2006 ERWIN N. GRISWOLD LECTURE BEFORE THE AMERICAN COLLEGE OF TAX COUNSEL:

NOW THAT YOU'VE CAUGHT THE BUS, WHAT ARE YOU GOING TO DO WITH IT? OBSERVATIONS FROM THE FRONTLINES, THE SIDELINES, AND BETWEEN THE LINES, SO TO SPEAK

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First, let's start with the adult attention deficit disorder version:

1. The tax shelter war is over. The government won.
2. There is no one-size-fits-all solution to abusive tax shelters of the future or tax avoidance concerns.
3. Tax avoidance is not inherently evil.
4. The weapons used to win the abusive tax shelter war will be of limited use in addressing tax compliance concerns of today and tomorrow.
5. The tax system is in serious need of repair.

Now you can go back to your blackberries.

I. THE TAX SHELTER WAR IS OVER. THE GOVERNMENT WON.

Taxpayers may have won a skirmish here and there, the paths may have been uncertain, but the outcome was never in doubt.

How do we know the war is over?

On the corporate side, companies are too busy complying with Sarbanes-Oxley,[1] electronically filing their Schedules M-3 and Forms 8886, and implementing FIN 48 to have time for tax shelters. A recent survey by accounting firm Ernst & Young confirms this.[2] The survey, which was based on data from 474 companies, indicated corporate tax departments were spending 23% of their time on tax financial reporting requirements in 2006, compared to 9% in 2004. During the same period, the time spent on tax planning decreased from 28% to 20%. The increased demands in financial reporting and tax compliance will continue to reduce companies' ability to plan or implement tax minimization strategies, legitimate or otherwise.

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[1]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

[2]Ernst & Young's recent Global Tax Risk Survey showed that companies are devoting more time to tax compliance and financial reporting and less time to tax planning. *Firms Increase Resources to Meet Reporting Requirements, Survey Says*, DAILY TAX REP. (BNA), Dec. 7, 2006, at G-9 (discussing Ernst & Young's Global Tax Risk Survey 2006).

On the individual side, the promoters, by and large, have been decommissioned. Commissioner Mark Everson stated in written testimony before the Senate Homeland Security and Governmental Affairs Committee, "[w]e are seeing evidence of changed behavior in the marketplace on the part of tax professionals, including accountants and lawyers. No longer are abusive tax shelters being marketed by top level accounting firms."[3] Commissioner Everson is not known for his optimism about the government's ability to quell tax shelters, but his statement, which he reiterated at the Tax Section's breakfast yesterday morning, recognized that the government had turned the corner.[4]

The lack of product affects both businesses and individuals but has a more significant impact on the individual side. Individuals are less likely to cook up tax shelters on their own. They need inspiration.

How did the government win the war?

It took the consistent efforts of multiple parties. Former Commissioner Charles Rossotti laid the groundwork by revitalizing and reorganizing the agency. Every Commissioner, it is said, "reorganizes" the agency, but Commissioner Rossotti did not just move boxes around on an organizational chart. He put a structure in place that allowed the Service to pursue tax shelters in a centralized, coordinated, and organized way that shut the sheltering activities down.

After considerable hand-wringing about its lack of tools to address tax shelters, the Treasury Department began using the authority it had to create an effective disclosure regime for identifying and addressing tax shelter transactions. It is worth noting that while the first regime was not all that effective in surfacing problems, it laid down a marker, and a review of its shortcomings led the Treasury Department in a brief period of time to the development of a more effective regime.

Commissioner Everson's commitment to enforcing the law unequivocally put words into action. With a firm view that paying one's taxes is a civic obligation that ought not be shirked, Commissioner Everson has pursued enforcement tenaciously and has been willing to let the chips fall where they may. Building on the reorganization Commissioner Rossotti put in place, Commissioner Everson has succeeded in forcing the agency to rethink its goals and how it goes about achieving them. A recent *New York Times* news article—and I use the term "news" loosely—illustrates how difficult it is to reform an agency of individuals who would prefer to keep doing business the comfortable way they have always done business without regard to the harm their old ways cause the tax system.[5] The Commissioner and I do not always agree on tax administration, but I admire what he has tried to accomplish in reshaping the agency.

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[3]*Everson Calls for 'Fundamental Reform' to Deal with Tax Gap*, 2006 TAX NOTES TODAY 187-36 (Sept. 26, 2006). The real challenge to the system is that the large businesses are otherwise occupied, but the agency continues to concentrate on them when the largest compliance concerns are in the small business or self-employed sector of the economy.

[4]*See Everson to Tax Bar: You Should Do More*, 2007 TAX NOTES TODAY 14-3 (Jan. 22, 2007) (discussing Commissioner Everson's remarks to the American Bar Association Section of Taxation on January 19, 2007).

[5]*See* David Cay Johnston, *Agents Say Fast Audits Hurt I.R.S.*, N.Y. TIMES, Jan. 12, 2007, at C1.

