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No. 12-562

In The

Supreme Court of the United States

UNITED STATES,

Petitioner,

v.

GARY WOODS, as Tax Matters Partner of Tesoro Drive Partners, et al.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF OF *AMICUS CURIAE* PROFESSOR AMANDEEP S. GREWAL IN SUPPORT OF NEITHER PARTY

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INTEREST OF *AMICUS CURIAE*[1]

Amicus is a professor at the University of Iowa College of Law, who teaches and writes in the area of federal tax law. This institutional affiliation is provided for identification purposes only.

The issues presented in this case seemingly relate only to the interpretation of technical jurisdictional and penalty provisions found in the Internal Revenue Code. However, the resolution of the interpretive issues may require the Court to discuss the controversial economic substance doctrine, which the district court applied in this case and which led to the penalty at issue. The interest of *Amicus* relates to ensuring the coherent development of tax-related judicial doctrines, including the economic substance doctrine, about which *Amicus* has previously written. *See* Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 Tax Notes 969 (2007), *available at* http://ssrn.com/abstract=1013388.

Although the Court has not been asked to review the district court's application of the economic substance doctrine, some discussion of the doctrine seems

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[1] Consistent with Supreme Court Rule 37.3(a), this brief is filed with the written consent of both parties. Also, consistent with Supreme Court Rule 37.6, *Amicus* hereby certifies that this brief was not authored in whole or in part by counsel for any party and that *Amicus* received no monetary contribution toward the preparation or submission of this brief other than the general financial support of the academic institution with which he is affiliated.

inevitable, given its close relation to both questions presented. *Amicus* therefore writes to aid the Court by describing the controversy regarding the doctrine. The phrase "economic substance doctrine" appears in more than 100 district and appellate court opinions but has never appeared in any opinion of this Court. See also, *e.g.*, Jasper L. Cummings, Jr., *The Economic Substance Doctrine as Penalty*, 138 Tax Notes 1465, 1474 (2013) ("The Supreme Court has never created or applied the economic substance doctrine."). Consequently, anything that the Court says here will receive close attention from the tax bar and government attorneys.

The tax law would undoubtedly benefit from Court guidance regarding the economic substance doctrine, but this case only indirectly touches on the doctrine and therefore presents a poor vehicle through which to provide guidance. *Amicus* thus urges the Court to expressly reserve its opinion on the broader economic substance issues implicated in this case, as discussed below. If the Court speaks about the economic substance doctrine but makes no reservation, its silence may be taken as a tacit endorsement of the district court's approach, which *Amicus* believes misconstrues the relevant Court precedents.

SUMMARY OF ARGUMENT

The judicially-created economic substance doctrine, which the district court applied in this case and which led to the penalty at issue here, has given rise to substantial confusion and controversy in the past two decades. According to the majority view, the economic substance doctrine allows a court to disregard "mere compliance with the code," *Estate of Stauffer* v. *Commissioner*, 403 F.2d 611, 621 (9th Cir. 1968), when determining whether a transaction qualifies for a tax deduction or other benefit. Under this "extrastatutory" approach to the doctrine, a court generally requires that a transaction exhibit objective economic substance and a subjective business purpose, even if no statute imposes those requirements.[2]

A small number of courts have taken a different approach and view the economic substance doctrine only as a tool to aid the construction of a statute. Under this "interstitial" approach, if a statute requires objective economic substance or a subjective business purpose, the court will demand the same of the transaction before it. But if the statute does not make those inquiries relevant, a transaction can

[2] The economic substance doctrine sometimes gets blended or confused with other doctrines and may go by other names, like the "sham-transaction doctrine." See, *e.g.*, *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001). As used here, the economic substance doctrine refers to the two-pronged test, with objective and subjective elements, used by the federal district and appellate courts in determining whether to disregard a transaction.

create tax benefits even if it lacks objective economic substance or a subjective business purpose. See, *e.g.*, *W. & K. Holding Corp.* v. *Commissioner*, 38 B.T.A. 830, at *839 (1938) (contribution to corporation falls within nonrecognition provision even though no business purpose present; *Gregory* v. *Helvering*, 293 U.S. 465 (1935), distinguished).

In the present case, the district court followed the majority view and treated the economic substance doctrine as an extrastatutory test. Thus, in its order granting the government's motion for judgment as a matter of law, the court did not analyze any statutory law, nor did it cite any provision of law, other than one relating to its jurisdiction. See Pet. App. 15a-22a. The district court decided the case by finding that the taxpayers' transactions failed the economic substance doctrine and held that the claimed tax deductions consequently could not be enjoyed. See Pet. App. 20a-21a.

