Expedited Challenges to Economic Substance: Erosion of Protections for Taxpayers and Problems for the IRS

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Reports accompanying the codification of the economic substance doctrine, the official explanation by the Joint Committee on Taxation, several of the IRS Notices and memos covered in this article, and at least one major case all emphasize the inapplicability of the economic substance doctrine to situations involving congressional inducements to taxpayers, such as tax credits and deductions.

Introduction

Disputes normally operate within the following parameters. If a case has compelling facts, emphasize those. If a case has strong support in applicable law, focus on that instead. If a case has neither, then simply throw everything at the wall and see what sticks. The last device, generally considered a legal Hail Mary, is the weakest of the three, used only as a last resort. Tax disputes have their own version of this. In situations where the actions of taxpayers comport with the rules enacted by Congress, the express language of such rules allows or even encourages the actions of the taxpayers, but the Internal Revenue Service ("IRS") strongly dislikes the outcome, the IRS often throws a tax Hail Mary called the "economic substance doctrine." This is what is occurring now, in the context of conservation easement transactions and elsewhere.

This article explains the economic substance doctrine and the reasons why Congress codified it, summarizes the IRS guidance over the following decade showing a policy of restraint in raising economic substance, reviews the mandate in 2022 radically changing the IRS's stance and authorizing Revenue Agents to challenge economic substance without first obtaining executive approval, identifies various sources demonstrating that attacks on economic substance are on the rise, and highlights just a few of the obstacles that the IRS will encounter if it continues down this path.

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Evolution of the Economic Substance Doctrine

Congress enacts tax laws, and the IRS issues regulations and other forms of administrative guidance to implement them. The government is replete with tax experts, but even they cannot foresee everything at the time they are formulating tax rules. Shortfalls often reveal themselves over time, the economy changes in drastic ways rendering earlier rules ineffective, and insightful taxpayers take favorable positions that comport with the express letter of the rules, but perhaps not their supposed "spirit." Accordingly, some courts find it necessary to "supplement" the law, crafted by Congress and effectuated by the IRS, in an effort to deter "unintended consequences."[1] The courts do so by creating various judicial doctrines, among them, the economic substance doctrine.

Codification

The economic substance doctrine remained solely an invention of the courts for many years. Things changed in 2010, though, when Congress passed the Health Care and Education Reconciliation Act.[2] That legislation "codified" the economic substance doctrine, meaning it transformed it from a theory created and applied by the courts into a specific provision in the Internal Revenue Code, Section 7701(o).

Why did Congress believe it necessary to codify the doctrine? The short answer is that things were a mess thanks to inconsistent rulings by different courts, at different levels, at different times. There was disagreement starting with the basics. Some courts applied a conjunctive test, holding that taxpayers must demonstrate that the transaction in question had economic substance (*i.e.*, the objective component) *and* a business purpose (*i.e.*, the subjective component) in order to avoid disallowance of all tax benefits. Other courts with a more taxpayer-favorable slant believed that transactions should survive if *either* economic substance or a business purpose existed. Still other courts simply viewed economic substance and business purpose as just two additional factors to consider in their analysis of a transaction. Finally, one court went so far as to question whether the economic substance doctrine, created by the judicial system, might be invalid as a violation of the separation-of-powers requirement.[3]

Uniformity among the courts was also missing when it came to the type and amount of non-federal-income-tax benefits a taxpayer must show to demonstrate that a particular transaction had economic substance. For instance, various courts denied benefits on grounds of no economic substance in situations where the transaction (i) lacked profit potential from the outset, (ii) had the possibility of yielding a profit but never achieved it, or (iii) featured only minimal risks to, and minimal profit prospects for, taxpayers.[4]

Congress, not surprisingly, tried to frame the issue more diplomatically. It explained the following in enacting the law in 2010:

> Tax avoidance transactions have relied upon the interaction of highly technical tax laws provisions to produce tax consequences not contemplated by Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining the overall integrity of the tax system. A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement the tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. The Committee recognizes that the IRS has achieved a number of successes in litigation. The Committee believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences.[5]

Codifying the economic substance doctrine is one thing, having it make an impact is another. Congress understood this; therefore, it fortified the penalty regime simultaneously with enacting Section 7701(o). Its rationale for doing so was straightforward: The IRS needed a "stronger penalty" to improve tax compliance and dissuade taxpayers from engaging in what it considered abusive transactions.[6]

Overview of the Law

Section 7701(o) provides that, in the case of a transaction (or series of transactions) to which the economic substance doctrine applies, such transaction shall be treated as having economic substance if, and only if, (i) the transaction changes the taxpayer's economic position "in a meaningful way," apart from federal income tax effects, *and* (ii) the taxpayer has a "substantial purpose" for engaging in the transaction, apart from federal income tax effects.[7] Taxpayers, the IRS, and the courts often refer to these as the *objective* profit-potential test and the *subjective* non-federal-income-tax-purpose test. A transaction must meet both tests if the taxpayer wants to obtain the tax benefits.[8]

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1. U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 295.
2. Health Care and Education Reconciliation Act of 2010, Public Law No. 111-152 (March 31, 2010).
3. U.S. Joint Committee on Taxation. 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-19-10. March 21, 2010, pgs. 143-144; U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pgs. 291-294.
4. U.S. Joint Committee on Taxation. 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-19-10. March 21, 2010, pgs. 144-145; U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pgs. 291-294.
5. U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 295.
6. U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 303.
7. Section 7701(o)(1); Section 7701(o)(5)(D).
8. In the case of individual taxpayers, the two-part economic substance test applies only to transactions entered into in connection with a trade or

