to reclaim the S-corporation stock in accordance with the terms of a redemption agreement.<sup>107</sup> The donee organization realizes its income only when the original donating shareholders redeem the S corporation stock from the tax-exempt organization at a prescribed price.<sup>108</sup> The duration of the transaction generally lasted between two to three years.<sup>109</sup>

The financial rewards to tax exempt organizations participating in S2C transactions were irresistible. The Los Angeles Department of Fire and Police Pensions reported receiving “payments totaling \$5.9 million dollars”<sup>110</sup> for participating in the transaction. The Austin Fire Fighters Relief and Retirement Fund did not disclose the amount of money it received. However,

the fund administrator [for this organization] characterized the S[-] Corporation stock as “basically useless” and stated that he believed the fund would only receive income from the stock when the original owner repurchased it. He [also] indicated . . . that the sentiment at the pension fund was not to “look a gift horse in the mouth.”<sup>111</sup>

These unprescribed benefits enable aggressive tax planning transactions and investment strategies that are exploited by taxpayers, consultants, and their advisors. The Senate Report on the Tax Shelter Industry details the enthusiasm for that exploitation:

[A]fter SC2 was launched, the head of KPMG’s Federal Practice sent the following email to the SC2 “area champions” around the country [stating]: I want to personally thank everyone for their efforts during the approval process of this strategy. It was completed very quickly and everyone demonstrated true teamwork. Thank you! Now let[’]s SELL, SELL, SELL!!<sup>112</sup>

Unprescribed benefits cost the U.S. treasury billions of dollars every year in lost tax revenue.<sup>113</sup> This cost is ultimately transferred to, and borne by, the public at large.<sup>114</sup> Additionally, one study concludes that aggressive tax planning also results

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Corporation, essentially by ‘allocating’ but not actually distributing that income to a tax exempt charity holding the corporation’s stock.” *Id.*

107. *Id.* at 28–29.

108. *Id.*

109. *Id.* at 29.

110. *Id.* at 127.

111. U.S. TAX SHELTER INDUSTRY, *supra* note 104, at 132.

112. *Id.* at 35.

113. *Id.* at 11 (“Accounting firms were devoting substantial resources to develop, market, and implement tax shelters, costing the Treasury billions of dollars in lost tax revenues.”).

114. *United States v. Gardellini*, 545 F.3d 1089, 1097 (D.C. Cir. 2008) (Williams, J., dissenting) (citing INTERNAL REVENUE SERVICE, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 10 (2007), available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf) (“The IRS estimates that tax fraud on individual income tax returns generates revenue losses of about \$197 billion a year (not counting \$25 billion in losses from nonfiling).”).

in a decrease in financial transparency.<sup>115</sup> The effects of aggressive tax planning are not limited solely to the field of tax, but have demonstrated effects in other areas of the law.

Unprescribed tax benefits also impose an administrative and an enforcement burden on an already strained IRS workforce, and have given rise to a tax shelter industry. “Tax shelters have been a growth industry for financial intermediaries; these intermediaries have dramatically expanded shelter opportunities for corporate taxpayers; and while corporate tax revenues have risen with the booming economy, shelters have removed billions from government coffers.”<sup>116</sup>

It is reasonable to expect that taxpayers will evaluate structures that maximize their return and minimize their transactional costs, including the tax cost of the transaction. Investment potential is frequently analyzed from a spectrum of opportunities that includes operational, financial, legal, accounting, and tax perspectives. Opportunities and risks are researched, decisions are made, and plans are implemented. This behavior is common to all, regardless of size, industry, or economic status. However, taxpayers engaging in aggressive planning transactions undertake activities of dubious substance and structure, with the intent of substantially reducing their tax liability—all under the guise of a permissive, albeit unprescribed, tax benefit.

Unfortunately, the cruel reality is that “[t]he more complex the tax system is, the harder it is to fathom its outcomes. There is substantial—and well-founded—public suspicion that well-heeled . . . taxpayers can use a complex system to their advantage, while other taxpayers cannot. Such a suspicion can seriously erode voluntary compliance, which is the bedrock of our system.”<sup>117</sup> The policy objectives of simplicity and fairness are eroded whenever taxpayers access unprescribed tax benefits.

#### IV. THE LIMITED EFFECTIVENESS OF JUDICIAL TAX DOCTRINES IN CURBING AGGRESSIVE TAX PLANNING

Courts have developed a number of judicial tax doctrines that operate as gap fillers to the Code. These doctrines provide taxpayers, the IRS, and the courts with a measure of guidance.<sup>118</sup> There exists a belief that “[n]o matter how perceptive the legislature, it cannot anticipate all events and circumstances that may unfold, and due to linguistic limitations, statutes do not always capture the essence of what is

115. See generally Karthik Balakrishnan, Jennifer L. Blouin & Wayne R. Guay, *Does Tax Aggressiveness Reduce Financial Reporting Transparency?*, (Mar. 20, 2011) (unpublished study), available at SSRN: <http://ssrn.com/abstract=1792783>.

116. Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 19 (2000).

117. William A. Drennan, *The Patent Office Is Promoting Shocking New Tax Loopholes—Should the Empire Strike Back?*, 60 OKLA. L. REV. 491, 518 (2007).

118. These tax doctrines are commonly known as the business purpose doctrine, the economic substance doctrine, the step transaction doctrine, the substance over form doctrine, the sham transaction doctrine, and the sham entity doctrine, discussed *infra*.



intended.”<sup>119</sup> Courts, the IRS, and taxpayers have invoked these doctrines to challenge or to justify aggressive planning transactions.

These common law tax doctrines, however, have limitations. At times they overlap and create confusion. It is not unusual to discover that “[t]he terminology of one rule may appear in the context of the other because they share the same rationale.”<sup>120</sup> As with any common law doctrine, conflicts among the circuits can arise and may require a Supreme Court resolution or an act of Congress to resolve the conflict.<sup>121</sup> Additionally, unlike income tax statutes that mandate a particular method of analysis, the very same judicial doctrine may articulate differing tests. Some courts have observed “[tests] give the comforting illusion of consistency and precision. [These tests] often obscure rather than clarify.”<sup>122</sup> Although these doctrines each purport to address a deficiency in the Code, “[a] study by the Joint Committee on Taxation concludes that ‘these doctrines are not entirely distinguishable’ and have been applied by courts in inconsistent ways.”<sup>123</sup> Applying these common law doctrines often adds another layer of complexity of analysis to an already challenging situation, leaving taxpayers and the IRS to engage in a “semantic ju jitsu”<sup>124</sup> as each litigant seeks to gain advantage over the other.

### A. The Business Purpose Doctrine

*Helvering v. Gregory*<sup>125</sup> is recognized as the fountainhead for common law doctrines. It is credited with originating the “business purpose” doctrine. It has also been credited with originating several other tax doctrines including the substance over form and the economic substance doctrine.

In *Gregory v. Helvering*, the taxpayer engaged in a tax-free reorganization transaction admittedly “[f]or the sole purpose of procuring a transfer of . . . shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result for a direct transfer by way of dividend . . . .”<sup>126</sup> By engaging in this transaction, the taxpayer sought to convert a dividend payment into a tax-free corporate reorganization. In defense of her actions, the taxpayer argued that “every element required by the [taxing statute] was done, a statutory reorganization was effected; and that the motive of the

119. Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587, 588–89 (2001).

120. *ASA Investorings P’ship v. Comm’r*, 201 F.3d 505, 513 (D.C. Cir. 2000) (quoting *Zmuda v. Comm’r*, 731 F.2d 1417, 1421 (9th Cir. 1984)).

121. For example, the economic substance doctrine was codified by Congress and resolved the circuit conflict regarding whether the test was conjunctive or disjunctive. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–68 (2010) (codified as amended at 26 U.S.C. § 7701(o)).

122. *Rose v. Comm’r*, 868 F.2d 851, 854, (6th Cir. 1989) (quoting *Collins v. Comm’r*, 857 F.2d 1383, 1386 (9th Cir. 1988)).

123. U.S. TAX SHELTER INDUSTRY, *supra* note 104, at 4.

124. *ASA Investorings P’ship*, 201 F.3d at 511.

125. 69 F.2d 809 (2d Cir. 1934), *aff’d*, *Helvering v. Gregory*, 293 U.S. 465 (1935).

126. 293 U.S. at 467.

taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows.”<sup>127</sup>

The Supreme Court rejected the taxpayer’s argument of literal compliance with the Code and affirmed the U.S. Court of Appeals for the Second Circuit.<sup>128</sup> Justice Sutherland, writing for the majority of the Court, noted:

The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or all together avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.<sup>129</sup>

The Court added that “an operation having no business or corporate purpose . . . was nothing more than a contrivance.”<sup>130</sup> The Court reasoned that a transaction which has no business purpose other than the mere technical compliance with the tax statutes, serves no business purpose, and can be disregarded by the IRS.<sup>131</sup>

The application of the business purpose doctrine generates considerable uncertainty for regulators and the courts. Courts grapple with fundamental questions such as “What constitutes a valid business purpose?” and “How much of a business purpose is required?” Not surprisingly, courts across the federal circuits have reached mixed results on these questions. *Compaq Computer Corp. & Subsidiaries v. Commissioner of Internal Revenue* illustrates the challenges faced by courts as they grapple with applying the business purpose doctrine.<sup>132</sup>

The taxpayer, Compaq, entered into a foreign transaction involving the purchase and immediate resale of American Depository Receipt (“ADR”) certificates.<sup>133</sup> The transactions were arranged so that the purchase and the sale of the ADR’s straddled the dividend date.<sup>134</sup> Compaq acquired the ADR *with* dividend rights and immediately sold the ADR’s *without* dividend rights.<sup>135</sup> The difference between the two selling prices generated a \$20.7 million dollar capital loss for Compaq which it intended to use to shelter part of a \$231.7 million dollar capital gain.<sup>136</sup> An economic analysis of the transactions reveal that the purchase transaction of the ADR’s included the price of the dividend that was declared and paid, while the subsequent sale transaction excluded it. The IRS challenged the transaction arguing that the taxpayer’s transactions lacked economic substance and a business purpose.

