Tax Avoidance Law: Finding the Supreme Court's Role in Uncertainty

Frank Yan†

I. Introduction

In 2014, a practice where U.S.-based corporations enter complex income shifting transactions to avoid U.S. income tax took center stage in tax avoidance policy.[1] This practice known as corporate inversions is just one attempt of many by corporations to continually find new strategies to avoid tax liabilities while still remaining within the letter of the law. The struggle for tax law is that it must continually adapt to these strategies or it will become outdated and ineffective.[2] Given this challenge, the judiciary has served as a policymaker by providing means beyond the written law for tax enforcement.

In this article, I will use the landmark case *Gregory v. Helvering*[3] to explain the principles of extralegal tax adjudication central to federal tax enforcement. The term "extralegal" refers to approaches of statutory interpretation where the Court fills a gap in the law by interpreting a statute's intent or purpose. In reaction to these principles, I will raise concerns about the blurring of the separation of powers between the Court and Congress and reduced certainty in tax avoidance law. I will attempt to clarify the answers to these contentions by examining the development of modern tax avoidance doctrine, highlighting the inconsistent applications of *Gregory* principles by lower federal courts and the clarification of the separation of powers through Congress' codification of tax avoidance doctrine. Finally, I argue that it is justified and viable for modern extralegal tax avoidance doctrine to sacrifice some degree of democracy and some certainty in tax law because such extralegal principles help maintain the long-term efficacy of American government while posing little threat to the integrity of democratic government. At the same time, the Supreme Court must be more active in maintaining national uniformity of court doctrine

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†: Frank Yan is a third-year in the College, majoring in Economics and Political Science.

1: Shayndi Raice, *How Tax Inversions Became the Hottest Trend in M&A*, Wall St. J. (Aug. 5, 2014).

2: A distinction should be raised between tax *avoidance* and tax *evasion*. While the two behaviors are not so different with regard to the ultimate goal of reducing one's tax liability, tax avoidance practices are formally legal whereas tax evasion practices are a direct rebuke of the law.

3: 295 U.S. 465 (1935).

over lower federal courts in order to prevent a degradation of federal power.

A final preliminary matter needs addressed. At first blush, this article may seem to rest on the assumption that the practice of tax mitigation is wrong in a moral or patriotic sense. Responses against attacks on the tax mitigation and avoidance include Justice Learned Hand's lower court opinion in *Gregory*, where he states that, "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[4] This essay does not censure the idea that individuals and firms should be allowed to lower their tax liabilities. There is also no assumption that government taxation and spending occurs in the most efficient and socially beneficial way. However, taxation is here to stay for the long (*long*) term. The focus of this essay instead is on those abusive tax strategies that, if allowed to proliferate, would mean that select individuals and firms with the ability to purchase professional tax services can significantly lower their tax liabilities, while other segments of the American population disproportionately bear the burden of federal taxation.

II. Tax Avoidance Politics, Policy, and Law

Before delving into the Supreme Court's role in tax avoidance adjudication, it is important to first situate the judicial system's role in tax enforcement relative to the legislative and executive branches. In a world of constantly evolving tax avoidance strategies, tax law is to some degree destined to be obsolete once it is passed, but Congress severely lags behind in revising the tax code to address these strategies.[5] For example, corporate inversions began in the U.S. during the 1990s and Congress reacted with legislation in 2004, but the legislation has been weak and still allows for the proliferation of inversions transactions a decade later.[6] Major tax reform that can address the fundamental issues incentivizing tax avoidance takes even longer; the most recent major tax reform was President Ronald Reagan's 1986 reform.[7] The cause of Congress's slow reaction can be found in the fundamental structure of American lawmaking between the executive and legislative branch. Deliberations over

4: *Helvering v. Gregory*, 69 F. 2d 809, 810 (1934).

5: Lee Hamilton, *Why Isn't Congress More Efficient?*, Center on Congress at Indiana University (2007), online at http://www.centeroncongress.org/why-isnt-congress-more-efficient.

6: Mindy Herzeld, *News Analysis: What's Next in Inversion Land?*, Tax Analysts (2014), online at http://www.taxanalysts.com/www/features.nsf/Features/F817995A255AFD2485257CF900427B06?OpenDocument.

7: See, e.g., Jeffrey Birnbaum & Alan Murray, *Showdown at Gucci Gulch* (1988).

bills can persist over several years and election cycles, because 535 lawmakers in Congress each have the desire and individual resources to voice their opinions and their versions of a given bill, Congressional procedure from committee hearings to a floor vote is a tedious process, and because the executive branch has veto power to check Congressional action.[8] Under these circumstances, Congress is almost always ill equipped to react quickly to new tax avoidance strategies.