The law does *not* define the key terms in quotes above. The legislative history provides some clues, though. For instance, it states that taxpayers can rely on factors *other than* profit potential to show that a particular transaction meets one, or both, of the two tests.[9] However, if a taxpayer relies on profit potential, the present value of the "reasonably expected" pre-tax profit needs to be "substantial" in comparison to the present value of the expected net tax benefits that would be allowed if the IRS were to respect the transaction.[10] The legislative history confirms that Section 7701(o) does *not* require a specific minimum return to satisfy the profit-potential test.[11]

The IRS can assert a penalty equal to 20 percent of the tax liability where such liability results from the disallowance of a tax benefit because the relevant transaction lacked economic substance.[12] The penalty increases from 20 percent to 40 percent in cases where a taxpayer did not adequately disclose to the IRS participation in the transaction on the relevant tax return or in a statement attached to the return.[13] In many situations, taxpayers can avoid penalties by demonstrating that they had "reasonable cause" for a tax understatement and acted in "good faith." Taxpayers cannot use such justifications to ward off the non-economic-substance penalty, though.[14] The legislative history refers to this as a "strict liability penalty," and the fact that taxpayers acquire a legal opinion before engaging in a transaction, from outside attorneys or in-house counsel, will not protect them from penalties if the transaction ultimately fails the economic substance test.[15]

Notice 2010-62

The IRS issued some "interim guidance" about Section 7701(o) and the related penalties about six months after Congress enacted the law in 2010. It came in the form of Notice 2010-62, which explained that the IRS planned to apply the two-part test mandated by Congress from that point forward. In doing so, however, the IRS explained that it would continue to rely on earlier cases decided by the courts applying various versions of the economic substance doctrine.[16] The IRS then acknowledged that the new law, Section 7701(o), only applies to transactions where the economic substance doctrine is relevant in the first place. This area of law continues to develop, explained the IRS, and it had no intention of publishing guidance that would specify the types of transactions to which the doctrine would or would not apply.[17]

The IRS also provided some clarity regarding disclosure levels and methods. Expanding on the standards initially set, Notice 2010-62 indicated that a transaction lacking economic substance would only be considered adequately disclosed if a taxpayer were to report it on a Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement), as appropriate.[18] It further explained that, if the transaction not only lacked economic substance but also constituted a reportable transaction, then taxpayers must also file a Form 8886 (Reportable Transaction Disclosure Statement) to meet the disclosure standard.[19]

Memo LMSB-4-0910-024

Simultaneous with the issuance of Notice 2010-62, the IRS released guidance to its examination personnel, including Revenue Agents. The directive was clear and concise: "To ensure consistent administration of the accuracy-related penalty [for transactions lacking economic substance], any proposal to impose [such penalty] at the examination level *must* be reviewed and approved by the appropriate Director of Field Operations *before* the penalty is proposed."[20] In other words, Revenue Agents lacked personal discretion to assert the strict liability penalty and first needed to get executive approval, from the Director of Field Operations ("DFO"). The IRS's own internal guidance confirmed the necessity of securing pre-penalty approval, instructing each division to create procedures that included, among other things, a "requirement of written executive approval" to assert economic substance penalties.[21]

Memo LB&I-04-0711-015

The IRS issued more guidance in mid-2011. Its purpose was to instruct Revenue Agents and their Managers about the analysis they needed to perform before approaching the DFO to request approval to raise the economic substance doctrine in a particular case.[22] The IRS outlined a four-step process for its audit personnel.

The first step was for Revenue Agents to evaluate whether the facts and circumstances in the case at hand tended to indicate that the economic substance doctrine was *inapplicable*. For instance, the doctrine likely would *not* apply where the transaction:

1. Is not promoted by a tax department or outside advisors;
2. Is not highly structured;
3. Contains no unnecessary steps;
4. Generates targeted tax incentives and is consistent with congressional intent;
5. Is conducted with unrelated third parties;
6. Creates a meaningful economic change for the taxpayer on a present-value basis;
7. Does not artificially limit gain or loss for the taxpayer;
8. Does not accelerate or duplicate a deduction;
9. Does not generate a deduction or basis increase that is not matched by an equivalent economic loss or expense;
10. Creates economic risk for the taxpayer
11. Does not involve a tax-indifferent party to which the income is attributed;
12. Does not result in a separation of income-recognition from a related de-

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business or an activity engaged in for the production of income. *See* Section 7701(o)(5)(B).

9 U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 298.

10 U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 298; Section 7701(o)(2)(A).

11 U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 298.

12 Section 6662(b)(6).

13 Section 6662(i).

14 Section 6664(c)(2).

duction between different taxpayers or different years;
13. Has a credible business purpose other than obtaining federal tax benefits;
14. Has a meaningful potential for profit aside from federal tax benefits;
15. Involves a significant risk of loss of the tax benefit;
16. Is not pre-packaged; and
17. Is not outside the taxpayer's ordinary business operations.[23]

This 17-factor test notwithstanding, the IRS gave a certain degree of leeway to Revenue Agents. It explained that if "some" of the preceding factors pertain to a transaction, and Revenue Agents "continue to believe" that applying the economic substance doctrine would be appropriate, then they could proceed.[24]

The second step essentially inverted the initial analysis, describing a number of factors that might indicate that economic substance doctrine is *applicable*. Such factors consisted of an abbreviated list from the first step; the IRS provided nothing new.[25]

The third step obligated Revenue Agents to answer the following series of questions before seeking penalty approval from the DFO:

1. Is the transaction a statutory or regulatory election?
2. Is the transaction subject to a detailed set of statutory or regulatory rules?
3. Does administrative or judicial precedent exist in which the economic substance doctrine was not raised in connection with the transaction, or was raised and then rejected by the courts?
4. Does the transaction involve tax credits (*e.g.*, low-income housing credits or alternative energy credits) designed by Congress to encourage certain transactions that would not be undertaken but for the credits?
5. Does another judicial doctrine, such as substance-over-form or step-transaction, more appropriately address the supposed non-compliance?
6. Does recharacterizing the transaction, such as changing debt to equity, better address the matter?
7. In considering all the arguments available to the IRS to challenge the tax result claimed by the taxpayer, is the alleged violation of the economic substance doctrine among the strongest ones?

