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I. INTRODUCTION

The 2010 enactment of Section 7701(o) of the Internal Revenue Code of 1986[2] imported the judicially-created economic substance doctrine into the Internal Revenue Code. In other words, it "codified" the doctrine. Economic substance is a long-standing judicial creation, recognized in many court decisions.[3] Under case law, the economic substance doctrine essentially provides that a tax benefit can be denied if it is not "the thing which the statute intended,"[4] even if the transaction meets all of the statutory and regulatory requirements for claiming the tax benefit.

Section 7701(o) provides rules that change the substantive content of the economic substance doctrine.[5] These modifications apply only where the economic substance doctrine is already applicable to the transaction ("relevant," in the statute's terminology), which is a determination that Congress leaves to the courts.[6] Section 7701(o) provides that such a transaction meets the economic substance test only if the transaction satisfies

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2. I.R.C. § 7701(o). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (the "Code") and the associated Treasury regulations. The full text of section 7701(o) appears in the Appendix, for convenience.

3. *See, e.g.*, ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 1997 WL 93314, at *36 (1997), *aff'd* 157 F.3d 231 (3d Cir. 1998) (*ACM*); Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104 (2d Cir. 2015) (*BNY Mellon II*), *cert. denied* 136 S.Ct. 1377 (2016).

4. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935); *see also, e.g.*, *BNY Mellon II*, 801 F.3d at 113 (citing the quoted language from *Gregory* as showing that the doctrine is aimed at discerning whether a claimed tax benefit is consistent with congressional intent).

5. *See generally* I.R.C. § 7701(o).

6. I.R.C. § 7701(o)(1), (o)(5)(C).

both an objective economic effect test and a subjective business purpose test.[7] It also states that profit potential may be used to meet these two tests only if the reasonably expected profit is at least "substantial" in relation to expected net tax benefits.[8] It further requires the Department of the Treasury (the "Treasury") to issue guidance to determine whether foreign taxes are treated as a cost in computing pre-tax profit for these purposes[9] (an issue on which the circuits are currently divided).[10]

Section 7701(o) appears to require new emphasis on the subjective prong, by implying that the subjective analysis must require something different than the objective test.[11] Many courts have used an analysis based on profit (or on change in economic circumstances) to determine whether a taxpayer had a subjective business purpose (especially for corporate taxpayers), so that the objective and subjective prongs have had significant (sometimes total) overlap in the past.[12] In addition, the objective prong has often been weighted more heavily than subjective intent, no matter how the courts described the relationship between the two prongs.[13] Section 7701(o)

7. I.R.C. § 7701(o)(1).

8. I.R.C. § 7701(o)(2)(A).

9. I.R.C. § 7701(o)(2)(B).

10. *See infra* note 242.

11. *See* I.R.C. § 7701(o)(1); *see also infra* Part III B.

12. *See, e.g.*, ACM, 157 F.3d 231, 260 (3d Cir. 1998); Sacks v. Comm'r, 69 F.3d 982, 988 (9th Cir. 1985) (referring to the objective and subjective analyses as "related factors"); *see also infra* note 205. *But see* Wells Fargo & Co. v. United States, 2014 U.S. Dist. LEXIS 99111, at *75–76 (D. MN. July 22, 2014) ("One possible construction is that any transaction that passes the economic substance test (based upon reasonable profit expectations) is by definition motivated by a business purpose. In that event, the subjective test would only become relevant if there was no economic substance. If that analysis is appropriate, however, it would be reasonable to expect clear authority to that effect").

For example, two federal circuit courts held that loans met the economic substance doctrine's requirements even though the loans' sole business purpose was the same access to funds that allowed them to meet the objective prong. *See BNY Mellon II*, 801 F.3d 104, 124 (2d Cir. 2015) (not discussing subjective purpose of the loan beyond stating that "Under both the objective and subjective prongs of the economic substance doctrine, the loan was no sham: It constituted $1.5 billion in cash that was available for BNY to utilize in any way it saw fit throughout the duration of STARS."); Salem Fin., Inc. v. United States, 786 F.3d 932, 955–98 (Fed. Cir. 2015) [hereinafter *Salem II*].

13. *See, e.g.,* Wells Fargo & Co. v. U.S., 260 F. Supp. 3d 1140, 1146 (D. MN. 2017) [hereinafter Wells Fargo II] ("although some courts have *said* that the lack of a business purpose can by itself invalidate a transaction, the actual results indicate either that this language was dicta (as in *ASA Investerings*) or that the taxpayer's subjective motives became less important when the transaction had substantial objective economic substance (as in *United Parcel Service*) . . . there is a gap between what courts say and what courts do: Although courts may say that a subjective non-tax business purpose is essential, courts in fact have been reluctant to disregard economically substantive transactions solely on the basis of the taxpayer's subjective motives.") (emphasis in original); Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 22 (1st Cir. 2016) (*Santander*) ("This court has been particularly wary of inquiring into the subjective motivations of taxpayers: '[U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind,

appears to require much of that to change, but that effect may have been inadvertent. Among other things, this raises questions as to the relative weight of statutory language and contradictory legislative intent, as expressed in the legislative history.[14]

Section 7701(o) also leaves some requirements, such as "meaningful" change in "economic position" and "substantial" business purpose, to be interpreted by the courts or through Treasury regulations.[15] Until such interpretations are provided, the plain meanings of "meaningful" and "substantial" appear to impose more stringent conditions than pre-codification case law (at least in some circuits).

Formerly a purely judicial doctrine,[16] the economic substance doctrine is now a mix of legislative requirements (like the profit-to-tax-benefit ratio

whether it be elaborate or simple.'") (citation omitted), *cert. denied* 137 S. Ct. 2295 (2017); ACM P'ship v. Comm'r, 157 F.3d 231, 262 (3d Cir. 1998) ("ACM's possession of the LIBOR notes, although not intended to serve non-tax purposes, had significant non-tax economic effects, consisting of several million dollars in actual economic losses. As we acknowledged in *Wexler*, even where a transaction is not intended to serve business purposes, it may give rise to a deduction to the extent that it has objective economic consequences apart from tax benefits.") (citations omitted), *see also id*. at 248 n.31 ("Where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations."); Sheldon v. Comm'r, 94 T.C. 738, 769 (1990); Cherin v. Comm'r, 89 T.C. 986, 994 (1987) [hereinafter *Cherin*] ("We have never held that the mere presence of an individual's profit objective will require us to recognize for tax purposes a transaction which lacks economic substance."), *id*. at 996; Pacheco v. Comm'r, T.C. Memo 1989-296, 1989 Tax Ct. Memo LEXIS 308, *16–17 ("In deciding whether a transaction is devoid of economic substance, the taxpayer's subjective statement as to his profit motive in entering into a transaction is relevant, but we place greater emphasis on objective facts demonstrating a realistic potential for profit."); Gampp v. Comm'r, T.C. Memo 1991-548, 1991 Tax Ct. Memo LEXIS 596, *33 (same); *see also* Yosha v. Comm'r, 861 F.2d 494, 499 (7th Cir. 1988) ("A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages—may indeed have had no other interest in the transaction."); *but cf.* IRS v. Cm Holdings (in Re Cm Holdings, Inc.), 301 F.3d 96, 102 (3d Cir. 2002) ("Although our Court has hinted that the objective analysis may be more important than the subjective, the latter analysis remains important.") (citation omitted); *id*. at 105–106 (rejecting taxpayer's argument that subjective motives cannot be considered by the courts in an economic substance analysis).

14. *See generally* Albemarle Corp. & Subsidiaries v. United States, 118 Fed. Cl. 549, 576 (Ct. Cl. 2015) (when the plain language of a statute is clear, it is generally unnecessary to consult the legislative history, but "[t]he Supreme Court has noted, however, that when it appears that the plain language of a statute resolves the issue, a court is to 'look to the legislative history to determine only whether there is [a] "clearly expressed legislative intention" contrary to that language, which would require us to question the strong presumption that Congress expresses its intent through the language it chooses.'") (quoting INS v. Cardoza-Fonseca, 480 U.S. 421, 432 n.12 (1987) (alteration in the original, further citations omitted)), *aff'd* 797 F.3d 1011 (Fed. Cir. 2015), *reh'g den'd* 805 F.3d 1060 (Fed. Cir. 2015), *cert. den'd* 136 S. Ct. 1659 (2016).

15. *See* I.R.C. § 7701(o).

16. The previous exclusive power of the judicial branch over the economic substance doctrine raises bigger-picture issues about the appropriateness of judicial doctrines that override the literal language of statutes and regulations. Such doctrines can create concerns about predictability, because the

test),[17] areas in which the Treasury has the newly acquired power to issue regulations, and areas left to the courts (such as the question of whether the doctrine applies to a particular transaction,[18] and any other issue that isn't preempted by the statute or by agency guidance).

One of the biggest changes caused by Section 7701(o) is the executive branch's ability to alter the economic substance doctrine by the exercise of regulatory authority.[19] This raises issues regarding the extent of such regulatory authority, and the Treasury's willingness to issue such guidance, especially given that there has been no guidance on the treatment of foreign taxes as costs, and little meaningful guidance on any other aspect of 7701(o).[20]

results can vary based on the facts and circumstances and because such doctrines can evolve over time. *See generally* Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW 807, 809 (1995); Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 255 (2002); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 577 (1992); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 206 (2001); *see also* Daniel M. Schneider, *Use of Judicial Doctrines in Federal Tax Cases Decided by Trial Courts, 1993–2006: A Quantitative Assessment*, 57 CLEV. ST. L. REV. 35, 50 (2009). Some commentators have criticized the economic substance doctrine, arguing that it is too vague, unpredictable, or subjective (on the part of the IRS or the courts), and that its role could be better filled by another approach. *See, e.g.*, Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 392 (2010); Allen D. Madison, *Rationalizing Tax Law by Breaking the Addiction to Economic Substance*, 47 IDAHO L. REV. 441, 476 (2011); *see also* Am. Bar Ass'n Sec. of Tax'n, Letter to the Treasury, reprinted at *Economic Substance Codification: ABA Has "Substantial Reservations"*, 115 TAX NOTES 389, 391 (2007) (expressing concerns about an earlier proposal for codification); Steven A. Bank, *Codifying Judicial Doctrines: No Cure for Rules But More Rules?*, 54 SMU L. REV. 37, 41 (2001) (discussing earlier codification proposals). The economic substance doctrine's judicial roots can also lead to issues regarding the appropriate interaction between the three branches of government. On the one hand, the doctrine allows judges to disregard literal compliance with a statute but, on the other hand, the entire point of the doctrine is to implement congressional intent (not to determine what the judiciary thinks is the best policy result, but to carry out the result that Congress intended).

17. *See* I.R.C. § 7701(o)(2)(A).

18. *See* I.R.C. § 7701(o)(5)(C).

19. *See generally* I.R.C. § 7805(a).

20. The IRS has issued two notices on section 7701(o). *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411; I.R.S. Notice 2014-58, 2014-44 I.R.B. 746. It has also written two letters of instructions to its own employees regarding the assertion of the post-codification economic substance doctrine. Heather C. Maloy, Large Bus. & Int'l Div., IRS, LB&I-4-0711015, Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (2011) [hereinafter LB&I Directive]; Heather C. Maloy, Large and Mid-Sized Business Division, IRS, LMSB-20-0910-024, Codification of the Economic Substance Doctrine and Related Penalties (Directive for Industry Directors; Director, Field Specialists; Director, Pre-Filing and Technical Guidance; Director, International Compliance, Strategy, and Policy) [hereinafter LMSB directive].

II. BACKGROUND

A. Brief Overview of Pre-Codification Economic Substance Doctrine

The economic substance doctrine is a judicial doctrine that essentially provides that tax benefits can be denied if such benefits are not "the thing which the statute intended,"[21] even if the taxpayer meets the specific requirements of the Code and regulations. If a transaction lacks economic substance, the entire transaction is disregarded for federal income tax purposes.[22] The transaction thus generates no federal income tax benefits (but also creates no taxable income, and no other federal income tax effects of any kind).[23]

21. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935); *see also, e.g.*, *BNY Mellon II*, 801 F.3d 104, 113 (2d Cir. 2015).

22. *See, e.g.*, *BNY Mellon II*, 801 F.3d at 108; Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 779 (5th Cir. 2001); Alessandra v. Comm'r, T.C. Memo 1995-238, 69 T.C.M. (CCH) 2768, 1995 Tax Ct. Memo LEXIS 240, *10–11 (1995); Lerman v. Comm'r, 939 F.2d 44, 45 (3d. Cir. 1991) ("If a transaction is devoid of economic substance—as the transactions involved here undeniably were—, it simply is not recognized for federal taxation purposes, for better or for worse."); *ACM*, 157 F.3d 231, 261–62 (3d Cir. 1998) (the entire transaction, and all its federal tax consequences, are disregarded, with an exception for separable parts with economic substance); Glass v. Comm'r, 87 T.C. 1087, 1175–76 (1986) ("It follows, of course, that since the straddle transactions were a sham, gains reported by petitioners in year two and thereafter do not constitute taxable income to them"); IRS v. Cm Holdings (in Re Cm Holdings, Inc.), 301 F.3d 96, 102 (3d Cir. 2002).

There is an exception for the federal income tax effects of a separable part of a bigger transaction, if such separable part itself has economic substance. *See, e.g.*, Alessandra v. Comm'r, T.C. Memo 1995-238, 69 T.C.M. (CCH) 2768, 1995 Tax Ct. Memo LEXIS 240, *14-15, *18-19 (1995); *Wells Fargo II*, 260 F. Supp. 3d 1140, 1146-47 (D. MN 2017); Bank of N.Y. Mellon Corp. v. Comm'r, T.C. Memo 2013-225, 106 T.C.M. (CCH) 367, 2013 WL 5311057 at *4 (2013), *aff'd* 801 F.3d 104 (2d Cir. 2015); *ACM*, 157 F.3d at 262.

Taxpayers recently challenged the idea that all federal income tax effects of an economic sham are disregarded (at least for deductions of foreign taxes), without success. *See* Wells Fargo & Co. v. United States, Civ. No. 09-cv-02764-PJS-TNL (D. MN Oct. 24, 2017) (taxpayer motion for summary judgement arguing that, among other things, foreign taxes that were not creditable by reason of economic sham treatment could nonetheless be deducted); Wells Fargo & Co. v. United States; No. 0:09-cv-02764 (order issued Sept. 15, 2017) (D. MN 2017); Santander Holdings USA, Inc., & Subsidiaries v. U.S., No. 1:09-cv-11043 (D. MA. July 17, 2018) ("A transaction's lack of economic substance is broadly fatal to tax benefits that arise only because of the condemned contrivance").

23. *See, e.g.*, *BNY Mellon II*, 801 F.3d at 108; Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 779 (5th Cir. 2001); Alessandra v. Comm'r, 69 T.C.M. (CCH) 2768 (1995).

The economic substance doctrine has a long history, expressed in voluminous case law.[24] It prevents taxpayers from claiming tax benefits that the courts see as frustrating congressional intent,[25] essentially where such benefits are viewed as meeting the language but not the spirit of the applicable Code and regulatory rules.[26]

Various Federal circuits use different tests to implement their analysis of whether a claimed tax benefit is within congressional intent and thus has sufficient economic substance.[27] Almost all circuits include an examination of objective profit potential or change in economic position (often called the objective prong or objective test) and also an analysis of whether the taxpayer's subjective motives included sufficient non-tax purposes (often called the subjective prong or business purpose test).[28]

Some circuits require that a transaction must meet both the objective and subjective prongs in order to have economic substance (the conjunctive test).[29] Other circuits state that a transaction that meets either the objective or the subjective prong has sufficient economic substance (the disjunctive test).[30] Still others explain that they do not apply a rigid two-prong test, but instead use a more flexible approach that includes examination of both objective profit potential and subjective purpose (hereinafter the flexible test, although it does not have a consistent label in the case law).[31] Other variations are also possible. For example, the First Circuit has stated that it

24. *See, e.g.*, ACM, 157 F.3d 231; *BNY Mellon II*, 801 F.3d 104.

25. *See, e.g*., ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 1997 WL 93314, at *36 (1997) (the doctrine addresses "tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings"), *aff'd* 157 F.3d 231 (3d Cir. 1998). That description of the economic substance doctrine from *ACM Partnership* was cited as the then-present law by the House Report that accompanied section 7701(o). *See* H.R. Rep. No. 111-443, 292, 292 n.107, *as reprinted in* 2010 U.S.C.A.N.N., 123, 224 & n.107 (2010). *See also, e.g*., Horn v. Comm'r, 968 F.2d 1229, 1237 (D.C. Cir. 1992) [hereinafter *Horn*] ("the sham transaction doctrine seeks to identify a certain type of transaction that Congress presumptively would not have intended to accord beneficial tax treatment").

26. *See generally* H.R. Rep. No. 111-443, at 292–93; Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 12 (2000).

27. *See* H.R. Rep. No. 111-443, at 293 (describing the differing approaches taken by various circuits); Amanda L. Yoder, Note, *One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine*, 75 MO. L. REV. 1409, 1419–24 (2010); Erik M. Jensen, *Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives*, 57 ST. LOUIS L.J. 1 (2012) [hereinafter, Jensen, *Responses*].

28. *See infra* note 33, *supra* note 12.

29. *See, e.g.*, *BNY Mellon II*, 801 F.3d 104, 115 (2d Cir. 2015); Pasternak v. Comm'r, 990 F.2d 893, 898 (6th Cir. 1993); Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 544 (5th Cir. 2009).

30. *See, e.g.*, *Horn*, 968 F.2d at 1234–35; Rice's Toyota World v. Comm'r, 752 F.2d 89, 91-92 (4th Cir. 1985).

31. *See, e.g.*, ACM, 157 F.3d 231, 247 (3d Cir. 1998); Sacks v. Comm'r, 69 F.3d 982, 987 (9th Cir. 1985).

prefers to examine only objective factors, and that it would rather avoid inquiry into the taxpayer's subjective motive.[32] But regardless of how each circuit describes its formulation of the economic substance test, almost all courts nonetheless examine both the objective and subjective factors described above, even in disjunctive-test circuits.[33]

Almost always, a circuit's particular framing of the economic substance test (conjunctive, disjunctive, flexible, or other) made no difference to the result of an economic substance case, because most courts reached the same answer for both the objective and subjective prongs (i.e., the court found that both prongs were met or that both were failed).[34] Therefore, the same ultimate finding on economic substance would have been reached (in most cases) regardless of whether the court required the taxpayer to meet one prong or both.

One recent, unusual exception to this pattern is the *Wells Fargo* case (including a jury verdict and a District Court decision).[35] The jury found that a loan had sufficient profit potential but lacked business purpose.[36] (This was a rare holding, because profit potential is often used to prove business purpose). The district judge in *Wells Fargo* subsequently held (applying a flexible approach) that the loan met the economic substance test and that the interest deductions relating to the loan were therefore allowable.[37] In another case, the Tax Court found that a transaction failed the objective prong, and declined to reach a finding on the subjective prong.[38] However, the court

32. *See* Santander, 844 F.3d 15, 22 (1st Cir. 2016).

33. *See, e.g.*, *Santander*, 844 F.3d 15, 22, 24–26 (discussing subjective motives even though the opinion says that the circuit prefers to examine only objective aspects of the test); Cherin v. Comm'r, 89 T.C. 986, 992, 994–96 (1987) (declining to reach a holding on the taxpayer's subjective motives after finding that there was no reasonable possibility of profit, but discussing the taxpayer's possible motives).

34. *See, e.g.*, Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827, 834 (D. Minn. 2015) [hereinafter *Wells Fargo I*] (stating that the Eighth Circuit has never had to choose a version of the economic substance test, because it has always decided both prongs favorably or both prongs unfavorably); *IES*, 253 F.3d at 353 (same); *see also* Wells Fargo & Co. v. United States, 2014 U.S. Dist. LEXIS 99111, at *75–76 (D. MN. July 22, 2014) ("Neither party cites a case in which a court finds a business purpose, but no economic substance or economic substance, but no business purpose.").

35. *See* Wells Fargo & Co. v. United States, No. 17-3578, No. 17-3676 (8th Cir. Nov. 24, 2017).

36. *See id.*; *see also* Cara Salvatore, *Jury Sides with Feds in Wells Fargo $76M Tax Credit Suit*, LAW360 (Nov. 18, 2016) https://www.law360.com/articles/864145/jury-sides-with-feds-in-wells-fargo-76m-tax-credit-suit [https://perma.cc/9G5E-VL4H]; Wesley Elmore, *Jury Sides with Government in Wells Fargo STARS Case*, TAX NOTES TODAY (Nov. 18, 2016) https://www.taxnotes.com/tax-notes/2016-11-21 [https://perma.cc/N6JM-LQQB]. In contrast, the same jury found that the related trust transaction failed both prongs of the economic substance test. *See id.*; *Wells Fargo II*, 260 F. Supp. 1140 at 1142.

37. *Wells Fargo II*, 260 F. Supp. 3d 1140, 1146 (D. MN 2017); *see also* Salvatore, *supra* note 36; Elmore, *supra* note 36.

38. Cherin v.Comm'r, 89 T.C. at 992, 994.

implied that the taxpayer (a businessman who switched from beauty parlors to investments in cattle) had sincere (but perhaps unwarranted) subjective profit motive.[39] If that were the case, the taxpayer might have prevailed under a disjunctive test (if unreasonable belief is sufficient), in contrast to his actual loss under the Tax Court's use of the conjunctive formulation—i.e., these two variations of the test might have reached different ultimate results.

Courts' overwhelming tendency to reach the same result on both prongs in the past might have been caused largely by the fact that the objective and subjective prongs were often given overlapping and redundant definitions (especially in application) before the effective date of Section 7701(o).[40] The objective prong usually emphasized whether there was a reasonable expectation of profit.[41] That same reasonable expectation of profit was often the primary element of the subjective business purpose analysis, especially for corporate taxpayers.[42]

B. BRIEF OVERVIEW OF SECTION 7701(O)

Section 7701(o) was enacted in 2010,[43] and applies to transactions entered into on or after March 31, 2010.[44] The provision is entitled "Codification of Economic Substance Doctrine."[45] It applies only if the economic substance doctrine is "relevant" to a transaction (i.e., only if the case presents the type of transaction or tax benefit to which the economic substance analysis can be applied, not a type that is exempt from such analysis), as determined by the courts.[46] If the economic substance doctrine is relevant, then Section 7701(o) sets forth several rules for its application.[47]

39. *Id*.

40. *See supra* note 12. Identical interpretations of the objective and subjective tests may no longer be possible after section 7701(o). *See* discussion *infra* Part III B.

41. *See infra* note 193. The profit inquiry does not require that actual profit materialize, but instead focuses on a reasonable expectation of profit. *See, e.g.*, Estate of Thomas v. Comm'r, 84 T.C. 412, 429 (1985) (it was not reasonably foreseeable that subsequent popularity of desktop computers would lead to a loss on supercomputer investment). The pre-codification version of the objective prong also considered economic effects other than profit, at least in some circuits. *See, e.g.*, *BNY Mellon II*, 801 F.3d 104, 119 (2d Cir. 2015).

42. *See infra* note 205.

43. It was enacted by Section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

44. *Id*.

45. I.R.C. § 7701(o).

46. I.R.C. § 7701(o)(1), (o)(5)(C).

47. I.R.C. § 7701(o).

First, the section requires that a transaction must satisfy both the objective and subjective prongs in order to meet the economic substance test.[48] In other words, all circuits must now use the conjunctive test, rather than the disjunctive test. (The flexible test may still be acceptable, as long as it requires that taxpayers meet both the objective and subjective prongs. See further discussion below.)