When Congress does react in a timely manner, it does not always create effective laws and rules to curb tax avoidance. On the one hand, restrictions targeting specific avoidance strategies only provide more text for tax professionals to operate on and even more incentive for tax avoidance. The oft-cited allusion in federal taxation literature to Moses' rod sums up the dilemma: "every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the commissioner on the hind part."[9] On the other hand, Congress may draft broad statutes, such as passive activity loss rules that aim to curb general categories of tax avoidance practices by restricting groups of outcomes rather than specific processes of tax avoidance.[10] Yet, even with these broad "outcomes-oriented" statutes, the fact that they still unavoidably reference certain types of transactions albeit on a broader level have permitted cunning tax professionals to plan around these statutes.[11] Overall, then, Congress can try to fight tax avoidance, but it cannot effectively play a direct role.

Beyond Congress, actions by the Internal Revenue Service (IRS) and the federal courts against tax avoidance are intertwined, with arguably more weight given towards the federal courts. The IRS can be effective at interpreting the tax Code and using its rulemaking authority to curb tax avoidance strategy, but even so, the IRS is not the final authority; its rules and interpretations can be resisted through litigation in federal courts. The prevalence of litigation is amplified in tax avoidance, because when the rewards of avoidance can be in the hundreds of millions of dollars, corporations have a strong incentive to spend the several million dollars to litigate.[12] Consequently, the IRS must work side-by-side with federal courts to maintain interpretations of the Code

8: See, e.g., Woodrow Wilson *Congressional Government* (1885).

9: Martin Ginsburg, *Making Tax Law through the Judicial Process*, 70 A.B.A. J. 74, 76 (1984).

10: Erik Jensen, *Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating Alternatives*, 57 St. Louis U. L.J. 1 (2012).

11: *Id.* at 19.

12: In the recent case *WFC v. U.S.*, Wells Fargo sought a $426 million tax deduction through a tax avoidance strategy developed by accounting firm KPMG. See *WFC Holdings Corp. v. U.S,* 728 F. 3d 736 (8th Cir. 2013*).*

favorable to the government.

Given these considerations on Congress and the Internal Revenue Service, both are unable to definitively stop tax avoidance strategies. Federal courts, then, are important in tax avoidance because they fill a vacuum in federal policy where the Congress and the IRS stand slow or incompetent to react.

IIa. *Gregory v. Helvering*

Under these circumstances, the Supreme Court has historically moved beyond the inadequacies and limitations of analyzing the plain meaning of a statute to interpreting the legislative intent and purpose of tax laws in order to fill in gaps in the tax code. Over the decades since the 1930s, tax avoidance adjudication has derived its foundational principles from the early case of *Gregory v. Helvering*.[13] In *Gregory*, petitioner Evelyn Gregory owned United Mortgage Corporation (UMC), which owned the subsidiary Monitor Corporation (MC).[14] Gregory wanted to sell MC without incurring taxes, so she set up a new corporation called Averill Corp solely to acquire MC, liquidate MC to herself, and personally sell the stocks of MC to avoid income tax.[15] At issue in the case was whether Gregory's transactions qualified as a corporate reorganization under section 112 of the Revenue Act of 1928.[16]

IIb. Principles of *Gregory*

The Supreme Court's decision in *Gregory* is important because it embodies three of the arguably most important principles in federal tax avoidance adjudication: examining legislative intent, business purpose, and substance over form. Writing for the majority, Justice Sutherland struck down the tax benefits by arguing that Gregory's actions did not qualify under the definition of a reorganization, because Gregory's actions had "no business or corporate *purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its *real character*" and that "the transaction upon

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13: 293 U.S. 465 (1935).

14: *Id.* at 467.

15: *Id.*

16: *Id.* at 467-68. Section 112 of the 1928 Revenue Act reads, "The term `reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred." egislateuthority to tuionally npowers and uncertainty in lawf the extent it creates uncertainty and entre doctre is an encroach

its face lies outside the *plain intent* of the statute." [17] When Justice Sutherland referred to the "plain intent," he had to personally evaluate Congressional reports on the bill version of the law.[18] Justice Sutherland found that the section's explicit goal was to protect normal business transactions aimed at reorganization from being taxed, and consequently Justice Sutherland concluded that the application of the reorganization statute required that Gregory's transaction have a business purpose in order to be tax exempt.[19] Finally, Justice Sutherland broke from the literal text of the 1928 statute to argue that even though Gregory's transaction followed the statutory definition of reorganization in *form*, the "real character" or *substance* of the transaction in reality had no business purpose.[20] Gregory's transaction thus could not qualify as a tax-exempt reorganization.