I hesitate to give Congress any credit, since I believe they helped create the problem through actions like the 1997 Senate Finance Committee hearings,[6] but ultimately Congress's support for the Treasury's tax shelter proposals and the Service's compliance programs sent a powerful message that tax shelter activities had risen to a level of nonsense that even Congress would not tolerate. I would add that tax shelters were largely a thing of the past by the time the 2004 tax shelter legislation was finally enacted.[7]

Tax practitioners, particularly members of the Bar, also played an important role by speaking out against tax shelter transactions and advocating for anti tax shelter measures.[8]

Armed with arguments carefully honed by government lawyers,[9] the courts backstopped the Service's efforts, not quite universally, but with more than enough frequency for taxpayers to realize the courts were an unreliable refuge. Despite the fact that there are still billions of dollars in tax shelter transactions pending resolution in the courts, the clear trend has been in favor of the government.

Finally, the transparency brought about by the tax shelter disclosure web,[10] Schedule M-3, and Sarbanes-Oxley had an effect similar to the passive loss rules of section 469 enacted in 1986. The new regime was not as prophylactic as section 469, but the added risk of detection reduced the benefit *and* the likelihood of benefit, eliminating much of the incentive for corporations to engage in tax shelter transactions.

A telling sign of the impact of the government's success is the result of the Service's Son of BOSS settlement initiative announced in May 2004. Over 1,000 taxpayers responded, conceding 100% of the tax owed, and paying the Service over $3 billion in tax, interest, and, in almost all cases, penalties.[11]

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[6]The Senate Finance Committee held a series of hearings in September and December of 1997, and January and February of 1998, which examined both the internal and public conduct of the Service, including taxpayer rights. These hearings led to the I.R.S. Restructuring and Reform Act of 1998. *See* S. REP. NO. 105-174, at 7 (1998).

[7]*See generally* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

[8]*See, e.g., ABA Release on "Serious Threat" of Corporate Tax Shelters*, 1999 TAX NOTES TODAY 216-39 (Nov. 10, 1999). Two Griswold lectures have addressed the problem. James P. Holden, *1999 Erwin N. Griswold Lecture before the American College of Tax Counsel: Dealing with the Aggressive Corporate Tax Shelter Problem*, 52 TAX LAW. 369, 374 (1999) (proposing revisions to Circular 230 as a way to curb aggressive transactions). Former Commissioner Randolph Thrower also focused on the ethical issue in his 2001 lecture. *See* Randolph W. Thrower, *2001 Erwin N. Griswold Lecture before the American College of Tax Council: Is the Tax Bar Going Casual—Ethically?*, 54 TAX LAW. 797 (2001).

[9]*See Remarks to the Texas Federal Tax Institute*, 2002 TAX NOTES TODAY 110-29 (June 6, 2002) [hereinafter *Alamo Speech*] (describing measures being implemented by the Service in conjunction with the Department of Justice to combat abusive tax shelters). *See also Korb Touts Technical Guidance Advice, Court Trends in IRS's Favor*, 2007 TAX NOTES TODAY 14-2 (Jan. 19, 2007) (discussing Chief Counsel Donald Korb's remarks to the American Bar Association Section of Taxation regarding the Service's streamlined guidance procedures and the Government's recent successes in court).

[10]Reg. §§ 1.6011-4, 301.6111-2, 301.6112-1.

[11]MICHAEL R. PHILLIPS, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, THE SETTLEMENT INITIATIVE FOR INVESTORS IN A VARIETY OF BOND AND OPTION SALES STRATEGIES WAS SUCCESSFUL AND SURFACED POSSIBLE NEXT STEPS FOR CURTAILING ABUSIVE TAX SHELTERS 2006-30-065 (2006). Note that a news report of the TIGTA study, cites a higher dollar figure than the figure cited by the study. *TIGTA Declares Son-Of-Boss Settlements a Success; Calls for Longer Statutory Assessment Periods*, 2006 TAX NOTES TODAY 65-9 (Apr. 5, 2006).

It is important to remember two points about the tax shelter activities that I believe are a thing of the past—for now. The first is that they were but a part of an anything-goes attitude that infected many businesses, professional services firms, and individuals during the 1990s. Viewing these tax shelters as limited to an attack on the tax system misses the broader context in which tax shelters had to be understood and addressed. The second is the fact that tax shelter activities were aided and abetted by the regulators—Treasury and the Service, in this case—talking tough but wringing their hands in lieu of acting. (That is not intended as a criticism of the regulators but rather the environment in which they found themselves—particularly the political environment. If I'd been in the government following the 1997 hearings, sitting on my hands may well have looked like a prudent course of action.) The problem is that the regulators' tough words weren't matched by tough actions and that emboldened the fast and loose.