Under Section 7701(o), the objective prong requires that the challenged transaction (the transaction that generates the challenged tax benefit) must "change[] in a meaningful way . . . the taxpayer's economic position."[49] The subjective prong, under section 7701(o), requires that such transaction have "substantial [non-tax] purpose."[50] Under the statute, profit potential cannot be taken into account for purposes of either prong unless the present value of reasonably expected profit is "substantial" in relation to expected tax benefits.[51] (This article refers to that requirement as the ratio test or profit ratio test.)[52] The section also requires the Treasury to issue regulations to treat foreign taxes as expenses in computing pre-tax profit, "in appropriate cases."[53]

Each of these provisions, and the additional detail in the statute, is discussed further below. Among other impacts, Section 7701(o) gives the Treasury the ability to issue guidance on the economic substance doctrine[54] (except on the issue of relevance, which is reserved to the courts).[55] Other than the regulatory mandate regarding the treatment of foreign taxes as an expense,[56] the ability to issue such guidance derives from the Treasury's general ability to issue guidance with respect to all Code provisions,[57] rather than from any specific grant of regulatory authority contained in Section 7701(o).

Section 7701(o) has only limited application to individual taxpayers (as opposed to corporations): For individuals, it applies only to "transactions

48. I.R.C. § 7701(o)(1).

49. I.R.C. § 7701(o)(1)(A).

50. I.R.C. § 7701(o)(1)(B).

51. I.R.C. § 7701(o)(2)(A).

52. *See id*.

53. I.R.C. § 7701(o)(2)(B).

54. *See* I.R.C. § 7805(a) (giving the Treasury the general authority to issue regulations to interpret Code provisions: "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title. . . .").

55. I.R.C. § 7701(o)(5)(C).

56. I.R.C. § 7701(o)(2)(B).

57. *See* I.R.C. § 7805(a).

entered into in connection with a trade or business or an activity engaged in for the production of income."[58] Other transactions of individuals are exempt from Section 7701(o), but not from the case law on economic substance.[59] The result of an economic substance analysis for an individual under the Section-7701(o)-modified economic substance doctrine, even for "transactions entered into in connection with a trade or business or an activity engaged in for the production of income," is not pre-determined. Even such transactions might not necessarily show both a meaningful change in economic circumstances and also sufficient non-tax motive.

The legislation that included Section 7701(o) also enacted amendments to several penalty provisions.[60] Under those amendments, deficiencies attributable to the economic substance doctrine (as defined by section 7701(o)) are subject to a 20-percent accuracy-related penalty.[61] Such penalty increases to 40 percent if the taxpayer does not sufficiently disclose the facts regarding the relevant transaction's claimed tax treatment.[62] The same penalties apply to tax deficiencies arising from any "rule of law" that is "similar" to the economic substance doctrine (as so defined).[63] "Reasonable cause" exceptions do not apply to such penalties imposed by reason of the economic substance doctrine or any "similar rule of law."[64] Thus, an opinion of counsel regarding the economic substance doctrine or similar rule of law does not protect against such penalties.[65]

58. I.R.C. § 7701(o)(5)(B).

59. In practice, however, the economic substance doctrine may seldom apply to such non-business, non-production-of-income transactions, because there are relatively fewer tax benefits claimable with respect to such transactions. *Compare* I.R.C. §§ 262 (personal expenses) and 183(b) (limited deduction for activities not engaged in for profit) *with* I.R.C. §§ 162 (trade or business expenses) and 212(1) (expenses "for the production or collection of income").

60. *See* I.R.C. §§ 6662(b)(6), 6662(i); 6664(c)(2), 6664(d)(2); 6676(c); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029, §1409 (amending the Code to add both new section 7701(o) and the relevant changes to the penalty provisions).

61. *See* I.R.C. § 6662(b)(6) (applying section 6662(a)'s penalty to tax deficiencies attributable to the economic substance doctrine or similar "rule[s] of law").

62. I.R.C. § 6662(i) (regarding failure to adequately disclose on a tax return or an attached statement). For a critique of the new penalty provisions, *see generally* Kathleen DeLaney Thomas, *The Case Against a Strict Liability Economic Substance Penalty*, 13 U. PA. J. BUS. L. 445, 447–49, 465–70 (2011) (discussing the penalty provisions).

63. *See* I.R.C. § 6662(b)(6).

64. *See id.*, I.R.C. §§ 6664(c)(2), 6664(d)(2). *See also* I.R.C. § 6676(c) (preventing reasonable cause exception from applying to "excessive amounts" attributable to the economic substance doctrine (as described in section 7701(o)) or any similar doctrine).

65. The Joint Committee on Taxation's report on Section 7701(o) and associated provisions refers to the strict liability nature of the penalties for economic substance doctrine-related deficiencies as follows:

After Section 7701(o)'s effective date, the economic substance doctrine has become a mix of 1) statutory mandates, 2) areas in which the Treasury can issue guidance, and 3) areas that the courts can interpret. The third set of issues includes any items that are not constrained by statutory language and on which the Treasury has not yet issued guidance, as well as the prerequisite question of whether the economic substance analysis can be applied to a particular transaction at all.[66]

Section 7701(o) also imposes some degree of consistency—but not total uniformity—on the various circuits' interpretations of the economic substance doctrine.[67] For example, all circuits must apply the profit ratio test. But although all circuits must address both prongs, different circuits could interpret "meaningful" economic change and "substantial" profit and business purpose differently. The various circuits can also differ in their analyses of the other areas left undefined or unanswered by the statute (and by future agency guidance), as described below.

No court has yet applied Section 7701(o). Multiple recent economic substance cases have been litigated, but all of these cases concerned transactions that occurred before Section 7701(o)'s effective date.[68] Given the time required to move a dispute through the litigation process, cases concerning Section 7701(o) may be arriving in the courts soon.

III. IMPACT OF SECTION 7701(O)'S SUBSTANTIVE RULES ON THE ECONOMIC SUBSTANCE DOCTRINE

> No exceptions (including the reasonable cause rules) to the penalty are available. Thus, under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law.

Staff of the Jt. Comm. on Tax'n, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," JCX-18-10, at 156 (2010) [hereinafter *Joint Committee Report*].

66. *See* I.R.C. § 7701(o)(5)(C).

67. *Cf.* Erik M. Jensen, *Sometimes Unguided (or Maybe Misguided) Economic Substance Guidance*, 32 J. TAX'N INV. 27, 28 (2015) [hereinafter Jensen, *Unguided*] (the conjunctive test "requirement might not require complete consistency among the circuits, but it is a step in the right direction").

68. *See, e.g.*, *Santander*, 844 F.3d 15; BNY *Mellon II*, 801 F.3d 104 (2d Cir. 2015); *Wells Fargo II*, 260 F. Supp. 3d 1140; *see generally* Rebecca Rosenberg, *STARS Wars: Application of the Economic Substance Doctrine to Foreign Tax Credits, and What the Future Holds*, 42 U. DAYTON L. REV. 165 (2017) [hereinafter Rosenberg, *STARS Wars*] (discussing the recent STARS cases, although these are not the only recent cases on economic substance).

A. 7701(o) Requires a Conjunctive Two-Prong Test

1. *Why Did Congress Bother Codifying the Two-Prong Conjunctive Test?*

Given that the choice of formulation (conjunctive, disjunctive, flexible, or other) of the economic substance test so seldom made a difference in the past (as far as the ultimate finding of whether a transaction was respected as having economic substance or not), one wonders why mandating conformity to the conjunctive test was important enough to require codification in Section 7701(o).[69] There are two obvious potential reasons: First, Section 7701(o) scored as a "revenue raiser," and second, Congress might have been concerned that different formulations of the economic substance doctrine could lead to different judicial results in the future, even though that seldom happened under existing case law. Both rationales are discussed further below.

First, Section 7701(o) was scored as a "revenue raiser"[70] (i.e., it was estimated that section 7701(o)'s enactment would generate additional tax revenue), which would have made it more appealing to Congress. Such revenue estimates are used to determine the aggregate impact of legislative proposals: Revenue raisers and losers are netted to determine if a proposed legislative package has a positive, negative, or neutral budget impact, as a whole.[71] Some commentators have speculated that Section 7701(o) was used to generate a net positive revenue estimate that would help pass the

69. As discussed throughout this article, Section 7701(o) also includes other changes to the economic substance test, as compared to pre-codification case law. *See, e.g.*, I.R.C. §§ 7701(o)(2)(A) (profit ratio test), 7701(o)(2)(B) (requiring regulations regarding the treatment of foreign taxes). But such other changes do not appear to have been the main reason for codification and might have been accomplished without also requiring the conjunctive test.

70. *See* Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009 (JCX-28-09), June 11, 2009; Jensen, *Unguided*, *supra* note 67, at 27 n.4 ("[C]odification was scored as a revenue-raiser, a factor supporting the idea that enhancement [rather than codifying the doctrine exactly as it existed in the case law] was the goal."); Richard M. Lipton, "*Codification" of the Economic Substance Doctrine–Much Ado About Nothing*, 112 J. TAX'N 324, 325 (June 2010) ("Congress enacted Section 7701(o) in order to raise an estimated $4.5 billion of revenue."); Monica D. Armstrong, *OMG! ESD Codified!: The Overreaction to Codification of the Economic Substance Doctrine*, 9 FLA. A.&M. U. L. REV. 113, 116 n.14 (2013).

71. *See generally* George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 N.Y.U. L. REV. 174, 185–87 (2009) (describing the cost estimating process generally); Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. REV. 863, 875–79 (2002) (describing budget estimates and revenue offsets generally); Rachelle Holmes Perkins, *Breaking The Spell Of Tax Budget Magic*, 6 COLUM. J. TAX L. 1, 6–12 (2014) (discussing budget estimates and revenue offsets generally).

Affordable Care Act.[72] Even if that was a major motivation for enacting Section 7701(o), it leaves the question of why this section would be predicted to raise revenue, given that the results of the conjunctive test and other versions of the economic substance test were nearly identical, in almost all cases (and when many circuits had already adopted the conjunctive test).[73] In other words, imposing the conjunctive test does not, at first glance, appear to change many court case results. It therefore does not appear to raise additional tax revenue by disallowing more tax benefits than the pre-codification version of the doctrine.

The reason for the positive revenue estimate regarding codification of the economic substance doctrine may have been the penalty provision amendments that accompanied Section 7701(o), rather than (or in addition to) codification itself.[74] Such penalties' effects may have been included with Section 7701(o)'s revenue estimate, even though they appear in other Code sections.[75] Those penalty provisions provide for a 20-percent penalty for tax understatements attributable to economic substance issues, without an exception for reasonable cause.[76] If the taxpayer fails to adequately disclose the facts regarding a transaction that lacks economic substance, the penalty percentage increases to 40 percent.[77] The positive revenue estimate for Section 7701(o) may be almost entirely due to such penalties, rather than the requirement that all circuits use the conjunctive test. Section 7701(o) itself may have been intended largely as a definitional section, describing the issue that triggers the 20- and 40-percent penalties.[78] Although this explanation has some appeal, Congress could have accomplished this goal without

72. *See, e.g.*, Jensen, *Unguided*, *supra* note 67 at 27, n.4; *cf.* Lipton, *supra* note 70 at 325, 333. *See also supra* note 70.

73. It is possible that several circuits had no need to fully commit to one formulation or the other of the economic substance doctrine in the past, if they only faced transactions for which all formulations led to the same result. For example, *IES* and *Wells Fargo* say this is the case for the Eighth Circuit, *see* IES Industries, Inc. v. United States, 253 F.3d 350, 353-54 (8th Cir. 2001); *Wells Fargo II*, 260 F. Supp. 3d at 1146.

74. *See supra* note 70.

75. *See* I.R.C. §§ 6662(b)(6) (20-percent penalty), 6662(i) (40-percent penalty in the absence of adequate disclosure), 6662(c), 6664(d)(2), 6676(c) (inapplicability of reasonable cause exceptions).

76. *See* I.R.C. § 6662(a), (b)(6) (20-percent penalty).

77. *See* I.R.C. § 6662(i) (40-percent penalty in the absence of adequate disclosure).

78. That would be consistent with Section 7701's general function as a section that holds a wide range of definitions, such as the definitions of "corporation," "domestic," and "shareholder." *See* I.R.C. § 7701. For an example of a substantive code provision that serves largely as a cross-reference or touchpoint for another rule, *see* I.R.C. § 904(d)(2)(H)(i), which essentially repeats a rule already stated in the pre-existing regulations (found in Treasury Regulation §1.904-6(a)(1)(iv)). Section 904(d)(2)(H)(i)'s real function appears to be setting forth the general rule so that an exception (not found in the regulations) can be provided in Section 904(d)(2)(H)(ii).

mandating the conjunctive test, by merely providing a broader definition (including multiple versions of the economic substance test) that the penalty provisions could cross-reference as a description of the economic substance doctrine.[79]

There is an alternative (or additional) explanation for why Congress may have felt the need to require the conjunctive test: Congress may have anticipated more disparity between the results of the various economic substance formulations in the future, even if such differences had seldom occurred before. Congress may have proven prescient in this respect: There is a recent instance in which a jury held that a taxpayer's transaction (a loan) met the objective prong because it had profit potential, but failed the business purpose prong because it lacked sufficient non-tax motives.[80] The jury was examining a loan that was connected to a STARS[81] transaction.[82] The taxpayer allegedly borrowed at a higher interest rate than it could have found elsewhere, in order to make another transaction with the same counterparty look more like a real business transaction (in anticipation of an economic substance challenge to such other transaction).[83] But although the taxpayer's interest costs were higher than market rate, it may have used the loan proceeds to generate a profit, giving it a potential argument under the objective prong.[84]

After the jury verdict, the relevant District Court requested briefs on how such a result should be treated,[85] which was essentially a question of whether the Eighth Circuit (in that case) applied the conjunctive, disjunctive, or

79. If the positive budget estimate does not stem from the penalty provisions, that would imply that congressional budget estimators thought that the substantive provisions of Section 7701(o) would increase tax collection by disallowing more tax benefits than pre-7701(o) versions of the economic substance doctrine. For the reasons explained above, such a result seems unlikely to flow from the imposition of the conjunctive test (unless from the potential strengthening effect on the subjective prong, which Congress does not necessarily seem to have intended). However, increased revenue collection might potentially follow from other substantive provisions of Section 7701(o), such as the rule that reasonably expected profit can only be taken into account if it is substantial in relation to expected net tax benefits. *See* I.R.C. § 7701(o)(2)(A).

80. *See Wells Fargo II*, 260 F. Supp. 3d 1140, 1143 (D. MN 2017); Salvatore, *supra* note 36.

81. STARS is an abbreviation for Structured Trust Advantaged Repackaged Securities. *See, e.g.*, Salem Fin. Inc. v. U.S., 786 F.3d 932, 936 (Fed. Cir. 2015).

82. *See Wells Fargo II*, 260 F. Supp. 3d at 1143.

83. *Wells Fargo II*, 260 F. Supp. 3d at 1146-47.

84. The *Wells Fargo* opinions do not provide details about the specific returns earned from the loan proceeds, but one opinion states that "Wells Fargo argues, it had a reasonable expectation of pretax profit because Wells Fargo's anticipated (and actual) return on capital in the ordinary course of its banking operations during the five-year period of the loan exceeded 5.8 percent." *Wells Fargo I*, 143 F. Supp. 3d at 842; *see also id*. at 844; *Wells Fargo II*, 260 F. Supp. 3d at 1146–47.

85. *See id.* at 1143; Salvatore, *supra* note 36.

flexible test before Section 7701(o)'s effective date. Because the jury found that the loan met the objective but not the subjective prong, the taxpayer would win under the disjunctive test, but lose under the conjunctive test.[86] The result under the flexible test was harder to predict. This is a rare example of a case in which the results of the objective and subjective prongs differed, so that the choice of approach (conjunctive, disjunctive, or other) made a difference to the ultimate question of whether the transaction met the economic substance test. Ultimately, the trial court predicted that the Eighth Circuit would apply the flexible approach.[87] Under that approach, the trial court held that the loan had sufficient substance to be respected.[88]

Cherin is another unusual example of a case where the use of the conjunctive rather than disjunctive test may have made a difference.[89] The taxpayer in that case invested in cattle, and the court found that there was no reasonable possibility of profit because of the cattle's poor quality, the ineffective management of the cattle, and similar factors.[90] The court then declined to take the taxpayer's subjective motivation into account, holding that lack of profit potential was sufficient (on its own) to show a lack of economic substance.[91] This was an application of the conjunctive test, which requires that the taxpayer meet both the objective and subjective prongs.[92] However, the court implied that the taxpayer may have sincerely (but mistakenly) expected a profit, i.e., that he was motivated by a desire for profit rather than by tax benefits.[93] If the court had examined the taxpayer's subjective intent in order to reach a holding on the subjective prong, and if it had applied the disjunctive test, the economic substance holding might have been different.

It is interesting to consider what other kinds of transactions could cause the two prongs to yield different results from each other: When will a

86. *See id*. The jury found that the trust transaction with the same counterparty failed both prongs of the economic substance test, and therefore lacked economic substance. *See Wells Fargo II*, 260 F. Supp. 3d at 1142.

87. *See Wells Fargo II*, 260 F. Supp. 3d at 1144–45.

88. *See id.* at 1143, 1146–47.

89. *See* Cherin v. Comm'r, 89 T.C. 986, 989–91 (1987).

90. *Id.* at 994.

91. *Id*.

92. *See generally id.* at 993–94.

93. At one point, the court even said that it was predictable that the taxpayer would stop paying the cattle managers once the taxpayer realized that expected profits were not materializing. *See id*. at 995–996. Because the court thought it unnecessary to reach a holding on business purpose after the taxpayer failed the objective prong, the entire discussion of the taxpayer's subjective intent is likely *dicta* (but interesting). *See id*.

taxpayer have subjective business purpose but not reasonable expectation of profit (or change in economic circumstances), or vice versa? Such a difference is the only fact pattern in which the ultimate result (the determination of whether the transaction has economic substance or not) of the conjunctive test differs from that of the disjunctive test or other economic substance formulations.

Different results for the objective and subjective prongs might occur, for example, when individuals have honest but unreasonable expectations of profit (so that they might have business purpose[94] but lack objectively reasonable profit potential or other change in economic position).[95] *Cherin* could be one instance of this phenomena (depending on the detailed facts that showed subjective intent).[96] Or one could imagine circumstances in which a taxpayer's intent is almost entirely focused on tax benefits, but the transaction also is reasonably expected to create profit[97] that is at least substantial in relation to such tax benefits (within the meaning of the profit ratio test).[98] This might be especially possible if the profit is much smaller than the expected tax benefits, even if it meets the "substantial" requirement of the ratio test. For example, profit that is one-fourth the amount of expected tax benefits might still be sufficiently "substantial," but the taxpayer's intent might be focused almost entirely on the tax benefits.

There are other situations in which a transaction might pass the objective test (based on reasonably expected profit, even if the transaction is less profitable than the alternatives), but fail the business purpose test, depending on how the post-codification economic substance doctrine further develops in the future. For example, in some instances, a taxpayer may have a choice between more and less profitable alternatives (like the higher-than-market-rate-interest loan in *Wells Fargo*,[99] a contract with higher transaction costs than the alternatives, or a rental property with lower returns than other options). If the taxpayer chooses a less profitable alternative in order to maximize tax benefits, does that make it harder to pass the business purpose

94. *See infra* Part III C (discussing whether business purpose must be reasonable).

95. As discussed above, Section 7701(o) has limited application to individuals, but it does apply to individuals' "transactions entered into in connection with a trade or business or an activity engaged in for the production of income." I.R.C. § 7701(o)(5)(B). Of course, transactions of individuals that are not described in the preceding phrase may still be subject to pre-Section-7701(o) versions of the economic substance test.

96. *See* Cherin v. Comm'r, 89 T.C. at 996.

97. *See, e.g.,* Wells Fargo II, 260 F. Supp. 3d at 1143, 1146.

98. *See* I.R.C. §7701(o)(2)(A).

99. *See Wells Fargo II*, 260 F. Supp. 3d at 1143.

test, even if the transaction meets the objective prong? (This question has occasionally been discussed by the courts,[100] but has not been definitively answered by the case law or by Section 7701(o).) The answers to these questions of interpretation affect the likelihood that a court's finding on the objective profit prong might differ from its finding on the business purpose prong.

Lastly, it is not clear why Congress chose the conjunctive test rather than, for example, requiring that the objective prong must be met in order for a transaction to have economic substance, and letting each circuit decide whether business purpose must also be proven.[101] (This would not be synonymous with the disjunctive test, which would accept either the objective or subjective prong as sufficient, so that the objective prong need not be met.) Such an approach would have been more consistent with the manner in which the courts have actually applied the economic substance doctrine.[102]

Overall, it is not clear that requiring uniformity among the circuits on the conjunctive test was a sufficient reason for codification, without the further detailed changes to the economic substance doctrine that are discussed below and without the impact of the penalty provisions associated with the codified doctrine.

2. *Substantive Impact (or Lack Thereof) of Requiring the Conjunctive Test*

a. In General

Section 7701(o)'s requirement that all circuits use the new, codified version of the conjunctive test has several substantive impacts. First, it gives the government an advantage, and taxpayers a disadvantage, in economic substance cases in circuits that formerly used the disjunctive test (or in circuits that did not - in practice - require taxpayers to meet the business

100. *See, e.g.*, Salem Fin. Inc v. U.S., 112 Fed. Cl. 587-88 (finding that a loan had no economic substance), Salem Fin. Inc. v. U.S., 786 F.3d 932, 950, 956–58 (Fed. Cir. 2015) (reversing on treatment of the loan); Pritired 1, LLC v. United States, 816 F. Supp. 2d 693, 739–40 (S.D. Iowa Sept. 30, 2011) (*Pritired*) (appearing troubled by the fact that, at least for some portions of the challenged transaction, the taxpayer chose a less profitable investment in order to generate foreign tax credits: "[I]t exchanged a positive cash flow (based on LIBOR plus 1%) for a lower cash flow," and "the Pritired transaction would have a cash return and IRR lower than an otherwise comparable investment in a general obligation municipal bond").

101. *See, e.g.*, the approach of the First Circuit in *Santander*. *Santander*, 844 F.3d at 22–23 (1st Cir. 2016).

102. *See supra* note 13.

purpose prong if they met the objective test, no matter how the economic substance test was described).[103] In theory, it must be harder for taxpayers to meet both the objective and subjective tests than just one or the other.[104] Thus, Section 7701(o) gives the government a better chance of disallowing a tax benefit, because now it only needs to win one of the two prongs (and taxpayers, conversely, must meet both) in every circuit.