Neither party has sought review of the district court's application of the economic substance doctrine, but because the doctrine relates to both questions presented, some discussion of it may be necessary. The first question essentially asks whether the gross valuation misstatement penalty "relates to" the determination that the partnership lacked economic substance (i.e., was a sham), such that the penalty can be considered in a partnership-level proceeding under Section 6226(f).[3] The second question relates to whether a gross valuation misstatement penalty in fact applies when the partnership is disregarded under the economic substance doctrine and the partners' outside bases are reduced to zero.

In addressing these issues, the Court should take a cautious approach and expressly reserve on whether the district court's extrastatutory application of the doctrine comports with the relevant precedents. The tax law will be best served if the Court addresses the validity of the extrastatuory approach (which *Amicus* disagrees with) when the relevant issues are properly briefed and argued, and not in connection with this case. Also, although Congress partially codified the doctrine in 2010, the new statute raises many questions, and the Court could risk prematurely answering those questions if it discusses the doctrine here.

Additionally, the Court should expressly reserve on whether a taxpayer may face penalties for violating federal common law. It's somewhat strange to impose a civil penalty without any finding that a taxpayer has violated a positively enacted law, but that's exactly what happens when a court upholds a penalty related to violating the extrastatutory economic substance doctrine. It's even stranger to impose

[3] Except when otherwise noted, all section references are to the Internal Revenue Code of 1986 (the tax code), codified in Title 26 of the U.S. Code, as in effect during the taxable years at issue.

criminal sanctions in these circumstances, but that happens too, in criminal prosecutions involving the doctrine. Any due process concerns raised by the application of penalties for a violation of federal common law should be addressed when the issues are properly presented, and not now, when the parties seem focused on thorny questions of statutory interpretation.

ARGUMENT

I. THE COURT SHOULD EXPRESSLY RESERVE JUDGMENT ON WHETHER THE DISTRICT COURT PROPERLY APPLIED THE ECONOMIC SUBSTANCE DOCTRINE

Judicial doctrines seem to abound in the tax law. The substance over form doctrine, the step transaction doctrine, and the assignment of income doctrine, to name a few, appear in opinions issued by most courts, including this one.

Although those of us in the tax field frequently call them "common law" doctrines, that's not really an accurate description of their function. Federal common law, strictly speaking, refers only to "a rule of decision that amounts, not simply to an interpretation of a federal statute or a properly promulgated administrative rule, but, rather, to the judicial creation of a special federal rule of decision." *Atherton* v. *FDIC*, 519 U.S. 213, 218 (1997) (internal quotation marks omitted). Tax-related judicial doctrines, however, do not create special rules of decision. Instead, courts generally use tax-related judicial doctrines to help determine the meaning of the authoritative statute at issue.[4]

The economic substance doctrine operates differently. Under the majority approach, apparently based on this Court's opinion in *Gregory* v. *Helvering*, 293 U.S. 465 (1935) (*Gregory*), when the economic substance doctrine applies, a court neither interprets statutory language nor believes itself constrained by it. Instead, the court will demand that a transaction exhibit objective economic substance and a subjective business purpose, regardless of whether any statute imposes those requirements. Consequently, courts may reach their decisions without citing any income

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[4] For example, under the substance over form doctrine, if a taxpayer called a particular transfer of money to his child a deductible salary (as opposed to a nondeductible gift), the taxpayer's characterization of the transfer would not control. Rather, to determine whether the transfer created a deduction under Section 162(a)(1) of the tax code, the court would look to substance, not form, and examine whether the transfer really was made for services rendered. After all, Section 162(a)(1) grants a deduction for actual salaries, not just any transfer labeled as such. Thus, the substance over form doctrine would be used to help the court determine whether the transfer fell within the statute, not to establish a new rule of decision. The step transaction doctrine and the assignment of income doctrine operate similarly. See, *e.g.*, *Commissioner* v. *Banks*, 543 U.S. 426, 433-34 (2005) (using assignment of income doctrine to aid construction of Section 61); *Commissioner* v. *Clark*, 489 U.S. 726, 737-38 (1989) (using step transaction doctrine to help determine the meaning of "exchange" under Section 356(a)).

tax statutes, like the district court did below. See Pet. App. 15a-22a. Under this extrastatutory approach, embraced by almost all district and appellate courts, the economic substance doctrine provides an independent rule of decision and reflects true federal common law. See also, *e.g.*, *Crispin* v. *Commissioner*, T.C. Memo. 2012-70, 2012 WL 858406, at *5 n.12 (March 14, 2012) (declining to consider statutory arguments because case was decided under the economic substance doctrine), aff'd, 708 F.3d 507, 514 n.15 (3d Cir. 2013) (making similar statement).