The facts tell the story of the results of inaction. From 1997 to 2000, over 3,000 transactions were registered with the Service by promoters.[12] The Service issued a number to the promoter for the transaction, which the promoter flashed to potential investors like a good housekeeping seal of approval, and then the Service put the registrations in a file drawer to gather dust. Even promoters who knew the registration number did not reflect the Service's approval took the lack of any action as acquiescence to the purported tax consequences of the transaction. Taking inaction as tacit acquiescence ultimately was a mistake with serious consequences for many promoters.[13] But the Service empowered promoters by failing to act while it had it within its power to rein in tax shelter activities before they got completely out of control. Of course no one living in the real world today would accuse the Service of sitting on its hands. Rather the issue for those giving it serious consideration is what the Service is, and should be, doing.

Despite the evidence of success, there continues to be legislative interest in doing something final, something definitive, something dramatic, that will kill all shelters for all times. There is reason for concern about the government's penchant for fighting the battles of the past rather than focusing on the future. The continuing fascination with codification of the economic substance doctrine illustrates that penchant well.

II. THERE IS NO ONE-SIZE-FITS-ALL SOLUTION TO THE TAX SHELTERS OF THE FUTURE OR TO TAX AVOIDANCE CONCERNS.

For several years now, proposals to codify the economic substance doctrine have been circulated, extolled and criticized, debated by Congress, and nearly enacted into law.[14] With the Democratic takeover of Congress, and return to pay-as-you-go,

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[12] *See Office of Tax Shelter Analysis (OTSA) Report to Treasury*, 2001 TAX NOTES TODAY 250-11 (Dec. 18, 2001).

[13] *See, e.g., KPMG Admits to Criminal Violations, Agrees to Penalty as Prosecution Deferred*, 2005 TAX NOTES TODAY 167-3 (Aug. 29, 2005).

[14] *See, e.g.*, Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, 109th Cong. (2006) (enacted without the provision codifying the economic substance doctrine that was included in the Tax Relief Act of 2005, H.R. 4297, as passed by the Senate, 109th Cong. § 411 (2006)).

some Hill staff have stated that codification of the economic substance doctrine is a near certainty.[15] Congressional revenue estimators have attached huge revenue scores to the proposal with the view that codification of the economic substance doctrine would strengthen the Service's hand in litigation and deter tax shelter activity.[16]

Rather than strengthening the Service's hand, a more likely outcome is that codification would result in ossification, depriving the doctrine of the flexibility that is its strength.[17] The government's string of victories is perhaps the best evidence that codification is unnecessary, and that the Service has many more arrows in its quiver than the two-prong business purpose and prospect for profit formulation. While proposals to codify the economic substance doctrine are phrased as a supplement to, and not as a replacement for, the doctrines applied by the courts, the practical reality is that many courts would treat the codification as a limit on their ability to sculpt an analysis to fit the facts before them.

The variation in the ways in which the courts analyzed the transactions—each court basing its decision on the peculiar issue and facts before it—illustrates the importance of flexibility in the analysis. The *Castle Harbour* court concluded a foreign partner was a lender, not a partner.[18] The *Coltec* court reversed a constitutional challenge to the economic substance doctrine and concluded the taxpayer lacked a business purpose for one small, but crucial, step in the transaction.[19] The *Dow* court found no prospect for profit.[20] The *BB&T* court concluded the taxpayer had not acquired a current leasehold interest.[21]

The recent cases also illustrate the uncertainty that the doctrine creates, even without codification. The multiple lines of analysis used by the courts to address tax shelter transactions present issues for taxpayers and the tax administrator alike. The analyses will be difficult to apply, to extrapolate, and, perhaps most important, to contain. What, for example, will the government do with the debt-equity analysis in *Castle Harbour*? *Castle Harbour* involved a foreign lender that was a partner in form but, according to the court, with protection against downside risk and an "insignificant" equity kicker. It might be likened to preferred stock issued by a highly rated corporation. Will the Service restrict the decision to situations in which the nominal partner is a tax-indifferent lender that books its partnership interest as a loan? Or will it attempt to apply the analysis whenever a case involving

[15]It was recently reintroduced in the Senate. *See* Export Products Not Jobs Act, S. 96, 110th Cong. § 201 (2007).

[16]Ironically, some staff admit that it may be ineffectual but seem held hostage to the revenue estimate.

[17]At a minimum, the government's recent courtroom successes suggest that the price tag on codification should be reconsidered.

[18]TIFD III-E, Inc. v. United States, 459 F.3d 220, 224 (2d Cir. 2006) (*Castle Harbour*).

[19]Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1359-60 (Fed. Cir. 2006).

[20]Dow Chem. Co. v. United States, 435 F.3d 594, 605 (6th Cir. 2006).

[21]BB & T Corp. v. United States, 2007-1 U.S.T.C. ¶ 50, 99 A.F.T.R.2d 376 (M.D.N.C. 2007).

nominal equity produces a tax result the government finds, for whatever reason, offensive?