If the answer to *any* of the preceding questions was "no," Revenue Agents were instructed to consult with their Manager and local IRS counsel *before* seeking penalty approval from the DFO.[26]

Revenue Agents reached the fourth and final step only after they had completed the first three steps and still concluded that arguing lack of economic substances was appropriate. In such instances, they, along with their Managers, presented a written analysis to the DFO. That was not the end of it, though. If the DFO preliminarily agreed and was inclined to proceed with an economic substance challenge, the DFO generally gave taxpayers an opportunity to present their side of the story, in person or in writing, before rendering a final decision.[27]

Notice 2014-58

After silence on the administrative guidance front for several years, the IRS issued Notice 2014-58.[28] It contained information on two main items. First, it supplied a definition of "transaction" in the context of the economic substance doctrine. Second, it clarified the meaning of the phrase "similar rule of law." The IRS confirmed in this regard that it would *not* assert the strict liability penalty under Section 6662(b)(6) reserved for transactions lacking economic substance without first alleging that Section 7701(o) functioned to disallow tax benefits claimed by the taxpayer. Notice 2014-58 went on to explain that in situations where the IRS disallows a tax benefit based on the substance-over-form or step-transaction doctrine, and *not* on the economic substance doctrine, it would not assert the penalty under Section 6662(b)(6).[29]

Memo LB&I-04-0422-0014

Since the economic substance doctrine was codified more than a decade ago, in 2010, Revenue Agents have been required to obtain executive approval *before* they could challenge a tax benefit based on the economic substance doctrine under Section 7701(o) and *before* they could assert the corresponding penalty under Section 6662(b)(6). This completely changed in April 2022, when the IRS issued its "updated information" to Revenue Agents and Managers. It said, concisely, that from this point forward "[e]xecutive approval is *not* required to raise the economic substance argument or assert related penalties."[30]

The new guidance, which the IRS released without efforts to draw attention, creates a new path for Revenue Agents. It generally indicates that Revenue Agents should consider all substantive and technical arguments that are reasonably relevant to the proper tax treatment of the transaction and then, based solely on their individual judgment, apply the economic substance doctrine if appropriate.[31] Limited exceptions to the general rule come into play when a particular case is "novel and/or significant," "will require significant resources to address," or involves a Compliance Campaign. In such instances, Revenue Agents merely need to check with local

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15 U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 304.

16 Notice 2010-62 (Sept. 13, 2010).

17 Id.

18 Id.

19 Id.

20 LMSB-4-0910-024 (Sept. 14, 2020) (emphasis added), Tax Analysts Doc. No. 2020-20089. *See also* I.R.M. 4.46.4.12.9(3) (09-23-2021).

21 I.R.M. 20.1.5.13.2 (04-22-2019).

22 LB&I-040711-015 (July 15, 2011). *See also* I.R.M. 4.46.4.12.9(4) (09-23-2021) and Exhibit 4.46.4-4.

23 LB&I-040711-015 (July 15, 2011).

24 Id.

25 Id.

26 Id.

27 Id.

28 Notice 2014-58 (Oct. 9, 2014). *See also* I.R.M. 4.46.4.12.9(5) (09-23-2021).

29 Notice 2014-58 (Oct. 9, 2014).

30 LB&I-04-0422-0014 (April 22, 2022) (emphasis added).

31 LB&I-04-0422-0014 (April 22, 2022).

32 Id.

33 LB&I-040711-015 (July 15, 2011).

34 Id.

35 LB&I-04-0422-0014 (April 22, 2022).

36 Notice 2017-10, Section 1.

37 *United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Complaint filed Dec. 18, 2018, pg. 47.

IRS field counsel or the head of the coordinated effort before proceeding.[32]

Consistent with earlier IRS publications, the new guidance contains a list of facts and circumstances that tend to show that the economic substance doctrine should apply.[33] Interestingly, the guidance encourages Revenue Agents to raise the economic substance doctrine in situations where it recommended exactly the opposite in the past. For example, back in mid-2011, the IRS seemingly urged Revenue Agents to utilize the economic substance doctrine sparingly, obligating them to struggle with the following questions, among several others:

1. Does another judicial doctrine, such as substance-over-form or step-transaction, more appropriately address the supposed non-compliance?
2. Would recharacterizing the transaction better address the issues?
3. Is the alleged violation of the economic substance doctrine among the strongest arguments that the IRS has to challenge the tax benefits related to a particular transaction?[34]

The IRS seems to have introduced a radical change in 2022, telling Revenue Agents to consider making economic substance an alternative argument in cases leading with substance-over-form, step-transaction, or recharacterization.[35]