Under a minority view, economic substance principles apply only to the extent that the governing statute makes them relevant. Courts following this interstitial approach read *Gregory* as a case that involved statutory interpretation, and not a case that created federal common law. However, a judge advocating that approach will likely find himself or herself writing in dissent or facing a firm reversal. See, *e.g.*, *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting); *Coltec Indus., Inc.* v. *United States*, 62 Fed. Cl. 716 (2004) (concluding that an extrastatutory economic substance doctrine violates the separation of powers), vacated and remanded, 454 F.3d 1340 (Fed. Cir. 2006). And even if one panel on a court applies the interstitial approach, a later panel might apply an extrastatutory approach. Compare *Horn* v. *Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992), with *Saba P'ship* v. *Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001).

Nonetheless, as *Amicus* has previously written, the interstitial approach, and not the extrastatutory approach, best comports with the relevant Court precedents.[5] The Court has never decided a tax case by turning a blind eye to the governing statutes, nor has the Court ever dismissed compliance with the law as a mere formality. Instead, consistent with the interstitial approach, the Court applies economic substance principles consistent with the governing statutes, not in contravention of them. See *Boulware* v. *United States*, 552 U.S. 421, 430-31 (2008) (acknowledging that in characterizing corporate distribution, "economic substance remains the right

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[5] See Amandeep S. Grewal, *Economic Substance and the Supreme Court*, 116 Tax Notes 969 (2007), *available at* http://ssrn.com/abstract=1013388. *Amicus* favors a particular view of the economic substance doctrine but recognizes that this case does not present the right vehicle for the Court to resolve the controversy relating to the doctrine. This brief is consequently submitted in support of neither party. Regarding the questions presented, *Amicus* expresses no opinion on whether the district court had jurisdiction to consider the gross valuation misstatement penalty (the first question). Also, although *Amicus* has due process concerns regarding the imposition of a penalty for a violation of the extrastatutory economic substance doctrine (relating to the second question), *Amicus* does not expect the parties to argue that issue, even putting aside any limitations on raising new arguments in front of this Court. Judging from the history of this case, the parties will approach the second question only by addressing whether the taxpayer's understatement of tax was "attributable to" a gross valuation misstatement, as required to impose the penalty at issue. See 26 U.S.C. § 6662(h)(1) (2000). *Amicus* expresses no opinion on the interpretation of "attributable to."

touchstone," but rejecting imposition of extra-statutory intent requirement onto Section 301); *Nebraska Dep't of Revenue* v. *Loewenstein*, 513 U.S. 123, 133-34 (1994) (dismissing taxpayer's reliance on the economic substance analysis in *Frank Lyon Co.* v. *United States,* 435 U.S. 561 (1978), because the statute in that case related to the ownership of property, whereas the statute at issue was concerned with other things); *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554, 562 (1991) (rejecting government's argument that taxpayer must satisfy economic substance test for transaction to trigger a loss under Section 1001, because the statute "embodies a much less demanding and less complex test"); *Frank Lyon Co.* v. *United States,* 435 U.S. 561, 583-84 (1978) (examining economic substance principles consistent with ownership determinations required by Section 167(a)); *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 740-41 (1977) (focusing on statutory requirements in determining whether to respect a transaction, and rejecting government's economic substance arguments, which had no statutory basis); *Knetsch* v. *United States*, 364 U.S. 361 (1960) (examining transaction to see whether it created genuine indebtedness under Section 163); *Gregory*, 293 U.S. at 470 (focusing on "statutory provision in question" in determining whether transaction qualified for benefit under the statute).

In the present case, the Court does not need to determine whether the extrastatutory approach or the interstitial approach reflects the correct understanding of its precedents. Although the taxpayers' complaint presented a separation of powers challenge to the extrastatutory economic substance doctrine, see J.A. 67, the Court's review at this stage relates only to jurisdictional and penalty issues. To the extent that the Court must discuss the economic substance doctrine, it should acknowledge that the district court applied an extrastatutory test but it should not endorse that approach. The Court should address the validity of the extrastatutory approach at another time, when the relevant issues are properly briefed and argued.

