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Space Madness: Subsidies and Economic Substance

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SPACE MADNESS: SUBSIDIES AND ECONOMIC SUBSTANCE

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Extending the reach of the recently codified economic substance doctrine to embrace transactions spurred by tax subsidies would help both Congress and taxpayers promote worthy objectives such as historic preservation and the production of renewable energy. Congress—or quite possibly the courts—could use losses as the lynchpin of an economic substance doctrine for subsidized transactions.

INTRODUCTION

In *2001: A Space Odyssey*, the artificial intelligence HAL 9000 famously descends into madness after failing to reconcile two incompatible directives.[1] As complex as any spacecraft, the tax law relies on its own version of HAL: the economic substance doctrine (ESD).[2] The ESD serves as a benevolent guardian preserving the income tax, just as HAL kept watch over an interplanetary vessel. Like HAL, the ESD has proved to be not only powerful but also unexpectedly fragile.

By stripping tax benefits from undeserving taxpayers participating in conventional transactions, the ESD defends Congress's handiwork against the entropy that is tax planning.[3] When Congress uses the tax law not only to collect revenue but also to deliver subsidies—creating synthetic spending provisions known as tax expenditures—the ESD finds itself in the same quandary that

† Professor of Law, Brooklyn Law School. This Essay benefited from thoughtful suggestions from Nelson Tebbe and from the extraordinary knowledge of the Executive Committee of the Tax Section of the New York State Bar Association.

1 2001: A SPACE ODYSSEY (Metro-Goldwyn-Mayer 1968). The computer is directed to keep information from the crew of the ship it controls, in violation of its original programming to accurately relay information. It attempts to resolve its dilemma by eliminating the crew that it must both deceive and inform.

2 *See* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 241 (1999) (applying the common law ESD).

3 *See id.*

triggered HAL's collapse.[4] Those incentives invite taxpayers, regardless of their pre-existing preferences, to engage in activities that Congress prioritizes—causing taxpayers to do precisely what the ESD was designed to prevent.

Simply put, when taxpayers engage in subsidized transactions, the ESD finds itself charged with simultaneously preventing and permitting transactions that would not occur in the absence of tax benefits. Two recent circuit court decisions might be read as embracing HAL's dark solution (eliminating the astronauts it cannot simultaneously deceive and keep informed). Rather than killing astronauts, the courts killed deals. The Fourth Circuit's *Virginia Historic Tax Credit Fund v. Commissioner* and the Third Circuit's *Historic Boardwalk Hall, LLC v. Commissioner* firmly rejected investors' claims to tax credits subsidizing historic preservation.[5]

Congress has long turned a blind eye to this problem. Even as it took the momentous step of codifying the common law ESD,[6] Congress remained silent. *Virginia Historic Tax Credit* and *Historic Boardwalk Hall* suggest that the courts would prefer to do likewise, crafting narrow opinions and novel doctrines to avoid squarely addressing the ESD's dilemma. As tax expenditures increasingly claim a central role in the nation's fiscal policy, continued inaction will leave more astronauts dead and more missions scrubbed. Tax authorities have launched sporadic rescue missions—the latest just months ago—but a comprehensive fix lies beyond their reach.[7]

This Essay explains how Congress—or, thanks to the recent codification of the ESD, the courts—could intervene to extend the ESD to subsidized transactions. Inverting the ESD's traditional focus on profits, Congress could articulate a threshold exposure to potential loss for purported investors in a subsidized transaction. Empowered by a codified ESD, courts could do the same, using exposure to losses to weave together apparently inconsistent

4 Edward Kleinbard uses the term "synthetic spending program" to refer to tax expenditures to highlight the similarities between tax and direct expenditures. *See, e.g.*, Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, 63 NAT'L TAX J. 353, 361 (2010).

5 Va. Historic Tax Credit Fund v. Comm'r, 639 F.3d 129, 145–46 (4th Cir. 2011) (rejecting taxpayers' claimed status as investors in a rehabilitation project benefiting from a Virginia historic rehabilitation tax credit); Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 462–63 (3d Cir. 2012) (finding that a purported investor in a rehabilitation project was instead a purchaser of tax credits), *reh'g denied*, 2012 U.S. App. LEXIS 24170 (3d Cir. Oct. 22, 2012).