IIc. Merits and Flaws: Legislative Intent, Business Purpose, and Substance over Form

Practically speaking, the principles from *Gregory* have served as a highly useful foundation for combatting tax avoidance strategies. As explained earlier, Congress' laws inevitably fail to account for all possible situations for a given issue. By looking at legislative intent and purpose instead, the Court can act on a broader base beyond the literal statute, in order to help fill the gaps of existing law as they appear.[21] These extralegal tools bring significant practical results, allowing the federal government to consistently win tax avoidance cases involving business purpose and substance over form.

On a more fundamental level, however, the Court's extralegal approaches in tax avoidance adjudication raise important issues over statutory interpretation, the influence of courts over policy, and the rule of law. In the first place, Justice Sutherland's opinion is based on an intentionalist theory of statutory interpretation, where a judge or justice ascertains what lawmakers

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17: *Id.* at 469-70 (emphasis added). It is interesting that Justice Sutherland, a highly conservative justice, voted against the taxpayer and wrote an opinion expanding the government's taxing ability. Tel Aviv Law School Lecturer Assaf Likhovski notes the political context of the decision within the Great Depression and of the potential indictment of millionaire Andrew Mellon for tax evasion at the time. Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*. 25 Cardozo L. Rev. 953 (2003).

18: Jasper Cummings, *The Supreme Court's Federal Tax Jurisprudence* 90 (2010).

19: *Gregory,* 293 U.S. at 469.

20: *Id.*

21: Ray Knight & Lee G. Knight, *Substance over Form: The Cornerstone of Our Tax System or a Lethal Weapon in the IRS's Arsenal?*, 8 Akron Tax J. 91 (1991).

intended in passing a given statute.[22] Justice Sutherland's interpretation of the Congressional report in *Gregory* was quite clear-cut because the author of the statute's reorganization section specified in Congressional testimony that his bill aimed to protect ordinary business transactions.[23] However, legislative intent is not always so easily ascertained, partly because of the multitude of Congressional reports, floor debate transcripts, and other documents that may indicate different or even contradictory intentions.[24] This example in *Gregory* of an intentionalist approach yields two sides of the coin. On the one side, interpreting Congressional intent helps prevent abuse of the law and reinforces the efficacy of federal legislation. In this sense, the federal courts help maintain Congress as the most powerful branch of government. On the other side, a troubling caveat is that if judges and justices are allowed to proceed freely with interpreting legislative intent, any judge may read his or her personal values into a decision by selectively choosing how to interpret a statute's intent.[25]

Furthermore, while the merits of legislative intent are ambiguous, the Court's development of tax avoidance doctrine over time significantly transgresses Congressional intent towards a common law approach. With regard to *Gregory,* although Justice Sutherland had reasoned that business purpose was necessary because the intent of the statute seemed to be geared towards protecting normal business transactions, the business purpose requirement in modern court doctrine has become a requirement independent of a statute's legislative intent.[26] By making the business purpose doctrine a standalone evaluation of a contended tax transaction, the Court has presupposed an assumption about the IRS code as a whole: that the purpose of the tax code is only to tax regular business transactions rather than extremely technical strategies involved in avoiding tax liabilities.[27] The Court has essentially developed doctrine on an more extreme philosophy of intentionalist interpretation, where the courts may still interpret legislative intent but also rely on mental exercises of thinking broadly about a statute's purpose, not necessarily directly relying on any Congressional records or

22: See, e.g., William Eskridge, Philip P. Frickey, & Elizabeth Garrett, *Legislation and Statutory Interpretation* (2000).

23: Cummings, *The Supreme Court's Federal Tax Jurisprudence* at 90 (cited in note 18).

24: Eskridge, *Legislation and Statutory Interpretation* at 214 (cited in note 22).

25: *Id*. at 222.

26: See the business purpose prong of the economic substance doctrine, as described below.

27: Michael Livingston, *Practical Reason, 'Purpovism,' and the Interpretation of Tax Statutes*, 51 Tax. L. Rev. 677 (1996).

other concrete evidence.

The discussion over statutory interpretation and independent construction of court doctrine boils down to important implications for the separation of powers between the Court and Congress. The slippery slope of abusing legislative intent or purpose leads the Court to the point of "legislating" substantial rules, even though it is officially, within the federal balance of powers, not the role of the courts to legislate. At the root of the issue is the fact that the legitimacy of American government is based in popular sovereignty, or in other words the ability of citizens to participate in government and vote for their leaders in the legislative and executive branches.[28] In contrast to the power of popular sovereignty, Supreme Court justices and federal court judges are politically appointed, serve for life tenure, and have developed their official duty of maintaining of the rule of law and the Constitution over the whims of popular sovereignty.[29] Furthermore, it may be argued that Congress itself does not have the authority to delegate its own constitutional powers away to any other branch of government. Case law on the non-delegation doctrine is especially notable during the Great Depression, when the Court struck down provisions of the National Industrial Recovery Act for delegating legislative power to President Franklin Roosevelt during a time of extremely aggressive executive power.[30] The suggestion, then, is that extralegal Court doctrines are not sustainable and contradictory of American democratic values.

