THE CASE AGAINST A STRICT LIABILITY ECONOMIC SUBSTANCE PENALTY

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The latest wave in tax shelter reform is the recent codification of the so-called "economic substance doctrine" and the accompanying strict liability penalty for violations of the doctrine. The new strict liability penalty has been criticized by tax scholars and practitioners for being unfair and disproportionate. However, most commentators have not evaluated whether there is any need for a separate penalty for violations of the economic substance doctrine at all, strict liability or otherwise. The first part of this Article considers the new economic substance penalty in light of the current penalties applicable to tax shelters and argues that a separate penalty provision for violations of the economic substance doctrine should not have been enacted. This Article will demonstrate that the current accuracy-related penalty regime is sufficient to address transactions that violate the economic substance doctrine and that the new penalty adds significant and undue complexity to the current regime.

This Article will then explore the strict liability aspect of the penalty and consider whether there is any justification for carving out transactions that violate the economic substance doctrine as especially deserving of strict liability as compared to other tax shelter transactions. Congress's justifications for the new strict liability penalty largely focus on taxpayer deterrence and reducing disadvantages to the IRS in enforcing penalties. However, Congress has failed to articulate why violations of the economic substance doctrine have been singled out for strict liability when other tax shelter penalties contain taxpayer defenses. The only way to properly justify a new tax shelter penalty with strict liability would be to tie that penalty to the most egregious forms of taxpayer misconduct, but there appears to be no link between violations of economic substance and the

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worst kinds of tax shelters. Given that violations of the economic substance doctrine are not a proxy for the most abusive tax shelter transactions, this Article concludes that the imposition of a strict liability penalty cannot be reconciled with other tax shelter penalties that provide for various forms of a reasonable cause defense.

I. INTRODUCTION

Tax shelters have plagued the IRS for decades, particularly because they are a moving target. Taxpayers continually find new ways to achieve unintended tax benefits through creative, technical readings of the Internal Revenue Code. Because participation in tax shelters is so difficult to prohibit *ex ante*, Congress has long relied on tax penalties to discourage this conduct. Starting in the early 1980s, three distinct accuracy-related penalties were introduced to the Internal Revenue Code to specifically address tax shelter transactions.[1] These provisions attack tax shelters from several angles, penalizing transactions designed to inflate a taxpayer's basis,[2] transactions with a significant purpose of tax avoidance,[3] and reportable and listed transactions that have been specifically identified as having the potential for abuse.[4]

With each new penalty, Congress has attempted to take a harder line on tax shelter participants. As these provisions have been amended over time, taxpayer defenses have either been removed or pared down significantly.[5] However, as new, more potent penalty provisions have been added to the IRS's arsenal in its fight against tax shelters, the older penalty provisions have been left largely intact. The result is that for any one transaction, a complicated matrix of penalty possibilities exists, with different rates and taxpayer defenses available depending on which penalty is applied.[6]

The latest wave in tax shelter reform is the recent codification of the so-called "economic substance doctrine" and the accompanying strict liability penalty for violations of the doctrine. The penalty was signed into law on March 30, 2010, as part of the health care reconciliation bill passed by Congress.[7] The new legislation provides for a 20 percent penalty for

1. *See infra* Part II.A. Additionally, there are penalties specifically aimed at tax shelter transactions that are not considered "accuracy-related" penalties. *See infra* text accompanying note 17.

2. *See* I.R.C. § 6662(h) (West 2010) (gross valuation misstatement penalty).

3. *See* I.R.C. § 6662(d)(2)(C) (West 2010) (substantial understatement penalty for tax shelter transactions).

4. *See* I.R.C. § 6662A (West 2010) (reportable transaction understatement penalty).

5. *See infra* Part II.A.

6. *See infra* Part IV.A.4.

7. Health Care and Education Reconciliation Act of 2010, H.R. 4872, 111th Cong., §

disclosed transactions that violate the economic substance doctrine, and a 40 percent penalty for undisclosed transactions.[8] The penalty also provides for strict liability, meaning no reasonable cause or other defenses are available to taxpayers.[9] The new economic substance penalty adds yet another layer to the existing tax shelter penalty matrix.

Justifications for the new strict liability penalty largely focus on taxpayer deterrence and reducing disadvantages to the IRS in enforcing penalties.[10] However, proponents of the penalty have failed to explain why the standard for tax shelter penalties has evolved into strict liability in the context of the economic substance doctrine. Tax shelter penalties have become harsher over time, yet it is unclear whether the strict liability penalty represents a new Congressional attitude towards cracking down on all tax shelter transactions or whether violations of the economic substance doctrine deserve special treatment separate and apart from tax shelter transactions covered by the existing penalty regime.

On the other side of the debate, the strict liability penalty has been criticized by tax scholars and practitioners for being unfair and disproportionate.[11] The criticisms generally focus on the fundamental problems with strict liability, both as it relates to tax penalties in general and as it relates to the economic substance doctrine. However, the controversy generated by the strict liability aspect of the new penalty has resulted in a tendency to view the penalty in a vacuum. What most commentators have not done is evaluate whether there is any need for a separate penalty for violations of the economic substance doctrine at all, and whether an accuracy-related penalty that provides for strict liability belongs in the current penalty regime.[12]

This Article will consider the new economic substance penalty in light of the current penalties applicable to tax shelters and argue that a separate strict liability penalty for violations of the economic substance doctrine should not have been enacted. To be clear, this Article does not attempt to

1409 (2010). The Obama administration had also supported a strict liability penalty for violations of the economic substance doctrine. *See* JOINT COMM. ON TAXATION, 111TH CONG., JCS-3-09, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL; PART TWO: BUSINESS TAX PROVISIONS (Comm. Print 2009) [hereinafter JCS-3-09], *available at* http://www.jct.gov/publications.html?func=select&id=7.

8. Health Care and Education Reconciliation Act of 2010, H.R. 4872, 111th Cong., § 1409 (2010).

9. *Id.*

10. *See, e.g.*, S. REP. NO. 110-206, at 91-92 (2007); JCS-3-09, *supra* note 7, at 63.

11. *See infra* note 98.

12. Technically, the new economic substance penalty has now become part of the current penalty regime. For purposes of this Article, however, I will use the phrase "current penalty regime" to mean the accuracy-related penalties that existed immediately prior to the enactment of the new economic substance penalty.

address whether strict liability is ever appropriate in the context of tax penalties, nor does it address the merits of a reasonable cause defense to the economic substance penalty. Rather, this Article examines whether a new strict liability penalty for violations of the economic substance doctrine should be part of the current accuracy-related penalty regime. My claim is that a fourth tax shelter penalty is redundant in light of the current accuracy-related penalties applicable to tax shelters, and that singling out the economic substance doctrine for strict liability cannot be justified when this standard has not been applied to other tax shelter penalties.

First, the new economic substance penalty results in significant overlap with other tax shelter penalties, as there don't appear to be transactions that would fall under the economic substance doctrine that are not covered by these other penalties. For example, it is hard to conceive of a transaction that violates the economic substance doctrine that wouldn't also meet the broad definition of "tax shelter" for purposes of the substantial understatement penalty under I.R.C. § 6662(d)(2)(C).[13] Congress has not identified what types of transactions it intended to capture with the new economic substance penalty that are not covered by the current tax shelter penalties.

Second, adding a fourth accuracy-related penalty aimed at tax shelters, with its own set of standards, adds significant and unnecessary complexity to the tax shelter penalty regime. Tax penalties should be consistent and understandable, which encourages compliance by helping taxpayers understand the potential consequences of their conduct.[14] In contrast to these objectives, the economic substance penalty further complicates the existing penalty matrix and makes it difficult for taxpayers to understand and predict the consequences of their behavior. Courts are already divided over which of the existing accuracy-related penalties should apply in the case of tax shelters,[15] and it appears that the IRS will have the ability to pick and choose between the new economic substance penalty and the accuracy-related penalties already at its disposal.

Third, even if a separate penalty for violations of the economic substance doctrine were justifiable, the strict liability aspect of the penalty cannot be reconciled with the defenses available for other tax shelter penalties. The economic substance doctrine is a judicial doctrine used to disallow tax benefits not intended by the Internal Revenue Code.[16] It does

13. A "tax shelter" is defined as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(2)(C)(ii) (West 2010).

14. *See infra* Part IV.B.1.

15. *See infra* Part II.B.2.a.

16. *See infra* Part II.B.1.

not identify a new type of behavior not anticipated by other tax shelter penalties, but rather provides a legal basis to disallow tax shelter benefits where other substantive provisions of the tax law fall short. Given that violations of the economic substance doctrine do not represent a unique subset of taxpayer behavior, there is no reason why taxpayer defenses to an economic substance penalty should be more limited than the defenses to other tax shelter penalties.

Fourth, carving out violations of the economic substance doctrine as a unique subset of tax shelter transactions with a stricter penalty as compared to other tax shelter penalties treats similarly situated taxpayers differently, leading to unjust and even absurd results. Based on the arguments set forth above, I conclude that a new strict liability penalty for violations of the economic substance doctrine should not have been adopted.

This article will proceed as follows: Part II offers an overview of the current penalties applicable to tax shelter transactions, exclusive of the new economic substance penalty. It also provides a brief overview of the economic substance doctrine and the application of the current penalty regime to violations of the doctrine by courts and the IRS prior to the codification of the economic substance doctrine and the enactment of the new economic substance penalty. Part III describes the legislation that was recently enacted and summarizes the primary justifications for and criticisms of the new penalty. Part IV argues against a separate economic substance penalty in light of the current penalties applicable to tax shelters. Part V critiques the strict liability aspect of the new economic substance penalty as it relates to the standards in other tax shelter penalties. Part VI concludes.

II. OVERVIEW OF ACCURACY-RELATED PENALTIES AND THE ECONOMIC SUBSTANCE DOCTRINE

A. *The Evolution of Accuracy-Related Penalties Aimed at Tax Shelters*

Over the past several decades, and prior to the recent codification of the economic substance doctrine, three accuracy-related penalties were added to the Internal Revenue Code to address the tax shelter epidemic.[17]

17. "Accuracy-related" penalties are generally based on a substantively incorrect return position. *See* I.R.C. §§ 6662 and 6662A (West 2010). There are a number of penalties that are not accuracy-related penalties that are intended to address other aspects of tax shelter transactions. These include penalties for failure to furnish information regarding reportable transactions under I.R.C. § 6706; failure to include reportable transaction information with a return under I.R.C. § 6707A; failure to maintain lists of advisees with respect to material transactions under I.R.C. §6708; and the penalty for promoting abusive tax shelters under I.R.C. § 6700.

Additionally, there are accuracy-related penalties that are not specifically targeted at tax shelter transactions, although the IRS could choose to apply them to any incorrect return

An examination of how these penalties have evolved over time provides the historical backdrop for the recent legislation that added a strict liability penalty to the Code for violations of the economic substance doctrine. These prior tax shelter penalties have all provided taxpayer defenses, and Congress has stated as recently as 2003 that it did not intend to provide for strict liability for tax shelter transactions.[18] However, the recent trend has been to make tax shelter penalties increasingly tougher on taxpayers, which has been accomplished largely by narrowing the reasonable cause defense and other defenses available for these penalties.

1. Valuation Misstatement Penalty

The first of these tax shelter penalties was added to the Internal Revenue Code in 1981, when Congress introduced a valuation misstatement penalty to address the "500,000 tax disputes outstanding which involve property valuation questions of more than routine significance."[19] Because Congress concluded that taxpayers had been encouraged to overvalue certain types of property, and because valuation of unique property is so difficult, the new penalty imposed a "bright line" test for significant overvaluations.[20] Although neither the statute nor the legislative history of the valuation misstatement penalty uses the phrase "tax shelter," both commentators and courts have viewed the penalty as a direct response to the tax shelter problem.[21]

The current valuation misstatement penalty provides for a 20 percent

position, including a position that resulted from participation in a tax shelter. *See, e.g.*, I.R.C. § 6662(b)(1) (West 2010) (20 percent penalty on an underpayment of tax attributable to negligence or disregard of rules and regulations).

18. *See infra* note 49 and accompanying text.

19. H.R. REP. NO. 97-201, at 243 (1981). *The Economic Recovery Tax Act of 1981*, Pub. L. No. 97-34, § 722, 95 Stat. 172, 341, added new § 6659 to the Internal Revenue Code. I.R.C. § 6659 was repealed by the *Omnibus Reconciliation Act of 1989*, Pub. L. No. 101-239, 103 Stat. 2106, which included the valuation misstatement penalty in current I.R.C. § 6662.

20. H.R. REP. NO. 97-201, at 243.

21. *See, e.g.*, McCrary v. Commissioner, 92 T.C. 827, 863 (1989) (Gerber, J., dissenting) ("Valuation is one of the major devices used in abusive tax shelters. It is the value inherent in an asset that will imbue a transaction with economic substance."); Rose v. Commissioner, 88 T.C. 386, 425 (1987), *aff'd,* 868 F.2d 851 (6th Cir. 1989) (finding that Congress's intent that penalties be applied in tax shelter cases is "particularly true to the extent that tax motivated transactions . . . include 'any valuation overstatement'"); Kathleen O. Lier, *The Evolution in Tax Shelter Litigation: The Tax Court Closes the Door on Generic Tax Shelters, But a Window Remains Open with Respect to the Additions to Tax and the Increased Interest Under I.R.C. § 6621(C)*, 36 LOY. L. REV. 275, 276 (1990) (noting that Congress responded to the significant backlog in the courts due to tax shelter cases); Richard J. Wood, *Accuracy-Related Penalties: A Question of Values*, 76 IOWA L. REV. 309, 310 (1991) (noting the valuation provisions were historically a battle against tax shelters).

penalty on the portion of the underpayment of tax attributable to a substantial valuation misstatement and a 40 percent penalty on the underpayment attributable to a gross valuation misstatement.[22] A substantial valuation misstatement results when the value or basis of property claimed on a return is 150 percent or more of the correct value,[23] and a gross valuation misstatement results when the claimed value is 200 percent or more of the correct value.[24] When the correct value or basis of property is zero, any amount claimed on a return with respect to the value of such property will result in a gross valuation misstatement.[25] A taxpayer's only defense against a valuation misstatement penalty is a showing that she acted with reasonable cause and in good faith.[26]

2. Substantial Understatement Penalty with Tax Shelter Carve Out

Shortly after the valuation misstatement penalty was enacted in 1981, the substantial understatement penalty was added to the roster.[27] An understatement on a taxpayer's return generally refers to the excess of the amount of tax required to be shown on the return over the amount of tax actually shown on the return.[28] A substantial understatement exists if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5000.[29] The current substantial

22. I.R.C. § 6662(b)(3), (h)(1) (West 2010). An "underpayment" means the amount by which the correct tax exceeds the amount shown on the taxpayer's return plus any amounts not shown on the return that were previously assessed or collected. Treas. Reg. § 1.6664-2(a) (2007). For example, amounts previously withheld but not reflected on a return should reduce a taxpayer's underpayment.

23. I.R.C. § 6662(e)(1)(A) (West 2010).

24. I.R.C. § 6662(h)(2)(A)(i) (West 2010).

25. Treas. Reg. § 1.6662-5(g) (1992). This regulation has not been amended to reflect amendments to I.R.C. § 6662(h) in 2006, which changed the threshold for a gross valuation misstatement from 400 percent to 200 percent. *See* P.L. 109-280, § 1219(a)(2)(A) (2006) (amending the definition of gross valuation misstatement in 6662(h)(2)(A)).

26. I.R.C. § 6664(c)(1) (West 2010). The determination of whether a taxpayer acted with reasonable cause and in good faith is based on an evaluation of all of the facts and circumstances. Treas. Reg. § 1.6664-4(b) (2003). The most important factor is the extent of the taxpayer's efforts to assess her proper tax liability. *Id.* Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the taxpayer's experience, knowledge, and education, or reliance on the advice of a professional if such reliance was reasonable under the circumstances and the taxpayer acted in good faith. *Id.* There are additional requirements for valuation misstatements relating to charitable deductions. *See* I.R.C. § 6664(c)(2) (West 2010).

27. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (adding new I.R.C. § 6661). I.R.C. § 6661 was repealed by the Omnibus Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, and the substantial understatement penalty was combined with the valuation misstatement penalty in current I.R.C. § 6662.