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127. *Id.* at 468–69.

128. *Id.* at 470.

129. *Id.* at 469.

130. *Id.*

131. *Id.*

132. 277 F.3d 778, 780 (5th Cir. 2001) [hereinafter *Compaq II*].

133. *Id.* at 779. (The court explained “[a]n ADR is a trading unit, issued by a trust, that represents ownership of stock in a foreign corporation.”).

134. *Id.*

135. *Id.* at 780.

136. *Id.*

The Tax Court in *Compaq I* cited to the United States Supreme Court, and announced that “a genuine multiple-party transaction with economic substance . . . compelled or encouraged by business or regulatory realities . . . imbued with tax-independent considerations, and . . . not shaped solely by tax-avoidance features ‘should be respected for tax purposes.’”<sup>137</sup> The Tax Court reasoned that “[t]o satisfy the business purpose requirement of the economic substance inquiry, ‘the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and . . . economic situation . . . .’”<sup>138</sup> The Tax Court noted that the “inquiry [into the business purpose] takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction.”<sup>139</sup>

The Tax Court noted that:

The freedom to arrange one’s affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.<sup>140</sup>

The Tax Court held in favor of the government, concluding that the transactions at issue lacked economic substance and a valid business purpose.<sup>141</sup> Dissatisfied with the outcome, Compaq appealed the decision of the Tax Court to the Court of Appeals.<sup>142</sup>

The Court of Appeals for the Fifth Circuit reversed the Tax Court.<sup>143</sup> It found that “as to [a] business purpose: even assuming that Compaq sought primarily to get otherwise unavailable tax benefits in order to offset unrelated tax liabilities and unrelated capital gains, this need not invalidate the transaction.”<sup>144</sup> The Court of Appeals cited with approval, the Supreme Court’s statement that “[t]he fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.”<sup>145</sup>

137. *Compaq Computer Corp. v. Comm’r*, 113 T.C. 214, 220 (1999) (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978)) [hereinafter *Compaq I*].

138. *Id.* at 224 (quoting *ACM P’ship v. Comm’r*, 73 T.C.M. (CCH) 2189 (1993), *aff’d in part, rev’d in part*, 157 F.3d 231 (3d Cir.1998)).

139. *Id.* at 224.

140. *Id.* at 221 (quoting *Saviano v. Comm’r*, 765 F.2d 643, 654 (7th Cir. 1985)).

141. *Id.* at 219–20.

142. *Compaq II*, 277 F.3d at 788.

143. *Id.*

144. *Id.* at 786.

145. *Id.* (quoting *Frank Lyon Co.*, 435 U.S. at 580).

The Court of Appeals also flatly rejected the Tax Court's rationale that an absence of risk in a transaction precluded the finding of a business purpose.<sup>146</sup> The Court of Appeals stated that "[t]he absence of risk that can legitimately be eliminated does not make a transaction a sham."<sup>147</sup> Managing, allocating and minimizing transactional risk are acceptable methods of satisfying the business purpose standard. The Court of Appeals concluded "that the transaction had a sufficient business purpose independent of tax considerations."<sup>148</sup>

Interestingly, both the Tax Court and the Court of Appeals cited approvingly to the same Supreme Court case of *Frank Lyon Co.* to justify their decision. However, they arrived at diametrically opposed conclusions. The Tax Court found for the IRS<sup>149</sup> and the Court of Appeals found for the taxpayer.<sup>150</sup> The uncertainty surrounding the application of the business purpose doctrine is inescapable since the "[b]usiness purpose [doctrine] necessarily involves subjectivity because no two applications can be the same; no taxpayer can be in precisely the same position as another taxpayer."<sup>151</sup>

The uncertainty concerning the business purpose rule is apparent. The IRS has successfully invoked the business purpose doctrine to invalidate a transaction that was entered into by the taxpayer for tax-avoidance purposes. For example, in *ACM Partnership*, the doctrine was successfully invoked to challenge a complex partnership transaction formed to generate capital losses.<sup>152</sup> In *Rice's Toyota World, Inc. v. Commissioner of Internal Revenue*,<sup>153</sup> the doctrine was also successfully invoked to challenge a sale-leaseback transaction which was designed solely for the purposes of generating depreciation deductions. In *Kirchman v. Commissioner of Internal Revenue*, the business purpose doctrine was again successfully invoked to challenge option straddle transactions which were executed to generate tax deductions, but which had no real risk of loss attached to the transaction.<sup>154</sup>

In contrast, taxpayers have successfully invoked the business purpose doctrine to validate a transaction notwithstanding the presence of tax motive reasons. In *ASA Investorings Partnership*, the court stated "[i]t is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax."<sup>155</sup> In *Jacobson v. Commissioner of Internal Revenue*, the court found a business purpose present in the face of a losing investment on the basis that such a loss was not predictable before the taxpayer engaged in the transaction.<sup>156</sup>

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146. *Id.* at 787.

147. *Id.*

148. *Id.*

149. *Id.* at 783 n.3. It bears noting that "[t]he Tax Court's decision in this case has been subject to extensive commentary, friendly and not so friendly."

150. *Id.* at 788.

151. Christopher M. Pietruszkiewicz, *Economic Substance and the Standard of Review*, 60 ALA. L. REV. 339, 373 (2009).

152. *ACM P'ship*, 157 F.3d at 247-48.

153. 752 F.2d 89, 90-92 (4th Cir. 1985).

154. 862 F.2d 1486, 1488-89 (11th Cir. 1989).

155. *ASA Investorings P'ship*, 201 F.3d at 513.

156. 915 F.2d 832, 839 (2d Cir. 1990).

“When the business purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a facade. But there is no absolutely clear line . . . .”<sup>157</sup> The business purpose doctrine has no seemingly objective standards and is imbued with discretion and judgment in its application. Courts disagree on the relative importance of the business purpose doctrine. One court states that “[t]he business purpose doctrine reduces the incentive to engage in . . . essentially wasteful activity, and . . . helps achieve reasonable equity among taxpayers who are similarly situated—in every respect except for differing investments in tax avoidance.”<sup>158</sup> However, this same court notes quite emphatically that “. . . the ‘business purpose’ doctrine is hazardous.”<sup>159</sup>

## B. The Economic Substance Doctrine

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.<sup>160</sup>

Courts applying the economic substance doctrine note that “the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits [should] not be afforded based on transactions lacking in economic substance.”<sup>161</sup> The economic substance doctrine has been used extensively by the IRS in combating abusive transactions. “From 1995 through October 2006, the United States utilized the economic substance doctrine to challenge taxpayers in 170 decided court cases involving over \$4.4 billion in taxable income.”<sup>162</sup>

Conceptually, the economic substance doctrine appears simple and straightforward. The doctrine, however, has proven elusive and problematic and has given rise to interpretational difficulties. Courts applying the economic substance test use a two prong test when analyzing the economic substance of a transaction. The objective prong requires examining the economic substance of the transaction and the subjective prong requires determining the taxpayer’s subjective intent when entering into the transaction.<sup>163</sup>

Until recently, the circuits were split concerning how to evaluate and apply the economic substance doctrine. The question was whether the test was to be applied

157. *ASA Investorings P’ship*, 201 F.3d at 513.

158. *Id.*

159. *Id.*

160. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006).

161. *Id.* at 1354.

162. Pietruszkiewicz, *supra* note 151, at 342 n.8.

163. *Rice’s Toyota World*, 752 F.2d at 91–92.

in a conjunctive manner or in a disjunctive manner. The Seventh Circuit,<sup>164</sup> Eighth Circuit,<sup>165</sup> and Eleventh Circuit<sup>166</sup> applied the test in a conjunctive manner. In contrast, the Second Circuit,<sup>167</sup> Fourth Circuit,<sup>168</sup> and the D.C. Circuit<sup>169</sup> applied the test in a disjunctive manner. The Federal Circuit Court of Appeals<sup>170</sup> took a different approach altogether. The remaining circuits considered the two prong test as elements in their analysis of the economic substance of the transaction.<sup>171</sup>

Congress codified the economic substance doctrine in 2010.<sup>172</sup> This codification resolved the circuit split. The codified economic substance rule mandates a two prong test when analyzing the economic substance of a transaction. The two prong test provides that:

In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.<sup>173</sup>

Moreover, the codified economic substance doctrine provides that the profit potential of a transaction is “met . . . only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.”<sup>174</sup>

The codification of the economic substance doctrine is a marked improvement over its common law form because it clarifies Congress's preference for a conjunctive test. It also establishes a uniform standard of analysis to be used when evaluating the economic factors. The codification of the economic substance doctrine also answers critics, such as Judge McKee, whose forceful dissent in *ACM Partnership* argued that a majority of the court “injected the ‘economic substance’ analysis into an inquiry where it does not belong.”<sup>175</sup> Courts now have a congressionally mandated rule which removes the cloud of doubt over its application by courts. However, future courts will continue to grapple with

164. *Yosha v. Comm'r*, 861 F.2d 494, 501–02 (7th Cir. 1988).

165. *IES Indus., Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001).

166. *United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001).

167. *DeMartino v. Comm'r*, 862 F.2d 400, 406 (2d Cir. 1988).

168. *Rice's Toyota World*, 752 F.2d at 91–92.