Of particular interest is that the result the taxpayer claimed in *Castle Harbour* was created by the Service's own complicated regulations and could have been subject to attack under those regulations. Rather than arguing the regulations, however, or stopping at correcting them prospectively, the Service sought to undo the result with a substance over form analysis. Assuming the regulations permitted the result sought by the taxpayer in *Castle Harbour*, the decision poses interesting questions. Does a free-floating economic substance doctrine permit the Service to undo the unintended results of its or Congress's drafting, thereby protecting the tax base from unfair incursions? Or does it promote laziness and sloppy thinking that deprives taxpayers of certainty and causes a loss of respect for the tax system as a system of laws and not of men?

The economic substance doctrine should be a tool of statutory construction. An economic substance analysis that is not moored to the relevant statutory provision gives no basis for determining whether the doctrine should be invoked. The substance over form branch of the economic substance doctrine is tethered to the relevant provision because it asks whether what the taxpayer did is that for which the statute provides. Mrs. Gregory lost because the pieces of paper she prepared were not the reorganization of a corporation described in the statute.[22]

Few would contend that a taxpayer should be able to attach whatever label it chooses to a document and expect the Commissioner to give the label tax effect. But more often than not, form controls. The reason for that may be simple practicality. Substance is facts and circumstances. How would one begin to establish parameters for, say, drawing a precise line between debt and equity based on facts and circumstances? What of the myriad other distinctions and lines drawn in the Code?

In an audit of a client a few years back, the Service hired an academic to determine whether AAA-rated debt issued by the client was equity. The academic dutifully constructed an algorithm to do just that. As I recall the theory, true debt was captured by the Treasury risk-free interest rate. The algorithm measured the equity portion of the bonds by the excess of the interest rate over the Treasury rate. Were the tax system to run on his algorithm, it would undoubtedly result in a substantial portion of highly-rated preferred stock being classified as debt—with deductions for the happy issuer and loss of favorable tax rates for the unhappy holders—and a substantial portion of non-investment grade debt being classified as equity—again with a reverse in expectations for the issuer and holder.

Professor Ginsburg once observed that tax should follow form because the substance is ambiguous.[23] The tax system would not function long if it were compelled to rely on algorithms. Moreover, a full attempt to tax consistent with the substance

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[22]Gregory v. Helvering, 293 U.S. 465, 469-70 (1935).

[23]The credit of the statement to Professor Ginsburg is based on the author's recollection. Although Professor Ginsburg thinks he might have said it, he could not confirm it. I am giving him credit because I know I am not the originator.

could never work in a tax system as antiquated and arbitrary as ours, and it is entirely inconsistent with its optionality.

The two-prong business purpose and prospect for profit branch of the economic substance doctrine has none of the tethers of substance over form. Thus, it functions much less as a tool of statutory construction and much more as a free-floating disallowance rule. It gives the tax administrator discretion fettered only by the courts and the taxpayers' willingness to pursue judicial review. The determination of a business's tax liability is rarely black and white. Numerous judgment calls regarding facts and the law support a business's determination of its tax liability. An untethered economic substance doctrine allows the government to challenge even routine judgments simply because it does not like the tax result achieved.

Codification of the two-prong test would confirm its role as a general anti-avoidance rule. The Service struggles now to determine when to argue the economic substance doctrine. How much more difficult would codification make that task? How much would it increase taxpayers' uncertainty? Codification would likely increase its invocation as a primary attack, thereby increasing the uncertainty taxpayers face in planning their affairs.[24]

Codifying the economic substance doctrine would stand in stark contrast to the long standing principle that a revenue raising law should be construed against the drafter. In *Gould v. Gould*, the Supreme Court stated, "In case of doubt [tax statutes] are construed most strongly against the government, and in favor of the citizen."[25] Although taxpayers may be much savvier today and the government less

[24]Former Chief Counsel B. John Williams and current Chief Counsel Donald Korb both have emphasized that the economic substance doctrine cannot and should not be the primary mode of attack. In one of his first public appearances, Williams called "less than satisfactory" the Service's tendency to raise the economic substance "all the time" and stated that it was something he intended to change. *See IRS Official Sketches Agenda for Office of Chief Counsel*, 2002 TAX NOTES TODAY 48-4 (Mar. 11, 2002). Rather, Williams highlighted a broader strategic approach to the tax shelter problem that involved guidance, strategic litigation, and strategic resolution. *See, e.g.*, *Alamo Speech*, *supra* note 9; *IRS Chief Counsel's Speech to Tax Executives Institute*, 2002 TAX NOTES TODAY 195-84 (Oct. 7, 2002). In 2005, Williams' successor, Korb, emphasized that the doctrine "should be used only rarely and judiciously" and emphasized its role as a tool of statutory construction. *See Korb Gives Speech on Economic Substance Doctrine*, 2005 TAX NOTES TODAY 16-22 (Jan. 25, 2005).