28. I.R.C. § 6662(d)(2)(A) (West 2010).

29. I.R.C. § 6662(d)(1) (West 2010).

understatement penalty, for both tax shelter and non-tax shelter transactions, is 20 percent of the underpayment attributable to the substantial understatement.[30]

The substantial understatement penalty was originally enacted to reduce taxpayer incentives to take questionable return positions that, if not rising to the level of fraud or negligence, subjected taxpayers to nothing more than tax and interest if successfully challenged on audit.[31] Although taxpayers could generally avoid the new substantial understatement penalty by either disclosing the transaction or having substantial authority for their positions,[32] the disclosure exception was not available for tax shelter transactions. A "tax shelter" was originally defined as an item arising from "a partnership or other entity, plan[,] or arrangement[,] the principal purpose of which is the avoidance or evasion of federal income tax."[33]

Under the originally enacted substantial understatement rules, taxpayers engaged in tax shelters needed to demonstrate both substantial authority for their position and a reasonable belief that the treatment claimed was more likely than not the proper treatment.[34] With respect to these more stringent requirements for tax shelters, Congress explained that "if the principal purpose of a transaction is the reduction of tax, it is not unreasonable to hold participants to a higher standard than ordinary taxpayers."[35]

The provision was amended in 1994 to remove the substantial authority and reasonable belief excuse for corporate taxpayers engaged in

30. I.R.C. §§ 6662(a), (b)(2) (West 2010).

31. S. REP. NO. 97-494(I), at 222-223 (1982).

32. Former I.R.C. § 6661(b)(2)(B). Under the current substantial understatement rules for non-tax shelter transactions, a taxpayer can avoid the penalty by showing: (1) she had a reasonable basis for her position and the position was disclosed; (2) she had substantial authority for her position; or (3) she acted with reasonable cause and in good faith. I.R.C. §§ 6662(d)(2)(B) and 6664(c)(1) (West 2010).

To have a reasonable basis, a return position must be more than arguable. Treas. Reg. § 1.6662-3(b)(3) (2003). A return position reasonably based on the Internal Revenue Code, Treasury regulations, revenue rulings, tax treaties, legislative history, private rulings, or other authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii) (2003) is generally treated as having a reasonable basis, even if it does not meet the substantial authority standard. *Id.* The substantial authority standard is less stringent than the more likely than not standard (requiring more than a 50 percent likelihood of success), but more stringent than the reasonable basis standard. Treas. Reg. § 1.6662-4(d)(2) (2003). Whether there is substantial authority for a return position must be determined by weighing the relevant authorities supporting the treatment against the authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3) (2003). Substantial authority is an objective standard and the taxpayer's subjective belief is not relevant. *Id.*

33. H.R. CONF. REP. 97-760, at 576 (1982). *See also* former I.R.C. § 6661(b)(2)(C)(ii).

34. *See* former I.R.C. § 6661(b)(2)(C)(i).

35. H.R. CONF. REP. 97-760, at 576 (1982).

tax shelter transactions.[36] Congress further expanded the scope of the penalty in 1997 by redefining tax shelter transactions as having "a significant purpose" of tax avoidance, replacing the prior "principal purpose" standard.[37] Additionally, in 2004, Congress removed the substantial authority and reasonable belief excuse for all taxpayers participating in tax shelters.[38]

As it stands today, a substantial understatement with respect to a tax shelter can be avoided by an individual taxpayer by showing that she acted with reasonable cause and in good faith.[39] In the case of a corporate taxpayer, the penalty can be avoided only through a special, more heighted reasonable cause and good faith requirement, which requires, at a minimum, substantial authority and a reasonable belief that the treatment claimed was more likely than not correct.[40]

3. Reportable Transaction Understatement Penalty

Further changes were introduced to the Internal Revenue Code to combat tax shelters with the passage of the American Jobs Creation Act of 2004 (the "Jobs Act").[41] In addition to removing the substantial authority and reasonable belief excuse from the substantial understatement penalty for taxpayers participating in tax shelters,[42] the Jobs Act created new I.R.C. § 6662A, which imposes an accuracy-related penalty on listed transactions and reportable transactions with a significant tax avoidance purpose.[43] A reportable transaction is a specific type of transaction identified by Treasury regulations as having the potential for tax avoidance or evasion.[44]

36. Uruguay Round Agreements Act, Pub. L. No. 103-465, § 744(b), 108 Stat. 4809, 5011 (1994) (amending I.R.C. § 6662(d)(2)(C)(i), *amended by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004)).

37. P.L. 105-34, § 1028(c)(2) (1997), amending I.R.C. § 6662(d)(2)(C)(iii).

38. P.L. 108-357, § 812(d). The excuse is maintained for individuals in Treas. Reg. § 1.6664-4(g) (2003), which remains outstanding. This excuse should apply to individual taxpayers for tax years ending before October 23, 2004, i.e., before the effective date of the 2004 amendments to I.R.C. § 6662(d)(2)(C) (2003).

39. I.R.C. §§ 6662(d)(2)(C), 6664(c)(1) (West 2010).

40. I.R.C. § 6662(d)(2)(C) (West 2010), Treas. Reg. §§ 1.6662-4(g)(1)(ii) (2003), 1.6664-4(f) (2003). A taxpayer is considered to have a reasonable belief that the tax treatment of an item is more likely than not correct if: (1) she concludes in good faith that there is a greater than 50 percent likelihood her position will be upheld after a analysis of the pertinent authorities; or (2) if the taxpayer reasonably relies in good faith on an opinion of a tax advisor that is based on the tax advisor's analysis of the pertinent authorities and concludes that there is a greater than 50 percent likelihood that the taxpayer's position would be upheld. Treas. Reg. § 1.6662-4(g)(4) (2003).

41. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

42. *Id.* at § 812(d), 118 Stat. at 1580. *See also* text accompanying note 39.

43. *Id.* at § 812(a), 118 Stat. at 1577-78.

44. I.R.C. §§ 6662A(d), 6707A(c)(1) (West 2010). Reportable transactions are defined

A listed transaction, which is a type of reportable transaction, has been specifically identified by an IRS publication as a tax avoidance transaction.[45]

The reportable transaction understatement penalty is equal to 20 percent of the reportable transaction understatement for a disclosed transaction,[46] and 30 percent of the reportable transaction understatement for an undisclosed transaction.[47] The reportable transaction understatement is generally determined by multiplying the increase in taxable income imposed upon the taxpayer from applying the proper tax treatment times the highest rate of tax applicable to the taxpayer.[48]

The legislative history of I.R.C. § 6662A provides that "[b]ecause disclosure is so vital to combating abusive tax-avoidance transactions . . . the Committee believes that a more meaningful (but not strict liability) accuracy-related penalty should apply to such transactions even when disclosed."[49] The only excuse to the reportable transaction understatement penalty is a strengthened reasonable cause and good faith defense, which, at a minimum, requires disclosure of the transaction, substantial authority, and a reasonable belief that the claimed treatment was more likely than not correct.[50] Although the stated purpose of I.R.C. § 6662A was to replace the current rules applicable to tax shelters with a new penalty,[51] the substantial understatement and valuation misstatement rules of I.R.C. § 6662 have been left intact.

B. The Application of Accuracy-Related Penalties in Economic Substance Doctrine Cases

A brief overview of the economic substance doctrine is in order to understand the context of the recently enacted penalty legislation at issue in this Article, which flows from Congressional efforts to codify the economic substance doctrine. Additionally, an examination of how the current penalty regime has been applied to transactions that lack economic

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in Treas. Reg. § 1.6011-4(b) (2010), and include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions that have been specifically identified by the IRS as transactions of interest. Taxpayers that have participated in reportable transactions must report the transaction on IRS Form 8886, *Reportable Transaction Disclosure Statement.* Treas. Reg. § 1.6011-4(a), (e) (2010).

45. I.R.C. §§ 6662A(d), 6707A(c)(2) (West 2010); Treas. Reg. § 1.6011-4(b)(2) (2010).

46. I.R.C. § 6662A(a) (West 2010).

47. I.R.C. § 6662A(c) (West 2010).

48. I.R.C. § 6662A(b) (West 2010).

49. H.R. REP. NO. 108-393, at 183 (2003).

50. *See* I.R.C. § 6664(d) (West 2010). There is no reasonable cause exception if the transaction is undisclosed.

51. *See* H.R. REP. NO. 108-393, at 183 (noting that the provision replaces "the rules applicable to tax shelters with a new accuracy-related penalty.").

substance in the absence of a special penalty provision sets the stage for my argument that an additional economic substance penalty is unnecessary and creates undue complexity within the current penalty regime.

1. Overview of the Economic Substance Doctrine

The economic substance doctrine has been developed by courts as a means of disregarding "transactions that comply with the literal terms of the tax law but lack economic reality."[52] Over time, the doctrine has evolved into having two components: (1) an objective prong, requiring a transaction to have economic substance (generally reflected in a realistic possibility of profit or a change in the taxpayer's financial position); and (2) a subjective prong, requiring a valid business purpose apart from tax avoidance.[53] Before the doctrine was codified, there was some disagreement among the federal circuit courts as to whether a taxpayer must satisfy both prongs to satisfy the economic substance doctrine, or if satisfaction of one prong is sufficient.[54] However, it was always clear that a transaction that lacks both a non-tax business purpose and objective economic substance can be disregarded by courts under the economic

52. Coltec Industries, Inc. v. U.S., 454 F.3d 1340, 1352 (Fed. Cir. 2006); *see also* Klamath Strategic Inv. Fund v. U.S., 568 F.3d 537, 543 (5th Cir. 2009) (citing *Coltec* and explaining the economic substance doctrine).

The origin of the doctrine can be traced to a line of Supreme Court decisions beginning with *Gregory v. Helvering*, in which the Court disregarded a transaction, even though it technically complied with the relevant Internal Revenue Code provisions, because it was undertaken solely to avoid a tax on a distribution from the taxpayer's wholly owned corporation. 293 U.S. 465 (1935). *See also Coltec*, 454 F.3d at 1352 (describing the origin of economic substance doctrine). Subsequently, in *Frank Lyon Co. v. United States*, the Supreme Court announced that a taxpayer's chosen form will be respected where "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . ." 435 U.S. 561, 583-584 (1978).

53. *See*, *e.g.*, *Coltec*, 454 F.3d at 1355-56 (describing the subjective and objective aspects of the economic substance doctrine); *Klamath Strategic Inv. Fund*, 568 F.3d at 544 (requiring the taxpayer to demonstrate two prongs); ACM P'ship v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998) (utilizing both subjective and objective prongs); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (requiring a legitimate business purpose or economic substance).

54. *Compare Klamath Strategic Inv. Fund*, 568 F.3d at 544 (adopting the majority view that lack of economic substance alone is enough to invalidate a transaction), *and Coltec*, 454 F.3d at 1355 (same) *with Rice's Toyota*, 752 F.2d at 91-92 (requiring both a lack of objective economic substance and a valid business purpose for transaction to be disregarded). The Third Circuit has taken the view that the subjective and objective tests "do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM P'ship*, 157 F.3d at 247.

substance doctrine.

2. Penalizing Violations of Economic Substance Under the Current Regime

Before the separate economic substance penalty was signed into law, the IRS was presented with a variety of choices from the current accuracy-related penalty regime when confronting a transaction that lacked economic substance. The government most frequently asserts that the gross valuation misstatement penalty applies in economic substance doctrine cases.[55] The substantial understatement penalty has also been asserted in the alternative, although the accuracy-related penalties of I.R.C. § 6662 cannot be applied cumulatively, nor can they be combined with the reportable transaction understatement penalty under I.R.C. § 6662A.[56]

a. Application of Gross Valuation Misstatement Penalty by Courts

There is a split among the federal circuit courts as to whether the gross valuation misstatement penalty applies to violations of the economic substance doctrine. Courts in the Second, Third, Fourth, Sixth, and Eighth Circuits have held that when an understatement stems from deductions that are disallowed due to a lack of economic substance, the deficiency is attributable to an overstatement of value and the penalty applies.[57] On the

55. *See, e.g.*, Keller v. Comm'r, 556 F.3d 1056 (9th Cir. 2009) (affirming a 20 percent negligence penalty arising from a cattle-breeding tax shelter but declining to uphold the IRS's assertion of a gross valuation misstatement penalty); Long Term Capital Holdings v. U.S., 330 F.Supp.2d 122 (D. Conn. 2004) (sustaining the IRS determinations of 40 percent gross valuation misstatement and 20 percent substantial understatement penalties related to capital losses arising from the unwinding of the Long Term Capital Management portfolio), *aff'd* 2005-2 USTC ¶50,575 (2d Cir. 2005); Clearmeadow Investments v. U.S., 87 Fed. Cl. 509 (2009) (holding that gross valuation overstatement penalties applied while disallowing loss deductions from a tax shelter known as "Son of BOSS").

56. *See* I.R.C. § 6662(b) (West 2010) (flush language), I.R.C. § 6662A(e)(2)(B) (West 2010), Treas. Reg. § 1.6662-2(c). However, the amount of the reportable transaction understatement is included when determining whether a taxpayer's understatement is "substantial" for purposes of I.R.C. § 6662(d)(1). I.R.C. § 6662A(e)(1).

57. *See* Merino v. Commissioner, 196 F.3d 147, 158-159 (3d Cir. 1999) (applying valuation overstatement penalty where overvaluation of the property was "an essential component of the tax avoidance scheme"); Zfass v. Commissioner, 118 F.3d 184, 191 (4th Cir. 1997) (affirming valuation overstatement penalty stemming from excessive deductions that were disallowed due to a lack of economic substance); Illes v. Commissioner, 982 F.2d 163, 167 (6th Cir. 1992) (applying the valuation misstatement penalty when a transaction lacked economic substance); Gilman v. Commissioner, 933 F.2d 143, 151 (2d Cir. 1991) (affirming Tax Court's penalty imposition and citing *Massengill*); Massengill v. Comm'r, 876 F.2d 616, 619-620 (8th Cir. 1989) (opining that "[w]hen an underpayment stems from

other side of the divide, the Fifth and Ninth Circuits have taken the position that when a deduction is denied because a transaction lacks economic substance, a valuation misstatement penalty may not be imposed because the understatement is attributable to an invalid deduction, rather than the overvaluation of an asset.[58] The majority view is also the position taken by the IRS,[59] so taxpayers who are not fortunate enough to reside within the Fifth and Ninth Circuits will likely continue to face the gross valuation misstatement penalty in economic substance doctrine cases.

b. Application of Other Penalties by Courts

The 40 percent rate on gross valuation misstatements makes it a more attractive alternative to the substantial understatement penalty.[60] It is not surprising, then, that if accuracy-related penalties are asserted at all in an economic substance doctrine case, the gross valuation misstatement penalty is almost always asserted, with substantial understatement and negligence

disallowed depreciation deductions or investment credit due to lack of economic substance, the deficiency is attributable to overstatement of value, and subject to penalty under section 6659.") (internal citation omitted).

This position has also been adopted by the Court of Federal Claims and the Tax Court, when not constrained. *See Clearmeadow Investments*, 87 Fed. Cl. 509, at 535-536 (rejecting the idea that section 6662 permits avoidance of penalties due to a lack of economic substance); Petaluma FX Partners v. Commissioner, 131 T.C. 84 (2008) (applying valuation misstatement penalties in a final partnership administrative adjustment [FPAA] case despite a lack of economic substance), *rev'd on other grounds*, 591 F.3d 649 (D.C. Cir. 2010) (appealable to D.C. Circuit, which has not decided the issue); and Palm Canyon X Investments v. Comm'r, 98 T.C.M. (CCH) 574 (2009) (applying gross valuation misstatement penalty arising from a transaction disallowed under the economic substance doctrine) (appealable to D.C. Circuit). The Tax Court will follow the decision of the Court of Appeals to which a case is appealable if the Court of Appeals has already decided the issue. *See* Golsen v. Comm'r, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (stating that "better judicial administration requires us to follow a Court of Appeals decision which is squarely on point where appeal from our decision lies to that Court of Appeals and to that court alone.") (footnotes omitted).

58. *See Keller*, 556 F.3d 1056, at 1061 (relying on *Gainer* as binding precedent and rejecting the Tax Court's imposition of gross valuation misstatement penalty); Gainer v. Commissioner, 893 F.2d 225, 228 (9th Cir. 1990) (relying on congressional intent to reject Commissioner's assertion of valuation overstatement penalty); Heasley v. Commissioner, 902 F.2d 380, 383 (5th Cir. 1990) (analogizing to *Todd* to reject assessment of valuation overstatement penalty); Todd v. Commissioner, 862 F.2d 540, 543 (5th Cir. 1988) (rejecting valuation overstatement penalty finding that the valuation overstatement did not create tax benefits that changed the amount of tax owed).