More Swinging of the Economic Substance Hammer

The recent IRS memo reversing longstanding restraint and essentially granting Revenue Agents sole discretion to assert economic substance challenges might constitute bad news for taxpayers, particularly those involved with conservation easements. Why? The IRS has been threatening for years to raise various theories, including judicial doctrines, for attacking conservation easements. For example, the IRS issued Notice 2017-10 in late 2016, warning that it might challenge easements based on the partnership anti-abuse rules, the economic substance doctrine, and/or other unspecified rules and doctrines.[36] Similarly, in a Complaint filed in federal court in 2018 seeking an injunction against multiple persons involved with easements, the government alleged that the relevant partnerships were not true partnerships, they existed solely as a conduit to "sell" tax deductions, they were shams, and they lacked economic substance.[37] Finally, in the Audit Technique Guide for conservation easements published in late 2020, the IRS encouraged its personnel to consider launching numerous arguments, including absence of bona fide partners, substance-over-form, step-transaction, and economic substance.[38] Consistent with all these actions, senior IRS officials have also speculated that "future cases could hinge on the whole picture of transactions misrepresenting their economic substance."[39]

Special Rules for Charitable Donations and Congressional Incentives

There is a silver lining to all this. Specifically, the IRS likely will face a slew of hurdles if Revenue Agents, relying on the new IRS memo in 2022, start broadly asserting that conservation easement donations should be disallowed and penalized on economic substance grounds. This article highlights merely a few of the impediments that the IRS will face.

Inapplicability to Charitable Donations

Many describe the economic substance doctrine as a two-part test. It really has three parts, the first of which is foundational. Section 7701(o) begins with a critical limiting phrase. It indicates that taxpayers, the IRS, and the courts should not even reach the two-part test unless the situation involves a "transaction to which the economic substance doctrine is relevant."[40] Commentators explain that the courts "have traditionally determined that the economic substance test does not apply . . . if Congress did not intend the doctrine to pertain to the particular tax benefit (*e.g.*, a specific credit or deduction) at issue."[41]

The fundamental decision about applicability is not made by looking to Section 7701(o), but rather by analyzing prior judicial precedent. The law states that the determination of whether the economic substance doctrine pertains in the first place "shall be made in the same manner as if [Section 7701(o)] had never been enacted."[42] As explained below, several cases have held that the economic substance doctrine is *not r*elevant to charitable donations, such that there is no need to even address whether (i) the transaction changes the taxpayer's economic position "in a meaningful way," apart from federal income tax effects, *and* (ii) the taxpayer has a "substantial purpose" for engaging in the transaction, apart from federal income tax effects.[43]

Skripak v. Commissioner – 1985

The taxpayers in *Skripak v. Commissioner* participated in a program whereby they executed a series of documents purporting to buy scholarly books for one-third their retail price, held the books for slightly more than six months (which sufficed to create long-term capital gain property during the relevant years), donated the books to small rural public libraries, and claimed charitable donation deductions based on the retail price of the books, which was about three times higher than what the taxpayers had paid a short time earlier.[44] The IRS audited, fully disallowed the claimed deductions, and imposed penalties. The IRS's primary theory was that the transaction in which the taxpayers engaged lacked economic substance, constituted a sham, and thus should be ignored for tax purposes.

The Tax Court rejected the IRS's argument on the following grounds:

> [The IRS] spent a great deal of time attempting to show that [the

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[38] Internal Revenue Service. Conservation Easement Audit Technique Guide. Publication 5464 (Rev. 11-2020), pgs. 69-72.

[39] Nathan J. Richman. "Future Easement Charges Could Pivot on Economic Substance Questions," 2020 Tax Notes Today Federal 19-4 (Jan. 29, 2021).

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

[41] Rebecca Rosenberg. "Codification of the Economic Substance Doctrine: Substantive Impact and Unintended Consequences," 15 Hastings Business Law Journal 55, 111 (2019).

[42] Section 7701(o)(5)(C).

[43] Section 7701(o)(1); Section 7701(o)(5)(D).

[44] *Skripak v. Commissioner*, 84 T.C. 285 (1985).

[45] *Skripak v. Commissioner*, 84 T.C. 285, 314-315 (1985).

[46] *Skripak v. Commissioner*, 84 T.C. 285, 319 (1985).

taxpayers] were completely inexperienced in every aspect of the book business and that [they] had virtually no chance of realizing an economic profit from their alleged acquisition and disposition of the reprint books. The record abundantly established that to be the case. Although we accept the truth of these matters, we have made no express findings on these facts because they are not pertinent to our inquiry. The deduction for charitable contributions provided by Section 170 is a legislative subsidy for purely personal (as opposed to business) expenses of a taxpayer. Accordingly, doctrines such as business purpose and an objective of economic profit are of little, if any, significance in determining whether [the taxpayers] have made charitable gifts. We think that the various documents [executed by the taxpayers and third parties] in fact comport with the economic substance and reality of these transactions, and we conclude that [the taxpayers] did in fact own and contributed the books to the various libraries.[45]

The Tax Court expanded on its reasoning later in its Opinion, criticizing the IRS for its singular and rigid focus:

> [The IRS's] seeming obsession with the mechanics of these transactions as shams appears to be caused by the admitted tax-avoidance motivation of [the taxpayers]. However, as stated above, the deduction for charitable contributions was intended to provide a tax incentive for taxpayers to support charities. Consequently, a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution.[46]

The Tax Court, dispelling any doubt, concluded its analysis of the IRS's primary attack by underscoring the need to accept the behavior encouraged by Congress in enacting Section 170:

> Under *Gregory v. Helvering*, so heavily relied upon by [the IRS], the determinative question is 'whether what was done, apart from the tax motive, was the thing which the statute intended.' Here . . . various qualified charitable donees received gifts of books belonging to [the taxpayers]. *This is precisely the result intended by Section 170*. [The taxpayers] owned the reprint books and made contributions of those books to the various libraries, and we hold that [the taxpayers] are entitled to deductions for their charitable contributions.[47]

Hunter v. Commissioner – 1986

The taxpayers in *Hunter v. Commissioner* learned of a tax-reduction program, promoted by Mr. Ackerman, involving the purchase of "limited edition prints" and subsequent donation of such artwork to museums.[48] Apparently, Mr. Ackerman, through one of his entities, purchased a large number of prints from a gallery for a low price because the gallery had owned them for a long time, failed to sell them to gallery visitors, and now considered them "excess inventory." Mr. Ackerman bought the prints for one-sixth of their retail price, sold them to the taxpayers for one-third of their retail price, and soon thereafter assisted the taxpayers in donating the prints and claiming charitable deductions for their full retail price. Taxpayers expected a tax deduction equal to approximately three times the amount they paid Mr. Ackerman.