6 I.R.C. § 7701(o) (2011).

7 The most recent rescue mission targeted the rehabilitation tax credit. *See* Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (creating a safe harbor for a partnership that claims rehabilitation tax credits). If it were a movie, the Revenue Procedure would be closer to Bruce Willis's *Armageddon* than to *2001: A Space Odyssey*, complete with last-minute heroics. ARMAGEDDON (Touchstone Pictures 1998).

congressional mandates. Either could help sustain investments in activities ranging from the production of renewable energy to the preservation of vulnerable historic structures.[8]

Part I of this Essay highlights the difficulties encountered by one tax expenditure: the rehabilitation credit supporting private investments in historically significant structures. Part II considers the origins of the ESD puzzle taxpayers and tax authorities now face, examining the rise of tax expenditures and their collision with the ESD. Part III concludes the Essay by explaining how shifting focus from profits to losses would help to reconcile Congress's conflicting aims.

I
THE CLASH OVER THE REHABILITATION TAX CREDIT

It might be possible to find a less likely catalyst for the controversy that flared around the rehabilitation tax credit, but it would be difficult. Like similar credits targeted at renewable energy and low-income housing, the rehabilitation credit advances an easy-to-love objective that Congress has chosen to support.[9] The rehabilitation credit promotes the preservation of historic structures by putting a thumb on the scale in favor of investments that, although in the public interest, would not occur in a conventional transaction.

Of course, such tax incentives are only one tool government uses to achieve those aims. The rehabilitation credit serves a purpose that could be capably served by a variety of forms of public intervention. The National Parks Service, for example, takes a direct role by

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8 Resolving this clash between congressional imperatives would also offer an alternative to two radically different—but equally troubling—visions of the ESD. First, requiring subsidized transactions to satisfy the ESD on a pre-tax basis—insisting that taxpayers would have acted no differently in the absence of the tax subsidy—would frustrate Congress's ability to encourage these activities. Second, an after-tax ESD that equates tax benefits with business profits might be worse, producing absurd results that sacrifice vigilance for generosity. The American Bar Association has argued in favor of this result. Under such an approach, the most generous subsidies would generate the most "substance" and would therefore be the most likely to survive an ESD challenge while more modest incentives would generate less "profit" and would be more susceptible to challenge. *See infra* note 46.

9 *See, e.g.*, Rev. Proc. 2007-65, § 1, 2007-45 I.R.B. 967. The rehabilitation credit is not the only tax expenditure that has raised this question. Just a few years ago, Revenue Procedure 2007-65 addressed uncertainty with respect to investments generating renewable energy production credits. By providing a safe harbor "under which the [IRS] will respect the allocation of [I.R.C.] § 45 wind energy production tax credits by partnerships in accordance with § 704(b)," the Revenue Procedure offered investors guidance regarding the types of transactions that would be viewed as consistent with the statute's aims. *Id.* As described below, that guidance illustrates how Treasury and the IRS could exert a more sustainable balance of ex post and ex ante influence over the evolution of transactions Congress chose to promote with the rehabilitation credit.

maintaining 27,000 "significant structures" in its 400 national parks.[10] Local governments often constrain private decision-making by designating particular areas as historic in order to preserve their character.

The use of a tax incentive offers both advantages and disadvantages compared to more direct forms of government involvement. On the one hand, it leverages government support with private capital and expertise. On the other, the use of tax rules to promote such objectives saddles tax authorities with responsibilities ordinarily assigned to expert agencies.[11]

The use of a tax expenditure—an offset to tax liability rather than a direct subsidy—creates a further headache. If an actor with the will to rehabilitate a historic structure has no tax burden to eliminate, the rehabilitation credit becomes impotent. In particular, local government agencies and nonprofits cannot claim the credit. Even when uniquely situated to identify and rehabilitate historic structures, they would generally be denied the opportunity to capitalize on this incentive by virtue of their tax-exempt status.[12]

Transactions tailored to compensate for this shortcoming highlight its significance. A state agency might, for example, own a historic structure and undertake the rehabilitation of the structure with public funds. The project may be one that fits well with the aims of the rehabilitation credit, but the government entity engaged in the rehabilitation project pays no federal income tax and therefore has no use for a tax credit.

