cause simple internal transactions to have unexpected and unwelcome tax consequences. One could argue that these termination rules could be improved on the margins by harmonizing them, to the fullest extent possible, with more fundamental corporate nonrecognition rules and the section 367 rules.

**E. Who Should Care?**

As this article attempts to show, currency tax consequences can creep into all manner of cross-border activities, including restructurings, acquisitions, sales, or repatriations. If there is a theme, it is that there are many areas in which policymakers could reduce uncertainty by plugging holes in the law and finalizing guidance. That is not to say that developing guidance would be an easy task — far from it, as one can only imagine the number of difficult policy calls required in balancing administrability and theoretical purity in developing rules under section 987. In an era in which a volatile dollar is the norm, however, the task takes on added importance, and the lack of consistent currency tax principles suggests that if and when possible, new rules should be reconciled with existing tax accounting and cross-border transactional principles.[69] Guidance should be practical and buck the trend of allowing perfect international tax theory to be the enemy of the good enough international tax policy.

[69]Policymakers have acknowledged the tension between "administrability" and "philosophical purity" in developing the section 987 regulations in the context of finding the right balance between tax policy and financial accounting treatment. *See* Amy S. Elliott, "Distressed Debt Guidance Expected This Plan Year," *Tax Notes*, Nov. 22, 2010, p. 872, *Doc 2010-24473*, or *2010 TNT 220-4*.

# Economic Substance Doctrine: Unconstitutionally Vague?

**By Thomas A. Cullinan and Shane A. Lord**

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Cullinan and Lord discuss the uncertainty regarding when the IRS would apply the codified economic substance doctrine and whether it should be concerned that too much uncertainty is bad tax policy that could render the new doctrine vulnerable to constitutional challenges. The views expressed herein are those of the authors and are not necessarily shared by any other attorney at Sutherland.

During the disruptive years of the 1960s, the city of Cincinnati passed an ordinance making it a criminal offense for "three or more persons to assemble . . . on any of the sidewalks . . . and there conduct themselves in a manner annoying to persons passing by." The new law was tested on December 7, 1967, when Dennis Coates — a student participating in a demonstration — was charged under the statute. The record does not indicate exactly what Coates did to be annoying, but those passing by said they felt annoyed, and he was arrested and convicted. Coates challenged his conviction on the ground that the ordinance was unconstitutionally vague — how could he know with certainty whether another person passing by would be annoyed by him? Having read about Coates, we are certain that some people would likely always be annoyed by him, while others would find him quite charming. Coates appealed his annoyance case all the way to the U.S. Supreme Court, which agreed with him and held:

> Conduct that annoys some people does not annoy others. Thus, the ordinance is vague, not in the sense that it requires a person to conform his conduct to an imprecise but comprehensible normative standard, but rather in the sense that no standard of conduct is specified at all. As a result, men of common intelligence must necessarily guess at its meaning.[1]

Accordingly, the Supreme Court struck down Cincinnati's annoyance law as unconstitutionally vague.

[1]*Coates v. City of Cincinnati*, 402 U.S. 611, 614 (1971).

### A. Uncertainty in Section 7701(o)

The newly codified economic substance doctrine is vague[2] in two different respects: It is unclear (1) *when* it applies and (2) *how* it applies. As to the former, the statute provides that the codified economic substance test only applies ''in the case of any transaction to which the economic substance doctrine is relevant.''[3] Instead of telling us exactly when the doctrine is ''relevant,'' the statute 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.''[4]

What does that mean? One could argue that before the doctrine was codified, the IRS decided when economic substance was relevant, in that it had discretion whether to raise it as an issue. Thus, one could read the statute (wrongly, in our view) as saying that the economic substance doctrine is ''relevant'' when the IRS decides to make it relevant. As we shall discuss below, this unfettered discretion raises serious constitutional questions, so let's look at some other possible definitions for ''relevant.''

Maybe ''relevant'' in this context means that the IRS would have decided to raise economic substance *and* it would have prevailed in court. In other words, maybe the newly codified doctrine applies to transactions that would have failed under the common law, but not to transactions that would have passed muster. That is rather awkward, however, because it seems to nullify the statute. Why did Congress codify the doctrine if it was not changing anything?

Hmmm. Maybe ''relevant'' means that the IRS would have decided to raise economic substance as an issue *and* it would have prevailed *if* the court had applied the conjunctive test or, perhaps, the newly codified version of the test. But that can't be right, either, because the statute says that the relevancy determination is to be made as if the statute had not been enacted.