A short discussion of two cases will help illustrate the sharp conflict between the extrastatutory and interstitial approaches and the importance of reserving judgment on this issue. In the first case, the Third Circuit applies an extrastatutory test and declines to interpret statutes, deciding that the economic substance doctrine trumps anything that Congress might have said. In the second case, the D.C. Circuit explicitly rejects the extrastatutory approach of three sister circuits and applies an interstitial approach.

A. The Extrastatutory Approach

The Third Circuit's opinion in *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002), reflects a typical application of the extrastatutory approach. In that case, the taxpayer engaged in a complicated transaction designed, in part, to generate interest deductions under Section 163(a). But the government challenged those deductions, and the parties ended up in court.

After losing in the district court, the taxpayer appealed and argued that the tax code supported its claimed deductions. The taxpayer had paid interest, and although Section 264 limits the interest deduction in some circumstances, the taxpayer argued that none of the special limitations applied. The Third Circuit, however, dismissed the taxpayer's reliance on statutes:

> We can forgo examining the intersection of these statutory details, for pursuant to *Gregory v. Helvering*, 293 U.S. 465 (1935), and *Knetsch v. United States*, 364 U.S. 361 (1960), courts have looked beyond taxpayers' formal compliance with the Code and analyzed the fundamental substance of transactions. Economic substance . . . is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it simply is not recognized for federal taxation purposes, for better or for worse.

In re CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002) (parallel citations and internal quotation marks omitted). Having re-framed the inquiry as one of common law analysis and not of statutory interpretation, the court applied the economic substance doctrine and disallowed the taxpayer's claimed deductions.

The Third Circuit's approach reflects the majority view today. In numerous cases, courts will not interpret any income tax statute, but will instead decide a case entirely under the economic substance doctrine. See, *e.g.*, *Bank of N.Y. Mellon Corp.* v. *Commissioner*, 140 T.C. No. 2 (2013) (determining eligibility for foreign tax credit by reference to economic substance doctrine, not by reference to Section 901 and regulatory requirements). Alternatively, a court might consider statutory issues in one proceeding and economic substance issues in another. See *Klamath Strategic Inv. Fund, LLC* v. *United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006) (taxpayer wins statutory issue), and 472 F. Supp. 2d 885 (E.D. Tex. 2007) (but loses under the economic substance doctrine), aff'd, 568 F.3d 537 (5th Cir. 2009). Or, in a single opinion, a court may perform extensive statutory analysis and find that a taxpayer has complied with all relevant statutes, but then separately conclude that the taxpayer loses under the common law. See, *e.g.*, *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. 2006). In so doing, the courts may acknowledge that the economic substance doctrine is "disturbing" because it grants "unelected bureaucrats . . . the power to rewrite laws enacted by Congress and the President." *Jacobs Eng'g Grp., Inc.* v. *United States*, No. CV 96-2662, 1997 WL 314167, at *2 n.5 (C.D. Cal. Mar. 5, 1997). Nonetheless, the economic substance doctrine frequently denies taxpayers benefits, even when they have "complied with each and every of the relevant requirements imposed by the Code." *H.J. Heinz Co.* v. *United States*, 76 Fed. Cl. 570, 592 (2007).

B. The Interstitial Approach

A court that applies an interstitial approach looks to the governing statute to determine whether and to what extent to apply economic substance principles. At times, this analysis will lead to the same result as under the extrastatutory approach – a transaction can easily fail both the economic substance doctrine and statutory requirements. But at other times, an interstitial approach will lead to a result different from that reached under an extrastatutory approach.

The circuit split created by the D.C. Circuit in *Horn* v. *Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (*Horn*), nicely illustrates this. *Horn* involved retroactive congressional enactments related to some so-called straddle transactions, the exact details of which can be omitted here. It suffices to say that these complicated transactions were designed to produce tax losses, not to serve any legitimate business or profit-oriented purpose.

In the 1970's, the use of the straddle transactions became widespread, and the IRS undertook massive enforcement efforts. Congress then stepped in and enacted retroactive rules relating to straddles to help deal with the resulting judicial logjam. See *Glass* v. *Commissioner*, 87 T.C. 1087 (1986) (consolidated case involving approximately 1,400 taxpayers) (subsequent history omitted).

Under Section 108(a) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817-18, Congress stated that a loss from a pre-1982 straddle transaction would be allowed only "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." This statute effectively denied taxpayers losses if they had entered into straddle transactions for purely tax avoidance purposes. However, in Section 108(b) of that statute, as amended, Congress established a special rule for commodities dealers. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817-18. Under Section 108(b), Congress said that "any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business."