Second, the structure of Section 7701(o)'s conjunctive test implies that the objective and subjective prongs must differ from each other. Third, the objective and subjective prongs are now required to be equal to each other. In pre-Section-7701(o) case law, in contrast, failing the subjective test was almost never enough (on its own) to cause a transaction to fail the economic substance analysis.[105] Instead, no matter what version of the economic substance test was applied, the objective prong was generally given more emphasis than the subjective prong.[106] Lastly, taxpayers may argue that the statute's description of the conjunctive test prevents courts from considering any other factors (such as congressional intent) in addition to the objective and subjective prongs. The latter three arguments may affect even those circuits that already used the conjunctive test before Section 7701(o)'s enactment. The impact on the business purpose prong is described in Part III C below. The possible argument that the objective and subjective prongs are now the only content of the economic substance test is discussed immediately below.

b. Does Not Prevent Use of Additional Requirements or Factors

There is a question as to whether Section 7701(o), by its phrasing and its requirement of the two-prong test, precludes courts' consideration (as part of the economic substance test) of anything else in addition to the two prongs. The statute provides that "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance *only if* [it meets the objective and subjective

103. *See id.* This article argues that there was not much difference, in practice, between the conjunctive test and other versions of the economic substance test before Section 7701(o). However, there is clearly a difference between the post-codification version of the doctrine under Section 7701(o) and the pre-codification version of the conjunctive, disjunctive, or flexible formulations.

104. Section 7701(o) also implies that the two prongs must be different from each other, so that the taxpayer is not merely required to meet two identical prongs. *See* further discussion *infra* Parts III B & C.

105. *See supra* note 13; *cf. supra* note 12.

106. *See supra* note 13.

prongs.]"[107] Although the words "only if" mean that both prongs are required, the "only if" phrasing does not technically prevent courts from examining or requiring other factors as well.[108] The statute does not say "if and only if," or use other language that mandates that the two prongs are necessarily always sufficient in themselves, or are the only factors.[109]

If the courts or the IRS choose to require more than the objective and subjective prongs in order to meet the economic substance test, such a requirement appears to be permitted under the statutory language and is generally taxpayer-unfavorable. In contrast, the courts and the IRS cannot find that a transaction has sufficient economic substance unless the taxpayer meets at least the objective and subjective prongs listed in the statute. After Section 7701(o), the objective and subjective prongs are a minimum, but not necessarily the entirety of the test, for finding that a transaction is respected under the economic substance doctrine.

Taxpayers are unlikely to argue for any additional requirements for meeting the economic substance test, but a court or the government might (in theory) suggest that more factors should also be taken into account, and that such added factors could preclude a transaction from having economic substance even if it meets the objective and subjective prongs. Such an approach could be consistent with the flexible version of the test previously applied by some circuits. Cases like *ACM* contemplated taking into account

107. I.R.C. § 7701(o)(1) (emphasis added).

108. *See* Jensen, *Unguided*, *supra* note 67, at 27 n.11 (2015) (reaching the same conclusion: "The statute seems to set only a minimum standard—economic substance does not exist unless both the objective and subjective tests are satisfied. A court therefore could, consistent with that minimum standard, presumably determine that other requirements must be satisfied for a transaction to have economic substance."); *see also* Jensen, *Responses*, *supra* note 27, at 32 n.156 (2012) (citing a commentator as pointing out that Section 7701(o) technically "does not codify the [economic substance doctrine] but rather codifies a precondition to taxpayer's escaping the [doctrine]," and agreeing with that characterization) (quoting Henry Stow Lovejoy et al., *Foreign Tax Credits, Economic Substance and the Future*, ABA Sec. of Tax'n, Comm. on Banking and Savings Inst. (Feb. 17, 2012)).

109. A Large Business and International Division (LB&I) directive, issued after section 7701(o)'s enactment, lists not two but eighteen factors for examiners to consider in analyzing whether the economic substance doctrine should be asserted. *See* LB&I Directive, *supra* note 20. The eighteen factors relate to whether the economic substance doctrine should be raised as an issue on audit. This resembles (but is narrower than) the preliminary question of whether the economic substance doctrine applies at all ("relevance," in the statute's terminology), and does not address the result of an economic substance analysis after the doctrine is determined to be applicable. In other words, the eighteen factors are not the test for whether the economic substance doctrine is met, but only factors for considering whether IRS employees should raise it as an issue. *See generally* Rebecca Rosenberg, *Codification of the Economic Substance Doctrine: Agency Response and Certain Other Unforeseen Consequences*, 10 WM. & MARY BUS. L. REV. 1 (2018) (forthcoming) [hereinafter Rosenberg, *Codification*] (discussing the IRS directive).

all of the facts and circumstances, as part of the economic substance test.[110] Technically, considering all of the facts and circumstances is still allowed (and can affect whether a transaction is respected as having economic substance), as long as the objective and subjective prongs are also both required.

One factor that courts might want to consider, in addition to the two prongs, is the legislative intent regarding the particular statute that creates the challenged tax benefit (e.g., the congressional intent relating to foreign tax credits versus interest deductions versus other benefits).[111] Congressional intent is the touchstone of the economic substance doctrine, according to many descriptions of the doctrine.[112] For example, the doctrine

110. *See* ACM, 157 F.3d 231, 246–47 (3d Cir. 1998) 246–47; *see also generally* Jerald David August, *The Codification of the Economic Substance Doctrine, Part I*, 12 BUS. ENTITIES 4, 21 (2010) (describing the United States Courts of Appeals for the Ninth and Tenth Circuits' formulation of the economic substance doctrine as an "all factors" method).

111. Congressional intent is already part of the relevance inquiry, i.e., the question of whether the economic substance doctrine applies to that type of tax benefit at all. *See, e.g*., Gardner v. Comm'r, 954 F.2d 836, 838–39 (2d Cir. 1992) (*per curiam)*; Lerman v. Comm'r, 939 F.2d 44, 54–56 (3d Cir. 1991); Horn v. Comm'r, 968 F.2d 1229, 1238 (D.C. Cir. 1992). But the relevance determination is not necessarily the end of the examination of congressional intent: Relevance is just the preliminary question of whether the rest of the economic substance analysis can proceed. The discussion in the text above suggests that courts could, in theory, take congressional intent into account not only as part of the preliminary relevance inquiry, but also (a second time), as part of the determination of whether the transaction meets or fails the economic substance test once that test is applied. Intent could also conceivably be considered as a means of interpreting the objective and subjective prongs (e.g., what kind of profit did Congress expect from transactions that generate interest deductions) in addition to being applied as a separate inquiry apart from the two prongs (as the *Santander* court used it). *See* Santander, 844 F.3d 15, 22, 24 (1st Cir. 2016) ("[W]e conclude both that the STARS Trust transaction had no objective non-tax economic benefit and that Congress, in creating the foreign tax credit regime, did not intend that it would cover this type of generated transaction.").

112. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was *the thing which the statute intended*.") (emphasis added); Knetsch v. United States, 364 U.S. 361, 367 (1960) (focusing on congressional intent, "[w]e, therefore, look to the statute and materials relevant to its construction for evidence that *Congress meant* in § 264(a)(2) to authorize the deduction . . . .") (emphasis added); *cf. Santander*, 844 F.3d at 22 (stating that the economic substance doctrine stems from *Gregory* and quoting the Supreme Court as saying that "the transaction upon its face lies outside the plain intent of the statute" (quoting *Gregory*, 293 U.S. at 470)).

Implementing congressional intent may also be the theoretical reason why courts are allowed to use the economic substance doctrine to disregard a taxpayer's literal compliance with statutory and regulatory rules, because doctrines of statutory interpretation may allow courts to ignore the literal language of a statute if the literal meaning is manifestly contrary to the intent of Congress (or if such meaning makes no sense). *See, e.g*., *Santander*, 844 F.3d at 21 ("The economic substance doctrine, like other common law tax doctrines, can thus perhaps best be thought of as a tool of statutory interpretation"); Gardner v. Comm'r, 954 F.2d 836, 838 (2d Cir. 1992) (*per curiam),* (citing statutory construction rules against finding absurd results, in support of court's finding that losses could be disregarded as lacking economic substance); Lerman v. Comm'r, 939 F.2d 44, 54–55 (3d Cir. 1991) (same); *cf.* Horn v. Comm'r, 968 F.2d is often described as examining whether "the thing that was done is the thing which the statute intended."[113] The economic substance doctrine can be described as focusing on whether the claimed tax treatment goes beyond the tax benefits that Congress intended to grant.[114]

Because legislative intent is so important to the economic substance analysis, it could potentially be applied as an additional factor. For example, in *Santander*, the United States Court of Appeals for the First Circuit concluded that a transaction lacked economic substance because the transaction had insufficient profit potential and violated congressional intent regarding the foreign tax credit. The court's analysis effectively treats congressional intent as another prong, i.e., as an additional inquiry separate from the objective and subjective tests.[115] That approach of considering congressional intent does not appear to be foreclosed by Section 7701(o), as long as the objective and subjective prongs described in Section 7701(o) are also required to be met. Instead, Section 7701(o) appears to leave courts able to decide whether to examine the congressional intent of the relevant tax benefit as part of determining whether a transaction meets the economic substance test, or to alternatively treat congressional intent inquiries as accomplished by means of the objective and subjective prongs rather than as a separate determination.

The next question would be whether the Treasury has the authority to provide instead that the objective and subjective prongs are the exclusive factors to be considered in applying the economic substance test (if the Treasury wished to do so, even though such guidance would make victory harder for the government). It is not entirely clear that this would be within the agency's regulatory authority: The statute says, "only if" rather than "if and only if," so that interpreting section 7701(o) to mean the latter ("if and only if") goes beyond the legislative language, and there is no specific grant

1229, 1239 (D.C. Cir. 1992) (reaching the opposite economic substance holding from *Lerman* and *Gardner* regarding losses under the same provision, "the canon of statutory interpretation that statutes should not be read to create 'absurd results' . . . is sensible, so far as it goes, but it can only be used to further Congress' intent, not to circumvent it"); *see also generally* Veronica M. Dougherty, *Absurdity and the Limits of Literalism: Defining the Absurd Result Principle in Statutory Interpretation*, 44 AMER. UNIV. L. REV. 127 (1994); Steve Wisotsky, *How to Interpret Statutes–Or Not: Plain Meaning and Other Phantoms*, 10 J. APPELLATE PRACTICE AND PROCESS 321 (2009).

113. Gregory v. Helvering, 293 U.S. 465, 469 (1935).

114. *See infra* note 115.

115. *See Santander*, 844 F.3d at 23–24 (analyzing a STARS transaction that occurred before section 7701(o)'s effective date); *see also Salem II*, 786 F.3d at 954 (as part of business purpose analysis: "Congress could not have intended to allow a taxpayer to claim a foreign tax credit, at the expense of U.S. tax revenue, for a transaction involving no commerce or bona fide business abroad and having no purpose other than to obtain foreign and domestic tax benefits.").

of regulatory authority that covers this issue.[116]

B. The Objective Prong

1. *Overview*

Section 7701(o)'s description of the objective prong begins with the requirement that "the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position. . . ."[117] It thus provides that the objective test can be met by a change in economic circumstances, rather than only by profit potential. Section 7701(o) also provides that profit potential can only be taken into account if reasonably expected profit is substantial compared to expected tax benefits (the ratio test).[118] It further indicates that reasonably expected profit is computed at present value.[119] Overall, the objective prong set forth in Section 7701(o) is largely consistent with most circuits' formulations,[120] but it contains the new requirements that change in economic position must be "meaningful" and that profit potential (if used to meet either prong) must meet the ratio test. Thus, the statute's description of the objective prong may be interpreted as constraining the courts' ability to adapt the objective prong in some respects. It contains a mix of elements that are left to Treasury guidance or to the courts (e.g., the meaning of the terms "substantial" and "meaningful") and requirements that are more closely defined (e.g., under the profit ratio test, profit is measured based on the amount that is reasonably expected, as computed at present value).

2. *Change in Economic Position*

a. In General

As described above, Section 7701(o) provides that the objective prong is met if "the transaction changes in a meaningful way . . . the taxpayer's

116. *See* I.R.C. § 7701(o).

117. I.R.C. § 7701(o)(1)(A). This article sometimes abbreviates this "changes in a meaningful way" requirement as "meaningful change," for brevity.

118. I.R.C. § 7701(o)(2)(A).

119. *See id*.

120. *See, e.g.*, *ACM*, 157 F.3d 231, 259–260 & n.56 (3d Cir. 1998) (saying that present value is an appropriate method for measuring profit); *see also supra* note 41, *infra* note 193.

economic position."[121] The Code language does not define either "meaningful" change or "economic position." That presumably leaves both terms open to judicial interpretation and Treasury guidance. The latter takes priority (prospectively only, unless such guidance is cast as an anti-abuse rule under Section 7805)[122] because the statute gives the IRS the authority to issue guidance,[123] but no such guidance has yet been issued.[124]

b. Lack of a "Reasonable Expectation" Standard

The statutory reference to change in economic position is not modified by the "reasonable expectation" or "potential" concepts that apply to profit.[125] Grammatically, Section 7701(o)(1)(A) states that a transaction meets the economic substance test only if it "changes in a meaningful way . . . the taxpayer's economic position." This makes it sound as if the change in economic position must actually occur, not just be reasonably expected to occur. However, "potential for profit" (if it passes the ratio test) is one element to take into account in evaluating this change in economic position.[126] Thus, there is a possible conflict between the objective prong's requirement for "change" (not just potential change) and the ratio test's strong implication that "potential" profit can be taken into account under the objective prong.

There are multiple possible approaches to reconciling this apparent conflict. For example, the profit ratio test (with its rule for the "potential for profit") could be read as implying that potential change (or reasonable expectation) can be enough to meet the objective prong, without *actual* change in economic position even for economic change other than profit.

121. I.R.C. § 7701(o)(1)(A).

122. Section 7805 generally requires that tax regulations apply prospectively only. *See* I.R.C. § 7805(b)(1). But it contains an exception for anti-abuse rules, which can apply retroactively. *See* I.R.C. § 7805(b)(3).

123. *See* I.R.C. § 7805(a) (providing general regulatory authority to interpret Code provisions).

124. To date, the IRS has issued two notices regarding section 7701(o), but neither defines "meaningful" change or "economic position." *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (stating that the IRS will apply case law to determine whether a transaction meets the objective prong under section 7701(o)); I.R.S. Notice 2014-58, 2014-44 I.R.B. 746.

125. *Compare* I.R.C. § 7701(o)(1)(A) ("transaction changes in a meaningful way . . . taxpayer's economic position") *with* I.R.C. § 7701(o)(2)(A) ("potential for profit" can be taken into account only if "reasonably expected pre-tax profit from the transaction is substantial" compared to expected net tax benefits). The statutory version of the *subjective* prong, in contrast, neither specifically refers to reasonable expectation nor implies a lack of impact for reasonably expected or potential (but not actually occurring) profit or other economic effects. *See* I.R.C. § 7701(o)(1)(B).

126. *See* I.R.C. § 7701(o)(2)(A).

But this interpretation is likely overbroad, because it seems to ignore the statutory requirement that a transaction "changes" (not just potentially changes) the taxpayer's "economic position."[127]

Alternatively, the statutory language seems better read as implying that the ability to consider potential or reasonably expected results applies only for profit (and only when profit potential passes the ratio test), and that other changes in economic position are subject to the higher standard of actually occurring. This approach (although not perfect) at least attempts to give effect both to the profit ratio test's concept of taking profit potential into account for the objective prong, and to the objective prong's requirement for "change" in economic position.

The statute could also be read as meaning that even profit must actually occur (must both meet the ratio test, which examines "reasonably expected" profit, and also actually occur) before it can be taken into account under the objective prong, because the objective statutory test requires "change[]" rather than just "reasonably expected" or "potential" change. But the courts and the IRS may be unlikely to make this argument. Such an approach, if taken, might hold that 1) the profit ratio test compares reasonably expected profit to expected tax benefits, in order to determine whether "potential for profit" can be taken into account, but 2) only actual profit is considered under the objective prong, because the transaction must actually "change[] in a meaningful way . . . the taxpayer's economic position."[128] This two-part approach, however, fails to explain why the ratio test addresses the use of "potential for profit" for both prongs,[129] if only actual profit is relevant for the objective prong. It also seems to make the profit ratio test pointless and moot for the objective prong, which is inconsistent with the statute's application of that test to both prongs.[130] This interpretation thus seems unconvincing.

Alternatively, one could argue that profit potential (in the absence of actual profit) can be "taken into account"[131] (i.e., considered) for purposes of the objective prong, but only to the extent that such profit potential produces actual change in economic position, such as a public relations effect or a change in stock price. Yet this avenue is not quite persuasive, because such actual changes (resulting from profit potential) presumably could be taken

127. *See* I.R.C. § 7701(o)(1)(A).

128. *Id.*

129. *See* I.R.C. § 7701(o)(2)(A).

130. *See id.*

131. *See id.*

into account under the objective prong on their own merits, even if profit potential itself did not pass the ratio test. This argument thus fails to keep the ratio test from being moot or meaningless for the objective prong.

Overall, there seems to be no perfect answer to the apparent conflict between the language of the objective prong ("change[]") and the ratio test ("potential for profit"). The best approach seems to be reading the objective test as requiring actual (not just potential) change, except that "potential for profit" (not just actual profit) can also be taken into account if such profit potential meets the ratio test.

c. What is a Change in Economic Position?

In the absence of regulatory guidance, the first obvious question would be: What is a change in "economic position"? It likely is a broader concept than profit, because the statute includes rules about when profit (specifically, profit potential) can be taken into account to prove the required change in economic position (implying that there are other ways, besides profit, to show such a change). Also, "economic position" is simply a different term than "profit," indicating that they have different meanings.

The pre-Section-7701(o) case law similarly treated the objective prong as going beyond a mere profit inquiry. Although the objective analysis is sometimes referred to as the profit test, many circuits had already held that this prong could be met by showing that the transaction caused a change in the taxpayer's economic circumstances (as well as by showing that the transaction had profit potential).[132] However, not all circuits had made such a statement (perhaps because not all circuits had considered the question). One of Section 7701(o)'s impacts is that it increases uniformity by requiring all circuits to define the objective prong more broadly than just profit potential. This naturally raises questions about what can alter economic position other than expected profit, especially for a corporation. Isn't

132. For example, *BNY Mellon II* concluded that a STARS transaction lacked profit potential, but then stated that the profit potential conclusion was not the end of the objective prong analysis. The court went on to examine whether there was a change in economic position (apart from profit). *BNY Melon II*, 801 F.3d 104, 119 (2d Cir. 2015), *cert. denied* 136 S. Ct. 1377 (2016). *See also, e.g.*, Santander, 844 F.3d at 25; *ACM*, 157 F.3d 231, 251 (3d Cir. 1998); UPS of America v. Comm'r, 254 F.3d 1014, 1019 (11th Cir. 2001) ("UPS really did lose the stream of income it had earlier reaped from excess-value charges. UPS genuinely could not apply that money to any use other than paying a premium to National Union; the money could not be used for other purposes. . . ."); *Salem II*, 786 F.3d at 949–50; In Re Cm Holdings, Inc., 301 F.3d 96, 103 (3d Cir. 2002) ("The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."). Some of the cases cited above were decided after section 7701(o)'s enactment but analyzed transactions that occurred before that section's effective date.

everything a corporation does ultimately aimed at potential profit? Even for individuals, isn't "economic" position necessarily about profit?

In addition to profit, "change[] in . . . economic position" might conceivably include changes in a taxpayer's legal rights (apart from tax costs and benefits), and the legal rights of others regarding the taxpayer, even if such changes do not directly alter reasonably expected profit. Such changes in legal rights might include, for example, subjecting oneself to the laws of a particular state or country, or to the potential claims of additional creditors, or increasing exposure to a particular borrower's credit risk (e.g., by allowing the lapse of a loan guarantee).[133] Although ultimately (perhaps indirectly) aimed at profit, these particular examples might change a taxpayer's legal rights without directly altering reasonably expected profit.

Also, "change" is not limited to positive events. Change in economic position could also include loss, rather than profit.[134] Such an interpretation would be consistent with the pre-codification case law's consideration of both upside and downside risks (i.e., the potential for either gain or loss) in the economic substance analysis.[135] If a taxpayer reasonably expects a loss from a transaction, but has a non-tax business motive (such as publicity, or maintaining a business relationship), that set of facts potentially could meet the two prongs set forth in Section 7701(o). (However, the publicity or continuing business relationship theoretically could lead, over time, to reasonably expected profit, which might be used to meet the objective prong without needing to look to other types of economic change.) Even if a loss can qualify as a "change[] . . . in economic position," are all tax benefits intended to apply to situations where the taxpayer reasonably expects a loss, or did Congress intend that some (not all) tax benefits be limited to potential profit situations? The statutory language of Section 7701(o) may allow the answer to vary for different tax benefits (even those to which the economic

133. Some of these possibilities raise issues similar to the distinction between tax and "business" transactions under the compulsory payment rule, within the foreign tax credit regulations. *See* Treas. Reg. §1.901-2(e)(5)(i) (last sentence) (2013) (exception for business conduct, business structure, and form of a business transaction); I.R.S. Chief Couns. Adv. Mem. 2009-20-051 (May 15, 2009) (drawing a distinction between "business" and "tax" conduct for purposes of the compulsory payment rule); I.R.S. Tech. Adv. Mem. 130972-06 (making the same distinction regarding a different fact pattern).

134. *See* Jensen, *Unguided*, *supra* note 67, 32 J. TAX'N INV. 27, text accompanying n.37 (theorizing that selling an asset at a loss could satisfy the objective prong because "when an asset is converted into cash" there is "a clear change in economic position").

135. *See*, *e.g.*, *BNY Mellon II*, 801 F.3d 104 (contract terms carefully limited the potential for loss); Jacobson v. Comm'r, 915 F.2d 832 (2d Cir. 1990) (transaction had potential for both upside and downside risk); Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 779 (5th Cir. 2001) (taxpayer had downside risk as well as profit potential) *rev'ing* Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 225 (1999) (transaction was carefully engineered to eliminate any potential for loss); *see also infra* note 175.

substance doctrine is relevant).[136]

If an expected loss is used as the reason for meeting the objective prong, the taxpayer may face some challenges in meeting the *subjective* prong, regarding business purpose. Taxpayers might cite, in such foreseeable-loss circumstances, subjective business purposes relating to publicity, business relationships, developing expertise, entering a new market, or similar motives. (But such motives, as discussed above, might also lead to reasonably expected profit rather than loss, in the long term, making it unnecessary to look beyond profit potential in order to meet the objective prong.) Such taxpayer theories might be more persuasive if the transaction is a normal, frequent aspect of the taxpayer's business (e.g., for an oil company conducting speculative drilling, or a pharmaceutical company conducting research into potential new medicines, rather than an oil company investing in a new drug with uncertain medical uses).

Perhaps the ability to meet the objective prong using means other than profit potential is aimed at situations that may be so high risk (like oil drilling or the movie business) that reasonably expected profit (when risk-adjusted) is either hard to quantify or relatively low.[137] *Santander* suggests that the option of meeting the objective prong without showing reasonably expected profit is meant to accommodate high-risk transactions or those that must wait a long time before one determines whether they will bear fruit or not.[138] (Product research and development, or prescription drug trials, are examples of investments that might or might not yield profit in the future, and whose results are hard to predict.)[139]

The *Santander* and *Salem II* cases—decided after section 7701(o)'s enactment—address transactions before Section 7701(o)'s effective date, but such courts use language similar to the statute: The cases discuss whether a transaction "meaningfully alter[] the taxpayer's economic position (other

136. Tax benefits intended for transactions that are expected to yield a loss might often be exempt from the economic substance test, under the relevance concept. *See, e.g.*, Sacks v. Comm'r, 69 F.3d 982, 991–92 (9th Cir. 1985) (discussing tax benefits relating to solar energy); Horn v. Comm'r, 968 F.2d 1229, 1238 (D.C. Cir. 1992). For example, the low income housing credit is arguably intended to apply even if losses are reasonably foreseeable, and the economic substance doctrine is generally said not to apply to such credits because of that specific congressional intent. *See, e.g.*, *Joint Committee Report*, *supra* note 65, at 152 n.344.