Still another problem is that the IRS has argued in many cases that a transaction must have economic substance to be respected for tax purposes, essentially treating economic substance as a precondition to applying the code. But that can't be right, for if all transactions must have economic substance, then economic substance would always be relevant, and the new test would have to be applied to every transaction, leaving no meaning to the qualification that the doctrine only applies when it is relevant.

There are still other ways to define ''relevant'' (we haven't even dusted off the dictionary yet), but suffice it to say that its meaning as used in the statute is not clear. Taxpayers are therefore uncertain about when the new statute will apply, which is causing a great deal of grief among taxpayers who are concerned about how some fairly basic transactions would fare under the new test. Under the new statute, if the doctrine is relevant, then a transaction will have 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.''[5] The purpose requirement is causing the most grief because of recent case law that the IRS reads as allowing it to slice and dice transactions to test whether the part of a transaction that gives rise to the challenged tax benefit has economic substance. Taxpayers are rightfully concerned that many transactions might fail if the doctrine is relevant and the transaction is defined so narrowly. For example, could taxpayers show a substantial nontax purpose for making a check-the-box election? What about for a section 1031 like-kind exchange? What about all the steps taken to qualify as a reorganization?

There is a second uncertainty as to when the new statute will apply. When Congress codified the doctrine, it imposed a strict liability accuracy-related penalty on any transaction that lacks economic substance. Thus, the reasonable cause and good-faith exception to accuracy-related penalties does not apply to an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance. In the new statute, however, Congress imposed the penalty not only on transactions that lack economic substance, but also on any transaction that fails ''to meet the requirements of any similar rule of law.''[6] Nothing in the statute explains what is meant by ''similar rule of law''; it arguably could be read to include at least any or all of the following: substance over form, step transaction, sham in fact, and codified or regulatory antiabuse provisions.

Our chief focus in this article is on the uncertainty involved in determining *when* the statute applies. Yet there are many uncertainties in *how* it is to be applied. For example, even if a taxpayer assumes the economic substance doctrine is relevant to a transaction, and assuming he knows

[2]That the new statute is vague seems beyond dispute. It would take several pages to cite all of the commentary about its uncertainties. The purpose of this article is to raise the question whether the statute is *unconstitutionally* vague.

[3]Section 7701(o)(1).

[4]Section 7701(o)(5)(c).

[5]Section 7701(o)(1).

[6]Section 6662(b)(6).

what the transaction is, a taxpayer will need to determine (1) whether his economic position has changed in a ''meaningful way'' (apart from federal income tax effects), and (2) whether he entered the transaction with a ''substantial purpose'' (apart from federal income tax effects). The statute, however, does not define either ''meaningful'' or ''substantial.'' The statute acknowledges that taxpayers usually will attempt to pass both requirements by showing the potential for profit, but restricts the way profit is calculated: ''The potential for profit of a transaction shall be taken into account . . . 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.''[7] Unfortunately, the statute does not explain what discount rate should be used to calculate present value. And while the statute explains that ''fees and expenses shall be taken into account as expenses in determining pre-tax profit,'' it does not explain what is to be included in ''fees and expenses.''

Many taxpayers and their representatives have asked the IRS to provide guidance clarifying how and when it will apply the newly codified economic substance doctrine. Taxpayers have requested that the IRS provide an ''angel list'' of transactions to which the new statute will not apply. The IRS has so far refused to provide this guidance.[8] Various high-level IRS officials have explained that the agency does not want to lock itself into a specific interpretation that will limit its flexibility to use this new statute as future (but unforeseen) circumstances warrant. One also gets the sense from the comments that the IRS may believe that some measure of uncertainty is good for the tax system.

### B. The Void-for-Vagueness Doctrine

The void-for-vagueness doctrine is embodied in the due process clause of the Fifth Amendment and is based on the principle that a person cannot be deprived of property without due process of law. A citizen is entitled to fair notice and predictability, so that he may have fair warning of what the law prohibits to conform to what the law requires. The court gave this ruling in *Grayned*:

> It is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined. Vague laws offend several important values. First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning. Second, if arbitrary and discriminatory enforcement is to be prevented, laws must provide explicit standards for those who apply them. A vague law impermissibly delegates basic policy matters to policemen, judges, and juries for resolution on an ad hoc and subjective basis, with the attendant dangers of arbitrary and discriminatory application.[9]

While the void-for-vagueness doctrine has generally been used to address laws with First Amendment implications, at least some case law suggests that the principles of the vagueness doctrine apply with ''special force to a taxing statute,'' as a taxpayer is entitled to a reasonable degree of certainty and definiteness to plan his economic affairs:

> Taxes, or, more specifically, the monies used to pay taxes, are a type of ''property'' of which a citizen cannot be deprived without due process of law. Due process requires of a statute a reasonable degree of certainty and definiteness — a requirement that applies with special force to a taxing statute. When it leaves the legislature, a statute must be complete in all its terms, and it must be definite and certain enough to enable every person, by reading the law, to know what his rights and obligations are and how the law will operate when put into execution. In addition, a statute which fails to provide clearly ascertainable and well-defined standards to guide the ministerial

[7]Section 7701(o)(2)(A).