59. *See, e.g.*, Notice 2002-50, 2002-2 C.B. 98 (providing an example of when a gross valuation misstatement penalty would be imposed as a result of an invalid deduction).

60. However, taxpayer defenses are more limited in the case of a substantial understatement with respect to a tax shelter. *See supra* notes 26, 39-40 and accompanying text.

penalties frequently asserted as alternatives.[61]

There have not yet been any economic substance doctrine cases involving the application of the reportable transaction understatement penalty. This is also unsurprising, since the penalty is effective only for tax years ending after October 22, 2004,[62] and the judicial decisions on economic substance generally come out a number of years after the transaction at issue.[63]

In some economic substance doctrine cases, courts have rejected the government's assertion of any penalties, despite the government's success on the merits, finding that the taxpayer satisfied one of the applicable defenses, such as reasonable cause and good faith.[64] Finally, there are a number of economic substance doctrine cases that do not address the issue of penalties at all.[65]

61. *See, e.g.*, *Klamath Strategic Inv. Fund*., 568 F.3d at 546 n.3 (reviewing § 6662 penalties asserted by the Commissioner attributable to gross valuation misstatement, substantial understatement of income tax, substantial valuation misstatement, and substantial understatement of income tax.); Cemco Investors, LLC v. U.S., 2007-1 USTC ¶50,385 (reviewing § 6662 penalties asserted by the Commissioner attributable to gross valuation misstatement of adjusted basis), *aff'd,* 515 F.3d 749 (7th Cir. 2008); Long Term Capital Holdings v. U.S., 330 F.Supp.2d 122 (D. Conn. 2004) (reviewing § 6662 penalties asserted by the Commissioner attributable to gross valuation misstatement, and as an alternative, negligence, substantial understatement of income tax, or substantial valuation misstatement penalties), *aff'd,* 2005-2 USTC ¶50,575 (2d Cir. 2005); *Palm Canyon*, 98 T.C.M. (CCH) 574 (reviewing Commissioner's assertions of gross and substantial valuation misstatements); New Phoenix Sunrise Corp. v. Comm'r, 132 T.C. No. 9 (2009) (reviewing § 6662 penalties asserted by the Commissioner attributable to gross valuation misstatement, and as an alternative, negligence, substantial understatement of income tax, or substantial valuation misstatement penalties); Stobie Creek Investments v. U.S., 82 Fed. Cl. 636 (2008) (reviewing the same); and Jade Trading v. U.S., 80 Fed. Cl. 11 (2007) (reviewing the same). *But see* TIFD III-E Inc. v. U.S., 660 F.Supp.2d 367 (D. Conn. 2009) (discussing, but declining to apply, the substantial understatement penalty for tax shelters; no mention of the gross valuation misstatement penalty).

62. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812(f), 118 Stat. 1418 (2004).

63. Even the most recent economic substance doctrine cases have involved tax years prior to 2004. *See*, *e.g.*, *Klamath Strategic Inv. Fund*, 568 F.3d at 537 (referring to tax years 2000-2002); Wells Fargo & Co. v. U.S., 91 Fed. Cl. 35 (2010) (referring to tax year 2002); TIFD III-E Inc. v. U.S., 660 F.Supp.2d 367 (D. Conn. 2009) (referring to tax years 1997 and 1998); *Palm Canyon*, 98 T.C.M. (CCH) 574 (referring to tax year 2001); Country Pine Fin. v. Comm'r, 98 T.C.M. (CCH) 410 (2009) (referring to tax year 2001); Consolidated Edison Co. v. U.S., 90 Fed. Cl. 228 (2009) (referring to tax year 1997); Schering-Plough v. U.S., 651 F.Supp.2d 219 (D.N.J. 2009) (referring to tax years 1991 and 1992).

64. *See*, *e.g.*, Klamath Strategic Inv. Fund, LLC v. U.S., 472 F.Supp.2d 885 (E.D. Tex. 2007) (holding that the gross valuation misstatement penalty did not apply to violations of economic substance; and taxpayer satisfied substantial authority and reasonable belief that treatment was more likely than not correct defense for substantial understatement penalty for a tax shelter transaction), *aff'd,* 568 F.3d 537 (5th Cir. 2009).

65. *See*, *e.g.*, *Coltec*, 454 F.3d at 1352 (failing to discuss penalties); *ACM P'ship*, 157 F.3d at 231 (stating that the IRS did not assert penalties); *Wells Fargo*, 91 Fed. Cl. 35

c. *IRS's Position on Penalties in Economic Substance Doctrine Cases*

The IRS has taken the position that the reportable transaction understatement penalty, the substantial understatement penalty with respect to a tax shelter, the negligence penalty, and the gross valuation misstatement penalty all may apply to a transaction that lacks economic substance.[66] In informal guidance, the IRS has also indicated a preference for the gross valuation misstatement penalty or the reportable transaction understatement penalty, when they apply.[67]

III. A NEW PENALTY FOR VIOLATIONS OF THE ECONOMIC SUBSTANCE DOCTRINE

As a result of the disagreement among courts as to whether the economic substance doctrine requires a taxpayer to demonstrate both objective economic substance and a subjective business purpose,[68] and in light of the uncertainty as to how to apply both the objective and subjective tests, legislation codifying the economic substance doctrine was signed into law on March 30, 2010.[69] The new legislation "clarifies that the economic substance doctrine involves a conjunctive analysis—there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction."[70] Although the codification of the

(stating that the IRS did not assert penalties); Consolidated Edison Co. v. U.S., 90 Fed. Cl. 228 (2009) (stating that the IRS did not discuss penalties); *Country Pine Fin.*, 98 T.C.M. (CCH) 410 (stating that the IRS did not assert penalties).

66. *E.g.*, Notice 2002-50, 2002-2 C.B. 98; Notice 2002-21, 2002-1 C.B. 730. The IRS takes the position that these penalties apply in the alternative. *See supra* note 56 and accompanying text.

67. *See* IRS Chief Counsel Advice, No. 200923042 (June 5, 2009) (suggesting that § 6662A should be the primary penalty).

68. *See, e.g.*, *Klamath Strategic Inv. Fund*, 568 F.3d at 544 (stating that the law regarding whether the economic substance doctrine requires a taxpayer to demonstrate both objective economic substance and a subjective business purpose is split with the majority requiring only one prong to be lacking to invalidate a transaction); *Coltec*, 454 F.3d at 1355-56 (finding that the lack of economic substance is sufficient to invalidate a transaction regardless of motive); *ACM P'ship,* 157 F.3d at 247 (explaining that the objective and subjective elements do not constitute discrete prongs of a two-step analysis, but rather are related factors which should be taken into account to determine whether the transaction had sufficient substance for tax purposes); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (affirming that *Frank Lyon Co. v. United States* requires both prongs to be taken into account when determining whether the transaction is a sham).

69. *See* Health Care and Education Reconciliation Act of 2010, H.R. 4872, 111th Cong. § 1409 (2010) (adding new I.R.C. § 7701(o)).

70. JOINT COMM. ON TAXATION, JCX-18-10, S. DOC. 2010-6147, TECHNICAL

economic substance doctrine is intended to provide "a uniform definition of economic substance," it is not intended to alter the flexibility of courts in other respects, including a court's determination of when the doctrine is relevant to a particular transaction.[71]

In addition to specifying that a conjunctive test is required, the legislation clarifies the requirements for both the objective and subjective prongs of the doctrine[72] and provides other special rules such as those for determining whether a transaction has profit potential.[73] The bill adds new I.R.C. § 7701(o), which states that a transaction shall be treated as having economic substance only if it changes the taxpayer's economic position in a meaningful way (apart from tax effects) and the taxpayer has a substantial purpose (apart from tax reasons) for entering into such transaction.[74]

Additionally, the recently enacted legislation contains a provision for a separate, new strict liability penalty for violations of the economic substance doctrine.[75] Legislative history surrounding the penalty provision is relatively sparse. Although Congress has made it clear that the penalty is intended to deter abusive tax shelters,[76] neither Congress nor the Joint Committee on Taxation (which has offered a number of technical explanations of the various proposals to codify the economic substance doctrine[77]) has offered insight as to why strict liability is now being

EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010" 153 (Comm. Print 2010) [hereinafter JCX-18-10]. *See also* JOINT COMM. ON TAXATION, JCX-11-10, S. DOC. 2010-5371, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE "AMERICAN WORKERS, STATE AND BUSINESS RELIEF ACT OF 2010," (Comm. Print 2010) (as passed by Senate, Mar. 10, 2010) [hereinafter JCX-11-10]; JOINT COMM. ON TAXATION, JCX-47-09, S. DOC. 2009-24413, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN H.R. 3962, THE "AFFORDABLE HEALTH CARE FOR AMERICA ACT OF 2009" 89-90 (Comm. Print 2009) (as amended Nov. 5, 2009) [hereinafter JCX-47-09] (noting that the new legislation clarifies and enhances the doctrine by providing a uniform definition of economic substance).

71. JCX-18-10, *supra* note 70, at 152; JCX-11-10, *supra* note 70, at 189; JCX-47-09, *supra* note 70, at 90. *See also* H.R. 4872, § 1409(a), new I.R.C. § 7701(o)(5)(C) ("[T]he provisions of this subsection shall not be construed as altering or supplanting any other rule of law . . . .").

Much has been written about the wisdom (or lack thereof) of codifying the economic substance doctrine, an issue which is beyond the scope of this article. *See, e.g.,* Monte Jackel, *Farming for Economic Substance: Codification Fails to Bear Fruit*, 119 TAX NOTES 59 (2008); Leandra Lederman, *W(h)ither Economic Substance?,* 95 IOWA L. REV. 389 (2010); Mark J. Silverman & Amanda P. Varma, *The Future of Tax Planning: From Coltec to Schering-Plough*, 126 TAX NOTES 341 (2010); Dennis Ventry, *Save the Economic Substance Doctrine From Congress,* 118 TAX NOTES 1405 (2008).

72. H.R. 4872, § 1409(a), new I.R.C. § 7701(o)(1)(A),(B).

73. *Id.* at § 1409(a), new I.R.C. § 7701(o)(2).

74. *Id.* at § 1409(a), new I.R.C. § 7701(o)(1).

75. *Id.* at § 1409(b).

76. *See infra* Part III.B.1.

77. *See* JCX-18-10, *supra* note 70 and accompanying text.

imposed in the context of the economic substance doctrine.

A. The New Economic Substance Penalty

The new legislation amends I.R.C. § 6662 to provide for a twenty percent penalty for disclosed transactions that lack economic substance and a forty percent penalty for "nondisclosed noneconomic substance transactions."[78] The penalty covers "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law."[79] The statute does not define what is meant by "any similar rule of law." The legislative history however, states that the penalty is intended to apply to a transaction that is disregarded as a result of the application of the same factors as those used in an economic substance analysis, even if a term other than the "economic substance doctrine" is used.[80]

The new penalty legislation also provides for strict liability, accomplished by amending I.R.C. § 6664(c) to eliminate the reasonable cause and good faith defense for any transaction lacking economic substance.[81] Additionally, the bill eliminates the special reasonable cause and good faith defense for reportable transaction understatements[82] for any portion of the reportable transaction understatement that is attributable to a transaction that lacks economic substance. There is no corresponding provision to eliminate the reasonable cause and good faith defense for reportable transaction understatements attributable to tax shelters, nor does the bill eliminate that defense for substantial understatements with respect to tax shelters.[83]

The final result on the strict liability front after the enactment of H.R. 7872 is the following:

> Any disallowance of claimed tax benefits by reason of a

78. *See* H.R. 4872, § 1409(b)(1-3) (adding new I.R.C. §§ 6662(b)(6) and 6662(i)). The legislation clarifies that the new penalty cannot be combined with other accuracy-related penalties.

79. *Id.*

80. JCX-18-10, *supra* note 70, at 155 n. 359. The "any similar rule of law" language introduces additional uncertainty as to the proper application of the penalty, the discussion of which is beyond the scope of this Article. For example, it is unclear if the "step transaction" or "sham" doctrines would constitute a similar rule of law. Silverman & Varma, *supra* note 71, at 357 (noting the lack of clarity as to what constitutes a similar rule of law and proposing that such language be removed from the statute).

81. H.R. 4872, § 1409(c)(1).

82. I.R.C. § 6664(d) (West 2010).

83. H.R. 4872, § 1409(c)(2). Additionally, the new legislation provides that an excessive claim for a refund which is attributable to a transaction that lacks economic substance will be subject to the twenty percent penalty under I.R.C. § 6676(a) and the reasonable basis exception is not available. *Id.* at § 1409(d).

transaction lacking economic substance within the meaning of new I.R.C. § 7701(o) is subject to strict liability.

A gross valuation misstatement penalty is still subject to the regular reasonable cause and good faith defense.

A substantial understatement with respect to a tax shelter is still subject to the same heightened reasonable cause and good faith defense.

A reportable transaction understatement is still subject to the same heightened reasonable cause and good faith defense, *unless* the tax benefits are disallowed because the transaction lacks economic substance (in which case strict liability applies).

B. Reactions to the New Strict Liability Penalty

Congress has advanced a number of justifications for the new strict liability penalty for violations of the economic substance doctrine. These arguments focus mainly on deterrence and the inherent disadvantage to the IRS in economic substance doctrine cases due to the complexity of the transactions. On the other side of the debate, many tax scholars and practitioners have vigorously opposed the new strict liability penalty.

1. Arguments in Favor of a Strict Liability Penalty

a. Deterrence

The Senate Finance Committee has reasoned that a stronger penalty imposed on transactions that lack economic substance will deter taxpayers from entering into such transactions and thus promote compliance.[84] It has also been suggested that a harsher penalty is justified in this context because the lack of IRS resources to litigate cases may lead to settlements that are not sufficiently detrimental to taxpayers to deter them from entering into transactions that lack economic substance.[85]

Proponents also point out that, under the current penalty regime, a taxpayer may completely avoid penalties and pay nothing but the tax owed plus interest if the taxpayer obtains an opinion from an advisor that concludes the position is more likely than not to prevail.[86] As a result, members of Congress have argued that a strict liability penalty "level[s] the playing field" between more aggressive and more conservative tax planners by forcing planners and taxpayers to focus on the potential downside if

84. Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. REP. NO. 110-206, at 114 (2007).

85. JCS-3-09, *supra* note 7, at 63.

86. *Id.* at n. 201.

their position is not sustained on the merits.[87] It has also been suggested that the strict liability penalty further "adds to the IRS's existing deterrence abilities" because it would apply both to transactions that would fall under the current definition of reportable transactions, and to transactions that have not yet been identified as abusive by the IRS.[88]

The deterrence argument has accompanied the enactment of all of the tax shelter penalties, and it doesn't appear that anything new has been offered in the case of the economic substance penalty. For example, the argument that taxpayers who successfully avoid penalties end up paying nothing more than tax and interest, and therefore have no motivation to avoid abusive transactions, was advanced in the early 1980s when the substantial understatement penalty was enacted.[89] The arguments supporting the new economic substance penalty fail to explain whether a stronger penalty is now needed because the current accuracy-related penalties have failed to adequately deter taxpayers from participating in tax shelters. If that is the case, then it appears a complete overhaul of the accuracy-related penalty regime may be in order. If that is not the case, then proponents have failed to explain why the deterrence needs for violations of the economic substance doctrine are unique vis-à-vis transactions covered by other tax shelter penalties.[90]

b. Complexity

Those in favor of the strict liability penalty have also asserted that economic substance doctrine cases often involve complex, "highly structured" transactions, where the taxpayer is the only party with access to and an understanding of all of the facts.[91] These cases often turn on extensive expert testimony or discovery on issues such as the profit potential of a specific transaction.[92] It has thus been argued that "such structured transactions are appropriately subject to a strict liability penalty that cannot be avoided by the presence of a tax opinion."[93] Additionally,

87. *Id.* at n. 202 (statement of Samuel Thomson, Jr., before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 9, 2006).

88. *Id.* at 68.

89. *See* S. REP. NO. 97-494(i), *supra* note 31, at 223 (noting that existing law did not adequately deter abusive transactions since the only penalties were tax and interest).

90. One commentator has argued that creating a harsher penalty for violations of the economic substance doctrine does not necessarily deter tax shelters more effectively, "as [a] taxpayer may still hedge his bets" that he will win his claim on the merits. Mik Shin-Li, *Strictly Wrong as a Tax Policy: The Strict Liability Standard in Noneconomic Substance Transactions*, 78 FORDHAM L. REV. 2009, 2046 (2010).