137. However, cases like Cherin suggest addressing this issue by adjusting the required amount of profit based on industry profit norms. *See* Cherin v. Comm'r, 89 T.C. 986, 993–94 (1987).

138. *See* Santander Holdings USA, Inc. v. United States, 844 F.3d 15, 25 (1st Cir. 2016).

139. *See, e.g.*, Boeing v. Comm'r, 537 U.S. 437, 443 (2003) (it is hard to predict which research and development efforts will prove beneficial and which particular product lines might eventually benefit from research); Treas. Reg. § 1.861-17(a) (same).

than with regard to the tax consequences)."[140] The courts imply that the quoted language includes a concept that "some transactions that are not immediately profitable without tax benefits, such as investments in 'nascent technologies'" may meet the objective prong by showing this change in economic circumstances.[141] One could argue, though, that such transactions have no need to look beyond profit potential: These investments could probably meet the objective prong (depending on their facts) by computing reasonably expected profit over the life of the investment, rather than only for the initial period (unless profit is uncertain). Such multiyear computations are used by most or all circuits in applying the economic substance doctrine, and also appear contemplated by 7701(o)'s rules.[142]

Of course, whether a risky or uncertain transaction is treated as yielding reasonably expected profit (e.g., future profit) is also affected by how the "transaction" is defined. For example, even if a pharmaceutical company is unsure whether a particular prescription drug trial will ever yield a marketable product, the company certainly expects that the aggregate of all of its research activities and all of its drug trials will produce a net profit eventually.

Perhaps one technical difficulty (solved by allowing other-than-profit means of showing change in economic circumstance) is created because the economic substance doctrine generally treats the tested transaction as consisting of the activities that produce the tax benefit.[143] However, businesses may evaluate the viability (potential profit) of their activities (such as research and development) based on a larger scale, e.g., by viewing the potential aggregate profitability of many activities together. Therefore, any one research and development trial, for example,[144] might have hard-to-predict results, or an expected loss (yielding a change in economic position without profit), even though the sum of all of the corporation's research and

140. *See Santander*, 844 F.3d at 25 (quoting *Salem II*, 786 F.3d 932, 950 (Fed. Cir. 2015) (alteration made by *Santander* court)). The quoted language above is very similar, but not quite identical, to Section 7701(o)'s language on economic position. The Section 7701(o) version reads: "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position. . . ." *See* I.R.C. § 7701(o)(1)(A).

141. *Santander*, 844 F.3d at 25 (citing Salem Fin., Inc. v. United States, 786 F.3d 932, 950 (Fed. Cir. 2015).

142. Section 7701(o) looks to the present value of reasonably expected profit, which implies an examination of profit over the life of a transaction (rather than annually or in the short term). *See* I.R.C. § 7701(o)(2)(A).

143. *See infra* notes 294 and 300.

144. This example assumes, without deciding, that the economic substance test is relevant to the research and development credit. *See* I.R.C. § 41.

development activities may have a net reasonably expected profit. In such a situation, allowing the taxpayer to meet the objective prong by using change in economic position from a transaction, rather than reasonably expected profit from the transaction, may be appropriate from a policy perspective. (The subjective business motive, in such a situation, might include the advancement of the company's expertise regarding a particular drug, as well as industry-norm small percentage potential for profit.)

3. *"Meaningful"*

The next question would be: how does one determine whether a change in economic position is "meaningful"?[145] The term "meaningful" is not defined in Section 7701(o). The statutory use of the word "meaningful" rather than "substantial" (which appears in the profit ratio test and the business purpose prong)[146] suggests that the two terms have different definitions.[147] The usual connotations of "meaningful" seem to exclude a merely *de minimis* change in economic position (whether or not caused by profit that is "substantial" in relation to expected tax benefits). "Meaningful" change could thus be more than the pre-codification economic substance case law required for the objective prong, depending on the circuit.[148] Because the required change in economic position is not limited to profit, there are also questions as to how to measure non-monetary changes, such as risk exposure or public relations impact, in order to determine if such changes are "meaningful." "Meaningful" is open to regulatory interpretation (if the Treasury chooses to issue guidance) or judicial reasoning. Potential interpretations and considerations are discussed below.

Some of the case law regarding pre-Section 7701(o) transactions examines meaningful change in economic circumstances, as part of the

145. *See* I.R.C. § 7701(o)(1)(A).

146. *See* I.R.C. § 7701(o)(1)(B) ("substantial purpose"); I.R.C. § 7701(o)(2)(A) ("if the present value of the reasonably expected profit is substantial in relation to the present value of the expected net tax benefits").

147. That would be a more helpful fact for statutory interpretation if "substantial" were defined, which it is not. *See id.*; I.R.C. § 7701(o)(1)(B).

148. The IRS has said that it will follow case law (including pre-codification case law) in interpreting the objective and subjective prongs, until further notice. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411. But that may not be within the IRS' authority, if the statutory requirement for "meaningful" change goes beyond what some circuits required before codification.

objective prong analysis.[149] Courts' references to meaningful change seem to be conveying the point that profit is not the only way to meet the objective prong. But such case law does not give a clear standard for how to determine whether economic change is meaningful or sufficient. In addition, such pre-codification case law was not interpreting the language of Section 7701(o).

The statute is not entirely clear as to whether meaningful change just indicates that profit isn't the only way to meet the objective prong, or whether it instead imposes a separate, additional standard, which could require more than just profit that is substantial in relation to tax benefits. Taxpayers will need to determine whether the meaningful change standard applies to profit (as an additional test, after the profit ratio test), or whether the ratio test is sufficient to show (without additional analysis of "meaningful" change) that profit potential meets the objective prong. The statute does not literally require the latter conclusion: the profit ratio test is the minimum requirement for taking profit potential into account, but is not described as necessarily sufficient to meet the objective prong in all circumstances. Thus, the courts and the Treasury are free to take the former view, that "meaningful" change is an additional requirement that applies even to profit potential that passes the profit ratio test.

Meaningful appears to mean more than *de minimis*, but it is unclear how much more. Nor does the statute specify how to measure when a change in economic situation is sufficient to be "meaningful," including whether such change must be meaningful in an absolute sense or (instead) in comparison to another item (and, if so, in comparison to what). Perhaps "meaningful" change in economic position requires change that is significant to the particular taxpayer. For example, profit that is one-half the size of expected tax benefits is almost certainly "substantial" within the meaning of the ratio test, but could conceivably not be "meaningful" for the specific taxpayer.

Is "meaningful" potentially a qualitative concept, rather than quantitative? Or does it incorporate both the size and the quality (or importance) of the economic change? Can "meaningful" have different definitions for taxpayers who have different circumstances from each other? For example, could a $10,000 potential profit constitute a "meaningful" change in economic position for a local small business, but not for a large multinational corporation? Could "meaningful" vary for different

149. *See* Salem Fin., Inc. v. United States, 786 F.3d 932, 951, 960 (Fed. Cir. 2015); Santander, 844 F.3d 15, 25 (1st Cir. 2016). These cases were decided after section 7701(o)'s enactment, although they address transactions that occurred before section 7701(o)'s effective date.

industries?[150] For example, could a $10,000 potential profit be meaningful for an independent grocer, but not for a jeweler? Industry alone seems a less compelling rationale for differing definitions of "meaningful" than a distinction based on facts and circumstances (including but not limited to total annual net profit from all activities—not just from the challenged transaction—for the taxpayer or the taxpayer's consolidated group).[151] Should the challenged transaction's relative profit (or other measure of significance) compared to average per-transaction profit for the taxpayer's other transactions be taken into account? In that case, high volume, low margin businesses (e.g., grocery stores) might have different economic substance results for a particular transaction than businesses with a low volume of transactions and high margin (e.g., oil drillers or fine art dealers). That does not necessarily seem to be a logical interpretation of the statutory language.

Defining "meaningful" to include a concept of either "significant" or "more than *de minimis*" raises conceptual issues, such as: Assume that a large multinational corporation with billions of annual profits engages in a transaction that is reasonably expected to generate $5,000 of profit (a miniscule amount for that corporation, compared to its average profit on most of its transactions and compared to its annual net profit), and $25,000 of tax benefits. Is that transaction automatically lacking in economic substance because it does not create "meaningful" change in economic

150. This would be consistent with the concept in Cherin (and other cases) that the amount of profit that is sufficient can differ based on the norms in the relevant industry. *See* Cherin v. Comm'r, 89 T.C. 986, 993–94 (1987). However, this does not necessarily mean that industry-specific analysis is equally applicable to the determination of whether the transaction "changes in a meaningful way . . . the taxpayer's economic position." *See* I.R.C. § 7701(o)(1)(A).

151. For the reasons discussed in this paragraph of the text and the next paragraph, perhaps "meaningful" allows the government another chance to argue that more profit (or more change in economic position) is necessary than merely profit that is substantial in relation to tax benefits. In the example above, $10,000 of profit might not be "meaningful" for a huge corporation even if $10,000 was substantial compared to expected tax benefits. However, such an interpretation implies that if the economic substance doctrine is relevant, a transaction lacks economic substance unless it creates a change in economic circumstances that is large enough to be "meaningful" for the relevant taxpayer. Yet it seems unlikely that Congress really meant to disregard, as lacking economic substance, all transactions that yield relatively small results for the taxpayer (based on that particular taxpayer's size and overall profits), absent other problematic circumstances. Therefore, perhaps "meaningful" means something other than "relatively large for this taxpayer." Perhaps it means something closer to "more than *de minimis*" as an absolute matter, rather than relative to the taxpayer's total annual profits (although that seems a low standard), or perhaps it is more of a qualitative standard than one based on size. These are issues that the courts will have to grapple with. Also, a transaction that passes the "meaningful" objective standard despite having a relatively small (for that taxpayer) profit might have difficulty showing the required substantial non-tax purpose—how would a large corporation show a substantial non-tax purpose for a transaction yielding $10,000 of profit (and significantly higher tax benefits)? The answer likely depends on the taxpayer's facts and circumstances.

situation?[152]

Surely the economic substance doctrine does not disallow tax benefits for all transactions that are relatively small (too small to be "meaningful") for the particular taxpayer. The troubling part of the small transaction described above is not its lack of size compared to total net profit from all transactions, but the relative size of this transaction's expected profit ($5,000) compared to tax benefits ($25,000). Yet that unbalanced ratio of one to five is likely to meet the profit ratio test[153] (i.e., it is likely "substantial"). The definition of "meaningful" arguably isn't the right place to address concerns about profit that is disproportionately small compared to tax benefits—but the profit ratio test doesn't impose a very high standard, which could leave the courts searching for another argument. For the hypothetical corporate taxpayer above, a transaction might instead yield five million dollars of expected profit, and twenty-five million dollars of expected tax benefits. What is problematic is not the size of the profit (in an absolute sense or compared to total profits), but the ratio of profit to tax benefits.[154]

A transaction that had $5,000 of reasonably expected profit and $500 of expected tax benefits is not as troubling (because smaller dollar amounts of tax benefits are involved and because profit exceeds tax benefits by a factor of ten). But this transaction raises exactly the same questions about the definition of "meaningful" change, and whether $5,000 can be a

152. Practically speaking, that is not a big enough tax benefit for such a large corporation to bother with (in terms of entering into a transaction in order to obtain such a relatively small tax benefit, with insufficient non-tax benefits). Therefore, the example above may be moot because tax benefits for challenged transactions of high-annual-income taxpayers are likely to be relatively large. Such large-tax-benefit transactions will require a more-than-*de-minimis* profit (profit that is substantial compared to the large tax benefit) because of the profit ratio test, if the taxpayer is using profit potential to meet either of the two prongs. If, instead, the example above showed expected net tax benefits of $250,000, the taxpayer could have trouble meeting the profit ratio test: $5,000 of reasonably expected profit might not be "substantial" in relation to $250,000 of expected net tax benefits.

153. *See* I.R.C. § 7701(o)(2)(A).

154. Perhaps the size of the profit from this transaction, compared to size of aggregate profit from all transactions for the year (or the usual profit from each of the taxpayer's transactions), is a factor better taken into account in analyzing whether there is substantial non-tax business purpose. There again, however, non-tax business purpose that only represents 20 percent of the purpose for a transaction might be sufficient (depending on what "substantial" means in that context). *See* I.R.C. § 7701(o)(1)(B). If business purpose must be substantial in an absolute sense, or in the context of taxpayer's other activities, there may be an argument that a taxpayer with billions of annual profits did not have sufficient non-tax purpose for a $5,000-expected-profit transaction (especially one which is outside its usual industry or its usual business practices) that was expected to yield $150,000 of tax benefits. Such debates will have to take into account, as mentioned above, that it is unlikely that Congress meant to disallow tax benefits for all relatively small transactions, a conclusion that implies that more than absolute size should be taken into account.

meaningful change for a corporation with billions of annual profits.

"Meaningful" is not measured as compared to expected tax benefits, unlike the profit ratio test. This creates a negative inference that other-than-profit methods of showing a change in economic position need not reach a particular ratio compared to expected tax benefits (or any other specific item), in order to show meaningfulness (at least until the courts or Treasury provide further interpretation). That could be a big advantage for taxpayers with respect to other-than-profit methods of showing change in economic circumstances. Query whether courts or the Treasury could require such a comparison to tax benefits even for other-than-profit indicators, or whether the negative inference described above is too strong to allow for contrary judicial or administrative interpretation. The latter seems more likely to be the case. A required comparison to an item other than tax benefits, however (e.g., the taxpayer's net worth, or the average economic change from the taxpayer's other transactions), is likely within the scope of acceptable judicial or administrative interpretation.

Given the absence of a statutory definition, the courts or Treasury can answer the questions above. Those answers might arrive piecemeal, over time, in response to specific fact patterns. Alternatively, administrative guidance might consist of a more comprehensive framework (e.g., in the form of regulations) that is not limited to a particular set of facts. Given the Treasury's apparent reluctance to issue guidance on Section 7701(o) in the near future,[155] the answers seem to be left to the courts for now. In that case, approaches could differ from circuit to circuit.

4. *Summary on the Objective Prong*

The objective prong is not limited to profit: It can be met by factors other than (or in addition to) profit. Conversely, profit (even if it meets the ratio test) might not necessarily be sufficient to show meaningful change in economic position. Section 7701(o) imposes the new standards of "changes in a meaningful way . . . the taxpayer's economic position"[156] and, for the profit ratio test, "substantial" profit. Those phrases are undefined, and

155. *See generally* Rosenberg, *Codification*, *supra* note 109.

156. I.R.C. § 7701(o)(1)(A). Similar language on meaningful economic change was used by the Salem II court, in an opinion that was written after section 7701(o)'s enactment but related to a transaction occurring before section 7701(o)'s effective date. *See Salem II*, 786 F.3d 932, 950 (Fed. Cir. 2015) ("What is critical is to identify transactions lacking economic reality, i.e., those that do not alter the taxpayer's economic position in any meaningful way apart from their tax consequences, typically entailing no risk and no significant possibility of profit other than as a result of tax considerations."), *cert. denied* 136 S. Ct. 1366 (2016)*; see also* Santander, 844 F.3d at 25.

therefore will be subject to interpretation by the courts and potentially (if it chooses to issue guidance) by the Treasury. There are many other, smaller technical requirements imposed by the statute regarding the objective prong that will similarly need to be interpreted in the future.[157]

C. The Subjective Prong

1. *Overview*

In pre-Section 7701(o) case law on the economic substance doctrine, the business purpose prong generally received less emphasis than the objective prong.[158] Often, the subjective prong was met or failed based on whether the taxpayer had a reasonable expectation of profit—the same factor that often proved crucial for the objective prong.[159] Thus, the two prongs were often functionally duplicative of each other, in large part.

Section 7701(o), however, creates an implication that the subjective prong is of equal importance to and must differ from the objective prong. This may lead to a new emphasis on attempting to prove subjective non-tax intent without duplicating the objective prong's analysis. In addition, Section 7701(o) imposes new requirements that subjective non-tax intent must be "substantial" and that profit potential can only be taken into account for proving such intent if it meets the profit ratio test.

2. *Differs from Objective Prong*

After Section 7701(o)'s effective date, the subjective prong (business purpose) must be considered, even in circuits that previously used the

157. I.R.C. Section 7701(o) also contains restrictions on taking financial accounting benefits into account for purposes of the subjective prong—but not for the objective prong. It states that, "[f]or purposes of paragraph (1)(B) [the subjective prong], achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction in Federal income tax." I.R.C. § 7701(o)(4). This implies that "achieving a financial accounting benefit" can be considered in determining changes in "economic position" (which are not limited to profit), even if such financial accounting benefits derive from the challenged federal income tax benefits. For example, financial accounting benefits that improve stock price, or smooth the way for a merger, could conceivably contribute to a "meaningful" change in "economic position," even if such benefits are caused by claimed federal income tax results. Such a taxpayer would still, however, need to meet the subjective prong without taking such financial accounting benefits into account (because section 7701(o) now requires that both prongs be met). The taxpayer would therefore need a "substantial" non-tax purpose other than financial accounting effects.

158. *See supra* note 13.

159. *See supra* note 12, and *infra* note 205.

disjunctive test or the flexible approach. In addition, the structure of Section 7701(o)(1), which says that a transaction meets the economic substance requirement only if it meets both prongs, implies that the business purpose test is different from the objective test. Otherwise, there would be no need to list two prongs.[160] The rules of statutory interpretation mandate against reading statutory language as moot, duplicative, or unnecessary, whenever possible.[161] These rules appear to require that "substantial purpose (other than Federal income tax effects)" (the subjective prong) must mean something different than "the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position"[162] (the objective prong), because if the two phrases were identical then one of them would be superfluous and moot.

This marks an important change from the manner in which the subjective prong was often applied before codification: In practice, the business purpose analysis was often duplicative of the profit inquiry, especially for corporate taxpayers.[163] Further, interpreting the business purpose prong as being different from the objective prong can only hurt taxpayers and help the government: Two different prongs (both required) must be less favorable for the taxpayer than one of such prongs repeated twice.

The IRS does not seem to agree with this reading that the two prongs must differ from each other: It has said that it will continue to apply economic substance case law in order to define the subjective prong.[164] All of such case law currently addresses transactions that occurred before Section 7701(o)'s effective date, so all of such cases interpret pre-Section

160. One could consider whether listing two prongs means that the business purpose prong *can* differ from the objective prong, but does not have to do so. In that case, though, there would be no reason for the statute to require two prongs instead of one, because meeting the business purpose prong would be optional rather than mandatory. As discussed above, the conjunctive and disjunctive versions of the economic substance doctrine are essentially the same, in practice, if the objective and subjective prongs are met by the same facts (usually profit potential). Congress' imposing a conjunctive test implies that the two prongs are different from each other because, if the two analyses are identical, the conjunctive and disjunctive tests always reach the same results as each other.

161. *See, e.g.*, Montclair v. Ramsdell, 107 U.S. 147, 152 (1883) ("give effect, if possible, to every clause and word of a statute, avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed"); Hibbs v. Winn, 542 U.S. 88, 101 (2004) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant"); Bailey v. United States, 516 U.S. 137, 146 (1995) ("We assume that Congress used two terms because it intended each term to have a particular, nonsuperfluous meaning."); Gustafson v. Alloyd Co., 513 U.S. 561, 577–78 (1995).

162. I.R.C. § 7701(o)(1).

163. *See supra* note 12, and *infra* note 205.

164. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411.

7701(o) law. That case law, as mentioned above, often treated the subjective prong as analyzing the same elements (chiefly profit and risk) that were used for the objective prong.[165]

Thus, the IRS's position appears to be that section 7701(o) has not changed the content of the subjective prong. But it is likely not within the IRS's authority to determine that the objective and subjective prongs can be duplicative of each other, even if pre-Section-7701(o) case law implicitly takes that approach. Instead, rules of statutory interpretation, created by Supreme Court precedent and by other case law, require that statutes (including the Internal Revenue Code) must be read so as to prevent any language from being moot.[166]

Even if the IRS proposes that the business purpose test means what it did under pre-enactment case law, courts are not bound by that decision if it exceeds the IRS' regulatory authority. Instead, courts can (and should) hold that the subjective prong must mean something different than the objective prong once Section 7701(o) applies. However, practically speaking, if the IRS or the Department of Justice, litigating on behalf of the government, concedes the business purpose prong in litigation, or stipulates that the business purpose prong is met where there is sufficient profit to meet the objective prong, it may be debatable whether the courts are able or willing to apply a different interpretation of the subjective prong on their own initiative.[167]

Given the wording of section 7701(o), the statutory version of the business purpose prong may be best read as requiring at least some component other than, or in addition to, profit potential (or economic change, if used by the taxpayer instead of profit potential), in order to prevent its analysis from duplicating that under the objective prong. The statute implies, though, that there may be some overlap between the objective and subjective

165. *See supra* note 12, and *infra* note 205.

166. *See supra* note 161 (statutory language generally should not be read as moot). In addition, if the objective and subjective prongs were duplicative of each other, there would be no reason to require the conjunctive test in Section 7701(o) rather than, for example, requiring that all circuits consider the objective prong. Requiring the conjunctive test (and thus creating greater uniformity among the circuits) was among Congress' stated goals in enacting Section 7701(o). *See* H.R. Rep. No. 111-443, at 295, 297; *see also Joint Committee Report*, *supra* note 65, at 152. Congress described that section as both "clarifying" and "enhancing" the economic substance doctrine. *See* H.R. Rep. No. 111-443, at 295; *see also Joint Committee Report*, *supra* note 65, at 152. The term "clarifying" indicates a lack of a major change from pre-enactment case law, but Congress also used the additional term "enhance," which implies change that makes the doctrine more rigorous.

167. *See generally* Rosenberg, *Codification*, *supra* note 109 (discussing an agency's (in this case, the IRS') ability to ignore congressional intent and taxpayers' likely choice not to challenge any such administrative approach that is taxpayer-favorable).

prongs (even if there cannot be complete identity): The profit ratio test applies to both prongs,[168] suggesting that profit potential can be taken into account for purposes of both tests.[169] This strongly implies that profit potential is at least relevant for the business purpose prong (or can be, in some circumstances).

However, the compelling indication that the two prongs must differ from each other implies that perhaps profit cannot be the sole factor used for meeting both prongs (in any given fact pattern). But how different do the two prongs' analyses have to be?[170] Is there a reasonable argument that the objective prong considers profit potential and other factors (all of which contribute to the analysis of whether there has been the required meaningful change in economic position), and the subjective prong considers profit potential and other factors (all in order to analyze the required substantial business purpose), but that both can be met (in any given fact pattern, for any particular transaction) by using exactly the same facts (e.g., profit potential alone, or profit potential plus one minor additional factor)?

If, under a proposed pair of definitions for the two prongs, one cannot imagine plausible circumstances in which the two prongs could differ from each other (i.e., could take into account different facts from each other or reach different results), then such a pair of definitions appears at risk of being invalid, by reason of the statutory implication that the two prongs must differ from each other. If the Treasury or the courts set forth pro forma interpretations of the two prongs, but reasonably expected profit is really the determining factor for both analyses (despite the additional factors nominally considered for each prong), would that be valid as a matter of statutory interpretation?

No taxpayer is likely to challenge a duplicative interpretation of the two prongs, but the government (if a court proposed such a set of definitions) or the courts (if Treasury guidance or government litigation took such a position) might think otherwise.