[8]*See* Notice 2010-62, 2010-40 IRB 411, *Doc 2010-20020*, *2010 TNT 177-14* (refusing to provide guidance in public or private rulings). While it is undisputed that a government agency can provide guidance to clarify un ambiguous statute (*see Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)), we assumed for purposes of this article that a government agency can cure through administrative guidance an unconstitutionally vague statute so as to avoid a determination by a court that such a statute is unconstitutionally vague. That assumption seems safe because, as discussed later in this article, we do not believe that taxpayers can make a ''facial'' vagueness challenge to the new statute. *See United States v. Mazurie*, 419 U.S. 544, 550 (1975) (''vagueness challenges to statutes which do not involve First Amendment freedoms must be examined in the light of the facts of the case at hand.''). IRS guidance that limits application of the new statute to only those transactions which clearly lack economic substance should avoid any legitimate challenge by a taxpayer.

[9]*See Grayned v. City of Rockford*, 408 U.S. 104, 108-109 (1972).

> officers charged by law with its implementation and administration creates an unwarranted and void delegation of legislative power.[10]

### C. Is the Codified Doctrine Vague?

Under the void-for-vagueness doctrine, the codified economic substance doctrine could be deemed unconstitutionally vague for at least two reasons: It arguably denies taxpayers notice of what it prohibits and promotes the exercise of arbitrary and discriminatory enforcement.

**1. Notice.** Under the void-for-vagueness doctrine, a citizen is entitled to clear notice of what conduct is prohibited by a law.[11] ''A statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to it application, violates the first essential of due process of law.''[12]

Whether the codified economic substance doctrine provides the constitutionally required notice seemingly starts with whether an average taxpayer can determine if the economic substance doctrine is ''relevant'' to a transaction. As discussed above, however, there are many uncertainties about how the relevancy determination is to be made.

A technical explanation by the Joint Committee on Taxation provides some guidance — if one is comfortable relying on legislative history.[13] The JCT said that the ''provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.''[14] The JCT then gave four nonexclusive examples:

> (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of Section 482 and other applicable concepts are satisfied.[15]

Also, and consistent with the notion that the common-law economic substance doctrine is only a tool of statutory construction, the JCT said:

> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the 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. Thus, for example, it is not intended that a tax credit . . . be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.[16]

Unfortunately, beyond the examples described by the JCT, a taxpayer cannot be certain whether and when the codified doctrine will apply. There are, of course, some egregious transactions to which the doctrine is obviously applicable. And there will be transactions similar enough to those described in the legislative history that a taxpayer can be confident of his position. However, there is a large area

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[10] *Weissinger v. Boswell*, 330 F. Supp. 615, 624-625 (M.D. Ala. 1971). *See also United States v. Merriam*, 263 U.S. 179, 187-188 (1923) (''But in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer.'').

[11] *See City of Chicago v. Morales*, 527 U.S. 41, 56 (1999) (invalidating an anti-gang ordinance as vague); *Kolender v. Lawson*, 461 U.S. 352, 357 (1983) (invalidating an anti-loitering ordinance as vague).

[12] *Connally v. Gen. Const. Co.*, 269 U.S. 385, 391 (1926).

[13] There is much debate about whether a technical explanation by the JCT constitutes official legislative history. In any event, if the technical explanation of the JCT is not official legislative history, then the applicability of the codified economic substance doctrine arguably becomes even more vague. We wonder why the IRS is unwilling to at least reiterate the quoted portions of the technical explanation in administrative guidance to provide some clarity.

[14] JCT, ''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 (Mar. 21, 2010), at 152, *Doc 2010-6147*, *2010 TNT 55-23*.

[15] *Id*. (footnotes omitted).

[16] *Id*. at 152, n. 344.

of uncertainty between the egregious transactions for which the economic substance doctrine will certainly be relevant and the type of transactions for which the legislative history deems the doctrine not relevant. Many basic transactions fall within this area of uncertainty and taxpayers therefore, to borrow language from *Coates*, must guess at whether the IRS will be sufficiently annoyed by the transaction to raise the codified economic substance doctrine. Because even basic transactions can arguably fail the meaningful way and substantial purpose tests, an innocent taxpayer's only defense to the IRS's assertion of the doctrine may be to argue that it is not relevant and that the IRS was wrong to raise the issue.