169. *Horn v. Comm'r*, 968 F.2d 1229, 1237–38 (D.C. Cir. 1992).

170. *Coltec Indus.*, 454 F.3d at 1340.

171. *See ACM P'ship*, 157 F.3d at 247–48; *Merryman v. Comm'r*, 873 F.2d 879, 881 (5th Cir. 1989); *Rose*, 868 F.2d at 853–54; *Casebeer v. Comm'r*, 909 F.2d 1360, 1363–64 (9th Cir. 1990); *Deweese v. Comm'r*, 870 F.2d 21 (1st Cir. 1989).

172. Health Care and Education Reconciliation Act of 2010, *supra* note 121, at 1067–68.

173. 26 U.S.C. § 7701(o)(1).

174. 26 U.S.C. § 7701(o)(2)(A).

175. *ACM P'ship*, 157 F.3d at 263 (McKee, J., dissenting).

identifying and defining abstract concepts contained within the codified statute, such as when does a “transaction change in a meaningful way . . . the taxpayer’s economic position,”<sup>176</sup> and when does “the taxpayer [have] a substantial [non-tax] purpose?”<sup>177</sup> These essential questions remain unanswered and will continue to be a source of dispute in future litigation, thus rendering its effectiveness in the battle against abusive transactions questionable.

### C. The Substance-over-Form Doctrine

The substance-over-form doctrine is another judicially created doctrine used by the courts and the IRS when evaluating potentially abusive transactions. “The concept of the substance-over-form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken.”<sup>178</sup> It is used by courts and the IRS to disregard the formalities of a transaction and to look through the form into the substance of the transaction. It has been used by the IRS with mixed results in abusive transactions.

*Commissioner of Internal Revenue v. Court Holding Co.*<sup>179</sup> is the landmark case giving rise to the substance over form doctrine. In *Court Holding II*, the taxpayer negotiated for the sale of its sole asset to a buyer.<sup>180</sup> After negotiating and reaching an oral agreement, the taxpayer accepted a \$1,000 payment from the buyer.<sup>181</sup> When the parties “met to reduce the agreement to writing,” the taxpayer company learned from its lawyer “that the sale . . . would result in the imposition of a large income tax . . . .”<sup>182</sup> The transaction was subsequently restructured from a direct sale by the corporate taxpayer, into a two-step transaction.<sup>183</sup> The first step involved a complete liquidation of the corporate assets in exchange for a surrender of the common shares held by the shareholders.<sup>184</sup> The second involved a direct sale of the property by the shareholders in their individual capacity to the buyer.<sup>185</sup>

The IRS argued that the sale transaction should be recast as a sale from the corporation to the buyer and that the intermediary forms, namely the complete liquidation by the corporation and subsequent sale by the shareholders, should be disregarded.<sup>186</sup> The corporate taxpayer argued “that the sale was made by its

176. 26 U.S.C. § 7701(o)(1)(A).

177. *Id.* § 7701(o)(1)(B).

178. I.R.S. Chief Couns. Mem. 200915033, 2009 WL 965870, at \*10.

179. 324 U.S. 331, 334 (1945) [hereinafter *Court Holding II*].

180. *Id.* at 332.

181. *Id.* at 333. There was a difference between how the [accounting] books and the 1940 income tax return of the corporation reported “rent”. The [accounting] books reflected rental income of \$1,000, while the income tax return reflected \$2,125. “The \$1,000 shown on the [accounting] books as income from rent in 1940 was determined to have been a payment on the purchase price.” *Court Holding Co. v. Comm’r*, 2 T.C. 531, 535 (1943) [hereinafter *Court Holding I*]. “Through inadvertence, the 1940 return was not verified by the officers who executed it.” *Id.* at 538–39.

182. *Court Holding II*, 324 U.S. at 333.

183. *Id.*

184. *Id.*

185. *Id.*

186. *Court Holding I*, 2 T.C. at 537.

stockholders individually after the property had been distributed to them in complete liquidation, and that therefore the [corporate taxpayer] realized no taxable gain on the sale.”<sup>187</sup>

The Supreme Court held for the government and rejected the taxpayer’s argument that the form of the transaction should control.<sup>188</sup> The Court held that “[t]he incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title.”<sup>189</sup> The Supreme Court disapproved of the taxpayer’s mid-stream change in transactional form in order to minimize the income tax liability. The court reasoned “[t]o permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.”<sup>190</sup>

Courts recognize that taxpayers have the freedom to structure their transactions in a manner which fulfills the taxpayer’s objectives. For instance, in *Higgins v. Smith*, the Supreme Court stated “[a] taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.”<sup>191</sup> However, the Supreme Court also recognized there are limits to a taxpayer’s choice involving tax matters. The Supreme Court remarked:

[T]he Government may not be required to acquiesce in the taxpayer’s election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation.<sup>192</sup>

Notwithstanding the taxpayer’s right to choose a form which best suits his interests and the IRS’s right to review a taxpayer’s choice, the contours of this doctrine continue to be elusive and undefined. This continuing uncertainty strikes at the core of the tax policy objectives of simplicity and efficiency.

187. *Id.* The Tax Court also rejected the taxpayer’s argument that the sale was unenforceable by virtue of the statute of frauds which requires a writing to enforce a contract involving the sale of land. The Tax Court disposed of this argument stating “as we have said, the [oral] contract which was executed and the sale which was consummated were in substance the petitioner’s contract and sale. Thus any question as to the effect of the statute of frauds is avoided, since the oral agreement was fully executed and performed.” *Id.* at 539.

188. *Court Holding I*, 324 U.S. at 334.

189. *Id.*

190. *Id.*

191. 308 U.S. 473, 477 (1940).

192. *Id.* at 477–78.



### D. The Step Transaction Doctrine

The step transaction doctrine is another common law doctrine frequently used to evaluate the substance and independent significance of each step to a transaction. It is used by courts to evaluate multiple steps of a transaction and, when necessary, to consolidate the different steps into a single transaction for income tax purposes.<sup>193</sup> When applied, the doctrine disregards the intermediary steps of a transaction and looks to the final step of the transaction. Of all the common law doctrines, the step transaction doctrine has yielded the greatest result for the IRS.

The Tax Court has recognized that “[t]he step transaction doctrine is in effect another rule of substance over form.”<sup>194</sup> It treats a series of formally separate ‘steps’ as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.”<sup>195</sup> As noted by the Tax Court in *Penrod*, “[t]here is no universally accepted test as to when and how the step transaction doctrine should be applied to a given set of facts. Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular situation.”<sup>196</sup> The three generally accepted approaches to the step transaction doctrine are the binding commitment test, the interdependence test, and the end-results test.<sup>197</sup>

The first approach is the binding commitment test, and is the narrowest of the three approaches. Under the binding commitment test “a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step.”<sup>198</sup> The binding commitment test has the advantage of promoting certainty in . . . tax planning . . . .”<sup>199</sup> Under this test, “a court must make an objective determination” concerning the parties respective obligations.<sup>200</sup> A party’s intent is disregarded under this test.<sup>201</sup>

The second approach, the interdependence test, “focuses on whether ‘the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.’”<sup>202</sup> This test requires a court to determine “whether the individual steps had independent significance or whether

193. True v. United States, 190 F.3d 1165, 1174 (10th Cir. 1999).

194. Penrod v. Comm’r, 88 T.C. 1415, 1428 (1987).

195. *Id.*

196. *Id.* at 1429.

197. *Id.* at 1429–30.

198. *Id.* at 1429. See Comm’r v. Gordon, 391 U.S. 83, 96 (1968); see also United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968); Ward v. Comm’r, 29 B.T.A. 1251 (1934).

199. *Penrod*, 88 T.C. at 1429.

200. *Id.*

201. *Id.*

202. *Id.* at 1430 (quoting Redding v. Comm’r, 630 F.2d 1169, 1177 (7th Cir. 1980); see also King Enter., Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969) (quoting the same language); Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184–85 (1942) (explaining that intermediate transactional steps are to be ignored where they contribute “nothing of substance to the completed affair”); South Bay Corp. v. Comm’r, 345 F.2d 698, 703 (2d Cir. 1965) (noting the importance of analyzing the transaction as a whole).

they had meaning only as part of the larger transaction . . . .”<sup>203</sup> Predictably, the evaluation of the individual steps has led to inconsistent results.

The third, and broadest approach, is the end result test:

Under this test, the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result. The end result test is based upon the actual intent of the parties as of the time of the [transaction].<sup>204</sup>

When evaluating the intent of the parties, a court “must necessarily rely rather heavily on objective facts under the theory that one’s actions generally reflect one’s intentions.”<sup>205</sup> The end result test is contextual and looks beyond the formalities of the underlying transaction to determine whether the doctrine is to be applied. “The Internal Revenue Service has indicated on several occasions that threshold steps will not be disregarded under a step transaction analysis if such preliminary activity results in a permanent alteration of a previous bona fide business relationship.”<sup>206</sup> The following cases illustrate how the step transaction doctrine is applied to disregard the intermediary steps undertaken by the taxpayer.