It might be more easily defensible, under the rules of statutory interpretation, to say that either the objective or subjective prong (for any particular transaction) can be based on reasonably expected profit, but not both. For example, either Treasury or the courts could interpret the

168. I.R.C. § 7701(o)(2)(A).

169. *See* I.R.C. § 7701(o)(1) (listing the two prongs).

170. There is also a distinction between saying that the definitions of the two statutory prongs cannot be identical and saying that the facts or arguments used (for a particular transaction) to meet the two prongs cannot be the same. In the former case, taxpayers could attempt to use the same factors to meet two differently described standards (objective and subjective).

combination of the profit ratio test (applicable to both prongs) and the requirement for separate objective and subjective prongs as meaning that a taxpayer who meets the objective prong primarily by showing profit potential must meet the subjective prong primarily by using facts other than profit potential (or vice versa). Such a possible interpretation leaves the question of what facts can be used to meet either test, other than profit potential.

3. *Meaning of Business Purpose*

Business purpose is referred to in Section 7701(o) as a "substantial purpose (apart from Federal income tax effects),"[171] but is not further defined in the statute. If it is not duplicative of the objective prong (e.g., a profit inquiry and meaningful change concept), it is not totally clear what business purpose means or how it is tested. Profit potential is one element (often the primary consideration) in the business purpose analysis under pre-Section-7701(o) case law.[172] The applicability of the ratio test to the subjective prong[173] indicates that profit potential can continue to be relevant in determining business purpose. Another possible factor is likely to be the taxpayer's due diligence, which is examined in some of the pre-Section-7701(o) case law.[174] Some cases have also considered whether the presence of risk shows a real business intent.[175] But other courts have disparaged that consideration, arguing that absence of risk merely shows good business

171. *See* I.R.C. § 7701(o)(1)(B).

172. *See supra* note 12, and *infra* note 205.

173. *See* I.R.C. § 7701(o)(2)(A).

174. *See, e.g.*, Rice's Toyota World v. Comm'r, 752 F.2d 89, 92–93 (4th Cir. 1985); Casebeer v. Comm'r, 909 F.2d 1360, 1364 (9th Cir. 1990); Rose v. Comm'r, 868 F.2d 851, 854 (6th Cir. 1989); IES Indus., Inc. v. United States, 253 F.3d 350, 355 (8th Cir. 2001); *cf.* Mahoney v. Comm'r, 808 F.2d 1219, 1220 (6th Cir. 1987) (discussing a lack of business-like conduct as an indication of a sham); *but see* Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 224–25 (1999), *rev'd* 277 F. 3d 778, 787 n.9 (5th Cir. 2001) (discounting the importance of due diligence, "Even if we agreed with the Tax Court that Compaq had not adequately investigated the risks, it would not make a difference to the outcome of this case. Though Compaq could have done more to evaluate the risks of the transaction, the process it used does not alone prove a lack of business purpose for a transaction that had real risks.").

175. *See, e.g.*, Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 223–24 (1999) (discussing lack of risk), *rev'd* 277 F.3d 778, 788 (5th Cir. 2001) (transaction had risk); DeMartino v. Comm'r, 862 F.2d 400, 406 (2d Cir. 1988) (transactions "were prearranged, contrived transactions conducted in a market rigged to produce tax losses"); Yosha v. Comm'r, 861 F.2d 494, 500-501 (7th Cir. 1988) (discussing lack of risk, but not specifying that this factor related only to motive or a subjective analysis: "The investor was at no risk. . . . . The lack of substance lies in the fact that the investor had zero prospect of gain or loss. The brokers were selling tax losses."); *see also supra* note 135.

planning.[176] Some courts have also discussed whether the marketing materials or the taxpayer's discussions about whether to enter into the transaction emphasized tax benefits (rather than profit).[177] It is not clear what other factors might be included in evaluating business purpose but are not also taken into account for the objective prong.

The lack of a statutory definition leaves the meaning of the business purpose prong open to judicial and administrative interpretation. However, those interpretations are constrained by Section 7701(o)'s implication that the business purpose prong must differ from the objective prong. At the moment, the IRS seems content to leave the explanation of "business purpose" to the courts.[178] The IRS has said only that it will continue to look to case law (which currently includes only pre-Section 7701(o) cases) in order to interpret the business purpose prong.[179]

There is thus likely some work ahead for the courts and litigants, in order to comb the vast economic substance case law for factors other than profit that have been used to evaluate business purpose and that are not duplicative of the objective prong analysis.[180] Because of the implication that the subjective prong now must differ from the objective prong, there will likely be more emphasis in the future on what elements exactly, other than or in addition to profit, contribute to the subjective prong analysis.

4. *Lack of Reasonableness Requirement*

Section 7701(o) does not explicitly impose a reasonableness requirement for business purpose.[181] (In contrast, expectation of profit has a reasonableness requirement, contained in the ratio test, although meaningful change in economic position otherwise does not.)[182] This absence in the business purpose test leaves open, for judicial analysis or administrative guidance, the question of whether "business purpose" must be reasonable, rather than just sincerely held. Is there a different answer (on such a reasonableness concept) for individuals and corporations? If business

176. *See, e.g.*, Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 784–85, 787 (5th Cir. 2001) (lack of risk doesn't prevent a transaction from meeting the economic substance test)*;* IES, 253 F.3d at 355.

177. *See, e.g.*, In Re CM Holdings, Inc., 301 F.3d 96, 107 (3d Cir. 2002).

178. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411.

179. *See id*.

180. *See* Rosenberg, *STARS Wars*, *supra* note 68, at 227–35.

181. *See* I.R.C. § 7701(o)(1)(B).

182. *Compare* I.R.C. § 7701(o)(2)(A) *with* I.R.C. § 7701(o)(1)(A).

purpose must be reasonable, how is it different from reasonable expectation of profit, which is generally the focus of the objective prong? None of these questions are answered by Section 7701(o).

The presence of a reasonableness requirement in the ratio test, however, may create a negative inference that reasonableness is not required for business purpose. Query, though, whether Congress generally intended tax benefits to apply for taxpayers whose non-tax purpose was not reasonable. Conceivably, that answer could differ for different tax benefits, depending the congressional intent for each such benefit. Such intent could impact the application of the business purpose requirement, because congressional intent is crucial for the economic substance inquiry.

Not applying a reasonableness requirement could create some practical difficulties: How can the IRS and courts test sincere subjective intent that isn't reasonable? From behavior, a la *Cherin*? (The taxpayer in *Cherin* stopped paying the tax shelter promoter when he realized that the expected profit results were not materializing.)[183]

5. *Substantial*

Section 7701(o) requires that the taxpayer's non-Federal-income-tax purpose be "substantial."[184] The term "substantial" is not defined. "Substantial" is the same word used in the profit ratio test[185] and therefore impliedly has the same meaning. The ratio test, however, measures substantiality by comparison to expected tax benefits, which the business purpose test does not.[186] Nor does the ratio test define "substantial." (The objective prong, in contrast, requires a "meaningful," rather than "substantial," change in economic position.)[187] Because "substantial" is undefined, it is left to the courts to interpret (or to the Treasury to address by guidance, if it chooses to do so).

In any event, "substantial" business purpose appears to be a significant increase from prior requirements in the case law. Pre-Section-7701(o) cases varied in their descriptions of how much non-tax purpose was required. However, some courts were satisfied as long as a transaction was not "solely" tax motivated, sometimes even if the taxpayer was "primarily"

183. *See* Cherin v. Comm'r, 89 T.C. 986, 989–91 (1987).
184. *See* I.R.C. § 7701(o)(1)(B).
185. *See* I.R.C. § 7701(o)(2)(A).
186. *Compare id*. to I.R.C. § 7701(o)(1)(B).
187. *See* I.R.C. § 7701(o)(1)(A).

motivated by tax benefits.[188]

Under the statutory language, "substantial" business purpose is analyzed separately for each taxpayer.[189] Thus, if one transaction involves twelve taxpayers, of whom eleven have a substantial business purpose and one does not, the one that does not will fail the business purpose prong regarding the transaction.

Can the courts or the Treasury, by guidance, require business purpose that is greater than "substantial"? Under the literal language of the statute and the rules of statutory interpretation, the answer appears to be yes. The statute says that a transaction has economic substance "only if" it has "substantial" business purpose, not "if and only if." However, it is hard to imagine the courts or Treasury choosing to take this approach.

6. *Business Purpose Summary*

The structure of Section 7701(o), combined with statutory interpretation rules that avoid construing legislative language as moot, strongly imply that the subjective prong cannot be a mere duplicate of the objective prong. The fact that profit potential can be taken into account for both prongs indicates that the facts and circumstances used to meet the two prongs can overlap, but does not overcome the strong presumption that the two prongs must differ from each other. Because courts are now required to apply both prongs, there is likely to be increased focus on the subjective prong in the future, as compared to a previous emphasis on the objective prong.[190] In addition, business purpose is now required to be at least "substantial" in order to meet the economic substance test.[191] This is a higher standard than the courts generally imposed before Section 7701(o)'s enactment.

D. Profit

1. *In General*

188. *See, e.g.*, *Compaq*, 277 F.3d at 786 (quoting *ACM*, 157 F.3d 23, 248 (3d Cir. 1998)).

189. Section 7701(o)(1) states that each transaction satisfies the economic substance test only if "*the taxpayer* has a substantial purpose . . . ." I.R.C. § 7701(o)(1) (emphasis added).

190. *See* note 13, *supra*.

191. I.R.C. § 7701(o)(1)(B).

The use of profit in the economic substance analysis, as modified by Section 7701(o), is a multi-step process: First there is the question of whether profit potential can be "taken into account" for the two prongs. This preliminary inquiry is governed by the ratio test. Only then, after that preliminary hurdle is passed, does one ask whether such profit potential, allowed to be taken into account after application of the ratio test, constitutes or helps to prove either "meaningful" change in economic circumstances or "substantial" non-tax purpose, or both.[192]

Profit has traditionally been a key factor in both the objective and subjective analyses, under pre-Section 7701(o) case law.[193] Although Section 7701(o) does not define the term "profit,"[194] it does provide several technical rules for its computation. First, profit potential may not be taken into account under either prong unless the transaction meets the profit ratio test, which applies a standard of "substantial" in relation to expected net tax benefits.[195] Second, the relevant amount that is compared to expected tax benefits is the "reasonably expected" profit, "pre-tax," and computed at present value.[196] Lastly, profit does not include either federal income tax effects or any state and local tax effects that are "related to" federal income tax effects.[197]

The focus on reasonably expected, rather than actually materializing, profit (for purposes of the economic substance analysis) was already present

192. *See* I.R.C. § 7701(o)(1)(A), (B).

193. Profit is often the start of and a key to the objective analysis. *See, e.g.*, Sheldon v. Comm'r, 94 T.C. 738, 767–68 (1990); Pritired 1, LLC v. United States, 816 F. Supp. 2d 693, 736–39 (S.D. Iowa Sept. 30, 2011); *BNY Mellon II*, 801 F.3d 104, 115, 119 (2d Cir. 205) (profit is a focus of the objective analysis, but not the end of the inquiry); IES Indus., Inc. v. United States,253 F.3d 350, 353 (8th Cir. 2001); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 93 (4th Cir. 1985). Profit has been an important factor not only for objective analyses, but for the subjective prong as well. *See infra* note 205; *see also supra* note 12.

194. The profit ratio test refers to both "potential for profit" and "reasonably expected pre-tax profit." *See* I.R.C. § 7701(o)(2)(A). It is not clear that these two phrases have the same meaning as each other—presumably, Congress would have used the same phrase twice if that were the case. *See supra* note 161.

195. I.R.C. § 7701(o)(2)(A). Technically, this limitation applies only to "[t]he potential for profit" rather than actual profit. *See* I.R.C. § 7701(o)(2)(A). For example, if a transaction was reasonably expected to result in $7 of profit, but actually resulted in $1 or $15, the profit ratio rule technically only applies to whether the taxpayer can take the $7 into account for both prongs, not whether it can consider the $1 or the $15. In theory, the courts or Treasury could provide (in case law or guidance, respectively) that actual profit is taken into account in some manner (e.g., as a post-hoc factor that helps evaluate whether the taxpayer's claimed expectation of profit was reasonable, either for the objective prong or as part of the business purpose analysis). As discussed above, actual profit may also be relevant to the determination of "meaningful [change in] . . . economic position." *See* I.R.C. § 7701(o)(1)(A).

196. *See* I.R.C. § 7701(o)(2)(A).

197. I.R.C. § 7701(o)(1)(A), (o)(3).

in the pre-Section-7701(o) case law.[198] In addition, reasonably expected profit is measured at its present value under Section 7701(o)'s profit ratio test.[199] This implies that such profit is measured in the aggregate, over the entire multiyear life of a transaction, rather than annually, although the statute does not actually say so. Such life-of-the-transaction aggregate profit measurements would also be consistent with the pre-Section-7701(o) case law.[200] Section 7701(o)'s inclusion of these concepts does provide some uniformity on these profit measurement rules across all circuits, including any that had not yet spoken on these measurement conventions. It also prevents any circuit from changing its mind on either concept.[201]

Section 7701(o) also imposes a ratio test (discussed further below) for profit potential: Profit potential is only taken into account, for purposes of either prong, if reasonably expected profit is "substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected."[202] This ratio test thus has two main components: First, reasonably expected profit must be at least "substantial" in order for profit potential to be taken into account. Second, "substantial" is determined not as an absolute matter, but in comparison to expected net tax benefits.

2. *Substantial Profit Might Not Always Be Sufficient to Meet the Objective or Subjective Prongs*

198. *See, e.g.*, Estate of Thomas v. Comm'r, 84 T.C. 412, 428–29 (1985).

199. *See* I.R.C. § 7701(o)(2)(A).

200. *See, e.g.*, Kirchman v. Comm'r , 862 F.2d 1486, 1493–94 (11th Cir. 1989); Glass v. Comm'r, 87 T.C. 1087, 1173–74 (1986) ("the focus of our attention is petitioners' entire tax straddle scheme, and not each separate straddle. It is the overall scheme which taints the deductibility of the year one losses.") (citations omitted); *see also* Estate of Thomas v. Comm'r , 84 T.C. 412, 438 (1985); Sheldon v. Comm'r, 94 T.C. 738, 768–69 (1990).

201. In addition, section 7701(o) requires that fees and transaction costs are treated as expenses and netted against income in order to determine pre-tax profit. I.R.C. § 7701(o)(2)(B). "Profit" already means gross income netted against costs, so it is not clear why Congress felt it needed a rule specifically addressing transaction costs and fees.

202. I.R.C. § 7701(o)(2)(A). The statutory language provides that profit potential is taken into account for the objective "and" subjective prongs only if it meets the profit ratio test. *Id*. It thus reads as if profit only needs to meet the ratio test if the taxpayer is taking profit into account for both prongs, not if the taxpayer is taking profit into account for only one or the other. Congress could have avoided doubt on this issue by writing that profit potential can be taken into account "for purposes of subparagraph (A) *or* (B), *or both*." Imagine, for example, that the taxpayer is meeting one of the prongs by using something other than profit, e.g., meeting the business purpose prong by showing due diligence or satisfying the objective prong by showing non-profit "change . . . in economic position." Could the taxpayer then analyze the other prong using profit potential that did not meet the ratio test? Presumably, this is not what Congress intended. The Treasury Department could clarify, in guidance, that the ratio test is not waived in situations where only one prong uses profit as a factor.

Section 7701(o) does not say that reasonable expectation of profit (even substantial pre-tax profit, as compared to expected tax benefits) is necessarily sufficient, on its own, to prove that the transaction "changes in a meaningful way . . . the taxpayer's economic position" as mandated by the objective prong or that the taxpayer has the "substantial [business] purpose" required by the subjective prong. Instead, the profit ratio rule only says that "[t]he potential for profit . . . *shall be taken into account* . . . only if" it meets the ratio test.[203] The ratio test is thus an initial hurdle before profit can be "taken into account," not a promise that the transaction will meet the economic substance doctrine.

However, under pre-Section-7701(o) case law, reasonably expected profit is almost always sufficient (without more) to meet the objective prong, at least if pre-U.S.-tax profit is large enough, compared to expected U.S. tax benefits.[204] In other words, the courts have not generally required that the taxpayer show *more* than a sufficient amount of profit (other factors in addition to profit) in order to meet the objective prong. Under pre-Section-7701(o) case law, expected profit has also been a major factor (perhaps the determining factor) for the subjective prong.[205] The IRS has stated that it

203. I.R.C. § 7701(o)(2)(A) (emphasis added).

204. *See supra* note 193.

205. *See, e.g.*, *BNY Mellon II*, 801 F.3d 104,118 (2d Cir. 2015) ("The focus [for the business purpose prong] is the reasonableness of the transaction and can be articulated as: would 'a prudent investor,' absent tax benefits, 'have made the deal?'") (citation omitted); *id*. at 123, 124; Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 786–87 (5th Cir. 2001) ("In light of what we have said about the nature of Compaq's profit, both pre-tax and post-tax, we conclude that the transaction had a sufficient business purpose independent of tax considerations."); *ACM*, 157 F.3d 231, 253–54, 257 (3d Cir. 1998); *Salem II*, 786 F.3d 932, 958 (Fed. Cir. 2015) (finding that a loan met the economic substance doctrine because it gave the taxpayer access to funds, "the STARS Loan in this case functioned to provide financing to BB&T, which is a legitimate business purpose."); *id*. at 952; Rice's Toyota World v. Comm'r, 752 F.2d 89, 92–93 (4th Cir. 1985) ("More critical [to the business purpose analysis] is the evidence that Rice paid an inflated purchase price for the computer"); Kirchman v. Comm'r , 862 F.2d 1486, 1493 (11th Cir. 1989); Bank of N.Y. Mellon Corp. v. Comm'r, T.C. Memo 2013-225, 2013 WL 5311057 at *4 (2013) ("the loan proceeds were available for petitioner to use in its banking business throughout the STARS transaction. Accordingly, the loan served a purpose beyond the creation of tax benefits . . . ."), *aff'd*, 801 F.3d 104 (2d Cir. 2015), *cert. denied* 136 S.Ct. 1377 (2016); Shriver v. Comm'r, 899 F.2d 724, 726 (8th Cir. 1990) ("The business purpose inquiry examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved."); UPS of America v. Comm'r, 254 F.3d 1014, 1019 (11th Cir. 2001) ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. . . . .") (citation omitted); Sheldon v. Comm'r, 94 T.C. 738, 767 (1990) (profit potential was not the only factor, but "the sole objective was to obtain the interest deduction. This is abundantly evidenced by the use of repos to market with locked-in losses in the transactions with no potential for any profit . . . . Accordingly, . . . the overriding and clear intent was to seek the interest deduction."); Glass v. Comm'r , 87 T.C. 1087, 1175–76 (1986); IRS v. Cm Holdings (in Re Cm Holdings, Inc.) 301 F.3d 96, 102–103, 106–107 (3rd Cir. 2002); Fox v. Comm'r , 82 T.C. 1001, 1023 (1984) (stating,

will follow the case law's interpretation of the two prongs for now, in interpreting section 7701(o)'s two prongs.[206]

But the case law has evolved before, in response to taxpayers' changing strategies and the resulting continuous presentation of new and different fact patterns before the courts.[207] The statutory language of the profit ratio rule, and the lack of a statutory requirement that any transaction that meets the profit ratio test must always be treated as meeting both prongs (or even the objective prong) appears to leave it open for the courts to decide, over time, that more than the described "substantial" (compared to tax benefits) profit is required to meet one or both prongs. In other words, courts appear still able to hold that even a transaction that has such substantial profit can lack economic substance in particular circumstances.

That's an important area of flexibility for the courts. Theoretically, for example, a court could decide (depending on facts and circumstances) that even profit that is "substantial" in relation to expected tax benefits (e.g., profit that is one-third of the size of expected tax benefits) might not represent a meaningful change in the taxpayer's economic position. Viewed slightly differently, courts appear able to consider, even after "substantial" profit is proven, whether other facts and circumstances nonetheless defeat compliance with the objective prong or the subjective analysis. This puts some pressure on the interpretation of "meaningful" in the description of the objective prong.[208] Conversely, this may also be an area where Treasury

as part of analyzing the taxpayer's motives: "petitioner . . . did not appear to make profit-maximizing decisions."); Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313, 1316–17 (11th Cir. 2001) (stating, without distinguishing between factors relevant for the objective and subjective analyses, that "The tax court found, without challenge here, that the program could never generate a pretax profit."), *cert. denied* 535 U.S. 986 (2002); Karr v. Comm'r, 924 F.2d 1018, 1024–25 (11th Cir. 1991) (using the same facts to analyze the objective and subjective aspects of the economic substance tests); *see also* Estate of Thomas v. Comm'r, 84 T.C. 412, 437–38 (1985); *but see* Cherin v. Comm'r, 89 T.C. 986, 994 (1987) ("The economic substance of a business transaction and the intent, purpose, or motive of an individual investor, while sometimes equated, are not identical. A business transaction by its very nature must have economic substance, that is, a realistic potential for profit . . . . The intent or purpose, which motivates an individual to enter into a business transaction refers to the subjective state of mind of the particular taxpayer before the Court.").

206. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411; *see also supra* part III C (arguing that the section 7701(o) version of the subjective prong now must differ from the section 7701(o) version of the objective prong, so that it might not be possible to use the same factors (e.g., profit potential alone) to meet both prongs).

207. For example, the economic substance case law evolved over time from saying that a transaction must have reasonably expected profit to requiring (at least in some courts) that such profit must be more than *de minimis*, or more than insignificant, compared to tax benefits. *See infra* note 320, and *supra* note 211; *see also, e.g.,* Pritired 1, LLC v. United States, 816 F. Supp. 2d 693, 741 (S.D. Iowa Sept. 30, 2011).

208. The subjective prong, as discussed below, may require (rather than merely allow) consideration of elements other than profit. *See* I.R.C. § 7701(o)(1)(B); *see also supra* part III C.

guidance (which is only possible because of the enactment of Section 7701(o)) could constrain the courts' ability to adapt the doctrine.

On the other hand, Section 7701(o) also does not require that every transaction to which the economic substance doctrine applies must have reasonably expected profit that is at least substantial as compared to tax benefits. The statute mandates that the profit ratio test must be met before profit potential can be taken into account for the two prongs of the economic substance test. But it does not say that a transaction lacking such "substantial" profit potential necessarily fails the economic substance analysis (or either prong). However, if profit potential doesn't rise to that minimum standard, the taxpayer will need other, different means of showing meaningful change in economic position and substantial non-tax purpose.

3. Profit Ratio Test

a. In General

As discussed above, Section 7701(o) provides that "potential for profit" may not be taken into account for purposes of the two prongs unless "the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits . . . ."[209] This profit ratio test is quite lenient: It allows disproportionate ratios between expected profit and tax benefits, as long as the "substantial" ratio standard is met. For example, reasonably expected profit of one and expected net tax benefits of four are likely to meet the test, because one to four (25 percent) is likely a "substantial" ratio. A lenient standard is consistent with the theory that the economic substance doctrine is an emergency backstop that is supposed to deny tax benefits to "the worst of the worst." Also, a tolerant standard enhances predictability. For example, taxpayers who have reasonably expected profit equal to half of their expected tax benefits are likely not worried about whether they can meet the profit ratio test.