91. JCS-3-09, *supra* note 7, at 64, 68.

92. *Id.*

93. *Id.* at 65.

proponents of the penalty have pointed out that, in applying the current accuracy-related penalties for reportable transactions, "there is little experience to date as to how the 'strengthened reasonable cause' requirements will be applied to particular facts" in these complex economic substance doctrine cases.[94]

The complex transactions argument is reminiscent of the argument that a bright line penalty was needed to address the difficult and fact-intensive valuation issues of "more than routine significance" that preceded the enactment of the valuation misstatement penalty.[95] Like the deterrence argument, the argument that highly structured transactions are appropriately subject to strict liability fails to differentiate between transactions that are found to fail the economic substance doctrine and equally complex (or identical) transactions that might be found to violate a substantive provision of the Internal Revenue Code.[96] Modern day tax shelters are almost universally complex, and if complexity is hindering the IRS's ability to successfully litigate tax shelter cases, this again calls for broader changes to the entire accuracy-penalty regime, rather than a special rule that would only aid the IRS in cases where the transaction is disallowed due to the economic substance doctrine.

Proponents are correct in noting that there is "little experience to date" as to how the strengthened reasonable cause requirements enacted in 2004 will play out in tax shelter cases, since the economic substance doctrine cases to date have generally involved tax years prior to 2004.[97] However, the fact that there has not been time to adequately study the effect of the most recent tax shelter penalty legislation only highlights the fact that the strict liability penalty is premature, and possibly unnecessary in light of the current accuracy-related penalties.

94. *Id.* at 68 n. 224.

95. H.R. REP. NO. 97-201 at 243 (1981); *see also supra* text accompanying note 20.

96. For example, in *Maguire Partners-Master Investments, LLC v. U.S.*, the court held that the taxpayer's tax shelter lacked economic substance, but that even if the economic substance doctrine did not apply, the taxpayer's claimed benefits were virtually eliminated under I.R.C. § 752 or Treas. Reg. § 1.752-6. No. CV 06-07371-JFW(RZx), 2009 WL 4907033, at *17-19 (C.D. Cal. Dec. 11, 2009).

97. JCS-3-09, *supra* note 7, at 64, 68. To date, no economic substance doctrine cases have involved the reportable transaction understatement penalty, which is effective only for tax years ending after October 22, 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 812(f), 118 Stat. 1418, 1580. *See, e.g.*, *Klamath Strategic Inv. Fund*, 568 F.3d at 537 (tax years 2000-2002); *Wells Fargo*, 91 Fed. Cl. 35 (tax year 2002); *Palm Canyon*, 98 T.C.M. (CCH) 574 (tax year 2001); *Country Pine Fin.*, 98 T.C.M. (CCH) 410 (tax year 2001); Consolidated Edison Co. v. U.S., 90 Fed. Cl. 228 (2009) (tax year 1997); TIFD III-E Inc. v. U.S., 660 F.Supp.2d 367 (D. Conn. 2009) (tax years 1997 and 1998); *Schering-Plough*, 651 F.Supp.2d 219 (tax years 1991 and 1992); *see also supra* text accompanying note 64.

2. Arguments Against a Strict Liability Penalty

a. Fairness

Despite the justifications proffered by legislators, the strict liability penalty has been roundly criticized by scholars and practitioners alike for being unfair and disproportionate.[98] What has been described as the "most obvious" argument against strict liability is that it unfairly punishes taxpayers who have made good faith attempts to comply with the law. The absence of a reasonable cause exception prohibits these taxpayers from introducing evidence of any mitigating circumstances that might otherwise lead a court or the IRS to conclude that the penalty should not apply.[99]

Additionally, many opponents of the penalty have argued that strict liability is particularly unfair and inappropriate in the context of the economic substance doctrine. Whereas strict liability may be appropriate in certain narrow, clearly defined situations, commentators have noted that application of the economic substance doctrine involves a great deal of ambiguity, such as how to define the objective and subjective prongs, and when application of the doctrine is even relevant.[100] Indeed, the doctrine applies even when the substantive provisions of the Internal Revenue Code, which more clearly define taxpayer behavior, do not apply to a transaction.

98. *See, e.g.*, Tax Analysts, New York State Bar Association Submits Comments on Modifications to House Healthcare Bill, 2009 TNT 182-25 (Sept. 22, 2009) (LEXIS) [hereinafter NY Bar Submits Comments] (citing Letter from Erika W. Nijenhuis, Chair, New York State Bar Association, to Senate Finance Committee Chairman Baucus and Ranking Member Grassley and House Ways and Means Committee Chairman Rangel and Ranking Member Camp (Sept. 22, 2009)); Tax Analysts, AICPA Calls for Reform of Civil Tax Penalty System, 2009 TNT 166-76 (Aug. 31, 2009) (LEXIS) (citing AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM (Aug. 28, 2009)) [hereinafter REPORT ON CIVIL TAX PENALTIES]; Tax Analysts, ABA Tax Section Comments on Codification of Economic Substance Doctrine, 2007 TNT 72-22 (Apr. 12, 2007) (LEXIS) (citing AMERICAN BAR ASSOCIATION SECTION OF TAXATION, PROPOSED CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE (Apr. 12, 2007)) [hereinafter ABA Proposed Codification]; Lawrence M. Hill & Alexandra Minkovich, *Tax Policy Gone Wild: Harsh Penalties as Revenue Raisers*, 115 TAX NOTES 79 (2007); David S. Miller, *An Alternative to Codification of the Economic Substance Doctrine*, 123 TAX NOTES 747 (2009); Silverman & Varma, *supra* note 71; Clinton Stretch et al., *Economic Substance and Strict Liability Do Not Mix*, 123 TAX NOTES 1357 (2009).

99. Stretch et al., *supra* note 98, at 1359.

100. *See, e.g.*, ABA Proposed Codification, *supra* note 98, at 10; REPORT ON CIVIL TAX PENALTIES, *supra* note 98, at 3, 7; Hill & Minkovich, *supra* note 98, at 81; Stretch et al., *supra* note 98, at 1360. For example, it has been noted that the proposal to apply the penalty to violations of the economic substance doctrine or "any similar rule of law" exacerbates this inherent ambiguity. ABA Proposed Codification, *supra* note 98, at 11; *see also supra* text accompanying note 70; *supra* text accompanying note 80.

b. Adverse Effects on Taxpayer Behavior

Other opponents have pointed out potential adverse effects on taxpayer behavior, suggesting that the severity of the penalty may over-deter taxpayers and cause them to avoid legitimate transactions.[101] A taxpayer with a legally defensible position may ultimately decide to abandon a business transaction for fear of being automatically subjected to a strict liability penalty if the IRS asserts that the economic substance doctrine is applicable.[102]

It has further been argued that the strict liability aspect of the penalty may actually discourage taxpayers from disclosing transactions, making it harder for the IRS to detect tax shelters.[103] Aggressive taxpayers may determine that the benefit from disclosure, *i.e.* a reduction in the penalty rate from 40 percent to 20 percent, is too small of a benefit compared to the potential benefit of avoiding detection, and thus a penalty, altogether.[104]

Opponents also argue that the severity of the penalty may lead to increased taxpayer incentives to litigate when the IRS raises the economic substance doctrine, which in turn burdens IRS and judicial resources.[105] Since the taxpayer will be subject to the penalty in every case in which it concedes, there is little incentive not to challenge the case on substantive grounds.[106]

c. Enforcement Issues

Others fear that courts might be reluctant to impose the penalty due to its severity and, thus, may be reluctant to find that economic substance is lacking in cases where the doctrine is appropriate.[107] The IRS has also criticized the legislation for creating a penalty that will be difficult to enforce,[108] and it has been suggested that the administration of the new

101. *E.g.*, JCS-3-09, *supra* note 7, at 64; Hill & Minkovich, *supra* note 98, at 81; Stretch et al., *supra* note 98, at 1361-62.

102. Stretch et al., *supra* note 98, at 1362. For example, it has been argued that taxpayers may be improperly deterred from commonly accepted tax planning choices, such as the choice to do business through a partnership. JCS-3-09, *supra* note 7, at 65.

103. Hill & Minkovich, *supra* note 98, at 81.

104. ABA Proposed Codification, *supra* note 98, at 12.

105. *E.g.*, JCS-3-09, *supra* note 7, at 64; ABA Proposed Codification, *supra* note 98, at 11; Hill & Minkovich, *supra* note 98, at 82; Stretch et al., *supra* note 98, at 1359.

106. *Id.*

107. JCS-3-09, *supra* note 7, at 64-65, 67; Hill & Minkovich, *supra* note 98, at 80; Miller, *supra* note 98, at 748; Stretch et al., *supra* note 98, at 1359.

108. *See, e.g.*, Tax Analysts, Korb Notes Declining Revenue Estimate for Economic Substance Codification, 2007 TNT 212-6 (Nov. 1, 2007) (LEXIS) [hereinafter Tax Analysts I].

penalty would be a drain on IRS resources.[109]

d. Motivated by Revenue

Finally, some commentators have also suggested that despite the deterrence rationale offered by Congress, the true motivation behind codification of the economic substance doctrine and the strict liability penalty is to raise revenue, which is often viewed as "an unsatisfactory rationale"[110] for penalty legislation.[111] It has been suggested that one of the main reasons Congress continued to include proposals to codify the economic substance doctrine in its bills was to help pay for them.[112] The Joint Committee on Taxation estimated that codification of the economic substance doctrine would raise revenue of $4.5 billion between 2010 and 2019.[113] Although it is unclear how much of this estimate is attributable to the strict liability penalty, it is logical to assume that most of the revenue would be derived from the new penalty, since the legislation otherwise merely codified an existing judicial doctrine that the IRS already had at its disposal.[114]

109. ABA Proposed Codification, *supra* note 98 at 11; Stretch et al., *supra* note 98 at 1359.

110. Hill and Minkovich, *supra* note 98, at 79.

111. REPORT ON CIVIL TAX PENALTIES, *supra* note 98, at 1, 4; Stretch et al., *supra* note 98, at 1361; Ventry, *supra* note 71, at 1410. The IRS's Penalty Handbook also states that while penalties do bring additional revenues into the Treasury, these results are "not reasons for creating or imposing penalties." INTERNAL REVENUE MANUAL § 20.1.1.2 (Feb. 22, 2008), *available at* http://www.irs.gov/irm/part20/irm_20-001-001r.html#d0e406.

112. Donald L. Korb, *Codification of the Judicial Economic Substance Doctrine*, 852 PLI/TAX 377, 395 (2008).

113. JOINT COMM. ON TAXATION, 111TH CONG., JCX-17-10, ESTIMATED REVENUE EFFECTS OF THE AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 4872, THE "RECONCILIATION ACT OF 2010" (as amended) (Comm. Print 2010), *available at* http://www.jct.gov/publications.html?func=startdown&id=3672. The revenue estimates for codification of the economic substance doctrine have been steadily declining. In 2009, the estimate was approximately $7 billion over ten years, and in 2005 the estimate was approximately $16 billion over 10 years. JOINT COMM. ON TAXATION, 111TH CONG., JCX-28-09, ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL (Comm. Print 2009), *available at* http://www.jct.gov/publications.html?func=startdown&id=3558; JOINT COMM. ON TAXATION, 111TH CONG., JCX-82-05, ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN S. 2020, THE TAX RELIEF ACT OF 2005 (Comm. Print 2005), *available at* http://www.jct.gov/publications.html?func=startdown&id=1533.

114. In criticizing codification for being driven by revenue concerns, then-IRS Chief Counsel Donald Korb stated that "[a]ll the money is in the penalties." Tax Analysts, *Korb Slams Textron Ruling, Wall Street Rule, Senate Economic Substance Bill*, 2007 TNT 197-3 (Oct. 11, 2007).

3. Putting the Penalty in Perspective

The most notable aspect of the economic substance penalty is that it provides for strict liability, and this has been the focus of the commentary surrounding the penalty. What most critiques of the legislation have not done is stop to query whether there is any need for a separate penalty for violations of the economic substance doctrine at all, strict liability aside.[115] Part IV of this Article will explore this question and conclude that a separate penalty for violations of the economic substance doctrine is unjustified. Part V will then explore the strict liability aspect of the penalty and conclude that it is similarly unjustified because there is no qualitative difference between transactions that violate the economic substance doctrine and transactions covered by other tax shelter penalties, for which a reasonable cause defense is available.

IV. ADDING A FOURTH ACCURACY-RELATED PENALTY TO THE CURRENT TAX SHELTER REGIME

This part argues against a separate economic substance penalty in light of the current penalties applicable to tax shelters. The economic substance penalty results in substantial overlap with the other tax shelter penalties. The current penalties have been consistently sustained by courts in economic substance doctrine cases, obviating the need for an additional penalty. Congress has not identified what types of transactions it intends to capture with the new economic substance penalty that are not covered by the current tax shelter penalties.

If the sole justification for the new penalty is strict liability, then the same result could have been accomplished by amending the current tax shelter penalties to remove the taxpayer defenses. Adding an economic substance penalty to the list of tax shelter penalties creates significant and unnecessary complexity in an already confusing penalty regime, making it difficult for taxpayers to understand and predict the consequences of their behavior.

A. Overlap with Other Tax Shelter Penalties Creates Undue Complexity

Are violations of the economic substance doctrine falling through the

115. Commentators often assert that a reasonable cause exception should be added to the proposed legislation. *See, e.g.*, Stretch et al., *supra* note 98. *But see* REPORT ON CIVIL TAX PENALTIES, *supra* note 98, at 14 (recommending a comprehensive study of current tax shelter penalties in lieu of a strict liability penalty for violations of the economic substance doctrine); Shin-Li, *supra* note 90, at 2048 (arguing that the current penalty regime is sufficient to address the tax shelter problem).

cracks of the current accuracy-related penalty regime, calling for a new penalty that specifically addresses transactions that fall under the doctrine? This is a question that does not appear to have been addressed by legislators and other advocates of the new economic substance penalty.

1. Past Experience Shows that the Current Penalty Regime Is Adequate

An examination of recent cases in which courts have applied the economic substance doctrine reveals that the government has more than enough accuracy-related penalties at its disposal and that it has been successful in asserting these penalties against the taxpayer in cases in which the government prevails on the merits.

For example, out of eight economic substance doctrine cases in which the government prevailed in 2009, penalties were sustained in four of the cases, while the taxpayer successfully defeated penalty assertions in only two cases.[116] The government has successfully asserted penalties in a number of high profile economic substance doctrine cases prior to 2009, as well.[117] In economic substance doctrine cases where taxpayers have successfully fended off penalties, they generally have been able to demonstrate reasonable cause or substantial authority.[118] Except in the cases in which courts, adopting the minority view, have determined that the gross valuation misstatement penalty is inapplicable to violations of the economic substance doctrine,[119] courts have not held that the current accuracy-related penalties are inapplicable to violations of the economic substance doctrine. Further, even in the minority of economic substance doctrine cases where the gross valuation misstatement penalty was found to

116. For cases sustaining penalties, see *Palm Canyon*, 98 T.C.M. (CCH) 574; *Clearmeadow Investments*, 87 Fed. Cl. 509; *New Phoenix Sunrise Corp.*, 132 T.C. No. 9; and *Maguire Partners-Master Investments*, 2009 WL 4907033. The taxpayer successfully defeated penalties in *Klamath Strategic Inv. Fund* and Southgate Master Fund LLC v. U.S., 651 F. Supp. 2d 596 (N.D. Tex. 2009). Additionally, in two other cases in which the government prevailed on economic substance in 2009, penalties were not discussed or were not asserted. *Country Pine Fin.*, 98 T.C.M. (CCH) 410 (penalties not asserted) and *Schering-Plough,* 651 F. Supp. 2d 219 (penalties not discussed).

117. *See, e.g.*, Stobie Creek Investments LLC v. U.S., 82 Fed. Cl. 636 (2008); Cemco Investors LLC v. U.S., 2007 WL 951944 (N.D. Ill. 2007), *aff'd*, 515 F.3d 749 (7th Cir. 2008); Long Term Capital Holdings v. U.S., 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 2005-2 USTC ¶50,575 (2d Cir. 2005).