In terms of procedure, Mr. Ackerman displayed on a table the prints for sale, placed the prints selected by the taxpayers in a separate drawer featuring their name, insured the prints, paid to have the prints packaged and shipped to museums after safeguarding them for over one year, and had the donations made in the name of the taxpayers.

The IRS audited the taxpayers and claimed that they should get a charitable deduction of $0 for a long list of reasons, among them that the transactions were shams and lacked economic substance. The IRS believed that the taxpayers "merely purchased a tax deduction which promised a three-to-one write-off on their investment."[49]

The Tax Court swiftly rejected the IRS's contention, holding that the "tax-avoidance motive" of the taxpayers in making the charitable donations did not preclude allowance of a deduction. The Tax Court alluded to what it said the previous year, in *Skripak v. Commissioner*, about Congress enacting Section 170 to incentivize taxpayers to support charities and the IRS being unable to use a taxpayer's desire to reduce taxes by donating to charities as grounds for disallowing a deduction.[50]

Weitz v. Commissioner – 1989

The taxpayers in *Weitz v. Commissioner* participated in a program pursuant to which they pooled funds with several other investors, had their agent purchase medical equipment in their names at bankruptcy auctions for low prices from distressed sellers, stored such equipment without using it for more than one year, donated the equipment to hospitals, and claimed charitable deductions based on the retail value of the equipment at that time of the donations.[51] The taxpayers expected a four-to-one return on their investment, even after paying the agent's commission.

The IRS raised a laundry list of arguments in an attempt to award the taxpayers a charitable deduction of $0,

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[47] *Skripak v. Commissioner*, 84 T.C. 285, 319-320 (1985) (internal citations omitted) (emphasis added).

[48] *Hunter v. Commissioner*, T.C. Memo 1986-308.

[49] *Hunter v. Commissioner*, T.C. Memo 1986-308. The IRS also raised the following additional arguments to support a full disallowance of the charitable donation deduction: (i) The taxpayers supposedly never owned the prints; (ii) The taxpayers did not satisfy the long-term holding requirement; and (iii) The activities of the taxpayers were substantially similar to those of commercial art dealers, such that the prints constituted ordinary income property instead of capital gain property.

[50] *Hunter v. Commissioner*, T.C. Memo 1986-308.

[51] *Weitz v. Commissioner*, T.C. Memo 1989-99.

[52] *Weitz v. Commissioner*, T.C. Memo 1989-99 (internal citation omitted) (emphasis added).

[53] Id.

[54] *Weintrob v. Commissioner*, T.C. Memo 1990-513.

[55] Id.

[56] *RERI Holdings I, LLC v. Commissioner*, T.C. Memo 2014-60.

[57] *RERI Holdings I, LLC v. Commissioner*, T.C. Memo 2014-60 (referencing *Scheidelman v. Commissioner*, 862 F.3d 189, 200 (2nd Cir. 2012)).

[58] *RERI Holdings I, LLC v. Commissioner*, T.C. Memo 2014-60 (referencing *Ford v. Commissioner*, T.C. Memo 1983-556).

[59] Tax Reform Act of 1969, Public Law No. 91-17, Section 201 (1969); U. S. House of Representatives, Tax Reform Act of 1969, 91st Congress, 1st Session, Report No. 91-782 (Dec. 21, 1969); *See also* Tax Reform Act of 1976, Public Law No. 94-455, Section 2124(e) (1976); *See also* Tax Reduction and Simplification Act of 1977, Public Law No. 95-30, Section 309 (1977). Notably, the IRS

several of which invoked economic substance in one fashion or another. For instance, the IRS suggested that the taxpayers failed to make a completed gift to the hospitals because they supposedly lacked donative intent. The problem, according to the IRS, was that the primary motivation of the taxpayers in acquiring and transferring the medical equipment to the hospitals was obtaining a tax deduction, not giving to charity. The Tax Court outright rejected this attack, explaining that the IRS was simply off base:

> Most of [the IRS's] argument that [the taxpayers] lacked generous and altruistic donative intent is irrelevant and ill conceived. *A charitable contribution may be motivated by the basest and most selfish of purposes as long as the donor does not reasonably anticipate benefit from the donee in return.* Although [the IRS] makes much of the fact that [the hospital] personnel chose the equipment which would be donated, there is no requirement that the donated property be unnecessary or useless to the donee. The record does not suggest that [the taxpayers] anticipated any benefit from [the hospital], the donee, in exchange for, or in response to, their contribution. *Although we are not unmindful of the tax benefits [the taxpayers] received from the contribution, that is not pertinent to any analysis of donative intent.* We conclude that [the taxpayers'] primary motivation in making the contribution was to donate equipment to the hospital without the expectation of any consideration from the donee, and that, therefore, [the taxpayers] were motivated by the intent needed to accomplish a charitable donation.[52]

The Tax Court, after dismissing other arguments advanced by the IRS, provided additional color regarding the inapplicability of the economic substance doctrine to situations involving charitable donations. It explained the following:

> Underlying each of [the IRS's] arguments is concern over the significant tax savings [the taxpayers] hoped to obtain as a result of their participation in the plan devised by [their agent and accountant]. [The taxpayers] and the other investors paid a relatively low price for the equipment which, at no cost or inconvenience to themselves, they stored for one year until they could donate it to [the hospital] and claim a charitable contribution deduction in an amount four times greater than their cash outlay. Nonetheless, [the taxpayers'] actions complied in every respect with statutory requirements. *As we recently noted in Skripak v. Commissioner, Section 170 allows a deduction from tax with respect to donations to charitable institutions even when the donation is carefully contrived to comply with the requirements of the applicable rules and regulations. [The taxpayers'] actions have been planned and executed to assure that their donation of medical equipment to [the hospital] would come within the definition of a deductible charitable contribution and all of the steps necessary to accomplish that goal have been effectuated. [The taxpayers] cannot be penalized for being careful.*[53]

Weintrob v. Commissioner – 1990

The taxpayers in *Weintrob v. Commissioner* were partners in a limited partnership that pooled investor money, purchased unimproved land, allowed the partners to "withdraw" land from the partnership in proportion to their capital account ratios, donate such land to charity, and claim charitable donation deductions that far exceeded the amount of money invested.[54] The IRS disallowed the deductions on several grounds, one of which was the supposed lack of economic substance. The IRS maintained, as it had in several cases mentioned above, that the only purpose for the series of transactions culminating in donations was to secure tax benefits for the partners. The Tax Court first noted that it had previously rejected a similar challenge by the IRS in *Skripak*. Consistent with that earlier decision, the Tax Court in *Weintrob* ruled that the taxpayers "parted with their own funds as the result of which the various qualified charitable organizations received finished gravesites [and] such being the case [the taxpayers] made substantive donations for which they are entitled to deductions" under Section 170.[55]

RERI Holdings I, LLC v. Commissioner – 2014

The taxpayer in *RERI Holdings, LLC v. Commission* was a limited liability company, with multiple members, treated as a partnership for federal tax purposes.[56] The partnership donated to a university complete ownership of another partnership, which itself held certain real property. The partnership claimed a charitable donation deduction of approximately $33 million. The IRS countered that the deduction should be $0 because the relevant transaction was a sham, lacked economic substance, and thus should be ignored for tax purposes. The taxpayer filed a Motion for Partial Summary Judgment with the Tax Court, asking it to declare from the outset that the sham-transaction doctrine and economic substance doctrine do not apply when determining whether a taxpayer's contribution to charity triggers a deduction under Section 170. The taxpayer, in support of its request, relied heavily on *Skripak* and the other cases described previously in this article. It also noted another case, this one involving the donation of a fa[ccedil]ade easement and a cash endowment, wherein the Tax Court observed the following: "It is true the taxpayer hoped to obtain a charitable deduction for her gifts, but this would not come from the recipient of the gift. It would not be a *quid pro quo*. If the motivation to receive a tax benefit deprived a gift of its charitable nature under Section 170, virtually no charitable gifts would be deductible."[57]

For its part, the IRS principally turned to *Ford v. Commissioner*.[58] In that case,

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first recognized tax deductions for charitable contributions of partial interests in real property several years earlier, in 1964. *See* Rev. Rul. 64-205.

[60] Tax Treatment Extension Act, Public Law No. 96-541, Section 6(a) (1980); U.S. Senate, Tax Treatment Extension Action of 1980, 96th Congress, 2d Session, Report No. 96-1007 (Sept. 30, 1980).

[61] U.S. Senate, Tax Treatment Extension Action of 1980, 96th Congress, 2d Session, Report No. 96-1007 (Sept. 30, 1980), pg. 9.

[62] U.S. Joint Committee on Taxation. Description of S. 1675 (Public Land Acquisition Alternatives Act of 1983). JCX-1-84, Feb. 4, 1984, pg. 10 (statement by Senator Malcolm Wallop) (emphasis added).

[63] U.S. Joint Committee on Taxation. Description of S. 1675 (Public Land Acquisition Alternatives Act of 1983). JCX-1-84, Feb. 4, 1984, pg. 15 (state-

the taxpayer was a limited partner in a partnership, which owned real property, an underwater habitat. The partnership decided to donate the property to a university. At that time, the fair market value of the property was $600,000, but it had a tax basis of $0 in the hands of the partnership because it had been fully depreciated already. Consequently, if the partnership had *directly* donated the property to the university, its charitable contribution deduction would have been $0. In an effort to avoid this unfavorable tax result, the following transactions occurred: A new corporation was formed, the partnership transferred the property to the corporation in exchange for 100 percent of its stock, the partnership then donated the stock (instead of the property itself) to the university, the partnership claimed a charitable donation deduction of $600,000, and the members of the partnership benefitted from their pro-rata share of the deduction. The corporation did not conduct any business while the partnership owned it, and its only asset was the property. The Tax Court held in *Ford v. Commissioner* that (i) the transfer of the property by the partnership to the corporation was done solely for purposes of obtaining a tax deduction for the partners, (ii) the corporation was a sham, acted solely as a conduit, and lacked economic substance, and (iii) as a result, the partnership, not the corporation, made the charitable donation to the university.