In *H.J. Heinz Co. v. United States*, the court applied the step transaction doctrine to invalidate a series of complicated transfers intended to generate a \$42.5 million dollar refund.<sup>207</sup> “At issue is whether the H.J. Heinz Credit Company (HCC), a subsidiary of the H.J. Heinz Company (Heinz) may deduct a capital loss of \$124,134,189 on a sale of 175,000 shares of Heinz stock.”<sup>208</sup>

Heinz created a wholly owned subsidiary, H.J. Heinz Credit Company (HCC), in 1983.<sup>209</sup> In 1994, HCC purchased 3.5 million shares of Heinz Stock.<sup>210</sup> In May 1995, HCC then transferred ninety-five percent of the stock it acquired to Heinz in exchange for a convertible note.<sup>211</sup> Heinz argued that the exchange “was a redemption [transaction] which should be taxed as a dividend, and that HCC’s basis in the redeemed stock should be added to its basis in the 175,000 shares it retained.”<sup>212</sup> The IRS countered, arguing that “no redemption [transaction] occurred because Heinz had no business purpose for interposing a subsidiary between itself and the shareholders . . . save to engineer an artificial tax loss.”<sup>213</sup>

Sustaining the disallowance by the IRS, Judge Allegra, writing for the United States Court of Federal Claims, cogently declared:

203. *Penrod*, 88 T.C. at 1430.

204. *Id.* at 1429–30 (citations omitted).

205. *McDonald’s of Zion, 432, Ill., Inc. v. Comm’r*, 76 T.C. 972, 989 n.26 (1981), *rev’d*, 688 F.2d 520 (7th Cir. 1982).

206. Rev. Rul. 79-250, 1979-2 C.B. 156.

207. 76 Fed. Cl. 570, 590–91 (2007).

208. *Id.* at 572.

209. *Id.* at 573.

210. *Id.* at 577.

211. *Id.*

212. *Id.* at 572.

213. *Id.*

This court will not don blinders to the realities of the transaction before it. Stripped of its veneer, the acquisition by HCC of the Heinz stock had one purpose, and one purpose alone—producing capital losses that could be carried back to wipe out prior capital gains. There was no other genuine business purpose. As such, under the prevailing standard, the transaction in question must be viewed as a sham—a transaction imbued with no significant tax-independent considerations, but rather characterized, at least in terms of HCC’s participation, solely by tax avoidance features.<sup>214</sup>

In a direct reference to an earlier Heinz ketchup slogan, “It’s Red Magic Time,” Judge Allegra rebuked Heinz and declared that “no amount of magic, red or otherwise, can hide the meat of the transactions in questions . . . .”<sup>215</sup>

In another case, *Long Term Capital Holdings v. United States* (“LTCH”), the court again applied the step transaction to disregard a series of transactions designed to generate \$106 million in tax benefits.<sup>216</sup> In *LTCH*, the taxpayer’s challenged the “IRS denial of \$106,058,228 in capital losses . . . .”<sup>217</sup> The court rejected the taxpayer’s (long term) argument that the step transaction should be precluded because its transactions purportedly “had economic substance . . . operated for valid and substantial business purposes to make a material pre-tax profit, and expected to continue in the same manner for the foreseeable future . . . .”<sup>218</sup> The court reasoned that “the presence of a valid business purpose and independent economic substance in the entity used as a transactional vehicle or some valid business purpose for the transaction itself does not bar application of the step transaction doctrine, rather both are circumstances to be considered in a multi-factor analysis.”<sup>219</sup> The court further noted that it “[saw] no reason why using an ongoing business entity. . . which otherwise engaged in independent profit making activities, as the vehicle to accomplish the parties’ ultimate objective should shield a transaction from step transaction analysis, particularly where the purpose of the transaction was to buy tax losses . . . .”<sup>220</sup> *LTCH* yields an interesting result because the court was willing to extend the application of the step transaction doctrine *notwithstanding* the presence of “independent profit making activities” in one of the steps to the transaction.<sup>221</sup>

Historically, the step transaction doctrine has been used to disregard transactions where the intermediate steps themselves lacked substance. However, these cases suggest a noticeable trend that the step transaction doctrine may be successfully invoked by the IRS despite the presence of economic substance within

214. *H.J. Heinz Co.*, 76 Fed. Cl. at 587.

215. *Id.* at 593.

216. 330 F. Supp. 2d 122, 127 (D. Conn. 2004), *aff’d*, 150 F. App’x 40 (2d Cir. 2005).

217. *Id.*

218. *Id.* at 192.

219. *Id.* at 193 (adopting the reasoning of the 10th Circuit) (citing *Associated Wholesale Grocers v. United States*, 927 F.2d 1517, 1526–27 (10th Cir. 1991)).

220. *Id.* at 193.

221. *Id.*

the intermediate steps. This recent trend by courts, signaling their willingness to apply the step transaction doctrine despite profitable intermediate steps, is a potent tool in the IRS's arsenal to combat abusive transactions.

### E. The Sham Transaction and the Sham Entity

Of all the common law doctrines used to combat abusive taxpayer conduct, the sham transaction doctrine is the most versatile of doctrines and the most problematic. Its virtue lies in its flexibility in application across a wide range of transactions, be they single-step transactions, multi-step transactions, personal, partnership, corporate, estate, or gift. It is problematic, however, in the sense that it contains no specified standard of analysis, no factors to be balanced, and no boundaries to be observed. Yet, it is routinely invoked by courts.

The sham transaction harkens to Justice Potter Stewart's colloquial expression, "I know it when I see it."<sup>222</sup> Its lack of a clearly defined framework creates abundant uncertainty in its application. Courts routinely differ in their application of this doctrine thereby making it an unreliable tool to curb abusive taxpayer conduct. For instance, to determine if a transaction is a sham, the Fourth Circuit Court of Appeals applies "a two-pronged inquiry . . . [examining whether] the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and [whether] the transaction has no economic substance because no reasonable possibility of a profit exists."<sup>223</sup> This is in contrast to the Eleventh Circuit Court of Appeals, which examines only whether the transaction lacks "economic effects other than the creation of tax benefits."<sup>224</sup>

The sham transaction doctrine is a subsidiary common law doctrine and is frequently linked with one of the remaining doctrines. The sham transaction doctrine functions more as a declaration of conclusion rather than as a tool for analysis. For instance, in *United Parcel Serv.*, the court noted that the "economic-substance doctrine, [is] also called the sham-transaction doctrine . . . ."<sup>225</sup> Another court noted that "[a] sham transaction is one that subjectively lacks a non-tax business purpose and objectively lacks economic substance beyond procuring tax benefits."<sup>226</sup> Neither of these statements is particularly helpful to an analysis. Of all the varying common law doctrines, the sham transaction is the weakest tax doctrine.

222. *Jacobellis v. Ohio*, 378 U.S. 184, 197 (Potter, J., concurring) ("I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [of obscenity] and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that:").

223. *Rice's Toyota World*, 752 F.2d at 91–92.

224. *Kirchman*, 862 F.2d at 1492 (citing *Knetsch v. United States*, 364 U.S. 361 (1960)).

225. *United Parcel Svc.*, 254 F.3d at 1018 (citing *Kirchman*, 862 F.2d at 1492).

226. *River City Ranches v. C.I.R.*, 313 F. App'x 935, 938 (9th Cir. 2009) (citing *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir. 1988)).

## V. THE LIMITED EFFECTIVENESS OF STATUTORY AUTHORITY IN CURBING AGGRESSIVE TAX PLANNING

Tax policy reflects the collective wisdom of Congress concerning fiscal approaches to economic and to social issues. For example, congressional action has been directed primarily to promote positive taxpayer conduct such as stimulating investment,<sup>227</sup> encouraging jobs creation,<sup>228</sup> or promoting retirement savings.<sup>229</sup> At the same time, Congress has to address dubious taxpayer behavior. To that end, Congress enacted several tax provisions to curb abusive transactions with the objective of encouraging taxpayer compliance and minimizing the administrative burden on the IRS. However, each one of these tax provisions contain structural limitations which diminish their effectiveness in combating abusive taxpayer practices and address aggressive tax planning strategies.

### A. Combating Aggressive Tax Planning and Abusive Taxpayer Conduct—Traditional Sections

Early in the history of the Code, Congress enacted two sections to deal with abusive taxpayer practices. One section addresses acquisitions made with the intent of avoiding or evading income tax.<sup>230</sup> The other section deals with transfer pricing issues.<sup>231</sup> A third section, added much later in the history of the Code, addresses passive activity losses. Taxpayers however, soon learned these sections were relatively easy to circumvent thereby limiting their efficacy.

#### 1. Section 269: Corporate Acquisitions Made to Avoid or Evade Tax

Section 269 of the Code was enacted to prevent taxpayers from trafficking in acquisition transactions for the purpose of accessing tax benefits.<sup>232</sup> This transaction pattern generally contemplates the acquisition by one company of another company for the purpose of exploiting the acquired company's tax attributes. In general, the acquiring company and the acquired company will have

227. 26 U.S.C. § 179 (2006). The section 179 deduction was enacted in 1958 to encourage investment in property and to enable a taxpayer to take an immediate tax deduction. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 204, 72 Stat. 1606 (codified as amended at 42 U.S.C. § 179).

228. 26 U.S.C. § 51(b)(3) (2010) (The Work Opportunity Tax Credit provides a \$6,000.00 per employee tax credit if a taxpayer hires certain disadvantaged workers.).

229. 26 U.S.C. § 219 (2006).

230. 26 U.S.C. § 269 (2006); 26 U.S.C. § 446 (authorizing the IRS to recharacterize a taxpayers method of accounting if it does not "clearly reflect income"); 26 U.S.C. § 1551 (authorizing the IRS to disallow the corporate surtax exemptions among controlled corporations unless the taxpayer can demonstrate that the transaction was not tax motivated. A review of accounting methods and consolidated income tax rules is beyond the scope of this article).

231. 26 U.S.C. § 482 (2006).

232. *Stockman Nat'l Life Ins. Co. v. United States*, 336 F. Supp. 1202, 1204 (D.S.D. 1971) (citing H.R. REP. NO. 78-871 (1943)) ("The Congressional Committee Reports indicate that Section 269 was 'designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability.'").

inverted tax attributes, that when combined, minimize the overall tax burden of the taxpayer.