118. *See, e.g., Klamath Strategic Inv. Fund*, 568 F.3d at 537 (finding that taxpayer satisfied substantial authority and reasonable belief that treatment was more likely than not a correct defense for the substantial understatement penalty for a tax shelter transaction) and *Southgate Master Fund LLC*, 651 F. Supp. 2d at 596 (finding that taxpayer had substantial authority and satisfied reasonable cause and good faith).

119. *See supra* note 58 and accompanying text.

be inapplicable, other accuracy-related penalties have been sustained in the alternative.[120] Thus, there is no indication that the current penalty regime has been inadequate in past economic substance doctrine cases.

2. Conceptually, the Current Penalties Should Continue to Apply

These results are not surprising, as there do not appear to be transactions that would fall under the economic substance doctrine that are not covered by at least one, if not all, of the other tax shelter penalties. Many transactions that lack economic substance would constitute a gross valuation misstatement, a tax shelter for purposes of the substantial understatement penalty, and would also constitute a reportable transaction.

a. Gross Valuation Misstatement

When Congress enacted the valuation misstatement penalty in the early 1980s, the typical tax shelter scheme often involved an ostensible purchase of a depreciable asset in a transaction in which the taxpayer made a minimal equity investment and obtained the benefit of depreciation deductions, interest deductions, and possibly an investment tax credit.[121] These transactions easily lent themselves to application of the valuation misstatement penalty, as was intended by Congress in enacting the penalty.[122] Taxpayers relied on the basis claimed in the purchased asset for depreciation and investment tax credits, and that basis was reduced to zero when the ostensible sale was nullified, which automatically satisfied the threshold for a valuation misstatement for courts taking the majority approach.[123]

Although the nature of tax shelters has evolved since the 1980s, more recent economic substance doctrine cases still tend to involve transactions in which the taxpayer relies on an inflated basis to obtain tax benefits, often a deductible loss.[124] Given that the majority of courts and the IRS take the position that violations of the economic substance doctrine result in a gross

120. *E.g.*, *Keller*, 556 F.3d at 1056.

121. *See, e.g.*, *Massengill*, 876 F.2d at 616 (denying depreciation deductions and investment tax credit on cattle purchase and upholding valuation misstatement penalty).

122. H.R. REP. NO. 97-201 at 243.

123. *E.g., Massengill*, 876 F.2d at 616 and Zirker v. Comm'r, 87 T.C. 970 (1986) (involving the depreciation of cattle).

124. *See, e.g.*, *Klamath Strategic Inv. Fund*, 568 F.3d at 537 (claiming taxpayer loss based on inflated basis in partnership interest); *Jade Trading*, 80 Fed. Cl. at 11 (claiming taxpayer loss based on inflated basis in partnership interest); H.J. Heinz Co. v. U.S., 76 Fed. Cl. 570 (2007) (claiming taxpayer loss based on artificially high basis in stock of its parent); Long Term Capital Holdings v. U.S., 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 2005-2 USTC ¶50,575 (2d Cir. 2005) (claiming taxpayer loss on sale of high basis preferred stock).

valuation misstatement,[125] this penalty should continue to be a powerful weapon in tax shelter cases. This is particularly true because, unlike the substantial understatement and reportable transaction understatement penalties, the rate on the gross valuation misstatement penalty is 40 percent, the same as the maximum rate on the new economic substance penalty.

b. Substantial Understatement with Respect to a Tax Shelter

An even bigger overlap appears to exist between transactions that violate the economic substance doctrine and transactions that meet the broad definition of "tax shelter" for purposes of the substantial understatement penalty under I.R.C. § 6662(d)(2)(C). Any economic substance doctrine case will likely involve a deficiency large enough to constitute a substantial understatement,[126] and the issue would be only whether the transaction constitutes a tax shelter under I.R.C. § 6662(d)(2)(C), such that the taxpayer's defenses to the penalty would be limited.[127]

A tax shelter is defined for this purpose as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.[128] In the case of the economic substance doctrine, as recently codified, a taxpayer has violated the doctrine if the transaction lacks either objective economic substance or a subjective business purpose.[129]

Under the new legislation, a court could find that a transaction failed the economic substance doctrine solely because it lacked a business purpose, without ever having to decide the issue of objective economic substance. Additionally, in many cases in which a court has determined that a transaction lacks objective substance, the court also concludes (unsurprisingly) that the taxpayer did not have a subjective business purpose.[130] If a taxpayer's transaction fails the subjective prong of the economic substance doctrine because it has *no* non-tax business purpose,

125. *See supra* notes 57 and 66 and accompanying text.

126. I.R.C. § 6662(d)(1) (West 2010).

127. *See supra* note 40 and accompanying text; I.R.C. §§ 6662(d)(2)(C) (West 2010), 6664(c)(1) (West 2010).

128. *See* I.R.C. § 6662(d)(2)(C)(ii) (West 2010).

129. H.R. 4872, § 1409(a), new I.R.C. § 7701(o)(2) (West 2010).

130. It is not surprising, for example, that a transaction resulting in negative cash flows lacks a valid, non-tax business purpose. *See, e.g.*, *Country Pine Fin.*, 98 T.C.M. (CCH) 410. Many economic substance doctrine cases involve transactions that fail both prongs of the test, including the subjective prong. *See, e.g.*, *Wells Fargo*, 91 Fed. Cl. 35; *Palm Canyon*, 98 T.C.M. (CCH) 574; and *Schering-Plough*, 651 F. Supp. 2d 219.

this would surely meet the lower threshold of having a "significant purpose" of tax avoidance under I.R.C. § 6662(d)(2)(C). Accordingly, the substantial understatement penalty for tax shelters should pick up a large number, if not the majority, of these cases.[131]

c. Reportable Transaction Understatement

The reportable transaction understatement penalty is still untested in the context of economic substance doctrine cases.[132] However, because it was specifically drafted to address tax shelter transactions,[133] the penalty should also cover a significant number of economic substance doctrine cases that involve tax years ending after October 22, 2004.[134] Reportable transactions include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest.[135] These categories encompass common features of tax shelter transactions, many of which have been the subject of economic substance doctrine cases.

For example, a "confidential transaction" is one offered to a taxpayer under conditions of confidentiality and for which a taxpayer pays a minimum fee to an advisor.[136] This describes the taxpayer's arrangement in *Stobie Creek Investments v. United States*, in which the Court of Federal Claims held that the taxpayer's transaction lacked economic substance.[137] In sustaining accuracy-related penalties in the case, the court concluded that the reasonableness of the taxpayer's reliance on an opinion of counsel was diminished because of clear conflict of interest, which was due to "[t]he proprietary nature of the confidentiality agreements required by [the law firm] and the calculation of the fee for its Tax Opinion based on a percentage of the gains to be sheltered . . . ."[138]

Additionally, a number of economic substance doctrine cases have constituted, and inevitably will continue to constitute, loss transactions. A loss transaction is a transaction in which a taxpayer claims a loss under

131. On the other hand, a transaction that meets the subjective business purpose prong but fails the objective economic substance prong would lack economic substance under the codified rules, but would not necessarily constitute a tax shelter under the substantial understatement rules.

132. *See supra* notes 62 and 63 and accompanying text.

133. H.R. REP. NO. 108-393, at 183 (2003).

134. To be subject to the reportable transaction understatement penalty under I.R.C. § 6662A, a taxpayer's reportable transaction must have a significant purpose of tax avoidance, unless the transaction is a listed transaction. I.R.C. § 6662A(b)(2) (West 2010).

135. Treas. Reg. § 1.6011-4(b) (as amended in 2010).

136. Treas. Reg. § 1.6011-4(b)(3)(i) (as amended in 2010).

137. 82 Fed. Cl. 636 (2008).

138. *Id.* at 715.

I.R.C. § 165 of at least $10 million in a single year in the case of a corporation (or partnership with corporate partners), or a loss of at least $2 million in a single year in the case of an individual.[139] The stakes in litigated economic substance doctrine cases will often meet these dollar thresholds. Further, as discussed in the context of the valuation misstatement penalty, recent tax shelters at issue in economic substance doctrine cases often tend to involve transactions in which the taxpayer claims a deductible loss under I.R.C. § 165.[140] Although there is a safe harbor under Treas. Reg. § 1.6011-4(b) that protects losses when a taxpayer has a "qualified basis," this safe harbor generally requires that the taxpayer's basis be derived from a cash outlay by the taxpayer.[141] In contrast, most tax shelters at issue in economic substance doctrine cases involve only a minimal equity investment by the taxpayer.[142]

Finally, a number of tax shelters that have been the subject of economic substance doctrine cases are listed transactions, some of which had already been identified by the IRS before the tax year at issue in the case.[143] This overlap between reportable transactions and tax shelters that violate the economic substance doctrine demonstrates that the reportable transaction understatement penalty, with its restricted taxpayer defenses, should be an effective tool in economic substance doctrine cases going forward.

3. A Hypothetical Analysis of Three Recent Cases

The above analysis indicates that the current tax shelter penalties are sufficient to cover most, if not all, economic substance doctrine cases, making an additional economic substance penalty redundant and confusing. This has been true historically, can be demonstrated conceptually based on the common features of tax shelter transactions, and should continue to play out in practice going forward. This last point can be illustrated by an

139. Treas. Reg. § 1.6011-4(b)(5) (as amended in 2010).

140. *See, e.g.*, cases cited *supra* note 124.

141. Rev. Proc. 2004-66, 2004-2 C.B. 966.

142. *See, e.g.*, *Klamath Strategic Inv. Fund*, 568 F.3d at 541-42 (taxpayers made equity investment of $1.5 million and claimed loss of approximately $25 million).

143. A listed transaction is a type of reportable transaction that has been specifically identified by the IRS as a tax avoidance transaction. I.R.C. §§ 6662A(d), 6707A(c)(2) (West 2010). *See, e.g.*, *Clearmeadow Investments*, 87 Fed. Cl. 509; *New Phoenix Sunrise Corp.*, 132 T.C. 161; Maguire Partners-Master Investments, LLC v. U.S., No. CV 06-07371-JFW(RZx), 2009 WL 4907033, at *17-19 (C.D. Cal. Dec. 11, 2009) (all involving the same listed transaction, which was identified by the IRS in I.R.S. Notice 2000-44, cited *infra* note 159). Each of the above-mentioned cases involves tax years after the issuance of I.R.S. Notice 2000-44. *See* Monte A. Jackel & Robert J. Crnkovich, *Son-of-BOSS Revisited*, 123 TAX NOTES 1481 (2009) (surveying various cases involving Son-of-BOSS litigation that occurred after the issuance of I.R.S. Notice 2000-44).

examination of three recent economic substance doctrine decisions. Although penalties were raised in only one of these cases, an examination of the tax shelters at issue illustrates how the current penalty regime is more than adequate.

a. *Wells Fargo: The SILO Tax Shelter*

In *Wells Fargo & Co. v. United States*, the Court of Federal Claims held that the taxpayer's sale in/lease out ("SILO") transaction lacked economic substance.[144] In a typical SILO transaction, the taxpayer enters into a purported sale-leaseback transaction with a tax exempt entity, under which the tax exempt entity sells property to the taxpayer and the taxpayer immediately leases the property back to the tax exempt entity.[145] The lease provides for rental payments, and substantially all of the purchase price is set aside by the tax-exempt entity to fund its lease obligations.[146] The taxpayer makes a minor equity investment and funds most of the purchase price with nonrecourse debt, the interest deductions on which offset the rental income it receives under the lease.[147] At the end of the lease term, the taxpayer generally has the option to either sell the property back to the tax exempt entity at a fixed price, or to impose a service contract on the tax exempt entity under which the taxpayer is reimbursed for its costs and is guaranteed a minimum after-tax rate of return on its equity investment.[148] The taxpayer is generally shielded from economic risk by this arrangement, and benefits during the lease term through taking depreciation deductions on the property (in addition to the interest deductions on the nonrecourse loan).[149]

Wells Fargo entered into a number of SILO transactions with various public transit agencies, in which it leased depreciable assets such as rail cars, locomotives, or buses.[150] The court employed the majority test for economic substance and held that Wells Fargo was not entitled to interest or depreciation deductions unless it could prove its SILO transactions had

144. 91 Fed. Cl. 35 (2010).

145. I.R.S. Notice 2005-13, 2005-1 C.B. 630. The initial sale may be in the form of a lease of the property with a term that is longer than the remaining useful life of the property, which the parties treat as a sale for tax purposes. *Id.*

146. *Id.* The tax exempt entity also retains an amount that represents a fee as an inducement to enter into the transaction.

147. *Id.* In reality, the interest and rental payments are often not made, but are recorded as offsetting book entries. *See Wells Fargo*, 91 Fed. Cl. at 39-40.

148. *See supra* note 145. The tax exempt entity's obligations are generally funded by the equity portion of the purchase price paid by the taxpayer. *See Wells Fargo*, 91 Fed. Cl. at 41.

149. I.R.S. Notice 2005-13, *supra* note 145.

150. *Wells Fargo*, 91 Fed. Cl. at 37.

both objective economic substance and a subjective business purpose.[151] The court held the transactions lacked objective economic substance because the only non-tax benefit Wells Fargo received was a return of its equity investment with interest.[152] The court also held that Wells Fargo lacked a non-tax business purpose and that it wouldn't have entered into the transactions but for the tax benefits.[153] Accordingly, Wells Fargo's transactions were found to fail the economic substance doctrine and the related tax deductions were denied.

Penalties were not discussed in the *Wells Fargo* case. The case also involved the 2002 tax year, before the effective date of the reportable transaction understatement penalty. However, based on the facts of the transaction alone, all of the current accuracy-related tax shelter penalties could have applied in this case.[154] Like the earlier tax shelters of the 1980s that relied on an ostensible sale to obtain depreciation deductions,[155] the depreciation deductions obtained by Wells Fargo in the transaction depended upon the basis it obtained through its purported purchase of the transportation assets. Because the transaction was ultimately disregarded under the economic substance doctrine, the IRS could have asserted that the correct basis in the assets was zero, resulting in a gross valuation misstatement.

Additionally, because the court determined that Wells Fargo lacked a non-tax purpose for entering into the transaction, the transaction likely would satisfy the definition of a tax shelter for purposes of the substantial understatement rules. Further, the reportable transaction understatement penalty could have been asserted[156] because SILO transactions are listed transactions.[157]

b. *Palm Canyon: The Son-of-BOSS Tax Shelter*

In *Palm Canyon X Investments v. Commissioner*,[158] the Tax Court found that the taxpayer's "Son-of-BOSS"[159] tax shelter lacked economic

151. *Id.* at 81.

152. *Id.* at 82.

153. *Id.* at 83.

154. This is assuming that the taxpayer could not meet the reasonable cause or other relevant defenses for the penalties.

155. *See*, *e.g.*, *Massengill*, 876 F.2d 616 (denying depreciation deductions and investment tax credit on cattle purchase and upholding valuation misstatement penalty).

156. This is assuming the tax year at issue was after the transaction was listed, and after the enactment of the reportable transaction rules in 2004.

157. I.R.S. Notice 2005-13, *supra* note 145. A compilation of all listed transactions is available at http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html.

158. 98 T.C.M. (CCH) 574 (2009).

159. These tax shelters grew out of and resemble an earlier tax shelter termed "BOSS" (Bond and Option Sales Strategy), leading to the name "Son-of-BOSS." *See* I.R.S. Notice

substance. The Son-of-BOSS shelter has multiple variations, all of which revolve around creating an artificially high basis in a partnership interest and subsequently disposing of that interest at a loss.[160] Under one common variation, the taxpayer borrows at a premium and contributes the proceeds to a partnership, with the partnership assuming the debt.[161] The taxpayer takes the position that when the debt is assumed, its basis in its partnership interest is reduced only by the principal amount of the debt under I.R.C. § 752,[162] but not by the additional amount of the loan proceeds that represent the premium.[163] When the taxpayer disposes of its partnership interest, it takes a loss in the amount of its basis, although its actual cash outlay in the transaction was zero or close to zero.[164]

In *Palm Canyon*, the taxpayer entered into another common Son-of-BOSS variation in which the taxpayer enters into offsetting foreign currency options that are contributed to a partnership.[165] The taxpayer took the position that its basis was only offset by the long option, but that the short option was too speculative to constitute a "liability" for purposes of I.R.C. § 752.[166] As in all Son-of-BOSS transactions, the ultimate result for the taxpayer was a tax loss with only nominal economic outlay.[167] The Tax Court held that the transaction lacked economic substance, concluding that the taxpayer did not have a legitimate non-tax business purpose for entering into the transaction, and that the transaction lacked pretax profit potential.[168]

The Tax Court held that the gross valuation misstatement penalty applied, or, in the alternative, that the transaction resulted in a substantial understatement subject to the tax shelter rules, or was subject to the negligence penalty.[169] As is the case for any Son-of-BOSS transaction, the tax benefits in the case were derived from the taxpayer's basis in its

2000-44, 2000-36 I.R.B. 255, *available at* http://www.irs.gov/pub/irs-utl/notice_2000-44.pdf.; I.R.S. Notice 99-59, 1999-2 C.B. 761.