Of course, all this uncertainty does not necessarily mean that the statute is unconstitutionally vague. There are many arguments for and against, which we briefly summarize below. We will leave it to others to argue about whether the codified doctrine *is* unconstitutionally vague. Our purpose here is only to suggest that it *might* be, which the IRS should take into account in deciding how forthcoming it is going to be with guidance.

There are several reasons why a court might refuse to hold that the new law is unconstitutionally vague. To begin with, most of the laws that have been held to be unconstitutionally vague implicated other constitutionally protected rights, such as the freedom to assemble partially at issue in *Coates*. Because tax laws do not generally implicate constitutionally protected rights, a challenge to such a law on vagueness grounds must be specific rather than facial.[17] In any event, vagueness challenges to taxing statutes are rare, so it is unclear how a court would react to an argument that the codified doctrine is vague under a specific taxpayer's facts that legitimately raise the issue of vagueness (as opposed to clearly egregious facts).[18] Moreover, the Supreme Court has held that economic regulation is subject to a less strict vagueness test because its subject matter is narrower.[19] (We question whether that is true with respect to taxes, however, because they apply to everyone.) Another reason why a court might be less inclined to hold the statute vague is that the Supreme Court has "expressed greater tolerance of enactments with civil rather than criminal penalties because the consequences of imprecision are qualitatively less severe."[20] Finally, it seems obvious that a court would want to know why the codified economic substance doctrine is unconstitutionally vague if the common-law doctrine is not.[21]

On the other hand, laws that survive vagueness challenges do so because the courts find the laws sufficiently detailed to inform citizens what is prohibited. Is that true here? It seems to us that determining whether a transaction has economic substance is far more complicated than determining whether particular conduct is annoying. Would a reviewing court take the additional complexity into account in deciding whether the codified economic substance doctrine is sufficiently detailed to pass constitutional muster? Moreover, while civil penalties may be subject to a lower standard of review than criminal penalties, a strict liability penalty may face a more stringent review than other civil penalties.[22]

Also, the codified version of the economic substance doctrine applies a mechanical test that, if applicable, would call into doubt many more transactions than the common-law doctrine did. As explained above, this is especially true if "transaction" is defined so narrowly that a taxpayer must show a substantial nontax purpose for pieces of basic transactions, such as the decision to make a check-the-box election. This will have an *in terrorem* effect on at least some tax planning — some transactions will not happen because taxpayers cannot know whether they will pass the new test if it

[17]*See United States v. Mazurie*, 419 U.S. 544, 550 (1975) ("vagueness challenges to statutes which do not involve First Amendment freedoms must be examined in the light of the facts of the case at hand."); *United States v. MacKenzie*, 777 F.2d 811, 816 (2d Cir. 1985) ("That the [tax] statute and regulations may present some doubtful cases does not mean that they are void for vagueness where the particular case at hand is not doubtful.").

[18]Many void-for-vagueness challenges of tax statutes have failed because the tax provision was not vague as to the specific taxpayer before the court. *See United States v. MacKenzie*, 777 F.2d 811, 816 (2d Cir. 1985) ("Generally speaking, a challenge to the tax laws on vagueness grounds must be specific rather than facial."); *Hersch v. United States*, 685 F. Supp. 325, 327-329 (E.D.N.Y. 1988) (holding that the gross valuation misstatement penalty of section 6700, as applied to the taxpayer, was not void-for-vagueness.); *United States v. Hempfling*, No. 1:05-cv-00594, 2005 U.S. Dist. LEXIS 24939 (E.D. Cal. Sept. 23, 2005) (holding that Section 6700 was not vague as applied to the

**(Footnote continued in next column.)**

taxpayer.); *see also The Nationalist Movement, A Miss. Non-Profit Corp. v. Commissioner*, 102 T.C. 558 (1994) (holding that Rev. Proc. 86-43, 1986-2 C.B. 729, was not vague or overbroad.).

[19]*Village of Hoffman Estates v. Flipside*, 455 U.S. 489, 498 (1982).

[20]*Id.* at 498-499.

[21]As held in *Connally v. Gen. Const. Co.*, 269 U.S. 385, 391 (1926): "The decisions of the court upholding statutes as sufficiently certain rested upon the conclusion that they employed words or phrases having a technical or other specific meaning, well enough known to enable those within their reach to correctly apply them, or a well-settled common law meaning, notwithstanding an element of degree in the definition as to which estimates might differ."