Following a decades-old pattern, the tax-indifferent party would partner with a tax-paying corporation. For its part, the agency releases its claim to rehabilitation credits generated by the rehabilitation project. In turn, the corporation shoulders a portion of the cost of the rehabilitation the agency would otherwise bear alone. From one point of view, the transaction represents a partnership, combining the agency's expertise and the corporation's capital. From another, it is simply a sale of tax benefits for cash.[13]

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10 *Preservation*, NAT'L PARKS SERVICE, http://www.nps.gov/history/preservation.htm (last visited Mar. 27, 2014).

11 Tax expenditures may take Treasury and the IRS far afield, but even in the most extreme cases, they do not require them to take on every task performed by government actors. *See* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 958 (2004) ("[A] proposal to have the IRS run the country's defense system . . . [] would not mean that bespectacled revenue agents would be parachuting into the Hindu Kush wearing night goggles, camouflage, and pocket protectors.").

12 A direct subsidy administered by, for example, the Department of the Interior could, of course, be designed to exclude tax-exempt actors. While theoretically possible, such a limitation might be difficult to explain.

13 Historic Boardwalk Hall, LLC v. Comm'r , 694 F.3d 425, 462–63 (3d Cir. 2012),

Hardly unique, transactions designed to "monetize" rehabilitation credits enjoy distinct advantages. For instance, unlike the low-income housing credit, the rehabilitation credit faces neither an upper limit on the availability of the credit to particular taxpayers nor an overall cap on rehabilitation credits allowed per year.[14] The ability to monetize an uncapped tax credit with few substantive restrictions on its availability presents an opportunity for taxpayers and a challenge for tax authorities.

Unsurprisingly, given their starkly different perspectives, taxpayers and tax authorities have come into conflict over these transactions. Over the past few years, partnerships designed to facilitate transfers of rehabilitation credits from active participants in historic preservation projects to entities with substantial tax liabilities have come under close scrutiny. Tax authorities have upended the expectations of taxpayers and advisors by successfully challenging transactions that many would place well within the mainstream.

The line between investments in projects eligible for the rehabilitation credit and similar state law tax benefits on the one hand and purchases of credits on the other became the subject of two prominent judicial decisions in as many years. In 2011, the Fourth Circuit decided *Virginia Historic Tax Credit Fund v. Commissioner*, declaring that the taxpayers were not acting as investors but instead had purchased tax credits provided by Virginia law.[15] In 2012, the Third Circuit's opinion in *Historic Boardwalk Hall, LLC v. Commissioner* rejected a taxpayer's claim that it had invested in a partnership created to renovate a historic structure and instead concluded that the transaction amounted to an impermissible purchase of rehabilitation credits.[16] In both cases, the courts elided the economic substance question, despite grounding their conclusions on the absence of investment risk.[17]

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reh'g denied, 2012 U.S. App. LEXIS 24170 (3d Cir. Oct. 22, 2012).

14 *See* Treas. Reg. § 1.48-12 (2011). Although it can be monetized, the rehabilitation credit faces strict limits on its transfer. In a sense, the low-income housing credit presents the mirror image of the rehabilitation credit. On the one hand, the amount of credits that can be claimed in any one year is limited since the credit is allocated to states according to a detailed formula. *See* I.R.C. § 42 (2011). On the other hand, it is relatively generous in allowing transferees to claim the credit. *Compare* I.R.C. § 42(d)(7) (generally allowing purchasers of property to claim low-income housing credits the seller of the property could have claimed), *with* Treas. Reg. § 1.48-12(c)(3)(ii) (allowing rehabilitation credits only to the first user of rehabilitated property).

15 639 F.3d 129, 145–46 (4th Cir. 2011).

16 *Historic Boardwalk*, 694 F.3d at 462–63.