160. I.R.S. Notice 2000-44, *supra* note 159.

161. *Id.*

162. Under I.R.C. § 752 (West 1954) (as amended in 1986), an assumption of a partner's liability by a partnership is treated as a cash distribution to that partner, which reduces its basis in its partnership interest.

163. I.R.S. Notice 2000-44, *supra* note 159.

164. *Id.*

165. 98 T.C.M. (CCH) 574, at *4, *14.

166. *Id.* at *14. *See also* Lee A. Sheppard, *Recent Shelter Cases: The Right Result For The Wrong Reasons*, 126 TAX NOTES 421, 426 (2010) (describing the Son-of-BOSS transaction at issue in the *Palm Canyon* case).

167. *Palm Canyon*, 98 T.C.M. (CCH) 574, at *14.

168. *Id.* at *27. The Tax Court did not have to determine whether a conjunctive or disjunctive test for economic substance was appropriate because it found that neither prong was satisfied. *Id.* at *19.

169. *Id.* at *29-*36.

partnership interest, which, when reduced to zero, resulted in a gross valuation misstatement. Additionally, the tax shelter rules for substantial understatements applied "[b]ecause the sole purpose of the . . . transaction was tax avoidance."[170] Finally, the transaction would have constituted a reportable transaction on at least two grounds. Not only is the Son-of-BOSS tax shelter a listed transaction,[171] but the transaction resulted in a claimed loss of approximately $5 million dollars, which would have likely satisfied the requirements for a loss transaction.[172]

c. Country Pine: The CARDS Tax Shelter

Country Pine Finance v. Commissioner[173] involved the Custom Adjustable Rate Debt Structure ("CARDS") tax shelter. In a typical CARDS transaction, a tax neutral party (such as a foreign entity not subject to U.S. taxation) incurs long-term debt from a lender and uses the proceeds to purchase assets such as short-term deposits or government bonds.[174] The taxpayer enters into a separate agreement with the tax neutral entity under which the taxpayer receives a portion of the purchased assets in exchange for the taxpayer's agreement to become co-obligor on the loan.[175] The fair market value of the assets transferred to the taxpayer is substantially less than the principal amount of the debt for which the taxpayer has agreed to become jointly and severally liable.[176] The taxpayer claims that its assumption of liability on the debt gives it a basis equal to the entire principal amount of the debt, and subsequently disposes of the assets at a loss.[177]

The Tax Court held that Country Pine's transaction lacked economic substance and disallowed the claimed loss.[178] The court found that the

170. *Id.* at *35.

171. *See* I.R.S. Notice 2000-44, *supra* note 159.

172. The $5 million dollar loss was claimed by Thighmaster World Corp., an S corporation, which is subject to the $2 million threshold for loss transactions under Treas. Reg. § 1.6011-4(b)(5)(D). *Palm Canyon*, 98 T.C.M. (CCH) 574, at *11. To be subject to I.R.C. § 6662A as a non-listed reportable transaction, the transaction must have tax avoidance as a significant purpose, a requirement which would have been satisfied based on the court's finding in this case.

173. 98 T.C.M. (CCH) 410 (2009).

174. *See* I.R.S. Notice 2002-21, 2002-1 C.B. 730 (describing the mechanics of the "CARDS" tax shelter).

175. *Id.* The fair market value of the asset transferred to the taxpayer equals the present value of the loan's principal payment at maturity, which the taxpayer agrees to pay.

176. *Id.* The tax neutral entity agrees to make all interest payments on the loan, and the parties anticipate that the purchased assets will constitute sufficient collateral to repay the loan.

177. *Id.*

178. *See Country Pine Fin.*, 98 T.C.M. (CCH) 410 at *16 (noting the loss was artificial and that the taxpayer lacked a nontax business purpose for entering into the transaction).

transaction failed the objective prong because it lacked profit potential and resulted in negative cash flow.[179] Additionally, the transaction failed the subjective prong because the court found that there was substantial evidence that the decision to enter into the transaction was motivated solely by tax avoidance.[180]

The IRS did not assert penalties in the *Country Pine* case.[181] However, the CARDS tax shelter relies on an inflated basis to achieve a deductible loss, which makes the gross valuation misstatement penalty applicable to the transaction. Additionally, the Tax Court's finding that the transaction was motivated solely by tax avoidance should satisfy the definition of tax shelter for purposes of the substantial understatement penalty. Finally, as was the case with the Son-of-BOSS tax shelter, the CARDS tax shelter at issue in *Country Pine* is both a listed transaction[182] and is likely a loss transaction,[183] which would have made the reportable transaction understatement penalty applicable in this case.

This analysis indicates that, even though tax shelters have evolved over time, the tax shelter penalties in the current accuracy-related regime should continue to apply in economic substance doctrine cases. The creation of a new tax shelter penalty does not appear to fill any gaps in the current regime.

4. The Complexity that Results from Adding a Fourth Tax Shelter Penalty

Given that the current accuracy-related penalty regime is more than adequate to address tax shelters, the new economic substance penalty does not appear to add anything useful to this regime. Rather, the new penalty exacerbates the problems with the current regime, which is arguably over-complicated already.

While noble, Congress's repeated attempts to stiffen penalties on tax shelters have been piecemeal.[184] Newer penalties have been enacted

179. *Id.* at *15.

180. *Id.*

181. *Id.* at *8.

182. I.R.S. Notice 2002-21, 2002-1 C.B. 730, *available at* http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html .

183. The case involved a partnership, Country Pine Finance LLC, that had individual members. The partnership claimed a $7,917,000 short-term capital loss and a $4,045,000 ordinary loss, which it disclosed under Temp. Treas. Reg. § 1.6011-4T (2007). *Country Pine Fin.*, 98 T.C.M. (CCH) 410, at *8. The reportable transaction rules have a $2 million threshold for losses claimed by partnerships that do not have all corporate partners. Additionally, there is an even lower threshold ($50,000) for individual losses based on certain foreign currency transactions. Treas. Reg. § 1.6011-4(b)(5)(C), (E) (as amended in 2010).

184. *See, e.g.,* NY Bar Submits Comments, *supra* note 98 (proposing modifications to

without removing or amending old penalties, with no explanation as to whether the newer penalties are intended to replace the older penalties, or whether they are meant to supplement the older regime by filling specifically identified gaps.[185] The result is that when dealing with an abusive tax shelter, a complicated matrix of potential penalties exists, each with different taxpayer defenses.

When a taxpayer is contemplating whether to enter into a particular transaction, or contemplating whether to take a certain tax position with respect to a completed transaction, the taxpayer may seek advice from an advisor or attempt to determine the potential tax consequences on its own. Either way, if the tax position is questionable, an important consideration likely will be the consequences of the taxpayer's position not being sustained on the merits, including what types of penalties might apply. A further consideration, particularly for a more sophisticated taxpayer, might be what can be done to avoid the application of a penalty in the event the taxpayer's position is not sustained on the merits.

For a taxpayer or tax advisor attempting to undertake such an analysis, a number of accuracy-related penalties must be considered.[186] The requirements for avoiding accuracy-related penalties will depend on how the transaction is characterized. For example, if the taxpayer's position results in a substantial understatement or a gross valuation misstatement, the taxpayer may be able to avail itself of the reasonable cause and good faith defense provided by I.R.C. § 6664(c). Even if there is not substantial legal authority that supports the taxpayer's position, the taxpayer may still be able to avoid the penalty through, for example, reasonable and good faith reliance on the advice of a tax advisor.[187]

However, if the transaction is deemed a "tax shelter," the taxpayer may be subject to the more stringent reasonable cause and good faith requirements for tax shelters, which require, at a minimum, both substantial authority and a reasonable belief that the taxpayer's position was more likely than not correct.[188] In this case, the taxpayer's good faith reliance on

the Section 6662 penalty in America's Affordable Health Choices Act of 2009).

185. *See supra* Part II.A.

186. *See, e.g., supra* Part II.B.1 (stating that this consideration is in addition to any non-accuracy-related penalties that may apply).

187. The most important factor in determining whether a taxpayer acted with reasonable cause and good faith for purposes of I.R.C. §6664(c) is the extent of the taxpayer's efforts to assess her proper tax liability. Treas. Reg. § 1.6664-4(b) (2003). Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the taxpayer's experience, knowledge, and education, or reliance on the advice of a professional if such reliance was reasonable under the circumstances and the taxpayer acted in good faith. *Id.*

188. Treas. Reg. § 1.6664-4(f) (2003) (the heightened reasonable cause and good faith requirement only applies to corporate taxpayers).

the advice of a tax advisor will not be sufficient to avoid the penalty if there is not legal authority amounting to "substantial authority" that supports the taxpayer's position.[189] Additionally, even if there is substantial authority to support the taxpayer's position, the taxpayer's reliance on an advisor will not be sufficient unless the advisor has unambiguously concluded there is a greater than 50 percent likelihood that the taxpayer's position would be upheld if challenged.[190]

A taxpayer must further consider whether its transaction would constitute a reportable transaction. If so, it will not be able to avail itself of the heightened reasonable cause and good faith defense unless it discloses its transaction.[191] Finally, if the transaction could be found to violate the economic substance doctrine, then no reasonable cause or other defenses will be available if the new economic substance penalty applies.[192]

A taxpayer contemplating a transaction that could potentially fall into several of these categories must contemplate whether it should attempt to satisfy the most stringent reasonable cause requirements, or whether it should assume that it will be subject to strict liability if penalized. In that case, the taxpayer might determine it is not worth the expense to satisfy the reasonable cause requirements. In addition to trying to determine which, if any, defenses the taxpayer should attempt to satisfy, the rate of the penalty will vary depending on which penalty applies.

The various defenses to accuracy-related penalties, as applicable after the recent codification of the economic substance doctrine, are illustrated in Appendix A. As can be seen from the table in Appendix A, the accuracy-related penalty regime presents a complicated matrix of taxpayer defenses for tax shelter transactions.

B. The Negative Implications of Complexity

The overlap between the new economic substance penalty and the current tax shelter penalties creates unnecessary complexity in the current penalty regime. Over-complicating the accuracy-related penalty regime defeats the very purpose for which these penalties were enacted. Taxpayers cannot be encouraged to comply with the tax laws if they do not understand the penalties that were designed to encourage good behavior. Similarly, the IRS must fully comprehend the intricacies of the penalty regime and have the resources to effectively enforce it.

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189. *See supra* text accompanying note 32.
190. Treas. Reg. § 1.6664-4(f)(2)(B)(2) (2003).
191. *See supra* note 50.
192. *See supra* text accompanying note 81.

1. The Stated Purpose Behind the Penalty Regime

The IRS's official policy on tax penalties is that they exist primarily to "encourage voluntary compliance."[193] Other than its brief policy statements in the Internal Revenue Manual, which are updated from time to time, the IRS's last official elucidation on penalty policy was offered in 1989, when an IRS task force published the results of a comprehensive study on civil tax penalties.[194] The report concluded that tax penalties promote voluntary compliance by helping taxpayers understand "right" versus "wrong" conduct, by deterring noncompliance, and by establishing the fairness of the tax system.[195]

The task force highlighted the importance of "comprehensibility" in tax penalties, observing that the IRS's goal of voluntary compliance required that penalties be both "understandable and understood" by taxpayers.[196] In order to properly deter taxpayers, the task force concluded that they must understand the probable consequences of their departure from the requirements of the tax laws, and further understand the logic upon which the penalty being imposed is based.[197]

In addition to promoting the deterrence objectives of voluntary compliance, the task force noted the effect that comprehensibility has on the administration of penalties. Specifically, the task force observed that:

> As penalties become more numerous and more complicated, it becomes more difficult for an employee of the IRS to be aware of all penalties and to make quality judgments as to when they should be asserted or abated. Thus, complexity works against both a taxpayer's ability to understand the consequences of noncompliance and the Service's ability to administer the system effectively and fairly.[198]

The penalty policies announced by the IRS task force, including the importance of comprehensibility, were also articulated by Congress when it overhauled the former penalty regime in 1989 in favor of a system that was

193. IRS PENALTY HANDBOOK, I.R.M. § 20.1.1.2 (Feb. 22, 2008), *available at* http://www.irs.gov/irm/part20/irm_20-001-001r.html#d0e406; IRS Policy Statement 20-1, I.R.M. § 1.2.20.1.1 (June 29, 2004), *available at* http://www.irs.gov/irm/part1/irm_01-002-020.html.

194. Tax Analysts, IRS Executive Task Force Releases Penalty Reform Proposals, 89 TNT 45-36 (Feb. 27, 1989) (LEXIS) [hereinafter Tax Analysts II] (citing Executive Task Force for the Commissioner's Penalty Study, *Report on Civil Tax Penalties*) (the stated goal of the Task Force's report was to set out the underlying reasons for tax penalties, a method of evaluating them, goals for penalty administration, an evaluation of existing penalties, and recommendations for change).

195. *Id.*

196. *Id.* at 43.

197. *Id.*

198. *Id.* at 44.

more closely tailored to the goal of promoting voluntary compliance.[199] Commentators and practitioners have also echoed the importance of comprehensibility in promoting voluntary compliance in more recent years. For example, in a statement of policy released by the American Bar Association Section of Taxation in 2009, the authors concluded that promoting voluntary compliance "requires that the penalties be relatively simple and logical."[200]

The current tax shelter penalty regime has trended away from the IRS's and Congress's stated policy of enacting penalties that are simple and easy to understand and to administer. The economic substance penalty further frustrates this stated policy because it adds yet another penalty to the list of accuracy-related penalties aimed at tax shelters, and contains standards (for example, strict liability) that are distinct from the standards imposed by the other tax shelter penalties. The substantial overlap that exists between the application of other tax shelter penalties and the new economic substance penalty[201] will make it hard for taxpayers to determine which penalty or penalties they must consider when contemplating the consequences of their conduct. This will inevitably require a certain amount of guesswork, particularly since neither the reportable transaction understatement penalty nor the new economic substance penalty has been tested in economic substance doctrine cases.

Additionally, the differing standards among the penalties require the taxpayer to consider a variety of requirements for a potential reasonable cause defense, which further frustrates the goal of promoting voluntary compliance.[202] For example, a taxpayer undertaking a transaction that might constitute a tax shelter and violate the economic substance doctrine will not know whether it is best served by incurring the additional time and expense to satisfy the heightened reasonable cause and good faith

199. *See* REPORT ON CIVIL TAX PENALTIES, *supra* note 98 (citing the Improved Penalty Administration and Compliance Tax Act, enacted as part of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106). For example, Sen. J.J. Pickle, Chairman of the House Committee on Oversight, observed that penalties should be "readily known and easily understood." *Id.* at 3 (citing Letter from Sen. J.J. Pickle, Chairman, House Subcommittee on Oversight, to Sen. Dan Rostenkowski, Chairman, House Ways and Means Committee (June 15, 1989) (available at 1989 TNT 128-4) (1989) (LEXIS)).

200. Tax Analysts, ABA Tax Section Recommends Overhaul of Tax Penalty Regime, 2009 TNT 75-25 (Apr. 22, 2009) (LEXIS) [hereinafter Tax Analysts III] (citing Stuart M. Lewis, *Statement of Policy Favoring Reform of Federal Civil Tax Penalties*, 2009 TNT 75-25, 2, (2009)). *See also* REPORT ON CIVIL TAX PENALTIES, *supra* note 98 ("Penalties should articulate standards of behavior that are clear and understandable so that taxpayers and practitioners know the extent of their obligations . . . .").

201. *See supra* Parts IV.A.1 and IV.A.2.

202. *See supra* Part IV.A.4.

requirement,[203] or whether it will likely be subject to strict liability if its position is not upheld. In effect, the new economic substance penalty has injected additional uncertainty as to what type of behavior Congress intends to encourage. Does Congress want to encourage taxpayers to seek the advice of tax professionals, thus promoting tax positions that are arrived at after a reasoned, legal analysis of relevant tax authority? Or is Congress's primary aim to more effectively deter taxpayers from participating in tax shelters by depriving them of any "out," including reliance on a tax opinion?[204] The answer is unclear. Either way, Congress cannot effectively shape taxpayer behavior through penalties if taxpayers do not know the standards that will apply to their conduct.