[22]*See, e.g., Okpalobi v. Foster*, 190 F.3d 337, 360 (5th Cir. 1999) ("Strict liability exacerbates vagueness.").

applies, not because taxpayers know that the transactions would fail. Even though taxpayers will not be able to make a facial challenge to the statute, that type of detail might bother a court.

**2. Arbitrary and discriminatory enforcement.** Under the void-for-vagueness doctrine, a law also is void if it does not provide officials with sufficiently clear guidelines to avoid arbitrary and discriminatory enforcement. The Supreme Court has said that:

> Although the doctrine focuses both on actual notice to citizens and arbitrary enforcement, we have recognized recently that the more important aspect of vagueness doctrine ''is not actual notice, but the other principal element of the doctrine — the requirement that a legislature establish minimal guidelines to govern law enforcement.'' Where the legislature fails to provide such minimal guidelines, a criminal statute may permit ''a standardless sweep [that] allows policemen, prosecutors, and juries to pursue their personal predilections.''[23]

Moreover, even if a statute is not vague on its face, an improper application of a statute can result in a determination that the statute is impermissibly vague. Addressing a rule that was not vague on its face but was vague in its application, the Fifth Circuit said:

> The present ''no solicitation rule'' at Parkland is not vague — no solicitation at all is permitted. However, in application, it is clear that some literature is allowed on the premises of Parkland. Thus it becomes vague because those seeking to place their literature or leaflets in the waiting rooms of the hospital have no idea whether their expressions constitute ''solicitation'' under the ''no solicitation rule.''[24]

The ''relevancy'' trigger gives the IRS a vast amount of discretion in deciding whether to apply the doctrine to a particular taxpayer. Recent guidance from the Large Business and International Division indicated that the relevant director of field operations (DFO) will have to approve the assertion of an economic substance penalty. (We assume that what that really means is that the DFO will have to approve assertion of the doctrine, because the penalty is a strict liability penalty.) But when fully staffed, there are 12 DFOs, and each of those individuals is likely to have different views about what economic substance means and how to interpret the statute. Further, it is unclear whether consolidating the decision-making process solves the arbitrary enforcement issue. Even if the IRS were to designate one person to decide when to apply the doctrine, that person would have great discretion in reaching a decision.

We believe that the IRS will (perhaps through internal guidance) be very careful in picking test cases for this issue. In recent years, we saw the IRS often assert that a transaction lacked economic substance as a backstop to other arguments. We think that practice will stop. In that sense, the new statute will likely hold some benefit for some taxpayers.

Yet even if the IRS does act cautiously by asserting the new statute only in egregious cases, that may not cure the arbitrary and discriminatory enforcement issue. On one hand, limiting the codified doctrine to the truly egregious cases may avoid a genuine challenge on the arbitrary enforcement issue, as taxpayers will not be able to make facial challenges to the statute and will have to argue that the enforcement is unconstitutional as applied to their facts. On the other hand, the statute gives the IRS vast discretion in deciding when to apply it, and it is that discretion which opens the door to a vagueness challenge. For example, the IRS apparently has complete discretion to raise the doctrine in one egregious case but not another (and that seems likely to happen with different DFOs making the decision). Of course, the IRS may assert that the statute does not give it any more discretion than it had before the doctrine was codified. That may be true. The point remains, however, that the doctrine now carries mandatory penalties for failing to comply with a conjunctive test that is not well defined.

### D. Conclusion

There is a great deal of uncertainty in when and how the IRS will apply the newly codified economic substance doctrine. While we understand the IRS's wish to maintain its flexibility, that flexibility leaves much uncertainty for taxpayers. While some uncertainty may be a good thing, there is a point when a law is so uncertain that it is simply unfair to enforce it. We have not made up our minds about whether the new statute is unconstitutionally vague, and wrote this article merely to suggest that too much uncertainty may be bad tax policy.

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[23]*Kolender v. Lawson*, 461 U.S. 352, 357-358 (1983) (internal citations omitted); *see also NAACP v. Button*, 371 U.S. 415, 466 (1963) (Harlan, J. dissenting) (''Laws that have failed to meet this [vagueness] standard are, almost without exception, those which turn on language calling for the exercise of subjective judgment, unaided by objective norms.'').

[24]*Dallas Ass'n of Cmty. Orgs. for Reform Now v. Dallas County Hosp. Dist.*, 670 F.2d 629, 633 (5th Cir. 1982).