One basic issue is whether the ratio test prevents courts or the IRS from

209. I.R.C. § 7701(o)(2)(A). The language of the ratio test strikingly resembles the language in I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn). That notice addressed certain withholding tax and cross-border-arbitrage situations. It predicted the issuance of regulations that would deny foreign tax credits to such fact patterns if "reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement." The notice was withdrawn without the issuance of such regulations. *See* I.R.S. Notice 2004-19, 2004-1 C.B. 606. But taxpayers continue to cite the ratios in Notice 98-5's examples as guidelines for acceptable profit-to-tax-benefit proportions. *See, e.g., Pritired*, 816 F. Supp. at 729, 741.

deciding that profit needs to be higher in relation to tax benefits before it is sufficient to meet the objective prong. Technically, such an interpretation appears possible, because the ratio test is only the minimum requirement before profit can be "taken into account," not the ultimate answer to the objective prong analysis. Another question is whether the ratio test applies to both prongs, or only one or the other, for any given transaction. Both issues are discussed further below.

b. Substantial Profit

Before Section 7701(o), multiple cases had already said that profit was not sufficient to meet the objective prong if it was merely "*de minimis*" or "insignificant" in relation to tax benefits.[210] But those cases did not require "substantial" profit, which appears to be a higher standard than merely an amount greater than "*de minimis*." (However, there is little on-point case law on the specific meaning of "*de minimis*," "insignificant," and other terms used in the case law in this context). Section 7701(o) thus may have made the objective prong a little harder for taxpayers to meet than pre-Section 7701(o) case law required. Also, if a particular circuit court of appeals had addressed only transactions that clearly had zero profit, such circuit court might not have had occasion to discuss whether miniscule (but greater than zero) profit was sufficient.[211] Section 7701(o) thus imposes a new standard for taking profit potential into account ("substantial") and a rule about determining that standard by reference to tax benefits, rather than as an absolute number or by comparison to some other amount.[212] It also makes those rules applicable to all circuits, which imposes some minimum level of

210. *See, e.g.*, Sheldon v. Comm'r, 94 T.C. 738, 768 (1990); *see also infra* note 341; *see also generally* Rosenberg, *STARS Wars*, *supra* note 68; *cf.* I.R.S. Notice 98-5, 1998-1 C.B. 334 (withdrawn) (predicting the issuance of regulations that would disallow foreign tax credits for certain types of transactions if profit was "insubstantial" compared to expected foreign tax credits).

211. Section 7701(o)'s legislative history describes a difference between cases that require more than nominal profit and cases that suggest that nominal profit is sufficient. It cites, as belonging to the first group of cases, Goldstein v. Comm'r, 364 F.2d 734, 739–40 (2d Cir. 1966), and Sheldon v. Comm'r, 94 T.C. 738, 768 (1990) (finding that profit was insufficient when the "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions"). In contrast, it cites Rice's Toyota World v. Comm'r, 752 F.2d 89, 94 (4th Cir. 1985), Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001), and IES Indus., Inc. v. United States, 253 F.3d 350, 354 (8th Cir. 2001), as belonging to the second type. *See* H.R. Rep. No. 111-443, 294.

212. Contrast suggestions by Joseph Bankman and Charlene Luke for contrary means of determining how much profit is sufficient to meet the economic substance test. *See* Bankman, *supra* note 26, at 26 (discussing potential use of absolute amount of profit); Charlene D. Luke, *Risk, Return, and Economic Substance,* 27 VA. TAX REV. 783, 785 (2008) (suggesting use of post-U.S.-tax-benefit profit). These approaches appear to be foreclosed now by Section 7701(o). *See* I.R.C. § 7701(o)(1), (o)(2)(A).

consistency, although circuits are still able to interpret "substantial" differently from each other.

The imposition of the "substantial" standard raises the question of whether courts or the Treasury, by guidance, can ever require a higher amount than "substantial" profit to meet the objective test. For example, can courts look to the absolute amount of profit, in addition to the ratio of profit to tax benefits? As is the case with the requirement that both prongs be met, the ratio test is literally phrased as a minimum rather than an exclusive standard. The statute says that profit potential is taken into account "only if" (not "if and only if") it meets the ratio test. The statutory phrasing therefore technically leaves open the possibility that courts or the Treasury could decide that even more than the ratio test (i.e., more than "substantial in relation to expected tax benefits") is required in order to take profit potential into account or to find that the transaction has sufficient economic substance. However, neither the courts nor the Treasury could provide an interpretation that takes profit potential into account for the two prongs where reasonably expected profit fails to meet the ratio standard. The ratio test thus establishes a minimum standard, without necessarily precluding higher requirements from the courts or from Treasury guidance.

Although it is technically possible that the courts or Treasury guidance could require more profit than the ratio test's minimum standard before taking profit into account, there are other alternatives to accomplish the same result. The government could instead argue that profit, even if taken into account, does not automatically constitute either a "meaningful" change in economic position or a "substantial" business purpose, and that facts and circumstances must be examined to determine whether such profit satisfies either or both of the two prongs. Meaningful change and substantial business purpose may be the more likely avenues for dispute, because the ratio test is only the standard for whether profit potential is "taken into account," while meaningful change and substantial purpose are the tests for actually meeting the objective and subjective prongs, respectively.[213]

Section 7701(o) does not define "substantial" for purposes of comparing profit to tax benefits under the ratio test. The Treasury could provide a definition (or parameters) in guidance. Unless and until that happens, courts can interpret the term. In the absence of administrative or judicial interpretations, taxpayers presumably will look to the ratios described in the examples of former Notice 98-5, which used similar

213. *See id*. (profit ratio test); I.R.C. §§ 7701(o)(1)(A) ("meaningful" change, for the objective prong), 7701(o)(1)(B) ("substantial" business purpose for the subjective prong).

terminology regarding expected profit that is "insubstantial compared to" tax benefits.[214] Taxpayers may also examine the ratios in the *Compaq*[215] and *IES*[216] cases, which decided that their respective taxpayers had reasonably expected profit that was sufficient to meet the objective prong.

Potentially, "substantial" profit in relation to tax benefits, like meaningful change, could vary based on the facts and circumstances or on the intent of the particular statute that creates the challenged tax benefit. In the latter case, "substantial" might differ for different tax benefits (e.g., foreign tax credits versus interest deductions).

Further, the courts or the Treasury might allow "substantial" to vary based on industry, e.g., for oil drilling versus lending. The idea of adjusting the amount of profit required, i.e., how much is substantial, based on industry norms does not appear in Section 7701(o). However, courts and the Treasury (by guidance) appear able to decide that Section 7701(o)'s undefined terms (substantial, meaningful, etc.) can have slightly different meanings or calibrations based on industry standards—this doesn't seem to be precluded by the statute. That would be consistent with case law, which says that the amount of reasonably expected profit that is sufficient to meet the objective prong varies depending on the standards and practice of the relevant industry.[217] This case law concept about industry generally emphasizes the varying amounts of risk in different types of businesses.[218]

E. Treatment of Foreign, State, Local, and Non-Income Federal Taxes

1. *In General*

Taxes other than Federal income taxes are potentially relevant to the economic substance analysis (as modified by Section 7701(o)) at various different points. First, both "changes in a meaningful way . . . the taxpayer's economic position" (for the objective prong) and "substantial purpose" (for the subjective prong) are computed "apart from Federal income tax effects."

214. *See* I.R.S. Notice 98-5 (withdrawn). The ratios in the notice's examples were 33:1, 12:1, and 8:1. The taxpayer in *Pritired* argued that its profit-to-credit ratio was better than the ratios listed in Notice 98-5, and that it therefore met the objective prong by showing sufficient profit. *See Pritired*, 816 F. Supp. 2d at 729. The *Pritired* court rejected this argument. *Id*. at 741.

215. *See* Compaq, 277 F.3d at 786.

216. *See* IES, 253 F.3d at 352.

217. *See, e.g.,* Cherin v. Comm'r, 89 T.C. 986, 989–91 (1987); Jacobson v. Comm'r, 915 F.2d 832, 838 (2d Cir. 1990).

218. For example, the *Jacobson* court said that the movie industry generally involves more risk than some other businesses. *See* Jacobson, 915 F.2d at 838.

This leaves the question of how other (non-Federal or non-income) taxes are taken into account (or ignored). Next, there's an issue as to which tax effects are excluded in computing "pre-tax" profit for purposes of the profit ratio test. Lastly, the ratio test uses expected net tax benefits as the comparison to profit.

Federal income taxes are clearly excluded from the computation of pre-tax profit, meaningful change in economic position, and substantial non-tax purpose. But other potentially relevant tax effects include foreign, state, and local taxes, as well as non-income Federal taxes, and their treatment is less clear. The issue arises for both tax *benefits* and tax *costs* of all taxes other than Federal income taxes. Can such tax *benefits* constitute profit, meaningful change in economic position, or a non-tax purpose? Can such tax *costs* reduce profit, impact the analysis of meaningful change, and decrease the ability to show a non-tax purpose? Can such costs or benefits contribute to the net tax benefit used as a comparison in the ratio test?

Section 7701(o) contains a special rule for state and local taxes: State and local tax effects that are "related to" Federal income tax effects are treated the same way as Federal income tax effects[219] and therefore are not taken into account for the objective and subjective prongs. By negative inference, state and local tax effects that are *not* so related presumably *are* taken into account for these purposes. The rule for state and local taxes applies for purposes of paragraph (1) of Section 7701(o), which lists the two prongs.[220] The references to pre-tax profit appear in paragraph (2) (in the profit ratio test and in rules relating to fees, other transaction expenses, and foreign taxes).[221] One could argue that the rule for state and local taxes, and its negative inference, also apply to "pre-tax profit" (as that term is used in paragraph (2)), because paragraph (2) functions only to provide rules for purposes of paragraph (1) (and the state and local tax rule applies to paragraph (1)).[222] Or one could alternatively contend that the rule (and negative inference) regarding state and local taxes do not affect "pre-tax profit," and that such rule could have explicitly applied for purposes of all of the provisions of Section 7701(o) if Congress had intended that meaning. Thus, treatment of state and local taxes other than for purposes of paragraph (1)'s rules on meaningful change and substantial purpose is unclear enough

219. *See* I.R.C. § 7701(o)(3). The rule is captioned "State and Local Tax *Benefits*" (emphasis added), but its text refers to "any . . . tax effect" and it therefore appears to apply to tax costs as well as benefits.

220. *See* I.R.C. §§ 7701(o)(3), (o)(1).

221. *See* I.R.C. § 7701(o)(2).

222. *See* I.R.C. § 7701(o)(2)(A).

to leave room for administrative or judicial interpretation.

The treatment of foreign tax effects and Federal non-income tax effects is even less clear. Both appear to be included in the evaluation of meaningful change in economic position and the analysis of non-tax purpose (the two prongs), which exclude only Federal income tax effects and related state and local tax effects.[223] But the ratio rule that governs whether profit can be taken into account for the two prongs refers to "pre-tax profit."[224] It does not say whether "pre-tax" means only "pre-U.S. Federal income tax," or also "pre-Federal excise tax" and "pre-foreign tax."[225]

The treatment of non-income Federal taxes is not directly mentioned in Section 7701(o). Reading the statutory language literally, costs and benefits relating to such taxes appear to be included in evaluating meaningful change in economic position and substantial business purpose (both of which exclude only "Federal *income* tax effects").[226] But such non-income-tax effects appear to be technically excluded from "pre-tax profit," until guidance (or the courts) define "pre-tax" as referring only to income taxes.

2. *Treatment of Foreign Taxes as Costs in Computing Profit*

In contrast, Section 7701(o) requires the Treasury to issue guidance that treats foreign taxes as costs for the computation of pre-tax profit, "in appropriate cases."[227] (The House version of Section 7701(o) required that

223. *See* Part 2, *infra*, for the disputed treatment of foreign taxes as a cost in computing profit, under pre-codification case law. The literal language of section 7701(o)'s objective and subjective prongs includes foreign tax effects in the analysis of meaningful change in economic position and of substantial purpose, respectively: Such change and purpose are determined "apart from Federal income tax effects," not apart from all tax effects. *See* I.R.C. § 7701(o)(1)(A), (B). That inclusion likely is not modified by the requirement that the Treasury issue regulations with respect to the treatment of foreign taxes as a cost in computing pre-tax profit, unless and until such guidance is issued. *See* I.R.C. § 7701(o)(2)(A). The IRS, however, appears to have a different interpretation: Notice 2010-62 states that the statute does not restrict the courts' ability to consider such treatment of foreign taxes as a cost. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 ("The Treasury Department and the IRS intend to issue regulations pursuant to section 7701(o)(2)(B). In the interim, the enactment of the provision does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases.").

224. *See* I.R.C. § 7701(o)(2)(B).

225. In contrast, Section 7701(o)(1)'s descriptions of the objective and subjective prongs both (unlike the profit ratio rule) refer to "Federal income tax." *See* I.R.C. § 7701(o)(1)(A) and (B), *compare* I.R.C. § 7701(o)(2)(B).

226. I.R.C. § 7701(o)(1)(A), (B).

227. *See* I.R.C. § 7701(o)(2)(B). However, Treasury does not appear to have the authority to make this guidance binding for individuals who are exempt from Section 7701(o)(1) (which requires and describes the two prongs) by reason of Section 7701(o)(5)(B) (exempting individuals not conducting the transaction as part of a trade or business or "for the production of income"). Instead, the regulatory

foreign taxes be treated as expenses in computing profit,[228] but that rule was changed in the conference version of the provision.)[229] The treatment of foreign tax costs and benefits as decreasing and increasing (respectively) profit is relevant for both the objective and subjective prongs.[230] There has been a long-running, contentious dispute about whether foreign taxes are a cost in computing profit, for purposes of applying the economic substance doctrine.[231] The circuits are currently divided on this issue.[232] The dispute on this issue in the pre-Section-7701(o) case law relates to claims for foreign tax credits (credits against U.S. tax for foreign taxes paid or accrued).[233] However, the issue (and section 7701(o)'s requirement that the Treasury publish guidance) are not limited to cases where foreign tax credits are the challenged tax benefit.

The Treasury has not yet issued the required guidance on the treatment of foreign taxes in computing pre-tax profit for purposes of applying the economic substance doctrine.[234] Until guidance is published, the issue is left to the courts, except as constrained by the statutory language. By not issuing guidance on this topic, the IRS risks a court's making a broad statement that foreign taxes are never treated as a cost, as *IES*[235] and *Compaq*[236] appeared to do.[237] Such a risk assumes that the courts have the

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authority is tied to the ratio test, which is only applicable for I.R.C. section 7701(o)(1). *See* I.R.C. § 7701(o)(2)(A), (B).

228. *See* H.R. Rep. No. 111-443, 298 ("Fees and other transaction expenses and foreign taxes shall be taken into account as expenses in determining pre-tax profit.").

229. *See* I.R.C. § 7701(o)(2)(B).

230. *See* I.R.C. §§ 7701(o)(1)(A), (B) (objective and subjective prongs); 7701(o)(2)(B) (profit ratio test, implying that profit potential can affect both prongs).

231. *Compare* Bank of N.Y. Mellon II, 801 F.3d 104, 113 (2d Cir. 2015), *Santander*, 844 F.3d 15, 24 (1st Cir. 2016), and *Salem II*, 786 F.3d 932, 951, 960 (Fed. Cir. 2015), *with* Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 782 (5th Cir. 2001), and IES Indus., Inc. v. United States, 253 F.3d 350, 354 (8th Cir. 2001). *See also* Rosenberg, *STARS Wars*, *supra* note 68, at 194–218 (discussing the controversy surrounding the treatment of foreign taxes for purposes of the economic substance test's consideration of profit).

232. *Compare* Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001), and IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001), *with* Bank of N.Y. Mellon II, 801 F.3d 104 (2d Cir. 2015), *Santander*, 844 F.3d 15 (1st Cir. 2016), and *Salem II*, 786 F.3d 932, 951, 960 (Fed. Cir. 2015). *See also* Rosenberg, *STARS Wars*, *supra* note 68, at 194–218.

233. *See Compaq*, 277 F.3d at 782; *IES*, 253 F.3d at 354; *BNY Mellon II*, 801 F.3d 104, 113 (2d Cir. 2015); *Santander*, 844 F.3d at 24; *Salem II*, 786 F.3d at 951, 960.

234. *See supra* note 223.

235. *See IES*, 253 F.3d 350, 354 (8th Cir. 2001).

236. *See Compaq*, 277 F.3d 778, 784–86 (5th Cir. 2001).

237. However, the Special Master in the *Wells Fargo* litigation suggested that the *IES* holding might be distinguishable based on its facts. *See* Wells Fargo & Co. v. U.S., 2014 U.S. Dist. Lexis 99111, *43-46; Wells Fargo & Co. v. U.S., 2013 U.S. Dist. Lexis 163955, *27-28, *32-33.

power to make such a decision, despite the statutory language that excludes only "Federal income tax effects" (and related state and local tax effects)—not foreign tax effects—from the application of the objective and subjective prongs.[238] Section 7701(o) analyzes both change in economic position (for the objective prong) and substantial purpose (for the subjective prong) "apart from Federal income tax effects."[239] That statutory phrasing implies that *foreign* tax effects *are* taken into account, unless and until the Treasury issues guidance on the treatment of foreign costs.[240] Therefore, it is not clear that the courts can treat foreign taxes the same way as federal income tax effects for purposes of section 7701(o)'s two prongs (including the determination of pre-tax profit for the purposes of applying such two prongs), in the absence of Treasury guidance. The IRS, however, appears to have a different interpretation: Notice 2010-62 states that section 7701(o) "does not restrict the ability of the courts" to consider such treatment of foreign taxes as a cost.[241]

Currently, the circuits are split on the question of whether foreign taxes are treated as a cost in applying the economic substance doctrine to foreign tax credit claims.[242] As the case law presently stands, three circuits have held that foreign taxes are treated as a cost in computing profit for purposes of the economic substance analysis,[243] two circuits have held to the contrary,[244] and the remaining circuits have not spoken on the issue. There is thus a split between the circuits, and a lack of precedent in some courts. It is not clear whether the answer could differ (in any circuit) for claims relating to other kinds of federal tax benefits.

238. *See* I.R.C. §7701(o)(1), (3).

239. *See* I.R.C. § 7701(o)(1)(A), (B); *see also supra* note 223.

240. The special rule for state and local income tax effects that are "related to a Federal income tax effect," and that are treated the same as federal income tax effects for purposes of the two prongs, creates a further negative inference that foreign income tax effects are not so treated (in the absence of Treasury guidance). *See* I.R.C. § 7701(o)(3). The legislative history contains "no inference" language regarding the treatment of foreign taxes as costs for pre-7701(o) periods. *See* H.R. Rep. No. 111-443, 298 ("No inference is intended as to the proper application of the economic substance doctrine *under present law*.") (emphasis added); *see also Joint Committee Report*, *supra* note 65, at 155 (same).

241. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411.

242. *Compare Compaq*, 277 F.3d at 782 (foreign taxes are not a cost when computing profit for purposes of the economic substance test), and *IES* (same), *with BNY Mellon II*, 801 F.3d 104,116 (2d Cir. 2015) (foreign taxes are treated as an expense when computing profit for purposes of the economic substance doctrine), *Santander*, 844 F.3d at 23 (same), and *Salem II*, 786 F.3d at 949 (same). The Wells Fargo decision (one of the STARS cases) has been appealed to the Eighth Circuit, which decided the *IES* case. *See* Wells Fargo & Co. v. United States, No. 17-3578, No. 17-3676 (8th Cir. Nov. 24, 2017).

243. *See BNY Mellon II*, 801 F.3d 104, 118 (2d Cir. 2015); *Salem II*, 786 F.3d at 951, 960; *Santander*, 844 F.3d at 23–24.

244. *See Compaq*, 277 F.3d 778, 784–86 (5th Cir. 2001); *IES*, 253 F.3d 350, 354 (8th Cir. 2001).

Section 7701(o) also raises the issue of whether and how the courts might take into account the Treasury's failure to issue the congressionally mandated regulations, e.g., through a theory that the agency cannot frustrate congressional intent by choosing not to act.[245] Taxpayers could potentially argue that the absence of guidance that the statute has required affects the answer as to whether foreign taxes are treated as a cost. For example, in circuits where pre-Section-7701(o) case law treats foreign taxes as a cost in the economic substance analysis,[246] taxpayers might prefer IRS guidance to the status quo. Such taxpayers might argue that Section 7701(o) requires the Treasury to restrict such treatment of foreign tax expenses to "appropriate cases,"[247] i.e., to less than all cases. Taxpayers in such situations could further assert that Treasury must issue such guidance, or that the courts must apply a less-than-all-circumstances rule for treating foreign taxes as an expense, if Treasury frustrates congressional intent by failing to act). However, Section 7701(o) also does not say what the content of the IRS guidance should be, unlike some other situations in which courts have faulted the agency for not issuing required guidance.[248]

Notice 2010-62 states that the IRS and the Treasury "intend to issue regulations" under section 7701(o)'s regulatory authority regarding foreign taxes[249]—but they have not done so. However, the government has repeatedly argued in court that foreign taxes should be treated as a cost in the economic substance analysis,[250] despite its failure to issue guidance consistent with its litigation position. Why does the Treasury think this is the right rule to be implemented by the courts as precedent, but not correct enough to issue guidance on? There are at least two possible explanations. First, at a practical, mechanical level, often the litigating agency in federal economic substance cases is the Department of Justice rather than the IRS

245. *Cf.* Int'l Multifoods Corp. v. Comm'r, 108 T.C. 25 (1997); American Air Liquide, Inc. & Subs. v. Comm'r, 116 T.C. 23 (2001); *see also generally* Amandeep S. Grewal, *Substance over Form: Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX L.J. 42 (2006) (discussing the legal impact of Treasury's failure to issue congressionally mandated or allowed regulations in various situations). Section 7701(o) states that the Secretary of the Treasury "shall" issue regulations regarding the treatment of foreign taxes. *See* I.R.C. § 7701(o)(2)(B).

246. *See BNY Mellon II*, 801 F.3d 104, 118 (2d Cir. 2015); *Salem II*, 786 F.3d at 951, 960; *Santander*, 844 F.3d at 23–24.

247. *See* I.R.C. § 7701(o)(2)(B).

248. *See, e.g.*, Int'l Multifoods Corp. v. Comm'r, 108 T.C. 25 (1997); American Air Liquide, Inc. & Subs. v. Comm'r, 116 T.C. 23 (2001).

249. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411; *see also generally* Rosenberg, *Codification*, *supra* note 109.

250. *See, e.g.*, *Compaq*, 277 F.3d at 784–85; *IES*, 253 F. 3d 354; *BNY Mellon II*, 801 F.3d 104, 118 (2d Cir. 2015); *Salem II*, 786 F.3d at 951, 960; *Santander*, 844 F.3d at 23–24.

(which is part of the Treasury Department)—that is the case everywhere except in Tax Court. Therefore, the government's litigation positions are not always identical to the IRS's willingness to issue regulations on a topic. But the IRS did argue that foreign taxes should be treated as expenses (in computing profit for purposes of the economic substance test) in the Tax Court in both *Compaq*[251] and *Bank of New York Mellon v. Commissioner*.[252]

As a second explanation for the lack of guidance on the treatment of foreign taxes (even though the IRS is willing to take litigation positions on the issue), the IRS may be facing a shortage of time and personnel. Even before the recent changes made by the Tax Cuts and Jobs Act,[253] the IRS was under pressure to issue many other types of foreign tax credit guidance (in addition to this treatment-as-an-expense issue): There were several new foreign tax credit rules enacted in 2010, in the same legislative package as Section 7701(o).[254] Additional foreign tax credit changes were enacted at the end of 2017.[255] However, there are large dollar amounts at stake in the economic substance cases,[256] which might have been expected to get the foreign-taxes-as-an-expense issue some priority.