2. Thoughtful Penalty Legislation

The guiding principles highlighted in the task force report are no less true today than they were twenty years ago when the IRS announced its penalty philosophy. The importance of comprehensibility is particularly relevant in today's tax penalty regime, as penalties have become more numerous and complex over time.[205]

Since the issuance of the IRS task force report in 1989, there has been a growing emphasis on the use of penalties to combat abusive tax shelters. Differentiating penalties imposed on taxpayers who participate in tax shelters from other penalties aimed at less egregious conduct necessitates some degree of additional complexity in the penalty regime. However, to continue to promote voluntary compliance, the benefits obtained through increasing the complexity of the penalty regime should be carefully weighed against the detriment it may cause to the overall policy goals of the penalty regime.

To this end, additional penalties should only be enacted after thorough evaluation of how the current penalty regime has addressed the perceived problem that the new penalty proposes to solve. Congress should avoid "piling on penalties"[206] by seeking first to identify and correct gaps in the

203. This expense may arise, for example, through the engagement of a professional tax advisor to render a tax opinion that satisfies the "more likely than not" standard required for reasonable cause.

204. It does not appear that Congress has answered this question. If the new economic substance doctrine penalty represents a new congressional attitude towards penalties, then presumably the strict liability standard is a replacement of the older reasonable cause standard.

205. *See* NATIONAL TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS: A FRAMEWORK FOR REFORMING THE PENALTY REGIME 1 (2008) (explaining that between 1954 and 2008, the number of civil tax penalties increased from approximately 14 to more than 130).

206. An earlier proposal for the new strict liability economic substance penalty was

current penalty regime before adding new penalties to the regime. Additionally, the enactment of new penalties, or amendments to current penalties, should not be undertaken in a vacuum. Even if a new penalty is deemed necessary because the current regime is entirely inadequate to address a particular problem, Congress should consider whether older penalties should be repealed, or whether it needs to clarify the interaction between the new penalty and the current penalties.[207]

In contrast to this approach, it appears the new economic substance penalty was enacted without careful consideration of the effectiveness of the current accuracy-related penalty regime in the context of tax shelters. For example, it is almost inconceivable that Congress could have determined that the new reportable transaction understatement penalty, enacted just six years ago in 2004, was insufficient in economic substance doctrine cases, when the case law has not yet caught up with the effective date of this penalty.[208] Additionally, Congress would have better served the goal of comprehensibility in the tax penalty regime by clarifying application of the current penalties to economic substance doctrine cases, such as clarifying the circuit split on the application of the gross valuation misstatement penalty,[209] rather than enacting a new penalty. If Congress did have specific justifications for a new penalty that outweigh the additional complexity created by the penalty, it has not effectively articulated these so that taxpayers, advisors, and the IRS can understand how and when the new penalty should be applied vis-à-vis the other tax shelter penalties.

This part has demonstrated that creating a new economic substance penalty is unnecessary because the current accuracy-related penalty regime is sufficient to address transactions that violate the economic substance doctrine. This part has further demonstrated that the new economic substance penalty will frustrate the goal of promoting voluntary compliance through comprehensibility because the new penalty adds significant and undue complexity to the current regime.

Given the substantial overlap between transactions that violate the economic substance doctrine and transactions covered by the other tax

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appropriately described by then-IRS Chief Counsel Donald Korb as "the latest example of Congress piling on penalties . . . ." Tax Analysts I, *supra* note 108. The American Bar Association Tax Section's statement on penalty policy also pointed out that stacking new penalties on top of existing penalties results in increased complexity and "do[es] little to enhance the perception of the tax system as reasonable." Tax Analysts III, *supra* note 200, at 4.

207. Although accuracy-related penalties generally cannot be stacked, the IRS is always free to assert a number of penalties in the alternative in the case of single transaction. *See supra* note 56 and accompanying text.

208. *See supra* notes 62 and 63 and accompanying text.

209. *See supra* Part II.B.2.a.

shelter penalties, the economic substance penalty does not appear to add anything "new" to the current regime, other than strict liability. But in addition to failing to articulate the reasons for enacting a new tax shelter penalty in light of the current penalty regime, Congress has also failed to articulate the reasons for imposing strict liability on transactions that violate the economic substance doctrine when it has elected not to do so for past tax shelter penalties.

V. IS THERE A PLACE FOR STRICT LIABILITY IN THE CURRENT PENALTY REGIME?

This part considers whether there is any justification for carving out transactions that violate economic substance as especially deserving of strict liability as compared to reportable transactions or tax shelter transactions where the economic substance doctrine has not been raised. This part will not attempt to make any normative conclusions about whether strict liability is fair or an effective deterrent in the context of tax penalties. Rather, I will argue that the strict liability aspect of the penalty cannot be justified in the context of the current penalty regime, which does not provide for strict liability, because there is nothing special about the economic substance doctrine as compared to other methods of policing tax shelters. While I have argued in Part IV that a new penalty is unnecessary altogether, irrespective of the standard imposed by that penalty, Part V will focus specifically on the strict liability standard and conclude that it cannot be reconciled with the standards imposed by the other tax shelter penalties.

A. There's Nothing Special About the Economic Substance Doctrine

It is clear that the recent legislation codifying the economic substance doctrine and adding a new economic substance penalty was intended by Congress to address the tax shelter epidemic.[210] This was also true when Congress enacted the valuation misstatement penalty, the substantial understatement penalty (with the carve out for tax shelters), and the reportable transaction understatement penalty.[211] The justifications advanced for the new economic substance penalty have largely centered

210. *See, e.g.*, 155 CONG. REC. S2624-01 (2009) (statement of Sen. Levin) ("[The economic substance doctrine] has become a powerful analytical tool used by courts to invalidate abusive tax shelters . . . . Since no tax shelter legislation would be complete without addressing this issue . . . this comprehensive bill proposes once more to include the economic substance doctrine in the tax code."); 151 CONG. REC. S9472-01 (2005) (statement of Sen. Bond) ("[This] bill would strengthen legal prohibitions against abusive tax shelters by codifying in federal tax statutes for the first time what is known as the economic substance doctrine.").

211. *See supra* Part II.A.

around the goal of deterring participation in tax shelters and giving the IRS an extra advantage in factually complex tax shelter transactions.[212] These justifications are appropriate concerns in the context of abusive tax shelters, but they don't address what it is about violations of the economic substance doctrine, apart from tax shelters in general, that merits a strict liability penalty. To justify singling out transactions that violate the economic substance doctrine for special treatment, Congress should have articulated why such transactions stand apart from other tax shelters.

1. "Tax Shelters" Versus the Economic Substance Doctrine

It is difficult to determine if violations of the economic substance doctrine are a subset of tax shelters, if tax shelters are a subset of violations of the economic substance, or if the two can be considered proxies for one another. There is no legislative or regulatory definition of a "tax shelter" that is intended as a substantive disallowance provision. In other words, tax shelters have been attacked from many angles, but there is no Internal Revenue Code provision that prohibits the use of "tax shelters" per se. This is unsurprising given the difficulty, if not impossibility, of finding a universal definition for the term.[213]

Although there may not be a generally accepted definition of what constitutes a tax shelter,[214] commentators have agreed on some of the defining characteristics of abusive tax shelters. Tax shelters have been described broadly as tax strategies that produce unintended benefits while complying with the literal terms of the Internal Revenue Code.[215] Put more simply, what separates abusive tax shelters from other transactions is whether or not Congress intended to provide the result claimed by the taxpayer.[216] Tax shelters have also been described as transactions that produce a tax deduction or tax loss without an accompanying economic

212. *See supra* Part III.B.1.

213. *See, e.g.*, Lederman, *supra* note 71, at 399.

214. *See id.*; Calvin H. Johnson, *What's a Tax Shelter?*, 68 TAX NOTES 879 (1995) (arguing that the best definition of "tax shelter" involves investments that are more valuable post-tax than pre-tax); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 328 (2002) (noting the absence of a universal definition and proposing that "tax shelter" be defined in terms of violation of congressional intent).

215. Joshua D. Blank, *Overcoming Disclosure: Towards Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1635 (2009).

216. Lederman, *supra* note 71, at 396-97. *See also* Schler, *supra* note 214, at 330 ("[I]t seems impossible to define a tax shelter except in terms of congressional or regulatory intent."). Schler argues that a tax shelter should be defined as a transaction that complies with the literal terms of the Internal Revenue Code, reaches a result unintended by Congress, and is accompanied by a tax avoidance motive. *Id.* at 331.

loss.[217] In contrast, there are other types of abusive transactions that generally would not be considered to constitute tax shelters, such as fraudulent transactions or transactions that constitute tax evasion.[218]

While the term "tax shelter" has been defined in the context of the penalty regime for purposes of the substantial understatement penalty,[219] that definition generally has been limited to its specific context. A definition that is based upon the taxpayer having a tax avoidance motive, such as that found in I.R.C. § 6662(d), is overly broad since it encompasses transactions that do not necessarily fall within the commonly accepted notion of tax shelters.[220] For example, nearly everyone would agree that the making of a check-the-box election under Treas. Reg. § 301.7701-3(c) would not constitute a tax shelter, even if the taxpayer's sole motivation for making the election was to avoid tax.[221]

Defining tax shelters by reference to the two prongs of the economic substance doctrine, as transactions that lack economic substance or a business purpose, is also overly broad. For example, one commentator has suggested that a transaction in which a taxpayer intentionally sells an asset to trigger gain that is offset by an expiring net operating loss, followed by an immediate repurchase of the asset with a stepped-up basis, would lack objective economic substance and a business purpose, but would not be considered to be a tax shelter.[222] It has also been suggested that such a definition of tax shelter is too narrow, as this would exclude transactions that meet the bare minimum amount of objective substance or business purpose to satisfy the economic substance doctrine but would otherwise be considered to be tax shelters.[223]

Although tax shelters continue to be generally undefined in legislation, Congress has specifically defined what constitutes a violation of the economic substance doctrine.[224] Under new I.R.C. § 7701(o), a transaction will only be treated as having economic substance if it changes

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217. David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 TAX L. REV. 29, 31 (2006). *See also* Peter Canellos, *Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and Tax Shelters,* 54 SMU L. REV. 47, 52-53 (2001) (comparing "real transactions" with "tax shelters").

218. Lederman, *supra* note 71, at 396 n.19. While a tax shelter generally complies with the literal terms of the tax code, a fraudulent or illegal transaction does not. Schler, *supra* note 214, at 330.

219. *See supra* note 128 and accompanying text.

220. *See, e.g.*, Schler, *supra* note 214, at 329 (noting that issuance of debt rather than equity would not constitute a tax shelter even if the sole motive was to obtain the interest deduction).

221. *Id.*

222. Hariton, *supra* note 217, at 35-36.

223. Schler, *supra* note 214, at 329-30.

224. *See supra* notes 70-74 and accompanying text.

the taxpayer's economic position in a meaningful, non-tax way, and if the taxpayer has a substantial non-tax purpose for entering into the transaction.[225]

The new economic substance doctrine legislation is, however, only a clarification of the existing judicial doctrine.[226] It is intended to provide "a uniform definition of economic substance," but is not intended to alter the flexibility of courts in determining when the doctrine is relevant to a particular transaction.[227] More importantly, the new legislation (and the legislative history thereof) does not claim to provide a uniform definition of "tax shelter." As discussed above, the objective and subjective prongs of the economic substance doctrine are both too broad and too narrow to fully encompass all abusive tax shelters.

But defining tax shelters was not the intent of codification of the economic substance doctrine. The economic substance doctrine is merely a judicial tool used to disallow tax benefits not intended by Internal Revenue Code when the substantive provisions of the Code fail to provide a basis for disallowance.[228] The doctrine gives courts one mechanism to distinguish between legitimate transactions and abusive tax shelters. However, courts may confront other tax shelters where the economic substance doctrine is not necessary to disallow the claimed benefits. This can be seen, for example, in tax shelter cases where courts have held against the taxpayer on alternative grounds that included both the economic substance doctrine and a substantive provision of the Code.[229]

The relationship between the economic substance doctrine and tax shelters makes it difficult to understand why Congress singled out the new economic substance penalty for a strict liability penalty. To isolate violations of economic substance as deserving of strict liability seems to suggest that, out of the realm of all tax shelters, these are the "worst" kinds of transactions. Yet Congress does not appear to be isolating a subset of tax shelters by codifying the doctrine. Tax shelters are clearly the problem, and the economic substance doctrine is simply one mechanism for substantively attacking the problem.

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225. *See supra* note 74.

226. I.R.C. § 7701(o) is appropriately entitled "Clarification of Economic Substance Doctrine."

227. *See* JCX-18-10, *supra* note 70, at 152; JCX-11-10, *supra* note 70, at 189; JCX-47-09, *supra* note 70, at 90*; see also* H.R. 4872, § 1409(a), new I.R.C. § 7701(o)(5)(C) (". . . the provisions of this subsection shall not be construed as altering or supplanting any other rule of law . . . ."), and *supra* note 71 and accompanying text.

228. *See, e.g.*, *Coltec*, 454 F.3d at 1354 ("[T]he economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance.").

229. *See supra* note 96.

Another possibility is that applying strict liability to violations of the economic substance doctrine is Congress's way of saying that all tax shelters are now subject to strict liability. But if that is the case, Congress should have explicitly said so. Codification of the economic substance doctrine is a poor (although perhaps convenient) platform for legislating a sweeping change to how Congress will now penalize tax shelters. Further, the fact that the reasonable cause defense was not removed from the other tax shelter penalties does not align with this theory.

2. Making Sense of the Current Tax Shelter Penalty Standards

Despite the difficulty of drafting substantive rules to prohibit tax shelters, the tax shelter problem has been addressed with some degree of success through disclosure rules and penalty provisions specifically targeted at tax shelters.[230] Although these tax shelter penalties have evolved over time, the changes to the accuracy-related penalty regime in the past decade can be understood when viewed in the context of Congress's overall goal of cracking down on tax shelters.

For example, the 2004 Jobs Act eliminated the substantial authority and reasonable belief excuse for all taxpayers participating in tax shelters.[231] This makes sense because defenses for substantial understatements with respect to tax shelters should be more limited than the defenses for other substantial understatements since tax shelters are the transactions Congress has a special interest in deterring and punishing.[232] It's true that the definition of "tax shelter" in I.R.C. § 6662(d) casts a wider net than what most would consider to be characteristic of true tax shelters.[233] However, the very use of the term "tax shelter" in the penalty legislation at least gives some indication of what sets the penalty apart from other substantial understatements. While the scope of the carve out for tax shelters in I.R.C. § 6662(d) is imperfect, it at least sends a clear message that Congress intended for taxpayer defenses to be limited when they

230. *See supra* Part IV.A.1; Canellos, *supra* note 217, at 52 (considering the tax bar's conclusion that disclosure rules and penalty provisions largely solve the problem of tax shelters).

231. *See supra* note 38 and accompanying text.

232. The difference in standards between the gross valuation misstatement penalty and the substantial understatement penalty for tax shelters can be similarly justified. Although the valuation misstatement penalty was enacted in response to the tax shelter epidemic, it was drafted broadly to address all valuation misstatements meeting a certain threshold, and Congress did not attempt to limit it to "tax shelters." *See supra* notes 19-21 and accompanying text. However, the more than twenty year gap in time between the enactment of the original valuation misstatement and the 2004 Jobs Act probably has more to do with the difference in standards between these penalties.

233. *See supra* notes 220 and 221 and accompanying text.

participate in tax shelters.

The addition of the reportable transaction understatement penalty is also comprehensible in the overall context of the accuracy-related penalty regime. At the time the penalty was enacted in 2004, a tax shelter penalty for substantial understatements was already in place with a heightened reasonable cause defense. The newer reportable transaction understatement penalty is even more severe than the substantial understatement penalty for tax shelters because it provides a more restrictive reasonable cause defense (requiring disclosure), along with a higher rate for undisclosed transactions, and the use of the understatement (rather than the underpayment) as the penalty base.[234] Although congressional justifications for the new penalty were generic and vague,[235] some sense can be made of the fact that the reportable and listed transactions were being singled out and treated differently.