Various commodities dealers consequently argued that they could enjoy losses regarding their straddle transactions. See *Fox* v. *Commissioner*, T.C. Memo. 1988-570, 1988 WL 133254 (Dec. 15, 1988) (consolidated case involving multiple commodities dealers) (subsequent history omitted). After all, in Section 108(a), Congress said that straddle losses could be enjoyed if they were incurred in a trade or business, and in Section 108(b), Congress created an irrebuttable presumption that losses claimed by commodities dealers were so incurred. Thus, the dealers argued, they should be able to enjoy deductions even if they were motivated solely by tax incentives.

Several circuit courts nonetheless concluded that the economic substance doctrine trumped the statute. Regardless of what any statute said, "[i]f 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." *Lerman* v. *Commissioner*, 939 F.2d 44, 45 (3d Cir. 1991) (*Lerman*); accord *Gardner* v. *Commissioner*, 954 F.2d 836 (2d Cir. 1992); *Cook* v. *Commissioner*, 941 F.2d 734 (9th Cir. 1991). And if a transaction is "not recognized for tax purposes, section 108 does not even come into play." *Lerman*, 939 F.2d at 52. Thus, the dealers could not rely on the statute and their claimed losses were denied.

But the D.C. Circuit applied an interstitial approach and reached a different result. In that court's view, Section 108(b) plainly granted the dealers their claimed deductions. The court was "at a loss to understand the Commissioner's suggestion, adopted by several courts, that the [economic substance] doctrine applies independently of section 108." *Horn*, 968 F.2d at 1238. By refusing to even consider Section 108(b), the IRS and three circuit courts had "close[d] off any consideration of whether Congress intended the 'loophole'" offered by the statute and thereby "read it completely out of existence." *Id.* at 1234-38. Congress clearly granted deductions to commodities dealers to help address the judicial logjam caused by straddle transactions – it was "inconceivable that Congress intended that the [economic substance] doctrine be laid *over* the statute." *Id.* at 1238. Although the D.C. Circuit reached its holding "with some trepidation in light of the contrary conclusions reached by three sister circuits," *id.* at 1234, the court would not allow the economic substance doctrine to "trump the plainly expressed intent of the legislature." *Id.* at 1231.

The circuit split regarding Section 108 of the Deficit Reduction Act nicely illustrates the differences between the extrastatutory and interstitial approaches to economic substance issues. Under the extrastatutory approach, Congress lacks the power to grant tax benefits to sham transactions (that is, transactions without economic substance). Consequently, a court simply will not look at a statute unless common law requirements are satisfied. See, *e.g.*, *Krumhorn* v. *Commissioner*, 103 T.C. 29, at *50 (1994) ("We disagree with the holding in *Horn* and hold, consistent with our prior cases and all other circuit courts . . . that it is appropriate before applying the per se rule of section 108(b) to inquire whether the straddle transactions at issue are devoid of economic substance."). But under the interstitial approach, although a court recognizes that it should think twice before blessing a tax-motivated transaction, it also recognizes that "[b]arring constitutional infirmity, Congress undoubtedly has the power to grant beneficial tax treatment to economically meaningless behavior." *Horn*, 968 F.2d at 1234. And even if a transaction unquestionably lacks economic substance, the court must examine the relevant statute "to see whether it *nonetheless* authorizes the claimed deductions." *Id.* at 1238.

In the present case, the Court should expressly reserve on whether the extrastatutory or interstitial approach best comports with its precedents. Although support among the lower courts for the interstitial approach seems slim, that approach reflects the best reading of *Gregory* and recognizes Congress's plenary authority to establish the tax laws.

II. THE EXTRASTATUTORY VERSUS INTERSTITIAL ISSUE REMAINS IMPORTANT EVEN AFTER THE ECONOMIC SUBSTANCE DOCTRINE'S PARTIAL CODIFICATION

Although Congress partially codified the economic substance doctrine in 2010, the new statute does not explain *when* the doctrine applies.[6] And because

[6] The new statute, 26 U.S.C. § 7701(o)(1) (Supp. V 2011), clears a circuit split regarding the formulation of the doctrine. Compare *Black & Decker Corp*. v. *United States*, 436 F.3d 431, 441 (4th Cir. 2006) (embracing a disjunctive test, under which a transaction must be respected if it exhibits either objective economic substance or a subjective business purpose), with *Coltec Indus., Inc*. v. *United States*, 454 F.3d 1340, 1355 n.14 (Fed. Cir. 2006) (explicitly rejecting Fourth Circuit's approach in favor of a conjunctive test). Section 7701(o)(1) adopts the conjunctive approach and says that the doctrine will be satisfied only if, to loosely paraphrase the statute, a transaction exhibits

the debate over the extrastatutory versus interstitial approaches largely turns on that issue, the new statute does not resolve the conflict between the approaches.