The Secretary has the authority to disallow any deduction, credit or other allowance of any taxpayer who acquires control<sup>233</sup> of a corporation. The Secretary may also exercise this authority if any taxpayer acquires the property of an unrelated company with a carryover basis in the acquired property. This authority is exercised if “the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy . . . .”<sup>234</sup> The income tax regulations clarify that “[t]he phrase ‘evasion or avoidance’ is not limited to cases involving criminal penalties, or civil penalties for fraud.”<sup>235</sup>

To invoke the proscription of section 269, a taxpayer must engage in an acquisition transaction, the principal purpose of which is the evasion or avoidance of income taxes.<sup>236</sup> Establishing an acquisition transaction is an objective determination. However, establishing a “principal purpose” is a more difficult challenge and involves, to some degree, a subjective determination. The income tax regulations provide no guidance to aid taxpayers in determining what constitutes a principal purpose. Instead, the income tax regulations declare in conclusory fashion “[i]f the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.”<sup>237</sup>

When examining for a principal purpose, one court seemed satisfied that a stipulation of purpose by the parties sufficed to defeat section 269. The court in *Hawaiian Trust Co.* stated that “a principal purpose must exceed in importance any other purpose.”<sup>238</sup> In this case, the court found dispositive in its inquiry of “principal purpose” that the parties own stipulations that a tax avoidance motive was not a controlling feature in the transaction. The court found persuasive the fact that “[a]t the time of the acquisition of the stock . . . no consideration was given by [the purchaser] to the tax aspects of the transaction”<sup>239</sup> notwithstanding the presence of tax benefits.

Courts have also held that a principal purpose is satisfied where a valid business reason exists for the acquisition transaction. For example, in *Arwood Corp. v. Commissioner of Internal Revenue*,<sup>240</sup> the IRS challenged the taxpayer’s merger of three corporations that effectively reduced the taxpayer’s overall income tax burden on the basis that the merger was entered into to avoid income taxes. The IRS argued that the taxpayer was “not entitled to benefit from these losses because

233. For purposes of section 269, “control” means “the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.” 26 U.S.C. § 269(a)(2).

234. *Id.*

235. Treas. Reg. § 1.269-1(b) (as amended in 1992).

236. 26 U.S.C. § 269(a)(2).

237. Treas. Reg. § 1.269-3(a)(2) (as amended in 1992).

238. *Hawaiian Trust Co. v. United States*, 291 F.2d 761, 765 (9th Cir. 1961).

239. *Id.* at 766.

240. 30 T.C.M. (CCH) 6 (1971), 1971 Tax Ct. Memo LEXIS 330.

he believes that there was no business purpose for the merger of the companies and that, even if there were such a purpose, the tax avoidance motives for the merger exceeded in importance any business purpose that may have existed.”<sup>241</sup> In contrast, the taxpayer argued that the principal purpose of the transaction was the acquisition of valuable intellectual property rights, and not the acquired tax benefits.<sup>242</sup>

The court sustained the merger of the corporations and upheld the taxpayer’s use of the merged losses. The court reasoned that “[w]hether or not the principal purpose for a given acquisition under section 269(a) is the evasion or avoidance of income tax is essentially a question of fact, and each case must necessarily be decided on its own merits.”<sup>243</sup> The court added “[w]e believe, on the facts presently before us, that the merger of [the three companies] was motivated principally by business considerations, and we have therefore concluded that this is not a proper case for the application of section 269[.]”<sup>244</sup> The taxpayer’s acquisition of certain patents and know-how in this transaction sufficed to persuade the Tax Court that the principal purpose of the merger was business motivated.<sup>245</sup> The Tax Court rejected the tax avoidance argument advanced by the IRS.

Additionally, the *Arwood* court rejected the IRS’s contention that the taxpayer’s choice of structure suggested a tax avoidance motive because the method chosen enabled the taxpayer to access the carryover of the operating losses.<sup>246</sup> The court remarked “[w]e do not believe that, whenever the method chosen in a given case to effect an acquisition is one which assures favorable tax results, we must necessarily conclude that the principal purpose of the transaction is tax avoidance.”<sup>247</sup>

“The objective of Section 269 is to nullify tax avoidance schemes[.]”<sup>248</sup> However, the effectiveness of section 269 as a tool for combating abusive tax transactions is limited because it triggers two prongs. Both prongs can be readily sidestepped by taxpayers. First, there must be an “acquisition” transaction with control.<sup>249</sup> Taxpayers can easily structure transactions to avoid triggering the control prong. Second, the transaction must have the avoidance or evasion of taxes as its principal purpose. Courts seem amenable in accepting a relatively low purpose threshold in satisfaction of this requirement as demonstrated by the case law.<sup>250</sup>

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241. *Id.* at \*49.

242. *Id.*

243. *Id.* at \*50.

244. *Id.* at \*51.

245. *Arwood Corp.*, 1971 Tax Ct. Memo LEXIS 330, at \*51.

246. *Id.* at \*60–61.

247. *Id.* at \*61. (“The merger in the instant case was designed to permit the deduction of the carryovers, in the event that such deduction would prove to be permissible. We think that arranging the merger in a manner that produces the most favorable tax results is simply intelligent business planning.”).

248. *Yunker Bros., Inc. v. United States*, 318 F. Supp. 202, 206 (S.D. Iowa 1970).

249. 26 U.S.C. § 269(a)(2).

250. *See, e.g., Hawaiian Trust Co.*, 291 F.2d at 766 (accepting the parties’ stipulation that at the time of the transaction, the taxpayer did not consider the tax consequences).

## 2. Section 482: Transfer Pricing

The transfer pricing rules,<sup>251</sup> commonly referred to as section 482, authorize the Commissioner to make reallocations of income and expense when it determines an abuse in transfer pricing. Transfer pricing practices have been a concern of Congress since the earliest days of the Code. Transfer pricing is defined as “the method by which companies allocate taxable income among individual business units[.]”<sup>252</sup> The transfer pricing rules were enacted by Congress to combat abusive practices by taxpayers who would shift income and expenses between commonly controlled companies with the effect of reducing the overall income tax burden of the enterprise. The predecessor of the current transfer pricing rules<sup>253</sup> “reflected congressional concerns about ‘the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized as foreign trade corporations.’”<sup>254</sup> In *W. Braun Co. v. Commissioner of Internal Revenue*, the Court of Appeals for the Second Circuit confirmed that “[t]he congressional purpose of section 482 was to prevent the use of controlled corporations to evade or avoid otherwise payable taxes by means of shifting profits or by other financial devices. The courts have given broad scope to the Commissioner’s discretion in making reallocations of income.”<sup>255</sup> Courts applying section 482 endeavor “to examine carefully the relationship between the controlled corporations to ascertain whether there was a ‘sound business purpose’ served by the use of the other corporation or whether the transaction was a mere sham to effect tax evasion.”<sup>256</sup>

Section 482 expressly grants to the IRS the authority to reallocate among commonly controlled organizations, items of “gross income, deductions, credits, or allowances . . . if [the IRS] determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”<sup>257</sup> “The two primary elements which must exist to sustain a section 482 allocation are the existence of commonly controlled companies and the earning of income by certain of these companies which in the absence of the Commissioner’s reallocation would not adequately be reflected in [their taxable income].”<sup>258</sup>

The theory behind section 482 recognizes that taxpayers with multiple organizations under common control may maintain a separate accounting system for each individual entity. The presence of two or more entities, each with its separate accounting systems, enables the shifting of income and expense items

251. 26 U.S.C. § 482 (2006).

252. *United States v. Bell*, No. 94-20342, 1994 WL 665295, at \*1 (N.D. Cal. 1994); *see also* OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, (1995) (“Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.”).

253. Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 227, 260 (1921).

254. *General Elec. Co. v. United States*, 3 Cl. Ct. 289, 293 n.12 (1983) (quoting S. Rep. No. 275-67, at 20 (1921)).

255. 396 F.2d 264, 266 (2d Cir. 1968).

256. *Id.*

257. 26 U.S.C. § 482.

258. *Local Fin. Corp. v. Comm’r*, 407 F.2d 629, 632 (7th Cir. 1969).



between entities. This concern became prominent as entities began to segment their activities across divisions, subsidiaries, and international boundaries. As a result, each organization accounts for its own particular item of income and expense. “Separate accounting [facilitates] the risk that a [taxpayer] will manipulate transfers of value among its components to minimize its total tax liability. To guard against such manipulation, transactions between affiliated corporations must be scrutinized to ensure that they are reported on an “arm’s-length’ basis . . . .”<sup>259</sup>

The regulations provide for several methods of scrutinizing the transfer price of an item between organizations with common control. The dominant principle governing transferring pricing is establishing a comparable uncontrolled transaction.<sup>260</sup> This approach effectively establishes a hypothetical third party price for the good, service or intangible at issue.

However, as a tool to combat aggressive tax planning, section 482 is limited in application. First, section 482 requires a commonly controlled group of organizations. Second, it requires allocations of income or expense that fail to clearly reflect income.<sup>261</sup> Unlike section 269, section 482 contains no clear definition of control. Instead, the regulations provide that the term “controlled” as used in section 482

includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise.<sup>262</sup>

The regulations add that “[a] presumption of control arises if income or deductions have been arbitrarily shifted.”<sup>263</sup> Defining control in such an ambiguous fashion invites uncertainty.