Finally, there are philosophical issues against Court flexibility with regard to the rule of law. There is an issue with the uncertainty of tax law under extralegal doctrine, which stands in contrast to the conventional sense of concrete, written law. On an abstract level, the written law is ideally absolute and consistent throughout its application because the resulting certainty provides legitimacy to the laws of Congress and upholds the structure of government based upon statutory law.[31] While realistically, most law is not absolutely clear in the ideal sense, tax avoidance law has more ambiguous statutes than other areas of law because of the highly fluid nature of its subject.[32] At this greater extreme, it may be questioned whether Court doctrine on tax avoidance has become so unpredictable that it is counterproductive against the rule of law.

This section has summarized the range of issues involving statutory interpretation, the separation of powers, and the rule of law that result when

28: Robert McCloskey, *The American Supreme Court* (2010).

29: *Id.* at 7.

30: See *Panama Refining Co. v. Ryan*, 293 U.S. 288 (1935).

31: Rebecca Prebble & John Prebble, *Does The Use Of General Anti-Avoidance Rules To Combat Tax Avoidance Breach Principles Of The Rule Of Law? A Comparative Study*, 55 St. Louis U. L.J. 21 (2010).

32: *Id.*

the federal courts deviate from the plain text of the law in tax avoidance cases. As Chief Justice John Marshall noted in *Marbury v. Madison*[33] and Justice Antonin Scalia alluded to in his treatise on textualism, this country is "a government of laws, and not of men."[34] The common problem among all these issues is how the roles of the three branches of government should be distributed in tax avoidance issues such that the issues are dealt with effectively while maintaining the structure and stability of American government.

III. Modern Economic Substance Doctrine: Reviewing the Merits and Flaws of Court Doctrine

The answer to these contentions in tax avoidance adjudication can be clarified by examining the developments of Court doctrine in modern adjudication. Based upon the principles found in *Gregory,* modern tax avoidance doctrine since 1978 is primarily embodied in what is known as the economic substance doctrine (ESD). Under the ESD, contested transactions face a two-prong test: the economic substance and business purpose prongs.[35] The economic substance prong is an objective test, where the taxpayer must show that the transaction in question led to an economic gain other than a reduction of tax liability.[36] The second business purpose prong is a subjective test identical to the one found in *Gregory*, based upon the ability of the Court to identify the substance of a transaction from the legal form.[37]

The significance of ESD's development is that while the Supreme Court first introduced the prongs of ESD, the Court eventually receded and left the development of the ESD largely to the lower federal courts.[38] By 1978, the Court had decided two major cases, *Knetsch v. U.S.*[39] and *Frank Lyon v. U.S.*[40] where it applied the two prongs of the ESD but did not explicitly describe them as Court doctrine. After *Frank Lyon*, however, the Court has not decided *any* cases on the issues of substance over form and business purpose

33: 5 U.S. 137 (1803).
34: *Id.* at 163. Also see, e.g., Antonin Scalia, *A Matter of Interpretation* (1997).
35: Philip Sancilio, *Clarifying (Or is It Codifying?) The 'Notably Abstruse': Step Transactions, Economic Substance, and the Tax Code*, 113 Colum. L. Rev. 138 (2013).
36: Senate Finance Committee, *Economic Substance Doctrine* (2007)
37: *Id.*
38: Cummings, *The Supreme Court's Federal Tax Jurisprudence* at 205 (cited in note 18).
39: 364 U.S. 361 (1960).
40: 435 U.S. 561 (1978).

in tax avoidance.[41] The result has been that the lower federal courts have been free to develop their own variations of the Court's two-pronged approach in *Knetsch* and *Frank Lyon*, resulting in different versions of ESD across the circuits. In other words, the freedom of the lower courts has resulted in significant uncertainty about the outcomes of tax avoidance adjudication. And while Congress did codify ESD in 2010 in an attempt to increase clarity, the codification only firmly delineated a small part of the ESD.