[25]245 U.S. 151, 153 (1917) ("In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out."); *see also* Princess Cruises Inc. v. United States, 397 F.3d 1358, 1362 (Fed. Cir. 2005) ("The trial court's decision was based on the canon of construction pronounced in *Gould v. Gould* . . . that ambiguities in tax statutes 'are construed most strongly against the government and in favor of the citizen.'"); Royal Caribbean Cruises, Ltd. v. United States, 108 F.3d 290, 294 (11th Cir. 1997) ("This interpretation is consistent with the general rule of construction that ambiguous tax statutes are to be construed against the government and in favor of the taxpayer. *See* . . . *Gould v. Gould*"); United States v. Brown, 536 F.2d 117, 122 (6th Cir. 1976) ("Our conclusion is consistent with the general rule established in *Gould v. Gould*" . . . where the Supreme Court interpreted a substantive taxing statute, stating: 'In case of doubt they (tax statutes) are construed most strongly against the government, and in favor to the citizen.'"); Greyhound Corp. v. United States, 495 F.2d 863, 869 (9th Cir. 1974) ("Tax statutes are not to be extended by implication beyond the clear import of the language used and, in case of doubt, are construed most strongly against

so—though I doubt that is the case—than was the case in 1917 when *Gould* was decided, as a policy matter, a free-floating economic substance doctrine, like other anti-abuse rules, is difficult to square with a rules-based system.

Former Chief Counsel B. John Williams referred to anti-abuse rules as "abusive anti-rules" because they allow the government to choose when to ignore the rules.[26] Such is the case with the economic substance doctrine. It allows legislators to be lazy. Rather than having to think carefully through the consequences—intended and unintended—of proposed legislation, it lets them shirk responsibility and leave it to the tax administrator and the courts to fix the unintended result.

The economic substance doctrine may also promote sloppy thinking by the tax administrator. Labeling a transaction "abusive" is an emotional reaction, not an analytical response. Rather than a careful analysis of the relevant statutory or regulatory provisions, it allows the tax administrator to attack every transaction it finds offensive without bothering with the analysis the taxpayer was compelled to apply. Taxpayers may believe this unfair. From the government's perspective, it is also risky. The tax administrator may miss compelling statutory or regulatory arguments that would have produced a decision for the government in cases when the courts decline to invoke economic substance.

Despite all the news about the tax gap, this country has a remarkably strong self-assessment system. Voluntary compliance is strong because people respect the system; they believe fundamentally that the system is fair. We will do well to insure that perception continues by minimizing the opportunities for tax avoidance. Respect for the system is also linked to taxpayers' perception that the system is fairly administered and they have been treated fairly. Actions that lead to the view that the system is unfair will ultimately harm voluntary compliance. Codification of the economic substance doctrine—or its careless use—could have that result because it is one-sided access to equitable relief. Courts do not grant taxpayers equitable relief. There is no comparable out when the rules produce a nonsensical and harmful result for taxpayers.

The foundation for confidence in our country is that we have a government of laws and not of men. Despite the current flap about transparency at the Service, there is no question that one's tax liabilities are not negotiated in private with

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the government . . . *Gould v. Gould*"); State Farm Mut. Auto. Ins. Co. v. United States, 200 F. Supp. 324, 338 (S.D. Ill. 1961) ("[C]onstruction must take place in the light of the well-established rule that a Revenue Statute will be strictly construed against the State, and in favor of the taxpayer. Where there is a reasonable doubt in the meaning of a revenue statute, it will be resolved in favor of the party taxed. . . . The leading case on this rule is *Gould v. Gould* . . ."); United States v. Hurst, 2 F.2d 73, 80 (D. Wyo. 1924) ("[R]evenue statutes must be more strongly construed against the government and in favor of the citizen in case of doubt. *Gould v. Gould* . . . . ").

[26]For a discussion of the difficulties of anti-abuse rules, see Frank V. Battle, Jr., *The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax System*, 48 TAX LAW. 801 (1995). Writing as part of a compendium on anti-abuse rules prompted by the promulgation of the partnership anti-abuse rules, Reg. section 1.701-2(b), Frank concludes that "[o]ne can only question the wisdom and effectiveness of an anti-abuse rule that spawns more and more rules, examples, and explanations, each with a level of specificity that obscures broader policies, thus creating new opportunities for abusive transactions." *Id.* at 806.

the tax administrator.[27] The flip side is that the tax laws give breaks to taxpayers. Structuring one's affairs to take advantage of them is not inherently evil.[28] Taxpayers should not be subject to the whim of the administrator or the courts. Visceral reactions should not factor into the equation. Neither should serendipity.

III. TAX AVOIDANCE IS NOT INHERENTLY EVIL.

If tax avoidance were inherently evil, Congress should not have enacted exclusions like section 101, deductions like section 162, recognition exceptions like sections 301, 351, 368, 721, or 1031 *et seq.*, credits like section 30, or elections like section 1362. It may be difficult to determine whether a Code provision has been used as Congress intended—and there may be charges that it has not—but with the ever-expanding panoply of available exclusions, deductions, elections, and credits, it is clear the largest purveyor of tax shelters is the United States Congress.