The Tax Court explained that *Skripak* and similar cases concerned taxpayers who participated in a tax-avoidance program that essentially involved buying tangible personal property at distress prices for the sole purpose of later contributing such property to a charity. In those cases, the Tax Court held that the absence of any non-tax motives for entering into the transactions was not an obstacle to the taxpayers claiming the charitable deductions. The Tax Court then noted that the situation in Ford was distinct from that in *Skripak*. The former case did not feature the direct purchase and subsequent donation of property by a taxpayer; rather, it involved the formation by the taxpayer of an entity, the corporation, in order to effectuate the transactions and achieve the desired tax results. The Tax Court summarized the issue in *Ford* as follows: "[W]hether the formation of a corporate shell should be respected for federal tax purposes where the sole purpose of the corporation was to enable the taxpayers (and others similarly situated) to obtain a charitable contribution deduction that would otherwise have been unavailable to them." Importantly, the Tax Court clarified that it disregarded the corporation in *Ford* because it lacked economic substance, but it did not disallow the charitable deduction altogether. It simply recharacterized the transaction from the donation of corporate stock to the direct donation by the partnership of the land to the charity.

The Tax Court noted that the IRS made several "clear" contentions in its opposition to the Motion for Partial Summary Judgment. These included that the partnership was a sham, the transactions lacked economic substance, and those sorts of judicial principles can serve to disallow charitable contribution deductions when the benefits claimed are inconsistent with the legislative goals underlying Section 170. However, the Tax Court was not clear as to why, exactly, the IRS was advancing some of its attacks. The Tax Court exhibited its befuddlement with the IRS's overall strategy by offering various rhetorical questions. First, the Tax Court pondered why the IRS wished to prove that the partnership should be disregarded because it supposedly was not formed to carry out a business venture? The biting question by the Tax Court was "so what?" Ignoring the partnership would result in a direct purchase and sale of property by the members of the partnership, and this scenario would render a charitable deduction for the partners pursuant to Skripak. Second, the Tax Court asked what would occur if it determined, consistent with the IRS's contentions, that the transactions in question lacked a non-tax purpose? Again, the inquiry by the Tax Court was "so what?" Citing Skripak and other cases addressed in this article, the Tax Court challenged the IRS as follows: "Have we not said sufficiently that gifts to charity need have no economic substance beyond the mere gift?" The Tax Court concluded that the IRS had not adequately explained how its assertions, even if true, would affect the entitlement of the partners of the partnership to a charitable deduction.

Incentivizing Easements

Congress has generally recognized tax deductions from the donation of a partial interest in real property for more than five decades, starting in 1969.[59] Congress codified this notion as Section 170(h) in 1980, thereby providing tax incentives to taxpayers for donating conservation easements.[60] Congress explained the reasons for this financial enticement as follows:

> The committee believes that the preservation of our country's natural resources and cultural heritage is important, and the committee recognizes that conservation easements now play an important role in preservation efforts . . . [T]he

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ment by President of the Conservation Foundation).

[64] Pension Protection Act, Public Law No. 109-280, Sections 1206 and 1219.

[65] Food, Conservation, and Energy Act, Public Law No. 110-246, Section 15302 (2008); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, Public Law No. 111-312, Section 723 (2010); American Taxpayer Relief Act, Public Law No. 112-240, Section 206 (2013); Tax Increase Prevention Act, Public Law No. 113-295, Section 106 (2014).

[66] Protecting Americans from Tax Hikes Acts, Public Law No. 114-113, Section 111 (2015).

[67] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 296 (emphasis added).

[68] U.S. Joint Committee on Taxation. 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-19-10. March 21, 2010, pg. 152, footnote 344 (emphasis added).

[69] LB&I-040711-015 (July 15, 2011).

[70] Id.

[71] LB&I-04-0422-0014 (April 22, 2022).

[72] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995).

[73] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) (internal citations omitted).

[74] General Counsel Memo 20124002F (Oct. 5, 2012), pg. 16 (maintaining that "the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving – or of a purported partnership engaged in – tax-favored activity finds no support apart from *Sacks*.")

committee found it appropriate to expand the type of transfers which will qualify as deductible contributions in certain cases where the contributions are likely to further significant conservation goals without presenting significant potential for abuse.[61]

Four years after enacting Section 170(h), members of Congress introduced legislation to sweeten the pot, so to speak. They wanted to expand the rewards to private parties for protecting land, mindful of increasing development pressures and decreasing federal budgets earmarked for land acquisition. A hearing about the proposed legislation left no doubt that Congress was incentivizing private land preservation, and the motivation of the donors was linked to tax benefits:

> The message could not be clearer if we are to tackle the task of preserving many of these precious resources in light of current pressures for development and the competition for funds, we have to identify and enact tools to accomplish this task. I believe that [the proposed legislation] contains such an opportunity. Building on the broad principles found in [Section 170(h)], which provides for the deductibility of contributions of partial interest in real property, we have sought with [the proposed legislation] to put together *a variety of tax incentives to further encourage the sale and contribution of significant natural areas.* Those principles which I believe must remain intact as we seek viable alternatives *to encourage and promote tax motivated transfers of scenic lands and wildlife habitat,* contemplate that tax benefits are provided only with regard to carefully defined natural areas. And that a sale or contribution qualifying for special treatment must be for conservation purposes. And that the recipient must be qualified to manage the resource, and that the recipient must have the commitment and the resources to enforce the conservation purpose.[62]

The proposed legislation and corresponding hearing in 1984 were the culmination of various workshops on land management and acquisition alternatives led by members of Congress. According to congressional testimony, such workshops rendered the following conclusions about tax policy: It was in the national interest to encourage land conservation through private donations and public appropriations, "conservation practices should be made more profitable to landowners via the provision of tax incentives," and there is a need "to provide new tax benefits to stimulate land conservation by private property owners."[63]