First, the reportable transaction understatement penalty addresses a specific subset of tax shelters. The penalty applies to all listed transactions and any reportable transaction for which the taxpayer has a significant purpose of tax avoidance.[236] Reportable transactions are specific types of transactions that have been identified by Treasury regulations as having the potential for tax avoidance or evasion, and include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest.[237] For both listed transactions and transactions of interest, the transaction has been specifically identified by the IRS through a notice or other publication.[238] The characteristics of confidential transactions, transactions with contractual protection, and loss transactions are also specifically identified by the regulations.[239] While it may be difficult to determine whether a transaction falls under the vague definition of "tax shelter" for purposes of the substantial understatement penalty, it is comparatively easy, for example, to determine whether a transaction constitutes a listed transaction.

Congress was not attempting to define all tax shelters through I.R.C. § 6662A, but it singled out a group of common tax shelter transactions for special treatment. Because listed and reportable transactions are a specifically identified subset of tax shelters, a separate penalty standard for these transactions is justifiable.

234. *See* I.R.C. §§ 6662A(a)-(d) (West 2010); H.R. 108-393, 108th Cong. Title III.A.5 (2003). There is no reasonable cause exception if the transaction is undisclosed.

235. H.R. 108-393, 108th Cong. Title III.A.5 (2003).

236. I.R.C. § 6662A(b)(2) (West 2010).

237. *See* I.R.C. §§ 6662A(d) (West 2010), 6707A(c)(1) (West 2010); Treas. Reg. § 1.6011-4(b) (as amended in 2010); and text accompanying note 44.

238. *See* I.R.C. §§ 6662A(d) (West 2010), 6707A(c)(1) (West 2010); Treas. Reg. § 1.6011-4(b) (as amended in 2010); and text accompanying note 44.

239. *See* Treas. Reg. § 1.6011-4(b)(3)-(5) (as amended in 2010).

Second, the fact that the standard for reportable and listed transactions is stricter than the standard imposed by other tax shelter penalties is also justifiable (although this was also not articulated by Congress). Because these transactions have been specifically identified and described in Treasury regulations, taxpayers are on notice as to whether or not a particular transaction is considered to be a tax shelter and will be penalized as such.[240] Given that Congress has specified which types of transactions need to be reported by taxpayers, it is not illogical to require disclosure to maintain a reasonable cause defense, even though other tax shelter penalties can be avoided without such disclosure.

3. No Justification for the New Strict Liability Penalty

In contrast to reportable and listed transactions, the economic substance doctrine legislation does not identify a narrowly defined subset of tax shelter transactions. It also does not identify a new type of behavior not anticipated by other tax shelter penalties. The doctrine merely provides a legal basis to disallow tax shelter benefits where other substantive provisions of the tax law fall short. Thus, there is no reason to carve out violations of the economic substance doctrine as a unique group of tax shelter transactions deserving of a stricter penalty as compared to other tax shelter penalties.

We don't have an explanation as to why, after the enactment of the new penalty, taxpayers in violation of economic substance doctrine are subject to strict liability, while taxpayers whose transactions constitute a "tax shelter" for purposes of the substantial understatement rules can rely on a reasonable cause defense. What we do know is that the legislative history of both the substantial understatement and economic substance doctrine penalties indicates that Congress wanted to crack down on tax shelters.[241] Given that violations of the economic substance doctrine do not represent a unique subset of tax shelters, and given that there does not appear to be anything more onerous about violating the economic substance doctrine as compared to participating in a tax shelter as defined under I.R.C. § 6662(d), there is no reason for taxpayer defenses to the economic substance penalty to be more limited than the defenses for the substantial understatement penalty for tax shelters.

If Congress felt that the "tax shelter" definition under I.R.C. § 6662(d) was too broad to be treated on par with violations of the economic substance doctrine, perhaps out of concern that the "tax shelter" definition

240. The reportable transaction understatement penalty is only effective for tax years ending after the date of its enactment. *See supra* text accompanying note 62.

241. *See supra* text accompanying note 35; *supra* Part II.B.2.a.

may cover some non-tax shelter types of transactions,[242] then it is unclear why the substantial understatement penalty with respect to tax shelters has a heightened reasonable cause defense at all. If Congress had some other justification for treating violations of the economic substance doctrine more harshly than tax shelters under I.R.C. § 6662(d), it should have articulated this reasoning. Without any rationalization for the differences in these taxpayer defenses, the accuracy-related penalty regime contains inconsistent standards, leading to disparate treatment of similarly situated taxpayers.

In the case of reportable and listed transactions, the disparity in standards is even harder to justify. Although Congress did adopt a provision that provides for strict liability for reportable and listed transactions that also violate the economic substance doctrine, it chose not to make strict liability the standard for all reportable and listed transactions subject to the reportable transaction understatement.[243] The result is simply that when a transaction is subject to both penalties, the standards in the economic substance penalty trump the reasonable cause defense for reportable transactions. In a tax shelter case where a court disallows tax benefits under a substantive provision of the Code and opts not to apply the economic substance doctrine, it appears the reasonable cause defense would still be available to the taxpayer if the reportable transaction understatement penalty is applied.

The fact that taxpayers are on notice as to what constitutes a reportable or listed transaction justifies the more limited taxpayer defenses for the reportable transaction understatement. In contrast, violations of the economic substance doctrine arise in areas of the law that are unclear, when neither statute nor case law is directly on point. Strict liability is not appropriate in the context of the economic substance doctrine given that Congress has explicitly rejected strict liability for listed and reportable transactions.[244]

This discrepancy between the taxpayer defenses to reportable transaction understatements and the economic substance penalty could lead to absurd results. For example, a taxpayer could engage in a listed transaction, but if the benefits are disallowed by the IRS or a court under a substantive provision of the Code rather than the economic substance doctrine, the taxpayer might be able to avoid all penalties if she can meet the heightened reasonable cause and good faith requirements for the reportable transaction understatement.[245] On the other hand, a taxpayer that

242. Schler, *supra* note 214, at 329.

243. H.R. 4872, 111th Cong. § 1409(c)(2) (2010); I.R.C. § 6664(d) (West 2010).

244. H.R. 108-393, 108th Cong. Title III.A.5 (2003).

245. It might be difficult, however, for a taxpayer to demonstrate that she had a reasonable belief that her position was more likely than not correct when the transaction had

engages in a tax shelter that has not yet been identified by the IRS as a listed transaction would not be able to rely on a reasonable cause defense if her tax benefits were disallowed under the economic substance doctrine. In some respects, the first taxpayer engaged in more egregious conduct than the second taxpayer, because the first taxpayer engaged in a transaction that the IRS had specifically identified in advance as a tax shelter. In contrast, the second taxpayer might have engaged in a novel transaction that had not yet been addressed by the courts or the IRS, and taken a good faith position that her claimed benefits were allowable.

After the enactment of the new economic substance penalty, whether taxpayers are on notice as to which particular transactions are abusive is no longer relevant to how the taxpayer will be penalized. The sole factor that determines whether or not a taxpayer can assert a reasonable cause and good faith defense is if the economic substance doctrine was the means by which a court or the IRS chose to disallow the claimed tax benefits. Taxpayers that partake in tax shelters that violate a provision of the Code will be better off than taxpayers that undertake novel transactions that comply with the letter of the Code but are later found to lack economic substance and a business purpose. All of these tax shelter participants should be subject to heightened penalty standards, but the disparities in standards in the new accuracy-related penalty regime do not make sense.

B. Disparities Lead to Disparate Treatment

The discrepancy in standards brought about by the new strict liability penalty frustrates the IRS's and Congress's overall goal of promoting voluntary taxpayer compliance, just as adding a fourth tax shelter penalty frustrates that goal by making the tax shelter penalty regime overly complex.[246]

The IRS's 1989 task force report on civil tax penalties concluded that, in addition to the importance of comprehensibility, an important way to promote voluntary compliance through tax penalties is to ensure that those penalties reflect the fairness of the tax system.[247] Taxpayers who feel that tax penalties are fair are more likely to be motivated to comply with the tax law. The task force further established that an essential aspect of establishing the fairness of the system is for tax penalties to be consistent, which includes consistency with the taxpayer's own prior experience and

been previously listed by the IRS. *See* I.R.C. § 6664(d) (West 2010). There is no reasonable cause exception if the transaction is undisclosed.

246. *See supra* Part IV.B.

247. *See* IRS PENALTY HANDBOOK, *supra* note 193, § 20.1.1.2.2, at 7; Tax Analysts II, *supra* note 194, at 19 (describing the philosophy of penalties), and accompanying text.

consistency between similarly situated taxpayers.[248] The IRS has also reiterated this goal more recently in its Penalty Handbook, stating that taxpayers' "overall confidence in the tax system is jeopardized" when penalties do not apply consistently in similar situations.[249]

The IRS task force went a step further and identified broad principles that should be followed in enacting penalty legislation to ensure that the goals of fairness and consistency are met. One of these core principles includes ensuring that the standards in penalties are logically tied to the level of culpability of the conduct being penalized. The Task Force stated:

> Penalty programs should consistently identify and assert penalties against those taxpayers who are the most culpable either because of the extent of a particular violation or the consistent pattern of violations over time. Those who deviate farthest from a standard of behavior should be the ones who receive the greatest penalty (as well as having the greatest likelihood of getting caught). This may have implications for the design of penalties -- leading to a preference for graduated penalties -- and may have implications for the types of taxpayer information that should be available to IRS.[250]

The task force's emphasis on consistency was also echoed by Congress when it overhauled the former penalty regime in 1989 in favor of a system that was more closely tailored to the goal of promoting voluntary compliance.[251] The importance of consistency has also been highlighted by tax practitioners, including the ABA Section of Taxation, which recently stated that penalties must be both "consistent" and "logical" to be effective in achieving voluntary compliance.[252]

Part IV.B described how the current tax shelter penalty regime has trended away from the IRS and Congress's stated policy of enacting penalties that are simple and easy to understand, and argued that the economic substance penalty further frustrates this policy. Similarly, the varying standards in tax shelter penalties that have evolved over the past three decades are increasingly at odds with the policy of promoting fairness through consistency. The ABA Section of Taxation correctly noted that "[t]he flurry of recent legislation enacting penalties relating to potentially

248. Tax Analysts II, *supra* note 194, at 51.

249. IRS PENALTY HANDBOOK, *supra* note 193, at 7 (describing the IRS's approach to tax penalties). *See also* IRS Policy Statement 20-1, *supra* note 193, at 7 (describing the IRS's approach to tax penalties).

250. Tax Analysts II, *supra* note 194, at 51-52.

251. *See, e.g.*, REPORT ON CIVIL TAX PENALTIES, *supra* note 98.

252. Tax Analysts III, *supra* note 200, at 2 (reporting on ABA Section of Taxation setting forth recommendations for federal civil tax penalty reform). *See also* Report on Civil Tax Penalties, *supra* note 98, at 6 (describing the way in which "penalties should treat similarly situated taxpayers similarly").

abusive transactions had made this area of the penalty regime among the most inconsistent . . . ."[253]

The strict liability aspect of the new economic substance penalty is a significant setback in promoting consistency in tax penalties. The inevitable result of applying strict liability to violations of the economic substance doctrine but not to other tax shelter penalties is that some tax shelter participants will be able to avail themselves of a reasonable cause defense while others who are subject to the new economic substance penalty will not. This is a prime example of similarly situated taxpayers being treated differently.

Part IV.B also argued that Congress should not have enacted a new tax shelter penalty without thoroughly considering the effectiveness of the current accuracy-related penalty regime in addressing violations of the economic substance doctrine. The same principle holds true for the new strict liability standard, and we are left with the impression that Congress did not fully think things through. As the IRS task force observed, fairness and consistency require that taxpayers who engage in more culpable conduct be penalized more harshly than taxpayers who engage in conduct that is less egregious.[254] If Congress wants to introduce a new, stricter penalty standard into the accuracy-related regime, that standard should be clearly tied to the conduct of "those who deviate farthest"[255] from established standards of behavior.

It is possible that the downsides of strict liability are outweighed by the benefits that would be gained in promoting voluntary compliance and deterring taxpayers from participating in abusive tax shelters. However, if Congress's aim is to apply strict liability to tax shelters, then all of the accuracy-related penalties aimed at tax shelters should provide for this standard. If Congress did not intend to impose strict liability across the board, then it should clearly separate and identify only the most egregious conduct for strict liability, leaving a reasonable cause defense in place for less egregious transactions. Regardless of the approach, if the accuracy-related penalty regime is to be perceived as fair and consistently applied, it should be readily apparent to taxpayers why stricter penalties apply to some transactions and more lenient penalties apply to others. The new strict liability penalty for violations of the economic substance doctrine misses the mark here, as it arbitrarily singles out some tax shelters for strict liability without a limitation for only the worst kinds of tax shelters.

253. Tax Analysts III, *supra* note 200, at 6 (reporting on ABA Section on Taxation emphasizing that penalties must be consistent).

254. *See* IRS PENALTY HANDBOOK, *supra* note 193, at 52 (describing the IRS's approach to tax penalties). *See also* IRS Policy Statement 20-1, *supra* note 193, at 7 (describing the IRS's approach to tax penalties).

255. IRS Policy Statement 20-1, *supra* note 193, at 52.

VI. CONCLUSION

This article has argued that enacting a separate penalty provision for violations of the economic substance doctrine was wholly unnecessary in light of the current accuracy-related penalties that are aimed specifically at tax shelters. The new economic substance penalty does not fill a gap left open by these other penalties, but rather adds a redundant, fourth tax shelter penalty to the mix. This inevitably adds undue complexity to the penalty regime, which in turn frustrates Congress's overall goal of promoting voluntary compliance through tax penalties.

This article has further argued that the strict liability aspect of the new economic substance penalty cannot be reconciled with the fact that the other tax shelter penalties provide for various forms of a reasonable cause defense. The only way to properly justify a new tax shelter penalty with strict liability would be to specifically tie that penalty to the most egregious forms of taxpayer conduct. Congress has not done that in the case of the economic substance penalty.

Without a coherent framework that ties stricter tax penalties to more egregious conduct, taxpayers are left trying to make sense of the inconsistent standards in the current tax shelter penalty regime. The only discernible pattern that has emerged from the evolution of tax shelter penalty legislation over the past three decades is that the penalty that is "last in time" is the strictest. Without any coherent explanation from Congress, it is hard not to question whether the economic substance doctrine was singled out for strict liability because the codification of the economic substance doctrine happened to be the latest phase in tax shelter reform. Congress had already tightened the reins on the reasonable cause defense significantly with respect to tax shelters (within the meaning of I.R.C. § 6662(d)) and reportable transaction understatements. If they felt the need to take it one step further, there was nowhere else to go from there but strict liability.

The inconsistencies in the penalty regime also make it easy to understand why critics have suggested that strict liability was included in the new legislation not because it was seen as appropriate for violations of the economic substance doctrine, but because it made revenue estimates higher (making the health care reconciliation bill more palatable).[256] These considerations may be inevitable facets of the political process, but they are not valid justifications for inserting a new strict liability penalty into an already complex tax shelter penalty regime.

256. *See* REPORT ON CIVIL TAX PENALTIES, *supra* note 98, at 1, 4; Stretch et al., *supra* note 98, at 1361; Ventry, *supra* note 71, at 1410; and text accompanying note 112.

APPENDIX A: Taxpayer Defenses to Accuracy-Related Penalties[257]

Non-Tax Shelter Substantial Understatement	**Gross Valuation Misstatement Penalty**	**Substantial Understatement Penalty for Tax Shelters**	**Reportable Transaction Understatement Penalty**	**Economic Substance Doctrine Penalty**
For all taxpayers: Reasonable cause and good faith (§ 6664(c)) Substantial authority (§ 6662(d)(2)(B)) Reasonable basis + disclosure (§ 6662(d)(2)(B)	For all taxpayers: Reasonable cause and good faith (§ 6664(c))	For corporations: Heightened reasonable cause and good faith requiring, at a minimum, substantial authority + reasonable belief that position more likely than not correct (§ 1.6664-4(f)) For individuals: Reasonable cause and good faith (§ 6664(c))	Transactions not lacking economic substance: Heightened reasonable cause and good faith requiring, at a minimum, disclosure+ substantial authority + reasonable belief that position more likely than not correct (§ 6664(d)) Transactions lacking economic substance: None, strict liability (§ 6662(d))	For all taxpayers: None, strict liability (§ 6664(c))

257. The four tax shelter penalties are juxtaposed with the substantial understatement penalty for comparison purposes only. The table does not reflect all accuracy-related penalties, including the penalty for negligence or disregard of rules and regulations under I.R.C. § 6662(b)(1) (West 2010).