As an enforcement tool, section 482 is a difficult section to apply. Although the statute itself is short, the regulations are long and complex. It contains many abstractions and ambiguities which only add to uncertainty about the appropriate standard for application. For example, in *Xilinx, Inc. v. Commissioner of Internal Revenue*, the court criticized the IRS for adopting inconsistent positions with the income tax regulations.<sup>264</sup> *Xilinx, Inc.* dealt with a corporation taxpayer who entered into a cost sharing agreement with its foreign subsidiary, where the

259. *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 305 (1994); *see also* 26 U.S.C. § 482; Treas. Reg. § 1.482-1(b) (2009) (explaining “arm’s length” standard) (codified at 26 C.F.R. § 1.482-1(b)).

260. *See* Treas. Reg. § 1.482-1(b-d) (codified at 26 C.F.R. § 1.482-1(b-d)) (discussing factors to consider in making comparison to an uncontrolled transaction).

261. Section 446 requires taxpayers to adopt a method of accounting that “clearly reflect[s] income.” 26 U.S.C. § 446(b).

262. Treas. Reg. § 1.482-1(i)(4) (2009) (codified at 26 C.F.R. § 1.482-1(i)(4)).

263. *Id.*

264. 125 T.C. 37, 55 (2005), *aff’d*, 598 F.3d 1191 (9th Cir. 2010) (the court admonished the IRS for inconsistent application of regulation 1.482-1(b)(1) versus 1.482-7(d)(1)).

corporation deducted the whole cost of employee stock options (ESO) rather than shared it with the subsidiary.<sup>265</sup> The IRS tried to argue that under regulation section 1.482-7, Xilinx and its subsidiary are both controlled participants who should share all operating expenses including the ESOs paid for employees' research and development services.<sup>266</sup> The court evaluated the arguments and determined that the Commissioner's allocations were inconsistent with the Arm's-Length Standard Mandated by 1.482-1, because the cost sharing agreement did not establish whether the ESOs were a cost to be shared while unrelated parties would not share the spread or grant date value.<sup>267</sup>

The IRS has also indicated in an administrative announcement that it would not pursue 482 when dealing with shelter transactions. In Rev. Rul. 2003-96,<sup>268</sup> the IRS discussed whether section 482 applies to unrelated parties engaged in a lease stripping transaction. The IRS held:

[T]he fact that unrelated parties engage in a transaction does not by itself evidence the type of control necessary to satisfy the "acting in concert or with a common goal or purpose" requirement of [the income tax regulations],<sup>269</sup> regardless of whether such transaction may be viewed as having arbitrarily shifted income between the otherwise unrelated parties. An application of [the income tax regulations]<sup>270</sup> to this type of situation would be inconsistent with the policies underlying section 482, which provides for allocations between or among organizations, trades or businesses "owned or controlled directly or indirectly by the same interests."<sup>271</sup>

The principal reason given is that without objective evidence of common control, section 482 could not be invoked.<sup>272</sup> The import of Rev. Rul. 2003-96 is that taxpayers can interpret this ruling favorably when considering potential transfer pricing application in the context of tax shelter transactions.

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265. *Id.* at 39–40.

266. *Id.* at 52–53.

267. *Id.* at 59–62.

268. Rev. Rul. 2003-96, 2003-2 C.B. 386.

269. Treas. Reg. § 1.482-1(i)(4) (as amended in 2009) (codified at 26 C.F.R. § 1.482-1(i)(4)) (the regulation provides in relevant part, "[c]ontrolled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise").

270. *Id.*

271. Rev. Rul. 2003-96, *supra* note 268.

272. See I.R.S. Notice 95-53, 1995-2 C.B. 334; *see also* FSA 200013004 (Dec. 23, 1999) (employing an objective analysis); FSA 200015024 (Jan. 11, 2000) (same); FSA 200218022 (Jan. 31, 2002) (same); FSA 200206006 (Oct. 29, 2001) (same); and FSA 200237016 (Sept. 13, 2002) (same).

### 3. Section 469: Passive Activity Losses

Prior to 1986, taxpayers were able to reduce their overall tax liability by deducting passive losses against active income. In 1986, Congress changed the ability of taxpayers to do so by adding the passive activity rules ("section 469")<sup>273</sup> to the Code. Section 469 contains the statutory framework for limiting the deduction of passive activity losses against active income. It allows the deduction of passive losses, but only against passive income. As a result, active income can no longer be reduced by passive losses.

A passive activity "means any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate."<sup>274</sup> The taxpayer "materially participat[es] in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial."<sup>275</sup> The income tax regulations enumerate seven standards taxpayers can use to establish material participation.<sup>276</sup> The scope of the passive activity rules applies to "any individual, estate, or trust, [and] any closely held C-corporation . . ."<sup>277</sup> However, in the case of a limited partnership interest, a special *per se* rule provides that "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."<sup>278</sup>

Section 469 is used to curtail abusive taxpayer practices by those who organize and operate their business activity either through an individual, corporate, estate or trust form. However, three recent cases exempt LLC's and LLP's from the application of the passive activity loss rules. In *Gregg v. United States*,<sup>279</sup> *Garnett v. Commissioner of Internal Revenue*,<sup>280</sup> and *Thompson v. United States*,<sup>281</sup> courts held resoundingly in favor of the taxpayer who used these hybrid entities to successfully bypass the application of section 469. One court reasoned "absent explicit regulatory provision, we conclude that the legislative purposes of the special rule of section 469(h)(2) are more nearly served by treating L.L.P. and L.L.C. members as general partners for [purposes of section 469]."<sup>282</sup>

It is not entirely clear why neither Congress nor the IRS have failed to act in addressing the coverage of section 469 as it applies to hybrid entities such as LLCs, LLPs, and LLLPs. However, what is clear is that by ignoring the advent of these hybrid entities, taxpayers are left with a glaring and obvious opportunity to structure transactions and thereby avoid triggering section 469.

273. Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (codified as amended at 26 U.S.C. § 469).

274. 26 U.S.C. § 469(c).

275. *Id.* § 469(h)(1).

276. Treas. Reg. § 1.469-5T(a), (e)(2) (as amended in 1992) (codified at 26 C.F.R. § 1.469-5T) (the regulation provides seven standards. In the case of a limited partnership, only factors 1, 5, and 6 are available).

277. 26 U.S.C. § 469(a)(2).

278. *Id.* § 469(h)(2).

279. 186 F. Supp. 2d 1123, 1127 (D. Or. 2000) (holding that LLC is not subject to section 469).

280. 132 T.C. 368 (2009) (holding that LLC and LLP are not subject to section 469).

281. 87 Fed. Cl. 728 (2009).

282. *Garnett*, 132 T.C. at 370.

## B. Combating Abusive Taxpayer Conduct—The Anti-abuse Sections

“[T]he large volume of cases generated by tax shelter examinations during the late 1970s and early 1980s [prompted the IRS] and the Tax Court [to] develop procedures to streamline the litigation process, and reduce the costs . . . in resolving [tax shelter] disputes . . . .”<sup>283</sup> Additionally, Congress amended the Code by adding two new anti-abuse provisions as part of the Deficit Reduction Act of 1984 to curb abusive tax shelters.<sup>284</sup> The first provision required “[a]ny tax shelter organizer [to] register the tax shelter with the Secretary . . . .”<sup>285</sup> The second provision imposed a list maintenance requirement on “[a]ny person who organizes any potentially abusive tax shelter or sells any interest in such a shelter . . . [to] identify[] each person [to whom] an interest in such shelter” was sold.<sup>286</sup> Unfortunately, these provisions proved to be nothing more than statutory decoys.

Twenty years later, “[i]n October 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs began an investigation into the development, marketing, and implementation of abusive tax shelters by accountants, lawyers, financial advisors, and bankers.”<sup>287</sup> In its report to Congress, the Subcommittee related that:

The sale of potentially abusive and illegal tax shelters is a lucrative business in the United States, and some professional firms such as accounting firms, banks, law firms, and investment advisory firms have been major participants in the development, mass marketing, and implementation of generic tax products sold to multiple clients.<sup>288</sup>

The 2002 Subcommittee report is particularly disturbing in light of the earlier action taken by Congress in 1984 to address “potentially abusive tax shelters.”<sup>289</sup> The 1984 provisions were enacted by Congress “for the purpose of providing the IRS with means to better monitor tax shelters, and, consequently, to deter abusive tax shelters that can adversely impact public revenues. Before 1984, no systematic information was available to assist the IRS in identifying the shelters that should be investigated.”<sup>290</sup>

283. Hartman v. Comm’r, 95 T.C.M. (CCH) 1448, at \*6 (2008) (One of the changes included creating “the Tax Shelter Branch in the National Office to oversee tax shelter litigation across the country and to organize and supervise individual tax shelter projects”).

284. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 677–78 (1984) (codified as amended at 26 U.S.C. § 6111); § 142(a), 98 Stat. at 681.

285. *Id.* § 141(a).

286. *Id.* § 142(a).

287. U.S. TAX SHELTER INDUSTRY, *supra* note 104, at 6.

288. *Id.*

289. Deficit Reduction Act of 1984, *supra* note 284, § 142(b). Former Code section 6112(b) defined a potentially abusive tax shelter as “(1) any tax shelter . . . with respect to which registration is required under section 6111, and (2) any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.”