Section 7701(o)(1) indicates that the economic substance doctrine applies whenever it is "relevant." 26 U.S.C. § 7701(o)(1) (Supp. V 2011). However, relevancy is left entirely to the courts – "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." 26 U.S.C. § 7701(o)(5)(C) (Supp. V 2011). Under this statute, courts enjoy complete authority to determine the relevancy of the economic substance doctrine but cannot look to the statute for guidance (that is, they must pretend like it doesn't exist).

The relevancy of the economic substance doctrine will be determined differently under the extrastatutory and interstitial approaches. Under the extrastatutory approach, "economic substance is a *prerequisite* to the application of any Code provisions allowing deductions." *Lerman*, 939 F.2d at 52. Consequently, but for a narrow situation carved out by statute, see Section 7701(o)(5)(B), the extrastatutory approach calls for an economic substance inquiry in all cases. Under the interstitial approach, however, Section 7701(o)(1) will apply only when the relevant

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both objective economic substance and a subjective business purpose.

income tax statute provides some indication that Congress intended to incorporate economic substance principles.

The extrastatutory versus interstitial question thus remains important in future cases. If the Court finds that it must discuss the economic substance doctrine in this case, it should act cautiously and reserve on whether the district court properly applied the doctrine. In time, the Court will be asked to provide guidance on the Section 7701(o)(1) relevancy rule, and the Court may risk addressing that issue prematurely if it approves or disapproves of the district court's approach here.

III. THE COURT SHOULD EXPRESSLY RESERVE JUDGMENT ON WHETHER A TAXPAYER MAY FACE CIVIL OR CRIMINAL PENALTIES FOR VIOLATING FEDERAL COMMON LAW

The Court's analysis of the penalty issue, if it reaches it, will involve thorny questions of statutory interpretation and the handling of mathematical impossibilities. The parties will likely argue over the meaning of the statutory phrase "attributable to" and might debate whether the Treasury's expansion of the statute enjoys deference.[7] See 26 U.S.C. § 6662(h)(1)

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[7] Assuming other requirements are met, the gross valuation misstatement penalty, as in effect during the taxable year at issue, applies when the adjusted basis of property is 400 percent

or more of the property's true basis. See 26 U.S.C. §§ 6662(b)(3), (e)(1)(A) & (h) (2000). However, in a case like this, where the IRS argues that a taxpayer has a zero basis in property, the statute does not apply. If a taxpayer claims a positive basis in property, but the property's basis is really zero, then the percent by which the claimed basis exceeds the true basis is considered undefined. And "undefined" is not equal to 400 percent or more, nor is it infinite – it's simply undefined. See Free Math Help, *Division By Zero*, http://www.freemathhelp.com/division-by-zero.html (last visited May 31, 2013); Professor Peter Alfeld, *Why can't we divide by zero?*, http://www.math.utah.edu/~pa/math/0by0.html (last visited May 31, 2013). A Treasury regulation addresses this by stating that zero basis circumstances are treated as satisfying the 400 percent or more threshold. See 26 C.F.R. § 1.6662-5(g). But this regulation, as a mathematical matter, misinterprets the statute and also contradicts its plain meaning – the statutory phrase "400 percent or more" does not include things that are undefined. (How can something be defined as "400 percent or more" if it cannot be defined?) *Amicus* thus believes that the regulation is invalid. Although the Treasury enjoys the authority to define ambiguous statutory language, it does not enjoy the power to define an unambiguously undefined mathematical concept. Nonetheless, *Amicus* is not aware of any circumstances where a taxpayer presented an argument along the lines suggested, and the lower courts generally apply a purposive approach to the valuation misstatement penalty and bless its application in zero basis circumstances. See, *e.g.*, *Gilman* v. *Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991) (acknowledging that its holding "strains the natural reading of the statut[e]" and that it is "somewhat odd" to apply a percentage-based penalty when the property's true basis is zero, but finding that the penalty is warranted because it "surely reinforces the Congressional objective of lessening tax shelter abuse"). And it's not clear whether the taxpayers in this case ever made or preserved the argument suggested here, so the Court may be able to avoid philosophical questions related to division by zero. See *also* Charles Seife, *Zero: The Biography of a Dangerous Idea* 23 (2000) ("[D]ividing by zero destroys the entire framework of mathematics.").