IIIa. Inconsistency in the Lower Federal Courts

In one decision from the 9th Circuit Court of Appeals, Judge Owen Panner complained about the lower courts' applications of ESD. He noted, "The casebooks are already glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision."[42] Judge Panner's remarks reflect the inconsistent development and application of the economic substance doctrine across the lower federal courts since the Supreme Court's self-restraint from the issue. From 2000 to 2010, lower courts decided upon versions of the economic substance doctrine that differed on whether the doctrine was a conjunctive (requiring both prongs) or disjunctive (requiring one of two prongs) of the economic substance and business purpose prongs.[43] Furthermore, the lower courts have disagreed on whether either prong of the ESD has been satisfied.[44] While some courts have accepted arguments about whether there was a potential for profit other than a lower tax burden to satisfy the economic substance prong, other courts have compared the given transaction to other transactions that usually occur in the similar transactions, and still other courts make a cost-benefit analysis of the transaction.[45]

41: Cummings, *The Supreme Court's Federal Tax Jurisprudence* at 205 (cited in note 18).

42: *Collins v. Commissioner of Internal Revenue,* 857 F. 2d 1383, 1386 (9th Cir. 1988).

43: See Yeoram Keinan, *It is Time for the Supreme Court to Voice its Opinion on Economic Substance*, 7 Hous. Bus. & Tax L.J. 93 (2006).

44: *Id.* at 134-37.

45: Yeoram Keinan, *The Many Faces of the Economist Substance's Two-Prong Test: Time for Reconcilitation?,* 1 N.Y.U. J. L. & Bus. 371 (2005). One specific example comes from the Court of Appeals for the Fourth Circuit. In *Black & Decker Corporation* v. *U.S.*, 436 F. 3d 431 (4th Cir. 2006), the court reversed and criticized the lower district court's analysis of Black & Decker's general business activities in evaluating the economic substance prong, rather than using the profit potential test.

These patterns of lower court interpretation point back to the first caveat coming out of *Gregory*, that the extralegal approach bears a risk of excessive uncertainty detrimental to the rule of federal law. In Federalist 80, Alexander Hamilton argued one of the major advantages to having a national Supreme Court was that it could uniformly interpret and enforce federal law and the Constitution across the States.[46] In a sense the lack of uniformity in applying ESD is a result of the uncertainty as to what requirements (conjunctive or disjunctive) the ESD entails. The existing uncertainty in federal court doctrine is detrimental to the nation because corporations in different circuits are subject to different tax treatment.[47] Without national uniformity in the application of court doctrine, corporations under the jurisdiction of circuits that apply a disjunctive ESD will be more likely to enjoy tax benefits, whereas those under the jurisdiction of circuits that apply a conjunctive test will be less likely to enjoy benefits.[48] This result could put corporations in some areas of the country at a competitive advantage against states in other regions, or even affect the residency choices of corporations for the sake of tax benefits. As seen in very recent cases like *WFC v. U.S.* on this issue, the tax deduction benefits numbering in the hundreds of millions of dollars are a substantial impetus for such possibilities.[49] The greater implication is that the federal governments' actions are distorting economic relationships between states, as well as weakening the rule of federal law and the strength of the federalist system.[50] Due to this weakness from the uncertainty in the tax code, then, either the Supreme Court or Congress needs to take action and reign in the lack of uniformity in avoidance doctrine.

IIIb. Codification of the Economic Substance Doctrine

In reaction to the lack of uniformity in ESD application, Congress has in fact attempted to remedy the situation by codifying ESD. As a part of the Health Care and Education Reconciliation Act of 2010,[51] Congress codified the doctrine in Section 7701(o) of the tax code, stating:

46: Publius, "The Powers of the Judiciary," in *The Federalist Papers* (1788).

47: The Second, Fourth, Eighth, and D.C. Circuits apply a disjunctive test, and the First, Seventh, Eleventh, and Federal Circuits apply a conjunctive test. See Tracy Kaye, "United States," in *A Comparative Look at Regulation of Corporate Tax Avoidance* 335-79 (2012).

48: "Amicus Curiae Brief of Atlantic Legal Foundation in Support of Petitioner," *WFC Holdings Corporation v. U.S.*, WL 1309320.

49: *WFC Holdings Corp. v. U.S.* 728 F. 3d 736, 741-42 (8th Cir. 2013*).*

50: Publius, "The Powers of the Judiciary" (cited in note 46).

51: Pub. L. No. 111-152.

> 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—
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> **(A)** the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
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> **(B)** the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[52]

The above section summarizes the objective economic substance and subjective business purpose prongs of the doctrine, establishing that the doctrine is in fact a conjunctive test.