290. United States v. BDO Seidman, 337 F.3d 802, 809 (7th Cir. 2003).

The 1984 provisions imposed registration requirements and list maintenance requirements on taxpayers and tax shelter promoters. The registration requirements compelled “any tax shelter organizer [to] register the tax shelter with the Secretary.”<sup>291</sup> A tax shelter organizer was defined to include “the person principally responsible for organizing the tax shelter . . . any other person who participated in the organization of the tax shelter, and . . . any person participating in the sale or management of the investment . . . .”<sup>292</sup> Additionally, the list maintenance requirement obligated “any person who organizes any potentially abusive tax shelter or sells any interest in such a shelter . . .” to maintain a list of participants.<sup>293</sup>

However, taxpayers and their advisors were able to successfully structure transactions to circumvent the application of these two sections. As a result, taxpayers engaged in numerous abusive transactions including: “using a loan assumption agreement to claim an inflated basis in assets acquired from another party[,] . . . improperly shifting basis from one party to another[,] . . . [and] deferring tax on income from investments used to fund deferred executive compensation.”<sup>294</sup> High net worth individuals, who were not subject to the proscription of the anti-abuse sections, engaged in abusive transactions marketed under various names like son of boss transactions<sup>295</sup> and basis shifting transactions.<sup>296</sup> Additionally, corporations and individuals alike, frequently utilized partnerships, S-Corporations, and trusts structures to avoid triggering sections of the anti-abuse provisions. Novel and then emerging entity structures such as LLP’s and LLLP’s were also deployed to facilitate questionable transactions.

In response to the abusive practices reported by the Committee, Congress amended the Code by adding new code section 6707A<sup>297</sup> as part of the American Jobs Creation Act of 2004.<sup>298</sup> The new provision sought “to stop abusive tax shelters . . . by imposing a penalty for a taxpayer’s failure to disclose participation in certain tax-avoidance transactions known as reportable transactions.”<sup>299</sup> “Congress also sought to strengthen the IRS by providing it with additional enforcement tools to induce compliance with the reportable transaction disclosure regulations.”<sup>300</sup>

Section 6707A imposes a penalty on “any person who fails to include on any return or statement any information with respect to a reportable transaction . . . .”<sup>301</sup> The penalty amounts vary depending on the class of penalty and the type of taxpayer. In the case of a natural person, the maximum penalty is \$50,000 for a

291. 26 U.S.C. § 6111(a) (1984) (amended 2004).

292. *Id.* § 6111(d)(1)(A-C) (1984).

293. *Id.* § 6112(a) (1984).

294. I.R.S. Daily Tax Rep. 55 DTR L-20, 2002 WL 429750 (Mar. 21, 2002).

295. *Id.* (citing I.R.S. Notice 2000-44, 2000-2 C.B. 255).

296. I.R.S. Notice 2001-45, 2001-2 C.B. 129.

297. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 811(a), 118 Stat. 1575 (codified as amended at 26 U.S.C. § 6707A (2010)) (the Act was effective for returns and statements due after October 22, 2004 and which were not filed before such date).

298. *Id.*

299. *Smith v. Comm’r*, 133 T.C. 424, 427 (2009).

300. *Id.*

301. 26 U.S.C. § 6707A(a).

reportable transaction and \$100,000 for listed transactions.<sup>302</sup> For all other taxpayers, the penalty is \$100,000 for a reportable transaction and \$200,000 for listed transactions.<sup>303</sup> A reportable transaction is defined as a transaction determined by the Secretary “as having a potential for tax avoidance or evasion”<sup>304</sup> and a listed transaction is “a transaction specifically identified . . . as a tax avoidance transaction . . . .”<sup>305</sup>

As part of the American Jobs Creation Act of 2004, Congress also added section 6662A<sup>306</sup> to the Code. This new section imposes a twenty percent penalty on the understatement if such understatement is due to a reportable transaction. The penalty increases to thirty percent if the taxpayer fails to adequately disclose the reportable transaction.<sup>307</sup>

Congress also strengthened the provisions governing commercial tax planners by redefining and increasing the scope of coverage of the anti-abuse provisions.<sup>308</sup> The initial scope of the 1984 legislation applied to a “tax shelter organizer” which included “the person principally responsible for organizing the tax shelter.”<sup>309</sup> The expanded 2004 standard now looks to a “material advisor” which is defined as

any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such aid, assistance, or advice.<sup>310</sup>

This change in definition broadened the scope of persons who are subject to the Code’s reporting, disclosure, and list maintenance requirements. Under the amended rules, “[e]ach material adviser[,] with respect to any reportable transaction[,] shall make a return [disclosing] information identifying and describing the transaction, information describing any potential tax benefits expected to result for the transaction and such other information as the Secretary may prescribe.”<sup>311</sup>

Congress also amended the list maintenance obligations of the 1984 legislation. The new 2004 standard now requires that “each material advisor[,] with respect to any reportable transaction[,] shall maintain a list identifying each person to whom such advisor acted as a material advisor and . . . such other information as the

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302. *Id.* § 6707A(b)(2).

303. *Id.*

304. *Id.* § 6707A(c)(1).

305. *Id.* § 6707A(c)(2).

306. § 812(a), 118 Stat. 1418 at 1577 (codified as amended at 26 U.S.C. § 6662A (2011)) (this section was also made effective for tax years ending after October 22, 2004).

307. 26 U.S.C. § 6662A(c).

308. *Id.* § 6111.

309. 26 U.S.C. § 6111(c) (1984).

310. 26 U.S.C. § 6111(b)(1) (2006).

311. *Id.* § 6111(a).

Secretary may require.”<sup>312</sup> The former list maintenance obligations imposed its requirements on “any person who organizes any potentially abusive tax shelter or sells any interest in such a shelter . . . .”<sup>313</sup> The enhanced list maintenance obligations broaden the scope to include any person who provides “aid, assistance, or advice” and who receives a payment in excess of a threshold amount.<sup>314</sup>

However, even with these reforms, the tax laws may not be a sufficient deterrent. First, it is undeniable that for a segment of taxpayers, the prescribed penalties undoubtedly will be a sufficient deterrent. There remains a segment of taxpayers for whom a \$50,000, \$100,000, or even a maximum \$200,000 penalty will constitute a sufficient financial deterrent.

Second, the rules<sup>315</sup> fail to address the proverbial cat-and-mouse game, namely, the pursuit of structural designs by taxpayers intent on avoiding tax or producing substantial tax benefits. Finally, what is most unsettling from an administration perspective is the ex-post nature of IRS announcements. Current IRS practice is to publish a notice identifying transactions it determines to be abusive.<sup>316</sup> The IRS follows a practice of publishing transactions which it “determine[s] . . . to be avoidance transaction[s].”<sup>317</sup> The IRS determination is made on an ex-post basis thereby lagging, sometimes by a considerable amount of time, the containment and prohibition of abusive transactions. This approach is to be criticized because it does nothing to combat the vast inventory of tax products. For example, the Subcommittee Report noted that “KPMG had provided . . . [a] list of more than 500 active tax products for various tax practice groups, which were intended to be offered to multiple clients for a fee.”<sup>318</sup> The elimination of one tax product, ten tax products, or even forty tax products as was done by the IRS in Notice 2009-59<sup>319</sup> fails to address the prospective application of the remaining tax products.

Taxpayers are using a combination of increasingly complex financial and structural arrangements, and ambiguities in the law in ways never envisioned by Congress when the tax laws were enacted. One “sad additional fact is that all parties to these transactions know there is substantial likelihood that the device employed, including the imaginative assertion of the proper factual setting, will not be uncovered by IRS agents even if the corporation is audited . . . .”<sup>320</sup> Preventing the erosion of the tax base, ensuring compliance with the tax laws, and diminishing

312. *Id.*

313. 26 U.S.C. § 6112(a) (1984).

314. 26 U.S.C. § 6111(b)(1) (2006).

315. *Id.* §§ 6707A, 6662A, 6111, 6112.

316. See I.R.S. Notice 2010-33, 2010-1 C.B. 609 (listing over 40 such tax positions).

317. See I.R.S. Notice 2009-59, 2009-2 C.B. 170 (identifying listed transactions); see also I.R.S. Notice 2009-55, 2009-2 C.B. 170 (identifying transactions of interest).

318. U.S. TAX SHELTER INDUSTRY, *supra* note 104, at 79 n.297 (KPMG’s tax shelter work led to a high profile prosecution: KPMG has admitted that it engaged in a fraud that generated at least \$11 billion dollars in phony tax losses which, according to court papers, cost the United States at least \$2.5 billion dollars in evaded taxes. I.R.S. News Release IR 2005-83 (Aug. 29, 2005)).

319. I.R.S. Notice 2009-59, 2009-2 C.B. 170.

320. Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of Long Term Capital Holdings v. United States*, 3 BERKELEY BUS. L.J. 381, 411 (2006) (quoting the Statement of Stefan Tucker, on behalf of the Section of Taxation, American Bar Association, before the House Committee on Ways and Means, Mar. 10, 1999).

confidence in the U.S. tax system are the keystone principles of effective tax policy. The time is upon Congress for swift and decisive action to protect the further erosion of the domestic tax base.

## VI. PROPOSAL AND CONCLUSION

“[T]he dissent is often more than just a plea; it safeguards the integrity of the . . . decision-making process by keeping the majority accountable for the rationale and consequences of its decision.”<sup>321</sup>

Tax policy touches upon a most fundamental question, “What is the role of government?” Trying to find a consensus on this question, let alone unanimity from a group of individuals contemplating its significance, is a daunting exercise. Invariably, seemingly irreconcilable questions over funding levels and distributional burdens will follow.

“Happily for the United States, most people pay their taxes. More happily, most pay out of a sense of conscience and perhaps even public spirit . . . with the threat of fines and prison only rather remotely in the back of their minds.”<sup>322</sup> However, tax protesters and aggressive tax planners seemed undeterred by Congressional efforts to curb abusive practices. Congress must address these taxpayers more forcefully.