(2000). As best as *Amicus* can tell, arguments in this case will not address whether, as a threshold matter, it's appropriate to penalize a taxpayer for failing the extrastatutory economic substance doctrine.

The Court has never spoken on the role of civil and criminal penalties in economic substance cases, and it should not broadly approve or disapprove of such penalties here. Determining whether penalties should apply for a failure to satisfy the common law involves difficult issues, which should be analyzed in the proper case. If the parties' arguments in this case relate only to matters of statutory interpretation and mathematical impossibilities, the Court's opinion should be similarly limited. Specifically, the Court should reserve on whether it's appropriate to penalize "mere formal compliance with statutory provisions." *Santa Monica Pictures, LLC* v. *Commissioner*, T.C. Memo. 2005-104, 2005 WL 1111792, at *99 (May 11, 2005) (rejecting reliance on statutory law as defense to Section 6662(b)(1) negligence penalty).

That's not to say that the taxpayers in this case complied with all relevant statutory provisions. If the district court had analyzed the taxpayers' transaction under the tax code, it could easily have found that it failed statutory requirements. The taxpayers' COBRA transaction reflected a dubious attempt to generate tax losses, whether analyzed under statutory law or the common law.[8]

However, as numerous other cases show, it's perfectly possible to comply with all laws enacted by Congress but nonetheless fail the extrastatutory economic substance doctrine. See, *e.g.*, *Coltec Indus., Inc.* v. *United States,* 454 F.3d 1340 (Fed. Cir. 2006) (extensive statutory analysis showed that taxpayer had complied with the tax code, but transaction disregarded under economic substance doctrine);

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[8] See generally Karen C. Burke & Grayson M. P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 Tax Law. 59, 72-78 (2008) (noting potential challenge to COBRA transaction under Section 752, which addresses tax consequences associated with a partner or partnership's assumption of a liability). Additionally, the taxpayers' transaction hinged on a finding that they created valid partnerships. But it's highly doubtful that an entity formed solely to generate tax losses qualifies as a partnership, as that term is used throughout Sections 701-777 of the tax code. See *Commissioner* v. *Culbertson*, 337 U.S. 733, 741-42 (1949) (partnership existence under the tax code turns on "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both," and presumably not for the purpose of avoiding taxes) (citations and internal quotation marks omitted). Unfortunately, the district court did not analyze Section 752 or make a statutory determination regarding the existence of a partnership. Had it done so, the knotty economic substance issues discussed here may have been easily avoided. The record reflects only a general determination that the taxpayers' various transactions employing partnerships, S corporations, and limited liability companies must be ignored under the extrastatutory economic substance doctrine. See Pet. App. 20a-21a.

Horn, *supra*; *WFC Holdings Corp.* v. *United States*, Civil No. 07-3320, 2011 WL 4583817, at *32 (D. Minn. Sept. 30, 2011) (taxpayer complied with requirements of the tax code, but no refund unless transaction "passes muster under the common law"). When a taxpayer fully complies with all positively enacted law, a penalty should not even be on the table. In fact, due process concerns may arise when a taxpayer complies with all statutory law but faces a penalty after a judicial determination that his transaction violated a common law doctrine. Cf. *BMW of N. Am., Inc.* v. *Gore*, 517 U.S. 559, 574 n.22 (1996) (due process protections against "'judgments without notice'" apply to civil penalties) (citation omitted).

Due process concerns become especially pronounced in the criminal context, where the economic substance doctrine can lead to the imprisonment of a taxpayer, even if he has fully complied with a statute. In *United States* v. *Wexler*, 31 F.3d 117 (3d Cir. 1994) (*Wexler*), for example, the government charged the defendant with criminal tax fraud related to his involvement with complex repo-to-maturity transactions, which were designed to generate massive interest deductions. Before trial, the defendant proposed a jury charge based on Section 163(a) of the tax code, which allows deductions on "all interest paid or accrued within the taxable year on indebtedness." Under the proposed charge, the defendant would be saved from conviction if his transactions created genuine indebtedness, as required by the statute, regardless of whether they also satisfied the economic substance doctrine. The district court, over the government's objection, accepted the defendant's proposed instruction.

Before the trial could begin, the government petitioned the Third Circuit for a writ of mandamus. It argued that a transaction that fails the economic substance doctrine cannot generate lawful interest deductions even if it "involve[s] the payment of interest on genuine indebtedness." *Wexler*, 31 F.3d at 122 (internal quotation marks omitted). Thus, according to the government, the jury instructions should allow for a conviction even if the defendant's transactions satisfied Section 163(a)'s requirements.