With regard to the lack of uniformity resulting from uncertainty in Court doctrine, the 400-word codification still leaves a lot that needs to be improved upon. The only clear improvement for uniformity is the specification that a conjunctive test must be used, thereby barring several of the circuits from using a disjunctive test. Besides this specification, there remains only additional ambiguity. First, by defining the satisfaction of the economic substance prong as any transaction that changes the taxpayer's economic position in a "meaningful way," the codification is ambiguous as to what is "meaningful."[53] Next, the statute's failure to define a "transaction" is problematic because it becomes uncertain which transactions the ESD applies to, and more importantly, which portions of the transaction will be evaluated under ESD.[54] When even the codification by Congress is this ambiguous, the Supreme Court must step in to introduce some certainty into ESD in providing guidance and imposing uniformity of doctrine application across the lower courts.

As long as the Supreme Court offers guidance to maintain uniformity, however, it seems that broader uncertainty in the reading of the ESD is still a viable option. First, Congress' codification of the ESD inherently endorses the Court's extralegal approach by putting a legislative stamp on the resulting doctrine from that approach. Furthermore, the practical aspects of an ambiguous ESD seem to outweigh the social costs of the lack of concrete rules in tax

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52: 26 U.S.C. §7701(o) (2010).

53: "Amici Curiae Brief of the Cato Institute, The Chamber of Commerce of the United States of America, and the Financial Services Roundtable in Support of Petitioner," *WFC Holdings Corporation v. U.S,* WL 1285828.

54: Jasper Cummings, *Economic Substance Doctrine Confusion*, Alston & Bird (2014), online at http://www.alston.com/advisories/economic-substance-doctrine/.

avoidance law.[55] When unpredictable tax avoidance strategies can ultimately hinder the ability of the government to collect tax revenue and function, some consistency in tax law must be sacrificed to ensure the survival of government and the rule of law in the long run.[56] In other words, the weakening of the rule of law in tax avoidance adjudication is a necessary evil to combat equally detrimental tax avoidance strategies.

In another vein, Congress' codification of ESD is also important for the caveat on the separation of powers raised earlier because the text of the codification eliminates some of the issues with the separation of powers and leaves the Court with an implicit authorization to read into the legislative intent of statutes. In explicitly codifying and backing the purely court-made business purpose prong of the ESD with legislative authority, Congress eliminates the problem that the embodied business purpose and substance over form principles were previously "legislated" by the Court without authority. What is left for the courts now is to decide the legislative intent of a statute, in order to determine whether the pursuit of tax benefits can be a justifiable reason to satisfy the definition of a certain statute.[57] This ability seems to be implicitly endorsed by Congress in the provision stating 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."[58] Determining the relevancy of ESD is a way of saying that the courts need to decide whether the statute in a given case intended to allow for tax benefits, and if not, then ESD is relevant. Ambiguous codification, then, is not a blank check for the courts to create their own tax policies. Rather, it eliminates the problems with the separation of powers by officially providing the Court with the authority to examine business purpose, and furthermore only reinforces the Court's ability to interpret statutes and legislative intent.

55: Rebecca Prebble & John Prebble, 55 St. Louis U. L.J at 38 (cited in note 31).

56: Judith Freedman, *Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle*, 4 Brit. Tax Rev. 332 (2004).

57: Brian Galle, *Interpretative Theory and Tax Shelter Regulation,* 26 Virginia Tax Review 357 (2006).

58: 26 U.S.C. §7701(o)(5)(C) (2010).

IV. Strength in Unpredictability: Unpredictable methods to combat unpredictable strategies

In summary, the previous section's analysis yields four main conclusions about the tolerance of the federal government structure towards the federal courts' application of extralegal doctrines against tax avoidance. First, uncertainty in federal court tax avoidance doctrine should be permitted only to the extent that it does not lead to inconsistency in the application of the doctrine across circuit courts. Next, due to the lack of uniformity in the application of ESD, the Court must step in to impose nationally uniform guidelines. Third, the presence of uncertainty in Supreme Court doctrine is viable as supported by Congress' implicit approval and as a practical barrier against the unpredictable nature of tax avoidance strategies, in contrast to the certainty of the rule of law. Finally, the separation of powers issue in the Court's extralegal approaches to tax avoidance is remedied by the fact that Congress has provided official legislative authority behind the Court's now formerly extralegal methods. The Court is now left primarily with the responsibility of interpreting both the codification of ESD and the legislative intent of the relevant tax statute in a given case.

IVa. Implications for Democratic Government

On the last point that Congress has sanctioned the ESD, there remains pushback against whether the Court's use of the doctrine is justifiable in democratic government, even with Congressional approval. Based on Article I, Section 8 of the Constitution, there is no justification for the Court's tax policymaking under ESD. Congress has the sole power founded in popular sovereignty to legislate tax law, and therefore Congress rather than the Court should be taking action to stem tax avoidance strategies. However, a wider perspective regarding the trade-off between the effects of tax avoidance strategies and extralegal court doctrine on American government must be considered.