A perilous culture of tax avoidance is entrenched in American society. The attitude of avoidance is understandable when one contrasts the historical principle of individual freedom from government intrusion<sup>323</sup> against the modern condition of tax collections. In 2010, the federal government collected \$1.9 trillion.<sup>324</sup> Individuals, estates, and trusts contributed forty-three percent of this amount, payroll taxes contributed 43.7 percent, and corporations contributed 9.6 percent.<sup>325</sup> If measured on a gross domestic product (GDP) basis, U.S. tax collections would rank ninth, according to the World Bank ranking system, just ahead of India’s reported 2010 GDP of \$1.7 trillion.<sup>326</sup> Taxpayers clearly have a right to plan their transactions to minimize their tax burdens. However, taxpayers do not have a right to pursue a frivolous claim and then seek to defend their frivolous position in the face of settled law. Likewise, taxpayers should not have an unqualified right to craft an aggressive tax position which has not been endorsed by Congress, nor to base their tax position upon authority which is questionable.

U.S. tax policy makers and tax administrators must continually reevaluate their efforts to address the abuses that both tax protesters and aggressive tax planning

321. William J. Brennan, *In Defense of Dissents*, 37 HASTINGS L.J. 427, 430 (1986).

322. *Gardellini*, 545 F.3d at 1097 (Williams, J., dissenting).

323. See generally PAINE, *supra* note 37.

324. INTERNAL REVENUE SERVICE, DATA BOOK 2010 3 (2010), available at <http://www.irs.gov/pub/irs-soi/10databk.pdf>.

325. See *id.* at Table 1.

326. See THE WORLD BANK, GROSS DOMESTIC PRODUCT 2010 (2011), available at <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (ranking countries by GDP) (last visited May 25, 2012).



inflict on the system of tax administration. This will require reexamining the tax policies of simplicity, efficiency, fairness, and revenue sufficiency<sup>327</sup> in the face of a globalized economy. The emergence of developing economies is exerting additional strain on U.S. tax administration as foreign jurisdictions make it increasingly attractive for U.S. taxpayers to access foreign tax benefits.<sup>328</sup> We live in an era of increased financial sophistication, porous economic borders, and a complex income tax structure. Any meaningful reform concerning abusive taxpayer practices must take into consideration that U.S. taxpayers operate in a global environment where the tax policies of foreign jurisdictions now influence how U.S. taxpayers respond.

Future reforms must consider that government appropriations for tax administration will decrease. For example, "IRS's appropriations in FY [fiscal year] 2011 were reduced by 0.2 percent in nominal dollars and by more when increased costs are taken into account as compared with the previous year."<sup>329</sup> Funding levels for future years face an uncertain future and come at a time when "the IRS has been given more and more tasks, but . . . is not receiving the resources it needs to fulfill these tasks . . . ."<sup>330</sup> A reduction in funding levels coupled with continuing taxpayer abuse and aggressive tax planning will inevitably increase the burden for tax administrators.

A reduction in funding levels will also affect the IRS's audit function and strain IRS operations. A 2010 taxpayer survey question asked survey participants "How much influence does . . . '[f]ear of an audit' . . . have on whether you report and pay your taxes honestly?"<sup>331</sup> Thirty-five percent of the participants answered affirmatively that "[f]ear of an audit" had a great deal of influence on their reporting activity.<sup>332</sup> This suggests that sixty-five percent of the population is undeterred by IRS audit efforts. Consider also that fewer than two percent of taxpayers are audited annually<sup>333</sup> and the environment for abusive taxpayer conduct becomes self-evident.

Tax benefits exist because they were intentionally structured by Congress and thereby reflect congressional intent in a particular area. Some tax benefits exist because of the creativity of planners, the necessity of commerce, and the desire of

327. MINARIK, *supra* note 7.

328. Rachelle Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 3 (2010) ("[T]here is growing evidence that our current tax system is not ideally structured to deal with the challenges of an internationally integrated economy.").

329. IR-2011-71, *National Taxpayer Advocate Submits Mid-Year Report to Congress; Identifies Priority Challenges and Issues for Upcoming Year*, I.R.S. (June 29, 2011), <http://www.irs.gov/newsroom/article/0,,id=241123,00.html>.

330. *Id.*

331. IRS Oversight Board, *2010 Taxpayer Attitude Survey*, 5 (Jan. 2011), <http://www.treasury.gov/irsob/reports/2011/IRSOB%202010%20Taxpayer%20Attitude%20Survey.pdf>

332. *Id.* (Twenty-nine percent answered "[s]omewhat of an influence", sixteen percent answered "[v]ery little influence, nineteen percent answered "[n]ot at all an influence" and two percent did not know, answer, or respond.).

333. IRS, ENFORCEMENT AND SERVICE RESULTS FOR FY 2010, at 2, *available at* [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf).

most individuals to minimize the burden of taxation.<sup>334</sup> Some tax benefits exist because the Service has not addressed the deficiency in the tax laws.<sup>335</sup> The Supreme Court's rule that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer"<sup>336</sup> is a cardinal principle in tax law. Subjecting tax benefits to increased scrutiny is reasonable.

Tax protesters and aggressive tax planning both present a material threat to effective tax administration because they touch upon the foundational pillars of tax policy.<sup>337</sup> The political rhetoric of closing loopholes, enacting income tax reforms, and simplifying the tax code is a national distraction from the central issue—*What tax policy should Congress pursue?*

With respect to frivolous returns, Congress should increase the penalty once again to a meaningful level and with substantial consequences. The evidence indicates that the current penalties have not sufficiently deterred tax protesters from continuing to engage in protester activities. Moreover, Congress should conduct a study to determine whether compensated taxpayer advocacy facilitators should be required to register, and to disclose to the IRS, course materials and participants.<sup>338</sup> The registration and disclosure could be done within a reasonable period of time before or after the organized event. This initiative will help expose protester sites masquerading as legitimate taxpayer assistance forums. Requiring the registration of tax forum facilitators, their clients, and the forums will help the IRS identify individuals likely to engage in tax protester activities.

With respect to aggressive tax planning transactions, Congress should enact a statute which requires taxpayers engaged in aggressive tax planning transactions to disclose, with the filed income tax return, their filing position and supporting authority. Specifically, taxpayers have to disclose that they have engaged in a transaction designed to significantly reduce their tax liability and include the relevant authorities supporting the tax position. Taxpayers shall demonstrate that the transaction undertaken is both intended and permitted pursuant to established authority.<sup>339</sup> "Intended" in the sense that a reasonable inference from the congressional record approving the application of the tax law to the subject transaction is possible, and "permitted" in the sense that the relevant authorities, be it Congress or the courts, affirm the application. Adding income thresholds as a

334. INTERNAL REVENUE SERVICE DATA BOOK, Table 9a (2011), available at <http://www.irs.gov/pub/irs-soi/11databk.pdf>.

335. Carrie M. Dupic, *Comment: The SUV Tax Loophole: Today's Quintessential Suburban Passenger Vehicle Becomes Small Businesses' Quintessential Tax Break*, 9 LEWIS & CLARK L. REV. 669 (2005).

336. *INDOPCO, Inc. v. C.I.R.*, 503 U.S. 79, 84, (1992) (citing *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

337. MINARIK, *supra* note 7 (Those pillars are "efficiency, equity, revenue sufficiency, and simplicity.").

338. See IRS Form, Referral Form for Reporting Abusive Tax Promotions and/or Promoters, available at [http://www.irs.gov/pub/irs-utl/referralform\\_reportingabusiveschemes.pdf](http://www.irs.gov/pub/irs-utl/referralform_reportingabusiveschemes.pdf) (for voluntary disclosure by third parties).

339. The regulations under section 6662 may be instructive. "Authority" includes several sources of law, such as statutes, court cases, legislative history, and regulations, although none of these is particularly relevant if "materially distinguishable" on its facts. See Treas Reg. § 1.6662-4(d)(3)(ii).

safeguard to exclude low dollar value transactions should be considered.<sup>340</sup> A failure to comply with the disclosure requirements shall result in a disallowance of the claimed tax benefits. The term “aggressive tax planning” means using any entity, device, or arrangement that lacks a material non-tax benefit in combination with any domestic or foreign law to significantly reduce the income tax liability of the taxpayer in the absence of permitted authority for such tax position.

Additionally, the statute of limitations shall be automatically extended to six years for taxpayers engaged in an aggressive tax planning transaction if not properly disclosed.<sup>341</sup> An extended statute of limitations already exists for failing to report a listed transaction,<sup>342</sup> as well as for omissions of income.<sup>343</sup> Extending the statute of limitations for aggressive tax planning is justified when one considers the challenges raised by the increased sophistication of transactions, the geographic dispersion of taxpayer information, and the decrease in IRS personnel. Moreover, extending the statute of limitations is reasonable when one balances the limited resources of the IRS against the fact that “many if not most tax practitioners view . . . it as their right to seek out and exploit loopholes in the way the provisions apply to innovative structures.”<sup>344</sup>

As noted by one court, “[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every device.”<sup>345</sup> However, by observing tax policy fundamentals, most tax laws can be written within the bounds of reasonableness, thereby narrowing the range of honest dispute. Our elected officials must refrain from engaging in the rhetoric of tax protesting under the guise of tax reform as evidenced by the “Tax Code Termination Act”.<sup>346</sup> Rather, they must embark upon a decisive course of action that confronts anticipated challenges while promoting the fundamental principles of tax policy.

340. For example, transactions with anticipated tax savings greater than 2 million dollars would be subject to the new statute.

341. Limited disclosure is required under current UTP rules for corporations. This proposal extends and expands disclosure requirements by all taxpayers—individuals, corporations, estates, and trusts.

342. 26 U.S.C. § 6501(c)(10) (2010).

343. *Id.* § 6501(e) A six-year statute exists if the taxpayer fails to report 25% or more of their gross income.

344. Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 668 (2006).

345. *ASA Investorings P'ship*, 201 F.3d at 513.

346. H.R. 462, 112th Cong. (2011).