On a technical level, it is also possible that the Treasury thinks that foreign taxes are appropriately treated as costs in some cases but not others, and has not yet decided which circumstances are which. For example, the Treasury might consider whether different rules (regarding the treatment of foreign taxes as an expense) should apply where foreign tax credits are not the challenged tax benefit (e.g., if the IRS is challenging an interest deduction or other benefit, but the taxpayer also has foreign tax expenses). Section 7701(o) itself implies that treating foreign taxes as a cost might not be the rule in all cases, after the Treasury issues guidance.[257] But presumably, while it considers the possible exceptions, the Treasury could

251. *See* Compaq Computer Corp. v. Comm'r, 113 T.C. 214, 222–23 (1999), *rev'd by* 277 F.3d 778 (5th Cir. 2001).

252. *See* Bank of N.Y. Mellon Corp. v. Comm'r, 140 T.C. 15, 35 (2015), *aff'd* 801 F.3d 104 (2d Cir. 2015), *cert. denied* 136 S.Ct. 1377 (2016).

253. *See* An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (commonly known as the Tax Cuts and Jobs Act), Pub. L. No. 115-97, 131 Stat. 2054 (2017).

254. *See* I.R.C. §§ 901(m), 904(d)(6), 909, 960(c).

255. *See, e.g.*, I.R.C. § 960(a), (d).

256. For example, the STARS cases involved hundreds of millions of dollars of foreign tax credits, although they occurred before Section 7701(o)'s effective date. *See BNY Mellon II*, 801 F.3d 104, 112 (2d Cir. 2015); *Santander*, 844 F.3d at 17; *Salem II*, 786 F.3d at 936; Wells Fargo & Co. v. United States, 143 F. Supp. 3d 827, 831 (D. MN. 2015).

257. *See* I.R.C. § 7701(o)(2)(B) ("in appropriate cases").

issue guidance stating that cost treatment applies in all cases until further guidance is issued (or the converse). It has not done so.

Especially given the dollar amounts at stake, isn't it worth issuing guidance that says something to the effect of "foreign taxes are a cost (for purposes of determining profit under the economic substance test) unless the taxpayer proves to the IRS's satisfaction that they are not appropriately treated as a cost under the facts and circumstances of a particular transaction"? Could an insufficiently nuanced regulatory rule that generally treats foreign taxes as a cost really be worse than current Fifth and Eighth Circuit precedents that arguably say that foreign taxes are never a cost?[258] Those court holdings appear clearly the wrong answer[259] and are also very costly for the U.S. Treasury. It seems that the prudent move would be for the Treasury to issue regulations consistent with the government's litigating position, or (at least) regulations stating that the default rule is that foreign taxes are treated as costs, unless the taxpayer persuades the IRS that a contrary answer is more appropriate under the facts and circumstances.

F. Determining when the Economic Substance Doctrine is Relevant

Relevance is essentially a preliminary step for determining whether the economic substance analysis applies to a transaction at all.[260] If the economic substance doctrine is relevant, then the objective and subjective prongs (and the rest of the economic substance doctrine) can be applied to determine whether the transaction passes or fails the economic substance test (i.e., whether it has sufficient economic substance to be respected).[261] A finding that the doctrine is relevant to a transaction (i.e., the transaction is not exempt from economic substance inquiry) does not determine the outcome of the economic substance analysis, and does not necessarily mean that the transaction will be disregarded for federal income tax purposes.[262] Conversely, however, a finding that the economic substance doctrine is *not* relevant to a particular tax benefit (e.g., perhaps low income housing credits)

258. *See Compaq*, 277 F.3d 778, 784–86 (5th Cir. 2001); *IES*, 253 F.3d 350, 354 (8th Cir. 2001).

259. *See generally* Rosenberg, *STARS Wars*, *supra* note 68.

260. *See* I.R.C. § 7701(o)(1).

261. *See* I.R.C. §7701(o).

262. *See, e.g.*, UPS of America v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001) (finding that a reinsurance transaction passed the economic substance test and should be respected); Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 781–82 (5th Cir. 2001) (economic substance doctrine was applied to the transaction, but taxpayer prevailed in its arguments that the two prongs of the test were met); IES Indus., Inc., v. United States, 253 F.3d 350, 354 (8th Cir. 2001) (same).

is the end of the inquiry, and prevents the two prongs (and the rest of the doctrine) from being applied or analyzed.[263]

The courts have traditionally determined that the economic substance test does not apply—and therefore the conjunctive, disjunctive, or other formulation of the analysis is not performed—if Congress did not intend the doctrine to pertain to the particular tax benefit (e.g., a specific credit or deduction) at issue.[264] For example, the low income housing credit arguably is intended to be granted even in non-economic transactions.[265] Courts have differed in the past on their determinations of which tax benefits are subject to the economic substance doctrine and which are not. For example, the United States Court of Appeals for the D.C. Circuit held that the allowance of a loss on straddle transactions for commodities dealers, under Section 108, was not subject to the economic substance doctrine.[266] It found that Congress had preempted and foreclosed an economic substance analysis on this issue because the statutory language irrefutably presumed that such losses of commodities dealers (but not of other taxpayers) were incurred in the course of a trade or business.[267] The relevant statute, Section 108, required that the transaction either be engaged in for profit or connected with a trade or business.[268] The court focused on congressional intent.[269] However, two other circuit courts reviewed the same Tax Court decision but reached the opposite conclusion from the D.C. Circuit.[270] Section 7701(o) does not

263. *See BNY Mellon II*, 801 F.3d 104, 113–14 (2d Cir. 2015); Gregory v. Helvering, 293 U.S. 465, 469 (1935).

264. *See, e.g.*, Yosha v. Comm'r, 861 F.2d 494, 498–99 (7th Cir. 1988) (observing that the statutory language of Section 165(c) "can be viewed as codifying the economic substance doctrine for loss deductions, thus placing it beyond the power of judicial reexamination"); Horn v. Comm'r, 968 F. 2d 1229, 1239 (D.C. Cir. 1992) (losses of commodities dealers under section 108 are not subject to an economic substance analysis); *see also* Sacks v. Comm'r, 69 F.3d 982, 991 (9th Cir.1995) ("The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability"); Casebeer v. Comm'r, 909 F.2d 1360, 1365 (9th Cir. 1990).

265. *See* I.R.C. §7701(o); *cf.* Steven A. Dean, *Space Madness: Subsidies and Economic Substance*, 99 CORNELL L. REV. ONLINE 151, 153 (2014) (suggesting adaptations to the manner in which the economic substance doctrine applies, or does not apply, to tax subsidies that are intended to encourage non-economic behavior).

266. *See Horn*, 968 F.2d at 1239.

267. *Id.*

268. *Id.* at 1238.

269. *Id.* at 1239–40.

270. *See* Gardner v. Comm'r, 954 F.2d 836, 838 (2d Cir. 1992); Lerman v. Comm'r, 939 F.2d 44, 54–55 (3d Cir.); *see also* Massey v. Comm'r, 950 F.2d 722 (3d Cir. 1991) (per curiam) (table) (reviewing the same tax court opinion as *Horn*, *Gardner*, and *Lerman*, and upholding the tax court's decision without writing an appellate opinion, so the issue of whether economic substance applies to the disputed section 108 deduction was not discussed).

preclude similar lack of uniformity among the circuits in the future, regarding whether or not the economic substance doctrine applies.

The IRS does not have the authority to issue guidance defining relevance. Section 7701(o) provides that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."[271] If Section 7701(o) had never been enacted, the Treasury would have no regulatory authority to issue guidance about when the judicial doctrine of economic substance applies. So, literally, there does not appear to be regulatory authority to address this issue. Congress did not give a reason for preserving this determination for the courts alone, without the possibility of regulatory guidance.[272]

Despite this lack of regulatory authority, taxpayers and practitioners asked the IRS to publish a list of transactions to which the economic substance doctrine does not apply or (conversely) an exclusive list of transactions to which economic substance does apply (to provide safety to everything else).[273] Although the IRS does not appear to have the authority to issue such a list,[274] no taxpayer would likely challenge the IRS's regulatory authority if taxpayers felt that the guidance benefited them. Therefore, in the case of any taxpayer-favorable guidance regarding relevance, regulatory authority might be a moot point.

The IRS has declined to issue formal guidance to taxpayers regarding relevance[275] (which seems consistent with its lack of regulatory authority on this issue). The agency has, however, issued instructions to its own examiners, concerning when the economic substance doctrine should be raised on audit and providing (arguably onerous) procedures for examiners

271. I.R.C. § 7701(o)(5)(C).

272. *See* H.R. Rep. No. 111-443, 295–296; *Joint Committee Report*, *supra* note 65, at 152; *see also* Rosenberg, *Codification*, *supra* note 109 (discussing the IRS' issuing *de facto* guidance on relevance by means of an internal directive that restricts its agents' ability to raise the doctrine); *cf. also* part III G, *infra* (discussing arguments that the Treasury may lack the authority to define the tested transaction).

273. *See*, *e.g.*, *Firms Seek Codified Economic Substance Doctrine Guidance*, 2015 TAX NEWS TODAY 23–30 (Feb. 2, 2015) (reprinting a letter from multiple practitioners to the Treasury Department); *Practitioners Want More Specifics on Codified Economic Substance Doctrine*, 2011 TAX NEWS TODAY 86–89 (May 2, 2011) (reprinting a different letter from practitioners to the IRS and the Treasury Department); *ABA Members Seek More Guidance on Codification of Economic Substance Doctrine*, 2011 TAX NEWS TODAY 12–13 (Jan. 18, 2011) (reprinting joint comments prepared by the American Bar Association Section of Taxation and members of the American Institute of Certified Public Accountants); *NYSBA Tax Section Recommends More Guidance on Codification of Economic Substance Doctrine*, 2011 TAX NEWS TODAY 5–14 (Jan. 5, 2011) (reprinting a report by the New York State Bar Association Tax Section).

274. *See* I.R.C. § 7701(o)(5)(C).

275. *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746.

to follow if such examiners choose to raise the issue.[276] This internal guidance is available for the public to see, and (practically speaking) taxpayers are likely to take such internal rules into account when evaluating the IRS's position. Therefore, the IRS has (in effect) published rules that address when the economic substance doctrine should and should not be applied (closely related to relevance), even though it technically has no authority to issue guidance on relevance. This raises many issues about the authority of the agency to frustrate the intent of Congress by issuing rules on a topic that was reserved to the courts. It also raises issues about the appropriateness of issuing *de facto*, unofficial guidance by means of internal letters to agency employees.[277]

The legislative history regarding Section 7701(o) does supply a non-exclusive list of normal business transactions for which Section 7701(o) is not expected to change the tax treatment. That list contains the following four types of transactions: Taxpayer choices between the use of debt and equity; a United States person's choice of the nationality (U.S. or foreign) of a corporation used to make a foreign investment; the choice to enter into a corporate organization or reorganization under Subchapter C of the Code; and the choice to conduct a transaction using a related entity (if Section 482's arm's length pricing requirements are met).[278]

This list is not quite a description of when the economic substance doctrine is relevant (although some commentators and taxpayers would like to interpret it that way).[279] Instead, this is merely a statement that Section 7701(o) is not expected to change the application (or non-application) of the economic substance doctrine to such transactions. To read the list of transactions as expressing congressional intent about relevance would conflict with the statutory language that directly states that relevance is to be determined "as if this subsection had never been enacted."[280] Such a reading would be inconsistent with the general rule of statutory interpretation that clear statutory language (e.g., Section 7701(o)'s statement that relevance is

276. *See* LB&I Directive, LMSB Directive, *supra* note 20; *see generally* Rosenberg, *Codification*, *supra* note 109.

277. *See generally* Rosenberg, *Codification*, *supra* note 109; Tim Wu, *Agency Threats*, 60 DUKE L.J. 1841, 1841 (2011) (not focusing on the IRS, but stating generally that "Over the last two decades, agencies have increasingly favored the use of . . . statements of best practices, interpretative guides, private warning letters, and press releases").

278. *See* H.R. Rep. No. 111-443, at 296; *Joint Committee Report*, *supra* note 65, at 152–53.

279. *See, e.g.*, Lipton, *supra* note 70, at 331 ("an important issue is the scope of the 'angel list' included in the legislative history. . . . This non-exclusive list . . . implies that many common tax planning techniques will be respected.").

280. *See* I.R.C. § 7701(o)(5)(C).

left to the courts to decide) overrides any legislative history statement to the contrary.[281]

Taxpayers may argue, nonetheless, that Congress did not intend the economic substance doctrine (as impacted by Section 7701(o)) to apply to the enumerated transactions in the legislative history or to other commonplace business choices.[282] They could further argue that the economic substance doctrine focuses on implementing congressional intent, so that the intent expressed in the House and Joint Committee Reports should affect courts' determinations of the doctrine's relevance to such transactions. This argument does not seem compelling in the face of the statute's clearly leaving the relevance determination to the courts.[283] Further, the four listed transactions in the House and Joint Committee reports appear immediately after a paragraph in which those reports explain that the issue of relevance is left to the courts and that "the provision does not change current law standards in determining when to utilize an economic substance analysis."[284]

However, even if Section 7701(o) does not prevent the application of the economic substance doctrine to the four listed transactions, courts have often (before section 7701(o)) decided not to apply the economic substance doctrine to such choices, on the grounds that Congress intended to allow taxpayers to make some decisions (e.g., the choice between debt and equity) based on tax consequences.[285] Under Section 7701(o), courts can continue to determine that the economic substance doctrine was not intended to apply to particular tax benefits. The legislative history appears to emphasize that the essential question in making such determination is whether the claimed tax benefit is consistent with congressional intent.[286]

281. *See* Albemarle Corp. & Subsidiaries v. United States, 118 Fed. Cl. 549, 576 (Ct. Cl. 2015), *aff'd* 797 F.3d 1011 (Fed. Cir. 2015), *reh'g den'd* 805 F.3d 1060 (Fed. Cir. 2015), *cert. den'd* 136 S. Ct. 1659 (2016); *see also supra* note 14.

282. *See* Lipton, *supra* note 279.

283. *See* I.R.C. § 7701(o)(5)(C).

284. H.R. Rep. No. 111-443, at 295–96; *see also Joint Committee Report*, *supra* note 65, at 152 (using almost identical language).

285. *See, e.g.*, Kraft Foods v. Comm'r, 232 F.2d 118 (2d Cir. 1956); Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988), *aff'd* 886 F.2d 1318 (7th Cir. 1989). The list of four transactions may represent Congress' understanding of the case law (as of the time of enactment) with respect to these transactions, without preventing the courts from adapting and refining the case law over time.

286. *See* H.R. Rep. No. 111-443, 296 n.129 (emphasis added):

> If the tax benefits are clearly consistent with all applicable provisions of the Code *and the purposes* of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision. See, e.g., *Treas*. Reg. § 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the

G. Codification Does Not Have Much Effect on Definition of the Transaction to be Tested

Historically, one key question in economic substance cases has been how to define the transaction to be tested (i.e., how to describe the set of the taxpayer's steps or actions to which the two prongs, or other formulation of the test, should be applied).[287] Section 7701(o) uses the term "transaction" to describe the tested set of activities.[288] The delineation of the transaction can determine the outcome of the economic substance analysis by including or excluding positive elements (e.g., elements with profit potential or business purpose).[289] Imagine, for example, that the only step that has profit potential or business purpose is separated, for purposes of applying the two prongs, from the three steps that create the claimed tax benefit.

Pre-Section-7701(o) case law generally held that the transaction that is to be tested consists of the steps that were necessary to generate the challenged tax benefit.[290] Section 7701(o) says only that the transaction to be tested "includes a series of transactions."[291] This is not a full description of what "transaction" means or doesn't mean, only a note about what a transaction "includes."

particular taxpayer when the essential nature of the transaction or situation is examined in the light of the *basic purpose or plan* which the deduction, credit, or other allowance was *designed by the Congress to effectuate*.

287. *See, e.g.*, *ACM*, 157 F.3d 231 (3rd Cir. 1998); Rice's Toyota World v. Comm'r, 752 F.2d 89, 91–92 (4th Cir. 1985); *IES*, 253 F3d at 353; Alessandra v. Comm'r, 69 T.C.M. (CCH) 2768 (1995)*; see also* Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104, 113 (2d Cir. 2015) (discussing whether a loan and trust should be tested together or separately for economic substance). For example, many cases have held that challenged transactions are tested separately from the related borrowing (if the interest deductions from such borrowing are not the focus of the transaction). *See, e.g., ACM*, 157 F.3d at 262; *Rice's Toyota World*, 752 F.2d at 91–92; *Salem II*, 786 F.3d at 960.

288. The term "transaction" is used throughout Section 7701(o) to indicate the set of steps or actions that are being tested, i.e., the set of items to which the relevance inquiry, the objective and subjective prongs, and the profit ratio test apply. *See* I.R.C. § 7701(o)(1), (2)(A), (5)(C).

289. *See generally* David P. Hariton, *The Frame Game: How Defining the "Transaction" Decides the Case*, 63 TAX LAW 1 (2009) (discussing the importance of determining the arrangement to be tested); *see also* Bankman, *supra* note 26, at 15 (defining the tested steps can determine the outcome of the economic substance analysis).

290. *See infra* notes 294 and 300; *see also generally* Rosenberg, *STARS Wars*, *supra* note 68, at 191–93. Section 7701(o)'s legislative history somewhat confusingly states that "some courts have bifurcated a transaction in which activities with non-tax objectives have been combined with unrelated activities having only tax-avoidance objectives, in order to disallow the tax benefits of the overall transaction." H.R. Rep. No. 111-443, 292. It isn't clear why this House Report refers to disallowing benefits from the overall transaction rather than disallowing benefits from the tax-motivated steps, which have been isolated from the remaining steps for the purposes of the economic substance analysis.

291. *See* I.R.C. § 7701(o)(5)(D).

The statute does not specifically state the converse possibility that "transaction" can mean one portion of a larger transaction, but neither does it forbid that approach. (The legislative history, in contrast, says that the provision "reiterates the present-law ability of the courts to bifurcate a transaction.")[292] Thus, if multiple parts of a transaction each constitute a transaction themselves (e.g., a loan and an investment) then Section 7701(o)'s partial definition seems to allow either treating each such portion as a separate transaction or grouping them together as one larger tested transaction, depending on the facts and circumstances.

The legislative history says that Section 7701(o) does not change the ability of the courts to aggregate or disaggregate a transaction in order to determine the unit to be tested.[293] Indeed, Section 7701(o)'s definition of "transaction" appears to allow the continued application of the pre-Section-7701(o) case law's approach, which has combined or disaggregated steps or transactions in order to delineate the tested items, with the goal of testing together the parts of the transaction(s) necessary for the tax benefit.[294] Section 7701(o)'s definition of "transaction" seems just meant to confirm that codification doesn't change the current judicial practice of defining the tested transaction on a case-by-case basis, depending on the facts and circumstances of each situation.[295] This intent is explained in Section 7701(o)'s legislative history.[296] This interpretation is also supported by "[t]he normal rule of statutory construction . . . that if Congress intends for

292. *See infra* note 293.

293. According to the legislative history:

> The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the [economic substance] doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.

H.R. Rep. No. 111-443, 296–97; *see also Joint Committee Report*, *supra* note 65, at 153 (same). Notice 2014-58, 2014-44 I.R.B. 746, cites the above language before purporting to give some (broad) standards for how to aggregate or disaggregate steps to determine the tested transaction.

294. *See, e.g.*, Bank of N.Y. Mellon II, 801 F.3d 104, 115 (2d Cir. 2015); *Salem II*, 786 F.3d 932, 951, 960 (Fed. Cir. 2015); *Santander*, 844 F.3d 15, 21–2 (1st Cir. 2016); Rice's Toyota World v. Comm'r, 752 F.2d 89, 91–2 (4th Cir. 1985); ACM, 157 F.3d 231, 247–48 (3d Cir. 1998); Coltec Indus. v. United States, 62 Fed. Cl. 716, 754–55 (2004), *rev'd by* Coltec Indus. v. United States, 454 F.3d 1340, 1352–54 (Fed. Cir. 2006) (testing separately the transaction that resulted in the challenged tax benefit and rejecting the lower court's approach of defining the tested transaction more broadly), *reh'g denied*, Coltec Indus., Inc. v. United States, No. 05-5111, 2006 U.S. App. LEXIS 24771 (Fed. Cir. Sept. 19, 2006), *cert. denied* 549 U.S. 1206 (2007); *see also infra* note 300.

295. *See, e.g.*, *BNY Mellon II*, 801 F.3d at 112-13 (applying economic substance doctrine to facts arising before Section 7701(o)'s effective date).

296. *See supra* note 293.

legislation to change the interpretation of a judicially created concept, it makes that intent specific."[297]

However, commentators have speculated,[298] and practitioners have worried, that Section 7701(o)'s definition of "transaction" expands the courts' and Treasury's ability to aggregate and disaggregate in order to define the arrangement (steps or portions of steps) to be tested. In particular, commentators worried that Congress enhanced the ability to aggregate or to instead separate steps of a single transaction (or multiple related transactions) in order to reach a taxpayer-unfavorable result.[299] This concern about a change in the definition of "transaction" seems unfounded, given the limited nature of Section 7701(o)'s definition of the "transaction" and the consistency of that description with the pre-existing case law, which is confirmed by the legislative history.

Under the pre-Section 7701(o) economic substance case law, the courts and government already had the ability to define the tested transaction by grouping and breaking apart various steps, and they generally focused on which steps were necessary to claim the challenged tax benefit and which steps were integrally connected to each other.[300] This delineation of the

297. Midatlantic Nat'l Bank v. New Jersey Dep't of Envt'l Protection, 474 U.S. 494, 501 (1986) (quoting Edmonds v. Compagnie Generale Transatlantique, 443 U.S. 256, 266–67 (1979)).

298. *See, e.g.*, Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411, 422–23 (2010) (discussing the impact of Section 7701(o) on the determination of the transaction to be tested under the economic substance doctrine and theorizing that the statute changes the courts' ability to aggregate and disaggregate steps in order to define the tested transaction).

299. *See id.*

300. *See, e.g.*, *BNY Mellon II*, 801 F.3d 104, 121, 123–124 (2d. Cir. 2015) ("The loan was not necessary for the STARS structure to produce the disallowed foreign tax credits.") (citation omitted); *ACM*, 157 F.3d 231, 260 (3d Cir. 1998) ("The Tax Court properly analyzed the profitability of the transactions whose economic substance is at issue, namely the contingent installment exchange of Citicorp notes for LIBOR notes which gave rise to the disputed tax consequences."); Coltec Indus. v. United States, 454 F.3d 1340, 1356 (Fed. Cir. 2006) ("the transaction to be analyzed is the one that gave rise to the alleged tax benefit."); *id*. at 1358 ("we must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. . . . It is this exchange that provided Garlock with the high basis in the Garrison stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus."); Nicole Rose Corp. v. Comm'r, 320 F.3d 282, 284 (2d Cir. 2002); Sheldon v. Comm'r, 94 T.C. 738, 767 n.19 (1990); Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 183 (D. Conn. 2004) (one "cannot avoid the requirements of economic substance simply by coupling a routine economic transaction generating substantial profits and with no inherent tax benefits to a unique transaction that otherwise has no hope of turning a profit"), *aff'd* 150 F. App'x 40 (2d Cir. 2005) (summary order); *Salem II*, 786 F.3d 932, 957 (Fed. Cir. 2015) (citing with approval Bank of N.Y. Mellon Corp. v. Comm'r, T.C. Memo 2013-225, 106 T.C.M. (CCH) 367 (2013): "The court based its ruling in that case on the same factors that are present here: (1) the loan was not necessary for the STARS structure to produce the disallowed foreign tax credits; (2) the loan proceeds were not used to finance, secure, or carry out the STARS structure; and (3) the loan served a purpose beyond the creation of tax benefits."); United States v. Wexler, 31 F.3d 117, 125–26 (3d Cir.

tested transaction was already, before Section 7701(o), a disputed point in litigation, as taxpayers argued for the most taxpayer-favorable inclusion of profitable steps in each case, and the courts tended to restrict the tested transaction to those steps connected with the asserted Federal income tax benefit.[301] Section 7701(o) does not appear to have expanded or otherwise changed the courts' ability to engage in this factual determination, except that it has arguably given the Treasury the ability to issue guidance on this topic (as discussed below).