As a practical matter, the Code appears to turn on serendipity. A may dispose of her interest in Whiteacre and acquire an interest in Blackacre without recognizing gain but only if she convinces B to swap interests and to do so within the parameters of section 1031. Recognizing that section 1031 was likely intended to cover more than A's and B's swaps of Whiteacre for Blackacre, and that Congress likely intended the deferral of gain if the taxpayer maintained a like-kind investment, the courts declined to narrowly circumscribe the statutory provision and an enlightened Treasury eventually issued rules to permit "safe swaps."[29] While some would argue that section 1031 should be repealed, rather than liberally interpreted, the safe swaps regulatory guidance has made the application of section 1031 much less a matter of happenstance, and that is a good thing.

If the Code turns on serendipity, so too will taxpayers' tax liabilities. Overlaying the economic substance doctrine on our arbitrary and antiquated but rule-based system will cause the serendipitous results to multiply. As a practical matter, if two taxpayers have undertaken exactly the same action but get very different tax results, something has gone awry. The overlay of a business purpose and prospect for

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[27]The Service does not sit around plotting how to give one taxpayer a deal without making it available to others. To the contrary, its efforts at consistency in treatment of taxpayers threaten at times to topple administration of the system.

[28]Two of the luminaries of the tax bar questioned the inquiry into motive four decades ago, noting the challenge of looking to motive or "state of mind" to determine the proper tax treatment. *See* Edwin S. Cohen, *Tax Avoidance Purpose as a Statutory Text in Tax Legislation*, 9 ANN. TULANE TAX INST., 229 (1960); Walter J. Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967). Eddie Cohen stated it well almost 50 years ago when he said: "if two taxpayers engage in identical transactions the income tax result should be the same for both, even though one of them may be motivated in part by the knowledge that his taxes will be reduced thereby and the other may be ignorant of the tax effect or give no substantial consideration to it." Cohen, *supra*, at 231.

[29]*See, e.g.*, Starker v. United States, 602 F.2d 1341, 1355 (9th Cir. 1979). The Treasury Department and the Service ultimately promulgated regulations governing the qualified intermediary structure. *See* Reg. § 1.1031(k)-1.

profit test will increase the likelihood of such inconsistent results. I was involved in a mediation recently that turned on the applicability of an accounting provision, one that has been "abused" mind you, but abused in the sense that taxpayers tried to bring themselves within it without actually following its requirements. This case involved a taxpayer who had followed the strictures, and therefore was properly applying the provision, or so it thought. The Service disagreed about whether it had followed the strictures, and, moreover, took the position that penalties should apply because the taxpayer had no business purpose for following the strictures. A taxpayer with a business purpose for following the strictures will get favorable accounting; one without will not. Two taxpayers. Identical actions. Opposite tax results.

Rules should be written so that we are content with the result whether the taxpayer is applying the rule because the facts coincidentally bring it within the rule's ambit or because the taxpayer has planned its way into it.

One of the interesting points about the statutory language drafted to codify the economic substance doctrine is that it has provided no instruction regarding when the doctrine should be applied. That has been attributed to wanting to leave the government with maximum flexibility in applying it.[30] This is another way of saying that legislators have been unable to articulate when the doctrine should apply and when it should not. Thus, the challenge is handed off to the Service, the courts, taxpayers, and their advisors. No change from the current situation. To the extent the judicial doctrine has been ineffective in preventing the erosion of the tax base it is at least partially attributable to assertions that the doctrine doesn't apply to particular statutory provisions or particular factual situations. Without guidance on when the doctrine will be applied, those who choose to may avoid the doctrine's implications.

Aided and abetted by lawyers. We hear a constant clamor in Washington for more rules: "[T]here ought to be a law!"[31] As Bayless Manning and then Gordon Henderson observed, however, more rules do not necessarily bring greater clarity.[32] More rules may merely breed more ambiguity, as though there were a natural law of conservation of ambiguity. So long as there are lawyers interpreting the tax laws there will be taxpayers taking advantage of ambiguities.

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[30]*See* S. REP. No. 109-336, at 138-39 (2006) ("The provision does not change current law standards used by courts in determining when to utilize an economic substance analysis. Also, the provision does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine. The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.") (Report to accompany the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, S. 1328, 109th Cong., which included a provision that would have codified the economic substance doctrine).

[31]I could not top Bayless Manning's description of this phenomenon in 1977: "Hyperlexis is America's national disease — the pathological condition caused by an overactive law-making gland." Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767, 767 (1977).

[32]To paraphrase Manning, we are drowning in the Code. *See id.* ("[W]e are drowning in law."); *see* Gordon D. Henderson, *Controlling Hyperlexis-The Most Important "Law And . . ."*, 43 TAX LAW. 177, 183 (1989).