If the Supreme Court has no ability to develop extralegal doctrine such as the ESD, then the federal courts would be forced to shift towards plain text readings of tax statutes. Even if Congress or executive agencies took on more responsibility to monitor and combat tax avoidance, tax advisory professionals would have an even greater ability to manipulate the plain text readings of tax statutes, and corporations would have even greater incentives to litigate than they do now because the chance of winning a court case would increase based on plain text readings. The result is that corporations and individuals with the resources to hire tax professionals will do so to lower their tax liabilities as

much as possible. When the wealthiest 5% of individuals pay about 57% of total individual income tax revenue[59] and when corporate income taxes make up 10% of all federal tax revenue,[60] it is disconcerting to think about the state of the federal government if corporations and individuals had so much latitude to avoid federal taxes. The federal government would potentially lose hundreds of billions of dollars in tax revenue, and would have to pursue significantly more deficit spending than it does now or significantly cut federal programs and funding. Not to mention, the tax burden would shift to poorer individuals and smaller businesses that do not have the resources to hire tax professionals. Under these circumstances, democratic values would be harmed through the deterioration of federal government administration and through the disproportionate economic power of the wealthy.

On the other hand, if the Supreme Court is permitted the latitude to flexibly interpret tax statutes under the ESD, the threat could be that the Court attempts to dramatically suppress the ability of corporations and individuals to mitigate their tax liabilities. It can be imagined that at some point in the future, justices could decide to apply extralegal tax doctrines so aggressively as to prohibit tax benefits on regular business transactions, hindering and deterring economic activity within the United States. Just as in the previous case of allowing tax avoidance to proliferate, American citizens and companies would suffer financially, tax revenues would decrease, and the government would see setbacks in administrative efficacy.

Between these two cases, the threat of Supreme Court overreach in tax avoidance adjudication is highly preferential over the threat of aggressive tax avoidance strategies. The crux of the entire issue lies on the incentives of each party. On the one hand, the Supreme Court does not have incentives, the resources, or the influence to aggressively prosecute tax avoidance. Moreover, Supreme Court justices are always cautious of overstepping into the authority of the other branches of government for fear of political retaliation, and President Franklin Roosevelt's threat of court packing during the New Deal is a historical lesson always in the back of the justices' minds.[61] On the other

59: Kyle Pomerleau, *Summary of Latest Federal Income Tax Data*, Tax Foundation (2013), online at http://taxfoundation.org/article/summary-latest-federal-income-tax-data.

60: *Historical Amount of Revenue by Source*, Tax Policy Center (2015), online at http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=203.

61: In modern cases such as *National Federation of Independent Business v. Sebelius* the Court implicitly notes its historical transgressions of legislative authority. In *Sebelius*, Justice Ruth Ginsburg writes, "Since 1937, our precedent has recognized Congress' large authority to set the Nation's course in the economic and social welfare realm. The Chief Justice's crabbed reading of the Commerce

hand, there is an entire industry of tax avoidance professionals driven by the incentive of corporate profits. Between these two incentives, to allow the Court to act on extralegal doctrine that leads to minimal threats towards democracy in the short term is not so bad a trade-off in order to maintain the long-term viability of American government.

V. Comparing Tax Law to Other Areas of Law

To further bolster the argument for broad flexibility in the Supreme Court's tax avoidance doctrines, it is useful to discuss the broader issues of statutory interpretation and construction common to other areas of law. Viewing these issues in other areas such as contract law, we see similar problems in these areas of law with similar solutions that maintain long-term social benefits at the short-term expense of providing judicial flexibility.

In contract law, the Uniform Commercial Code (UCC) could be viewed as an analog to the Internal Revenue Code. Like the complex and wide-ranging tax code, the UCC is a complex set of laws identically codified in each state that governs a wide range of areas including transactions in borrowing and lending money, leasing equipment, contracts, and bank deposits. Like the constantly evolving nature of tax avoidance strategies, new types of business transactions are constantly being invented and old ones developing alongside new technology.[62] Curiously, unlike the *ad hoc* development of court doctrine leading up to the codification of the economic substance doctrine, a primary drafter of the UCC, Karl Llewellyn, incorporated a broad section in the first place meant to serve as a guide to statutory interpretation of the complex code.[63] Similar to general guidelines of the codified ESD, section 1-102(1) of the Uniform Commercial Code Act reads, "This Act shall be liberally construed and applied to promote its underlying purposes and policies."[64] On the state Supreme Court level, these provisions have allowed for the flexibility

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Clause harks back to the era in which the Court routinely thwarted Congress' efforts to regulate the national economy in the interest of those who labor to sustain it." *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566, 2609 (2012) (Ginsburg, J., dissenting).