Treasury addressed the definition of "transaction" in Notice 2014-58—but didn't appear to say much.[302] The notice states that the definition of the tested transaction can vary based on the facts and circumstances.[303] It further indicates a possible approach of analyzing separately "tax-motivated steps that are not necessary to accomplish the non-tax goals."[304] The case law tends to express a very similar concept in the converse: delineating (by aggregation or separating out) the steps that *are* necessary to the claim of the disputed tax benefit.[305] The notice's discussion of the meaning of

1994) (focusing on the part of the transaction that generated the tax benefits, "Wexler's case differs in a critical respect. There is no debt obligation that can be separated from the underlying repo scheme or that was undertaken for some reason other than the tax benefits of deducting interest on that obligation itself. The obligation that Wexler argues to be an economically substantive 'genuine indebtedness', the loan secured by the government securities, is the very obligation that will generate the interest payments constituting the tax benefits of the entire transaction."); *see also supra* note 294, *infra* notes 301, 305.

301. *See, e.g., Rice's Toyota World*, 752 F.2d at 91–92; *ACM*, 157 F.3d at 245; *BNY Mellon II*, 801 F.3d at 106–107; Alessandra v. Comm'r, 69 T.C.M. (CCH) 2768, *10-11 (1995); *see also supra* note 300.

302. *See* Notice 2014-58, 2014-44 I.R.B. 746.

303. IRS Notice 2014-58 states that:

> For purposes of determining whether the codified economic substance doctrine applies, "transaction" generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.

I.R.S. Notice 2014-58, 2014-44 I.R.B. 746.

304. The notice states that:

> Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the "transaction" includes all of the steps taken together—an aggregation approach . . . . However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the "transaction" may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals—a disaggregation approach.

I.R.S. Notice 2014-58, 2014-44 I.R.B. 746.

305. *See, e.g., ACM*, 157 F.3d at 262–63, 256 n.48; *BNY Mellon II*, 801 F.3d at 121, 123–24; *see also* U.S. v. Wexler, 31 F.3d 117, 125–26 (3rd Cir. 1994) (focusing on the part of the transaction that generated the tax benefits, "Wexler's case differs in a critical respect. There is no debt obligation that

"transaction" is thus largely consistent with the approach of the pre-Section 7701(o) case law. The notice, like the statute, does not appear to expand or otherwise change the courts' ability to consider which steps should be tested together as one unit, or instead separated into discrete parts, under the economic substance doctrine.[306]

The description of the tested transaction raises an interesting issue about the Treasury's regulatory authority on this topic. Initially, it appears that Section 7701(o)'s choice to include a definition of "transaction" gives the agency the ability to address and refine that definition, within the bounds of congressional intent. Before Section 7701(o), courts had the sole authority over this determination, and the Treasury could not issue regulations regarding the arrangement to be tested under the judicial doctrine.[307] Although there is no specific grant of regulatory authority on the "transaction" definition, Section 7805 gives the Treasury general authority to issue guidance regarding Internal Revenue Code provisions.[308]

However, the legislative history clearly states that Section 7701(o)'s definition of "transaction" does not alter the courts' ability to aggregate or disaggregate in order to describe the tested transaction.[309] This legislative history could be used to argue that Congress did not intend to grant regulatory authority to the Treasury to define the tested transaction, but instead meant to leave this determination to the courts (like the determination of relevance).[310] But Congress did not choose to include statutory language that affirmatively keeps "transaction" the sole province of the courts, as it did for "relevance."[311] Instead, Congress relied on legislative history (a House Report as well as a description by the Joint Committee on Taxation[312])

can be separated from the underlying repo scheme or that was undertaken for some reason other than the tax benefits of deducting interest on that obligation itself."); *see also infra* notes 294, 300.

306. Query whether a notice could have such an impact in any event. Notice 2014-58 quotes the legislative history that says that the courts' ability to define "transactions" is unchanged. *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746; *see also supra* note 293.

307. The executive branch, in its capacity as litigator, always had some influence by choosing to assert particular arguments or not. For example, the government could choose to concede that five steps should all be tested together. But (before codification) the courts had the final say and were free to disagree with the litigating agency's theory of how the tested transaction should be defined.

308. *See* I.R.C. § 7805(a).

309. *See supra* note 293.

310. *See* I.R.C. § 7701(o)(5)(C).

311. *Compare* I.R.C. § 7701(o)(5)(D) (addressing the term "transaction") *with* I.R.C. § 7701(o)(5)(C) (addressing relevance).

312. Descriptive reports by the Joint Committee on Taxation are not technically legislative history but are commonly considered as an indication of congressional intent or as an aid to understanding legislation. Courts have varied in the weight that they give to such Joint Committee reports. *See* Fed. Power Comm'n v. Memphis Light, Gas & Water Div., 411 U.S. 458, 472 (1973) (a Joint Committee on

rather than statutory language to express the unchanged powers of the courts regarding "transactions."[313]

Given the general priority of statutory language over legislative history,[314] the Treasury arguably has the ability to issue guidance regarding aggregation or disaggregation of steps to define the tested transaction, despite the legislative history's statement that the courts' powers in this regard should be unchanged. But the Treasury's authority to issue guidance on this topic could be disputed. This is especially the case because it is the absence of a prohibition on regulations, not an affirmative grant of

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Taxation explanation was a "compelling contemporary indication" of legislative intent); Fannie Mae v. United States, 379 F.3d 1303, 1309 (Fed. Cir. 2004) ("as a post-enactment explanation, the Blue Book interpretation is entitled to little weight."); Flood v. United States, 33 F.3d 1174, 1178 (9th Cir. 1994); Estate of Wallace v. Comm'r, 965 F.2d 1038, 1050 n.15 (11th Cir. 1992); McDonald v. Comm'r, 764 F.2d 322, 336 n.25 (5th Cir. 1985); AD Global Fund, LLC v. U.S., 67 Fed. Cl. 657, 677 (2005) (explaining that Joint Committee explanations are prepared by staff, not legislators, and are often prepared after legislation is enacted (so that they do not represent materials that were available to and influenced legislators before a congressional vote), but that such explanations have nonetheless been viewed as informative by some courts, while being discounted by others).

For Section 7701(o), the House Report was written before amendments by the Senate and before the final version of the statute was enacted, but the Joint Committee Report was written after enactment. *See* H.R. Rep. No. 111-443, *as reprinted in* 2010 U.S.C.A.N.N. 123 (2010); *Joint Committee Report*, *supra* note 65, at 156 (2010). The fact that the House and Joint Committee reports contain the same language regarding the unchanged ability of the courts to determine the "transaction" (*see supra* note 293) suggests that this thought survived the Conference Committee and still applies to the final, enacted version of Section 7701(o).

313. At least one commentator has disparaged this particular legislative history, although his argument was that the House Report was not publicly quoted by the IRS or others soon enough after enactment and that it was a budget committee report rather than a conference committee report. *See* Amy S. Elliott, *Economic Substance Notice's Sham Treatment Reverses LB&I Course*, 2014 TAX NOTES TODAY 202–205 (Oct. 20, 2014) ("Cummings also pointed out that in extending the penalty to apply to sham transactions, the IRS cited the legislative history of the Health Care and Education Reconciliation Act of 2010. That House report 'has never before been cited by the United States government,' Cummings said. 'I'm not that comfortable relying on House reports that just got discovered last week.'"); Andrew Velarde, *IRS Releases New Guidance on Economic Substance Doctrine*, 145 TAX NOTES 174 (Oct. 13, 2014) ("Cummings . . . said that the promotion of a budget act report, which is not a House conference report, to legislative history had hardly ever been done in any reported case decision before it appeared in the Chemtech litigation, and had never been cited in other IRS notices."); *see also* Jasper L. Cummings, Jr., *The Sham Transaction Doctrine*, 145 TAX NOTES 1239 (Dec. 15, 2014) (referring to "the alleged legislative history, which was not a House conference report"); *id.* at n.149 (explaining that "H.R. Rep. No. 111-443 has never been cited by Treasury or the IRS. It has been cited in five court opinions . . . . The report on the Budget Reconciliation Act bundled up the reports from the prior year, one of which was the Ways and Means Committee report on the section 7701(o) proposal. *See* John Cannan, *A Legislative History of the Affordable Care Act,* 105 LAW LIB. J. 131 (2013).").

314. *See, e.g.*, Albemarle Corp. & Subsidiaries v. U.S., 118 Fed. Cl. 549, 576 (2014), *aff'd* 797 F.3d 1011 (Fed. Cir. 2015), *reh'g den'd* 805 F.3d 1060 (Fed. Cir. 2015), *cert. den'd* 136 S. Ct. 1659 (2016); *see also supra* note 13.

specifically described regulatory authority,[315] that arguably allows the agency to define "transactions," in contradiction with the legislative history's apparent intent to leave the "transaction" determination to the courts. The "transaction" issue could lead to vigorous debate in the future regarding the relative power of legislative history to prevent regulatory guidance or to influence its content.

The Treasury apparently believes that it has regulatory authority in this regard, because it addressed the definition of "transaction" in Notice 2015-58.[316] Although practitioners criticized the content, or lack thereof, in that notice,[317] they apparently did not challenge the IRS's authority to issue guidance on this topic. That lack of challenge may stem from a preference for IRS guidance that is more favorable or predictable than judicial decisions. If the IRS were to issue guidance that disfavored a particular taxpayer's arguments, one could expect a discussion of whether the legislative history nonetheless leaves this issue to the judiciary rather than the agency.

Given the stated intent not to alter the courts' ability to delineate the tested transaction, perhaps the only reasons to add a definition of "transaction" to the statute were to clarify that pre-enactment practice on this topic was not being changed, and to show that Congress approves of the courts' current approach. This might have been clearer if Congress had merely stated, as it did for relevance,[318] that Section 7701(o) would not change the determination of the tested transaction. It is not obvious why Congress chose different approaches for making possibly the same point for "relevance" and "transaction."

H. Section 7701(o) Constrains the Ability of Courts to Adapt the Doctrine

315. The Treasury's regulatory authority regarding the meaning of "transaction" derives from the general regulatory authority granted by section 7805, rather than from a subject-specific grant contained in section 7701(o) itself. *Compare* I.R.C. § 7805(a) *with* I.R.C. §7701(o)(2)(B).

316. Notice 2014-58, 2014-44 I.R.B. 746.

317. *See, e.g.*, Amy S. Elliott, *Practitioners Troubled by Economic Substance Notice*, 145 TAX NOTES 277 (Oct. 20, 2014) (practitioners criticized the notice's description of "transactions"); Andrew Velarde, *IRS Releases New Guidance on Economic Substance Doctrine*, 145 TAX NOTES 174 (Oct. 13, 2014) (practitioners negatively discussed the notice's treatment of "transactions"); *see also Firms Seek Codified Economic Substance Doctrine Guidance*, 2015 TAX NEWS TODAY 23–30 (Feb. 2, 2015) (reprinting a letter from multiple practitioners to the IRS, which discussed the definition of "similar rule of law"); Amy S. Elliott, *Economic Substance Notice's Sham Treatment Reverses LB&I Course*, 2014 TAX NOTES TODAY 202–205 (Oct. 20, 2014) (practitioners expressed concern about the notice's interpretation of "similar rule of law").

318. *See* I.R.C. § 7701(o)(5)(C).

Among its other effects, Section 7701(o) constrains, without eliminating, the ability of the courts to adapt the economic substance doctrine over time, in order to respond to new fact patterns.[319] Gradual evolution had been the previous pattern for the doctrine.[320] The courts (rather than the Treasury) formerly had the sole ability to alter and adapt the economic substance doctrine.[321] Now the courts' ability to adapt the doctrine has been constricted in two ways: Section 7701(o) provides some specific rules, such as the ratio rule for taking profit potential into account,[322] and it also allows the Treasury to issue guidance.

How much restriction is actually placed on the courts' ability to interpret the economic substance doctrine depends on how much precision (as opposed to room to maneuver) is contained in each of the substantive provisions of Section 7701(o) (discussed above), and also on whether the Treasury chooses to issue guidance and the content of that guidance.

For example, "purpose (apart from Federal income tax effects)," "substantial," and "meaningful" are all mandatory concepts and standards in the economic substance analysis under Section 7701(o).[323] But the definitions of these standards are left to the courts, unless and until the Treasury issues guidance. The statutory descriptions of the two prongs contain some detail, but not so much precision as to foreclose all judicial interpretation (at least until the Treasury weighs in with guidance). However, the Treasury can now have the last word on most economic substance topics if it wants to (by issuing guidance)—a change that has

319. *See* Erik M. Jensen, *Codification of the Economic Substance Doctrine*, 28 J. TAX'N INV. 87, 88 (2011) (noting that some commentators were concerned that codification restricted the potential for future adaptation); Bernard Wolfman, *Why Economic Substance Is Better Left Uncodified*, 104 TAX NOTES 445, 445 (2004) (discussing a previous codification proposal and the possibility that codification could prevent future adaptation of the doctrine).

320. For example, when taxpayers began showing minimal (rather than zero) profit from challenged transactions, some courts clarified that *de minimis* or insignificant profit was not sufficient to meet the objective prong. *See, e.g.*, Sheldon v. Comm'r, 94 T.C. 738, 767–68 (1990) (profit that was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions" was not sufficient); Knetsch v. U.S., 364 U.S. 361, 365–66 (1960) (expected profit that was "a relative pittance" was not enough); WFC Holdings Corp. v. U.S., 728 F.3d 736, 746 (8th Cir. 2013) ("modest profits" relative to "substantial tax benefits" were not enough, citation omitted); Salem Fin., Inc., 786 F.3d 932, 951, 960 (Fed. Cir. 2015) (profit "grossly disproportionate to the tax benefits" was not sufficient); Keeler v. C.I.R., 243 F.3d 1212, 1214 (10th Cir. 2001) (possible profit from straddle transactions was "anemic beside considerable capacity for tax gaming").

321. *See supra* note 16.

322. *See* I.R.C. § 7701(o)(2)(A).

323. *See* I.R.C. § 7701(o)(1)(A), (B), (2)(A).

occurred by reason of Section 7701(o).[324]

How much flexibility is left to the courts, and how much regulatory authority is granted to the Treasury, varies depending on the sub-topic and the amount of detail that Section 7701(o) provides for each issue. One issue that stands out as being specifically reserved to the courts is whether the economic substance doctrine applies at all (whether it is "relevant"), which is to be determined "as if this subsection had never been enacted."[325]

There is also the question of whether, when, and to what extent the Treasury will choose to exercise its regulatory authority on any topic under Section 7701(o). At the moment, it appears to be in no hurry.[326] The regulatory authority derived from Section 7701(o) constrains the courts' interpretation of economic substance rules only on those topics on which guidance is actually issued.

III. CONCLUSION

Section 7701(o)'s codification of the economic substance doctrine presents a series of issues regarding the impact of the substantive provisions of the statute on the judicial doctrine, including unintended consequences.

324. There have previously been disagreements about whether Treasury regulations could impose rules that contradict prior judicial decisions about the meaning of particular statutory provisions. For example, multiple courts held that subsequent regulations could not have such an effect, in the "Mexican Railroad cases." *See* Missouri Pac. R.R. Co. v. United States, 301 F. Supp. 839, 841 (E.D. Mo. Oct. 10, 1967), *aff'd in part and rev'd in part on other grounds*, 411 F.2d 327 (8th Cir. 1969); Missouri-Illinois R.R. Co. v. United States, 381 F.2d 1001, 1004 (Ct. Cl. 1967); Chicago, Burlington, & Quincy R.R. Co. v. United States, 455 F.2d 993, 1003 (Ct. Cl. 1972), *rev'd on other grounds*, 412 U.S. 401 (1973); Missouri Pac. R.R. Co. v. United States, 497 F.2d 1386, 1395 (Ct. Cl. 1974); *see generally* Rev. Rul. 78-256, 1978-1 C.B. 438 (1978); G.C.M. 37264 (1977). In that situation, Congress enacted statutory language that essentially repeated the disputed regulatory rule, ending that particular conflict between the executive and judicial branches. *See* I.R.C. § 901(i). The situation regarding the economic substance doctrine is arguably different from the Mexican Railroad cases, because the Treasury would be interpreting a relatively new statute, section 7701(o), that has not yet been applied by the courts.

325. *See* I.R.C. § 7701(o)(5)(C).

326. *See* Andrew Velarde, *ABA Section of Taxation Meeting: 'Wait-and-See' Approach for More Economic Substance Guidance*, 146 TAX NOTES 744, 2015 TNT 21-8 (Feb. 9, 2015). One Treasury official indicated in public comments that further Section 7701(o) guidance might not be coming any time soon:

> "I think the position is more a wait and see to see how . . . it evolves, to see how cases evolve, to see how the notices and the directives end up working in implementation," said Rochelle Hodes, attorney-adviser, Treasury Office of Tax Legislative Counsel [speaking at an American Bar Association meeting in 2015].

Id. The IRS has issued, so far, two notices regarding section 7701(o), and two letters addressed to its own employees (regarding procedures for raising economic substance issues). *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411; I.R.S. Notice 2014-58, 2014-44 I.R.B. 746; LB&I Directive, *supra* note 20; LMSB Directive, *supra* note 20; *see generally* Rosenberg, *Codification*, *supra* note 109.

It is not clear that the statute's choice of the conjunctive test (rather than other versions of the doctrine) is much of a change from the courts' usual practice before codification. Almost all circuits previously examined both objective and subjective factors, regardless of how they described the economic substance test.[327] However, the statutory formulation might conceivably make a difference in the future for cases like *Wells Fargo*,[328] where the objective and subjective prongs may (unusually) yield different results.

In contrast, Section 7701(o)'s (possibly inadvertent) implication that business purpose is a different analysis than the objective prong, but that the two prongs are of equal importance, changes the way the doctrine was applied before codification. The subjective prong is thus likely to become more important than it was, compared to the usual economic substance approach before codification. Formerly, the subjective prong almost never caused a transaction to fail the economic substance test, because the objective prong was often given more weight (as the doctrine was actually applied, even if not in its formal description).[329] That priority treatment of the objective prong will have to change after Section 7701(o), although taxpayers and the IRS seem not to have focused on this statutory effect. In addition, it is not clear yet what exactly taxpayers will be required to prove in order to show the required business purpose, now that business purpose arguably cannot be identical to the profit analysis that is usually the basis (in practice) for the objective prong.

Section 7701(o) locks in "substantial" as the required minimum for business purpose and for the profit ratio test, without defining "substantial." Similarly, "meaningful" change in "economic position" is now required in order to meet the objective prong, but the quoted terms are not defined in the statute. These "meaningful" and "substantial" terms appear to require more from taxpayers than pre-Section-7701(o) case law. Among other things, meaningful change may mean actual change, rather than reasonably expected change.

Section 7701(o) also imposes a degree of consistency on the circuits, some of which might not have previously opined on every issue affected by Section 7701(o) (e.g., whether profit needs to reach a minimum size in relation to tax benefits, or whether economic change other than profit can

327. *See e.g.*, *Casebeer*, 909 F.2d at 1363–66; *see also supra* note 33; *cf. also supra* note 12.

328. *See Wells Fargo II*, 260 F. Supp. 3d 1140, 1143, 1146 (D. MN 2017) (jury found that a loan met the objective prong but not the subjective prong, and the court held that such a result was sufficient to meet the economic substance test).

329. *See supra* note 13.

meet the objective prong). However, codification does not mandate every aspect of the economic substance doctrine, but instead leaves room for judicial and administrative interpretation. For example, undefined terms in Section 7701(o) remain open to various constructions by different circuits (at least until the Treasury issues guidance). Therefore, the circuits may still lack complete uniformity in their application of the economic substance doctrine.

In addition, codification does not technically prevent the courts or the Treasury (by guidance) from requiring more than the minimum standards set in the statute. For example, Section 7701(o) does not appear to prevent the courts or Treasury guidance from examining more than just the two prongs (*e.g.*, from examining additional factors), or requiring more profit than the ratio test describes, although the latter may be unlikely.[330]

Section 7701(o) leaves a patchwork of substantive issues that courts can answer until the Treasury speaks, concepts on which the Treasury can issue guidance, and rules that are required by the Code. This is a change from the status quo before Section 7701(o)'s effective date, when the economic substance doctrine's content was determined entirely by the courts. Before such effective date, the Treasury had no authority to issue guidance, but instead could only argue about interpretation of the doctrine as a litigant.[331] Thus, what is important about Section 7701(o) is not only what it mandates, but also how it alters the relative power of the courts and Treasury to adapt the economic substance doctrine in the future.

Even if there has not been much substantive guidance on Section 7701(o) so far, apart from two IRS notices,[332] the provision has the potential to cause more change because the Treasury has the ability to issue additional substantive guidance about the economic substance doctrine in the future. In addition, some requirements in the statute (e.g., the need for "substantial" business purpose) are mandatory and therefore may impact court interpretations of the economic substance doctrine even without IRS

330. It is not clear that even technically preventing courts from requiring more than "substantial" business purpose or profit would hamper judicial interpretation much, because "substantial" is not defined—for either the business purpose prong or the profit ratio test. *See* I.R.C. § 7701(o)(1)(B), (2)(A). In addition, change in economic position must be "meaningful" (which also is not defined) even if the profit ratio test is met. *See* I.R.C. § 7701(o)(1)(A). The courts have the ability to define these statutory terms (unless until the Treasury issues guidance on such definitions).

331. Before Section 7701(o) took effect, the Treasury Department, through the IRS, could decide when to raise economic substance arguments (i.e., in which fact patterns) on audit and in the Tax Court, but it could neither issue guidance that mandated a definition for various terms nor set rules regarding how the doctrine should be applied.

332. *See* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411; I.R.S. Notice 2014-58, 2014-44 I.R.B. 746.

regulatory action.

We can expect to see section 7701(o)'s impact in the future, as courts begin to interpret its effects on the economic substance doctrine and as the Treasury potentially issues binding guidance under the statute.

Appendix

TEXT OF SECTION 7701(o):

(o) Clarification of economic substance doctrine

(1) *Application of doctrine* In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) *Special rule where taxpayer relies on profit potential*

(A) *In general* The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) *Treatment of fees and foreign taxes* Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

(3) *State and local tax benefits* For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) *Financial accounting benefits* For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) *Definitions and special rules* For purposes of this subsection—

(A) *Economic substance doctrine* The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) *Exception for personal transactions of individuals* In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) *Determination of application of doctrine not affected* The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(D) *Transaction* The term "transaction" includes a series of transactions.