Lawyers are literalists. We parse words and mine distinctions. We split hairs to achieve or prevent a particular result. The distinction need not be meaningful, just a distinction. It must be noted, of course, that many statutory and regulatory provisions are drafted the same way and that meaningless distinctions have tripped up many a taxpayers' quest for a tax break. Somehow whether a distinction is meaningful or meaningless depends on which side of it we want to come out. Of course, we are also trained in the art of persuasion. We can make mountains out of molehills and molehills out of mountains depending on what circumstances require. Sometimes successfully. Sometimes not. A recent appellate decision dispensed with the taxpayer's mountainous distinctions between its transaction and the transaction in a prior adverse decision of the court by stating that so far as the court could tell, the only real difference was that the taxpayer had not negotiated its deal in Bermuda.[33]

As lawyers we are also trained to do the opposite: to distill a case, a ruling, a statutory provision to its essence—the principle of law for which it stands. Having distilled a case or ruling to its essence, we take the principle and apply it more broadly without looking back to the context for the conclusion. But the process of distillation, particularly of a case or ruling, can result in the evaporation of significant nuances upon which the result depended. Thus, the constraints that ought to guide application of the principle are lost. If the facts and circumstances are considered, the process of finding meaningful or meaningless distinctions begins again.

That is what lawyers do. Our literalism bears part of the blame for the complexity of the Code and regulations and for the perceived need for anti-abuse rules. So does our distillation of the law. Inquiries into business purpose or a taxpayer's "intent" will not mitigate those problems.

Much of the blame for circumvention of the tax laws rests squarely on the policies the tax law is intended to implement and the absurd line drawing in the Code. What better example is there than the section 199 manufacturing deduction, which favors a particular economic activity, though the concept of "manufacturing" was stretched beyond recognition by the end of the legislative process. The result: many pages of regulations to define what qualifies as manufacturing and what does not, and many pages of regulations to explain how to calculate the benefit for manufacturing and exclude that which does not qualify. The complexity and arbitrariness are a real danger because they promote an environment where "self-help" is acceptable.

One can only color within the lines if one can see where the lines are. The same may be said for the government: how does it know whether the crayon stayed within the line if the line cannot be seen? One reason there is so much discomfort with the branches of the economic substance doctrine is that the cases and rulings

[33]Saba P'ship v. Commissioner, 273 F.3d 1135, 1141 (D.C. Cir. 2001).

in which it is articulated and applied are extremely difficult to distill into elements or factors that may be applied to other situations. Moreover, the cases themselves are not easily reconciled. As a consequence, it is difficult to know if the taxpayer has avoided taxes as Congress intended or crossed an invisible line putting the avoided taxes back on the table. Codifying the economic substance doctrine is likely to add nothing but confusion about the availability of congressionally granted tax avoidance opportunities.

IV. THE WEAPONS USED TO WIN THE ABUSIVE TAX SHELTER WAR WILL BE OF LIMITED USE IN ADDRESSING TAX COMPLIANCE CONCERNS OF TODAY AND TOMORROW.

I assume it is obvious by now that my references to tax shelters are to the risk-free, quick trade, no upside or downside deals so prevalent in the 1990s and the early part of this decade—transactions that most practitioners would agree lack economic substance, however defined. Those deals are gone—perhaps not forever, but certainly for now. Obviously, the passing of tax shelters as we knew them does not mean we ought to have no concerns about the health of the tax system, but the compliance problems of today and tomorrow are not the abusive tax shelters of the past. We face a serious risk if we continue to look at the problems as "abuses," thereby wasting a lot of resources for the government and taxpayers and squandering opportunities to reevaluate the statutory provisions and the policies they implement.

The weapons used to win the abusive tax shelter war are not a silver bullet solution to the tax compliance concerns of today and tomorrow. Continuing to treat them as such will get in the way of a thoughtful evaluation of whether the tax avoidance is good or bad, whether it was intended or unintended, whether it merits the tax administrator stepping in or whether it should be turned over to Congress for statutory change. Even results that appear unintended may be the creation of congressional policy, sound or not. The statutory scheme may be the result of an unhappy compromise. It may result from an inability to craft rules that reach a perfect result. It may reflect policies completely invisible from the surface but that nevertheless carry out congressional decisions. The point is that judgments about whether tax avoidance is good or bad should only be made with a full understanding of the underlying policy and an appreciation of the results the statutory provision necessarily produces.

Commissioner Everson's testimony before the Senate Finance Committee in June of last year indicated that the Service has moved beyond the tax shelters of the past.[34] His testimony focused on concerns in the international area—transfer pricing, transfers of intangibles, hybrid instruments, and entities—and fairly mundane provisions such as the R&D credit, the manufacturing deduction, and executive compensation—provisions that are difficult to comply with and difficult to administer, but not provisions that it is reasonable to characterize as tax abuses.

[34]IR-News Rel. 2006-94, 2006 U.S. Tax Rep. (RIA) ¶ 86,304.

So-called arbitrage transactions, which have gotten considerable attention of late, are a good example of that. Tax considerations factor into the structures—both planning to avoid double taxation and planning to take advantage of minimization opportunities—but the transactions are real and use the tax rules as they were designed. Often the transactions make use of the fact that tax systems around the globe cannot sing—or at least they can't sing in harmony. While harmonization would do much to simplify the job of the tax administrator and of the tax planner, a review of the disharmony among the 50 states is probably a good indicator of the likelihood of harmonization in the international arena. Don't look for it anytime soon.