62: John Gedid, *U.C.C. Methodology: Taking a Realistic Look at the Code,* 29 William and Mary L. Rev. 341 (1988).

63: *Id*. at 385.

64: U.C.C., §1-102(1). The purposes are, "(a) to simplify, clarify and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; (c) to make uniform the law among the various jurisdictions."

of the UCC to adapt to new transaction situations.[65] The lesson is that like the ESD's use against tax avoidance, it is only by flexible judicial interpretation of the UCC beyond the literal text can the code keep up with the constantly evolving nature of business transactions and efficiently facilitate economic activity. And while these actions do require some overreach of courts into "lawmaking," the ultimate end of keeping the statute relevant and maintaining the legal infrastructure for economic activity is a worthy long-term benefit for the trade-off of a nominal threat of judicial overreach.

Extending this conclusion to a more general discussion of law, Rutgers Law School Professor Michael Livingston suggests that the UCC and the tax code are on one end of a spectrum of laws with complex and broad structure, while on the other end of the spectrum are standalone statutes.[66] The same tools for statutory interpretation and construction can be used on all statutes on this spectrum, but different weights are given to the range of tools including analyzing legislative intent and legislative purpose.[67] Livingston's suggestion is quite logical and supportable by modern adjudication. When looking at complex systems of law such as the UCC or the tax code, the overall structure of and patterns among statutes within the code can provide a strong sense the code's purpose, which in turn can help judges and justices interpret and apply a specific statute. This approach is even supported by Justice Scalia, who espouses a "new textualist" approach to statutory interpretation but who authored the majority opinion in *United States v. Woods*,[68] which supported an analysis of the "structure of [the Tax Equity and Fiscal Responsibility Act] [TEFRA] and its other provisions" to interpret a specific section of the 400-page statute.[69] In contrast, when looking at shorter statutes such as the Civil Rights Act of 1964 in *United Steelworkers v. Weber*,[70] the Court suggested that the relative brevity of that statute does not permit as much insight into its general purpose as would be the case with a 400-page statute or a 70,000-page tax code.[71] Consequently, interpretations of the general purpose of these statutes are much more contentious, and in *Weber* Justice Brennan faced pushback from Justice Rehnquist on the wide stretch of Justice Brennan's interpretation of legislative purpose against the plain text of the statute[72] Of course, this argument about the spectrum of statutory interpretation and the

65: Gedid, 29 William and Mary L. Rev at 361 (cited in note 62).
66: Livingston, 51 Tax. L. Rev. at 687 (cited in note 27).
67: *Id.*
68: 134 S. Ct. 557 (2013).
69: *Id.* at 563 (citing *Maracich v. Spears*, 133 S. Ct. 2191, 2193 (2013)).
70: 443 U.S. 193 (1979).
71: *Id.* at 200-08.
72: *Id.* at 219-220 (Rehnquist, J., dissenting).

prevalence of more flexible interpretative tools on one end does not necessarily assume anything about the coherence of longer and more structured laws that permits for the realization of overall purpose. No one would admit that the tax code is coherent at 70,000 pages. However, the volume of this code provides for relatively more evidence for interpreting overall purpose and code patterns, allowing for more weight given to flexibly interpreting purpose beyond the text of the statute.

VI. Conclusion

Tax avoidance is a constantly evolving practice that is difficult for all three branches of the federal government to fight. As the legislature is slow to react and the executive's measures are subject to litigation, the Supreme Court and lower federal courts have filled a vacuum in tax avoidance policy by developing extralegal means of interpreting the tax code. Over time, the extralegal means established in *Gregory* and based on legislative intent, business purpose, and substance over form have served as the foundation to tax avoidance adjudication. Deep issues, however, arise from extralegal approaches on the uncertainties undermining the rule of law and on the grey areas in the separation of powers between the Court and Congress. Over the development of the modern economic substance doctrine, it is apparent that there needs to be national uniformity in the application of extralegal court doctrine to reduce uncertainty. Upon this condition of national uniformity, the uncertainty element in the application of extralegal doctrine can remain an essential and constitutionally viable factor in tax avoidance adjudication to counter the unpredictability of tax avoidance strategies. Going forward then, federal court tax avoidance doctrine can carry on as a fluid and unpredictable area of law, but only if the Supreme Court takes a more active role and becomes the guiding force in tax avoidance adjudication that it once was.