The Third Circuit agreed, emphasizing that "economic substance is a *prerequisite* to any Code provisions allowing deductions," *id.* at 124 (internal quotation marks and alterations omitted), and that the court's embrace of the doctrine "continues in full force today, with no exception for § 163 deductions." *Id.* at 127. The district court thus had to revise its jury instructions to allow for a conviction even if Section 163(a)'s specific requirements had been met, because the economic substance doctrine "*also* bars interest deductions under that section of the code." *Id.* at 123 (emphasis supplied).

The decision to extend the economic substance doctrine to criminal prosecutions should be made by the Supreme Court, not by the lower courts. Even if the Court endorses the majority view – that *Gregory* created true common law and did not follow statutory law – none of the Court's cases say anything about prosecuting taxpayers for violating judge-made rules. Due process may require that the government point to statutory law, and not the common law, when building a criminal case against a defendant. See *United States* v. *Kozminski*, 487 U.S. 931, 951 (1988) (refusing "to tolerate the arbitrariness and unfairness of a legal system in which the judges would develop the standards for imposing criminal punishment on a case-by-case basis").

Recently, Congress codified a civil penalty for violating the economic substance doctrine, but the new statute exacerbates rather than mitigates the potential due process problems. Section 6662(b)(6) of the tax code imposes a 20% penalty on any underpayment attributable to a failure to satisfy the economic substance doctrine or a "similar rule of law" (an undefined phrase). 26 U.S.C. § 6662(b)(6) (Supp. V 2011). That penalty increases to 40% if the taxpayer didn't make proper disclosures on his return. See 26 U.S.C. § 6662(i) (Supp. V 2011). Although a taxpayer can usually escape the various Section 6662 penalties if he had reasonable cause for his underpayment and acted in good faith, no such defense exists for the Section 6662(b)(6) economic substance penalty. See 26 U.S.C. § 6664(c)(2) (Supp. V 2011). In other words, a taxpayer faces a strict liability penalty for violating the economic substance doctrine or a similar rule of law.

Recall, however, that Congress in Section 7701(o) explicitly declined to provide any guidance on when the economic substance doctrine applies. Instead, courts must determine when the doctrine is relevant. Additionally, Section 7701(o)(5)(C) forbids courts (and therefore taxpayers) from looking at the statute for guidance on the relevancy question. The interplay between Section 7701(o) and the penalty provisions thus reveals a troubling set of circumstances:

> (1) Congress partially codified a doctrine;
>
> (2) Congress declined to provide guidance on when the doctrine applies;
>
> (3) Congress prevented courts and taxpayers from looking at the statute to determine when the doctrine applies;
>
> (4) But a failure to satisfy the doctrine, or an undefined similar rule of law, results in a strict liability penalty.

Amicus is not aware of any circumstance where Congress imposed a strict liability penalty but declined to explain when it might apply.

In coming years, the courts may be asked to determine the extent to which Congress can impose penalties in this manner. However, if the Court approves of penalties in this case, that might close off judicial consideration of the issue. After all, if penalties are appropriate here – when the district court pointed to no statute that the taxpayer violated and when there was no statute that even recognized the economic substance doctrine – then maybe the codified penalty poses no problems, either.

The Court should address how penalties relate to the economic substance doctrine when the parties brief and argue the relevant issues. If in this case the parties do not do so, but instead focus on issues of statutory interpretation and mathematical impossibilities, the Court should expressly reserve on whether, as a threshold matter, it is appropriate to penalize a taxpayer for violating the extrastatutory economic substance doctrine.

CONCLUSION

Because the economic substance doctrine relates to both questions presented, the Court may need to discuss the doctrine to some extent. If the Court discusses the doctrine, it should expressly reserve on whether the district court properly applied the doctrine. If the Court speaks about the economic substance doctrine but makes no reservation, its silence may be taken as a tacit endorsement of the extrastatutory approach. Although the Court may ultimately decide that *Gregory* authorizes judicial legislation, that decision should be made only after the relevant issues are briefed and argued, and not now.

Additionally, the Court should not express an opinion on whether it is appropriate to penalize a taxpayer for failing the economic substance doctrine. Although this case involves such a failure, the arguments here will probably relate only to hypertechnical interpretive and mathematical issues. Thus, in deciding this case, the Court should expressly reserve on whether the doctrine can apply in the criminal context, and it should state that no inferences should be drawn about the constitutionality of the Section 6662(b)(6) civil penalty.

Respectfully submitted,

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