Our system of international taxation leaves much to be desired. It is exceedingly complex and often produces surprising—and therefore presumably unintended—results. Many believe that a territorial system like those of many of our major trading partners would be a more sensible system. It would mean the end (more or less) of the foreign tax credit, the need for foreign tax credit planning, and of opportunities for cross-crediting which can reduce a multinational business's effective tax rate. It would also increase pressure on transfer pricing. Advocates of capital export neutrality, of which the number may be shrinking, fear that a territorial system would cause a flood of investment abroad. However, the rising wealth of the 95% of the market that resides outside the United States is doing that on its own. Business needs and market demands, not taxes, are driving the investment decisions.

The foreign tax credit provisions of current law are an elaborate set of rules that represent competing views and policies and previous legislative trials and errors. In a simple world, we can describe the result the rules should produce. In a complex world, the results break down. Consequently, the rules are far from perfect. There have been efforts over the years to improve the extent to which they match income and credit but anything more than rough justice may be beyond us, regardless of how elaborate or nuanced the rules. The United States may eventually adopt a territorial system, but until it does, we will have to contend with the current system. In the meantime, the fact that the results are imperfect, or even surprising, should not give license to upset them except in the context of a thoughtful revision of the rules.

It is interesting to note that the biggest recognized compliance problem today falls in the area of unreported income and overstated deductions of small businesses and the self-employed. Yet it is an area that attracts little attention from the media, deep thinkers, policy makers, or Congress. Fixing small business and self-employed compliance problems is far less sexy and much harder work than lambasting big businesses. Witness the *New York Times*' negative coverage of the Service's best-run division. It is also far more controversial. Small business has its own committees on the Hill, and committee members leap into the fray against the most modest of proposals to address small business compliance concerns. Not that the committees' concerns are completely invalid. Too often proposals to clean up compliance concerns end up as nothing more than additional paperwork for the already compliant. Too often the law is "enforced" rather than "adminis-

tered," costing taxpayers untold dollars and hours trying to establish the lack of a problem.

The current focus on the tax gap is fraught with similar peril—a measure intended to catch the noncompliant can quickly morph into a costly administrative burden ensnaring the compliant. To state the obvious, anti-abuse rules are no fix for these concerns—they would only exacerbate the problem. Addressing these issues requires a thoughtful reconsideration of our tax system.

V. THE TAX SYSTEM IS IN SERIOUS NEED OF REPAIR.

Much of the debate over tax reform has been over whether to fix the income tax or adopt a consumption tax in income tax drag. The President's Tax Reform Panel proposed both.[35] In the last couple of years, the nature of the debate has become clearer. Advocates of a consumption tax argue that expensing, thereby removing tax on the risk-free return on capital, is the key to greater economic growth. In the past, consumption tax advocates have talked about "eliminating" the tax on capital causing great consternation for those concerned about the shift in tax burden to the segment of the population that is "capital-less."

Expensing does not, however, eliminate the tax on capital.[36] It does, at least in the academic laboratory setting, neutralize the effect of the tax system on different kinds of investment. Given our revenue scoring conventions, it also costs the government a lot of money. That being the case, rates would have to be higher in a consumption tax than would otherwise be the case. Some have asserted that expensing makes higher tax rates far less important. That can only be the case if we are indifferent to extraordinary returns. Perhaps the problem is that in economics, extraordinary returns do not exist.

If a trade-off between expensing and higher rates is in fact required, then expensing would necessitate higher rates on risk-takers, on those investing for more than a Treasury bond return. It is difficult to see why a tax system that exempts risk-free returns to investors while taxing extraordinary returns more heavily is preferable to an income tax system with low rates, particularly if an objective is greater economic growth. Don't we want to reward those who have taken risks and created products or provided services of extraordinary value? I am confident any economist worth his salt could explain the errors in my analysis in short order. In the time the economist takes to explain it, another investment will have been made in a country with low income tax rates. Despite the fascination of the consumption tax advocates with expensing, businesses prefer low rates to expensing. They would trade a tax system that is neutral among investments for a tax system that provides lower rates on extraordinary returns.

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[35] *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005), *available at* http://www.taxreformpanel.gov/final-report/.

[36] A properly designed consumption tax does not permit a deduction for interest, thus eliminating one of the flaws of the current system—the distinction between debt and equity.

The right answer to the debate over whether we should have a consumption tax or an income tax is: both. We need to fix the income tax and add a real consumption tax like a value-added tax.

We cannot cure what ails the tax system by codifying the economic substance doctrine or arming the government with anti-abuse rules that allow it to challenge whatever it finds troubling. So let's get about fixing our income tax by clearing out the underbrush and eliminating uneconomic distinctions, and let's get about drawing up a value-added tax. And if that all sounds ridiculously pollyannish, blame it on my Minnesota roots, where the bartenders roust the drunken patrons from the bar at closing time by calling, "It's time!"