Section 170(h) has been modified and enhanced several times since its introduction. For instance, in 2006, Congress made the tax benefit even more appealing to taxpayers by allowing them to deduct up to 50 percent of their adjusted gross incomes (instead of 30 percent) the year of the donation and to carry forward unused deductions for up to 15 years (instead of five years).[64] Congress extended these enhanced benefits several times, from 2008 through 2014.[65] It finally made them permanent in 2015.[66]

Following the Wishes of Congress

Congress left no doubt when it enacted Section 7701(o) back in 2010 that the economic substance doctrine should *not* apply where taxpayers engage in transactions in conformity with a specific tax incentive. The legislative history states the following on this critical issue:

> *If the tax benefits [of a transaction] are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the treatment fails the economic substance doctrine as defined in this provision. See, e.g.,* Treas. Reg. § 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit or other allowance would be to distort the liability of the 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.*[67]

The Joint Committee on Taxation expanded on the notion. It explained the following about the inapplicability of the economic substance doctrine to situations where taxpayers are acting in accordance with the wishes of Congress:

> *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. § 1.269-2, stating that characteristic 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 light of the basic purpose or plan which the deduction, credit, or other allowance was designed by Congress to effectuate. *Thus, for example, it is not intended that a tax credit (e.g., Section 42 (low-income housing credit), Section 45 (production tax credit), Section 45D (new market tax credit), Section 47 (rehabilitation credit), Section 48 (energy credit), etc.) 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 [or deduction or other allowance] was intended to encourage.*[68]

The IRS, likewise, has recognized that behavior by taxpayers, done in accordance with the incentives provided by Congress, should not be punished by disallowance of tax benefits. Indeed, the IRS guidance explained earlier in this article contains several examples. The legal memo issued in mid-2011 states that the economic substance doctrine likely is not applicable to a "transaction that generates targeted tax incentives and is, in form and substance, consistent with congressional intent in providing the incentives."[69] That same legal memo also tells Revenue Agents not to seek approval to challenge economic substance if the transaction in question "involves tax credits (*e.g.,* low-income housing credits, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits."[70] Even the most recent memo from the IRS, issued in 2022 and granting Revenue

Agents nearly full autonomy to make determinations about economic substance, warns that certain transactions enjoy an exemption. It explains that, notwithstanding the long list of facts and circumstances that Revenue Agents should consider as part of its analysis, "the economic substance doctrine may not be appropriate if the transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives."[71]

Finally, although judicial ambivalence exists on the issue, various cases have held that it is improper for the IRS to assert the economic substance doctrine in tax disputes focused on congressional incentives. Perhaps the most famous example is *Sacks v. Commissioner,* wherein the taxpayer invested in solar water heaters in reaction to a package of tax laws, enacted by Congress and the state of Arizona, which encouraged people to invest in wind, solar, geothermal and other alternative energy sources.[72] The taxpayer claimed depreciation and investment tax credits for solar units, and the IRS disallowed them on grounds that the relevant transactions were shams. The Tax Court ruled in favor of the IRS, but the Court of Appeals reversed. In concluding that the transactions were not shams, the Court of Appeals underscored the inapplicability of the economic substance doctrine and similar judicial devices in situations involving congressional inducements, such as tax credits, deductions, etc.

> Absence of pre-tax profitability does not show "whether the transaction had economic substance beyond the creation of tax benefits" where Congress has purposely used tax incentives to change investors' conduct. Congress and the Arizona legislature purposely skewed the neutrality of the tax system, even more than the usual tax credits and accelerated depreciation designed to encourage more investment in capital goods than would otherwise be made, because they sought to induce people to invest in solar energy . . . If the [IRS] treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative [hand]. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made.
>
> Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses. If the [IRS] were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. Yet the [IRS] in this case at bar proposes to use the reason Congress created the tax benefits as ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose.[73]

The IRS, unsurprisingly after its loss, has attempted to narrow the holding in *Sacks* and diminish its use in other contexts.[74]

Conclusion

Congress enacted the economic substance doctrine in 2010, and the IRS exercised pragmatism in addressing it for more than a decade thereafter. In particular, the IRS indicated in published guidance that it only intended to raise the doctrine where it was applicable in the first place. It also created several barriers designed to avoid premature or improper disallowance of tax benefits and assertion of strict-liability penalties based on economic substance grounds. For many years, Revenue Agents were obligated to conduct a 17-point test, address seven rhetorical questions, present a written analysis, *and* obtain executive approval *before* they could drop the economic substance hammer on taxpayers under audit.

That all changed in April 2022, when the IRS released a memo essentially authorizing Revenue Agents to use their individual judgment regarding economic substance challenges, with no need to seek executive approval. Based on that memo, combined with other recent actions and announcements by the IRS, the expectation is increased allegations that certain transactions lack economic substance, including those involving donations of conservation easements.

This article shows that if the IRS proceeds in this manner it likely will face a number of legal challenges. For example, several cases have held that the economic substance doctrine does not even apply in the context of charitable donations. Moreover, the legislative history to Section 170 explicitly emphasizes the importance of preservation, the need "to encourage and promote tax motivated transfers of scenic land and wildlife habitat," and the rationale for providing "new tax benefits to stimulate land conservation by private property owners." Finally, reports accompanying the codification of the economic substance doctrine, the official explanation by the Joint Committee on Taxation, several of the IRS Notices and memos covered in this article, and at least one major case all emphasize the inapplicability of the economic substance doctrine to situations involving congressional inducements to taxpayers, such as tax credits, deductions, etc.

Will this reality dissuade the IRS, particularly its newly-empowered Revenue Agents, from seeing violations of economic substance around every corner? No. Therefore, taxpayers should brace themselves, hire good legal counsel, and get ready for prolonged battles over economic substance in the coming years.