17 *Virginia Historic Tax Credit* and *Historic Boardwalk* are, of course, different in that the former involves a state tax benefit rather than a federal benefit. As the Tax Court notes in *Virginia Historic Tax Credit*, in some contexts federal tax provisions treat the pursuit of state tax benefits as a legitimate, non-tax business purpose sufficient to inoculate a transaction. *See* Va. Historic Tax Credit Fund v. Comm'r, T.C. Memo 2009-295, at *12 (citing to [I.R.C.] § 355's acknowledgement of the pursuit of tax benefits as a

Although it did not rule on the question of whether the investors were partners, the Fourth Circuit catalogued a host of factors that raised doubts regarding the purported investors' intent to share risk and return.[18] Rather than benefiting from the favorable treatment provided for investments in a partnership, the transaction was taxed like any other sale of goods.[19] Looking beyond the form chosen by the parties, it concluded "that the only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery."[20] Accordingly, the opinion invoked a regulatory presumption that reciprocal transfers between partners and partnerships occurring within two years constitute sales rather than investments,[21] and determined that the relevant "factors strongly counsel for a finding that these transactions were sales."[22]

In *Historic Boardwalk*, the Third Circuit focused squarely on the eligibility of an investor for the rehabilitation credit.[23] The investor, a corporation, acquired an interest in a limited liability company—classified as a partnership for tax purposes—formed by a state agency to conduct a major renovation of a historic property.[24] Overturning the Tax Court's decision[25] that the investor was entitled to claim rehabilitation credits generated by the renovation, the Third Circuit concluded that the investor was not a "bona fide partner" because the investor "lacked a meaningful stake in either the success or failure" of the venture giving rise to the rehabilitation credits.[26]

In articulating the basis for its decision, the Third Circuit embraced the government's view that, although its holding rested on an application of the disguised sale rules, *Virginia Historic Tax Credit* was relevant to its analysis of the investor's status as a partner.[27] The

legitimate business purpose so long as the bulk of the benefits are nonfederal).

18 *Va. Historic Tax Credit*, 639 F.3d at 143–44.

19 Treating the state tax credits no differently than any other property that a partnership might buy or sell, the opinion found that Congress intended I.R.C. § 707 to apply broadly enough to warrant treating the Virginia credits as property. *Id.* at 142. As the proceeds of a sale of property, the Fourth Circuit concluded that what were labeled investors' contributions represented taxable income for the transferors for credits. *Id.*

20 *Id.* at 145.

21 Treas. Reg. § 1.707-3(c) (2011).

22 *Va. Historic Tax Credit*, 639 F.3d at 143–44.

23 Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 448 (3d Cir. 2012), *reh'g denied*, 2012 U.S. App. LEXIS 24170 (3d Cir. Oct. 22, 2012).

24 *Id.* at 429. The investor acquired its interest in the limited liability company through a wholly-owned subsidiary.

25 The Commissioner's loss in the Tax Court can be traced largely to that court's conclusions regarding the economic nature of the investor's interest. *See, e.g.*, Historic Boardwalk Hall, LLC v. C.I.R., 136 T.C. 1, 30 (2011) (concluding that the investor's partnership "interest is not more like debt than equity because [the investor] is not guaranteed to receive a 3-percent return every year").

26 *Historic Boardwalk*, 694 F.3d at 463.

27 *Id.* at 454 n.54 (noting that the taxpayer "simply ignores why many of the

court found both *Virginia Historic Tax Credit* and *Castle Harbour*—an earlier Second Circuit case concluding that a taxpayer's stake in a partnership resembled debt too closely to be "a bona fide equity participation"[28]—helpful in evaluating the investor's stake.[29] Each case, the court explained, illuminates the central question of the investor's status by highlighting the importance of risk and reward.[30]

The court traced that question to *Culbertson v. Commissioner*, which asks "whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of [an] enterprise."[31] In determining that the corporate investor in *Historic Boardwalk* was not a bona fide partner, the Third Circuit found that the investor had "no meaningful downside risk"[32] and "a dearth of any meaningful upside potential."[33] Although the parties scrupulously maintained the form of a partnership investment—"[r]ecruiting teams of lawyers, accountants, and tax consultants" to accomplish it—the "substance of [the] transaction . . . was calculated to be a 'sale of . . . historic rehabilitation tax credits.'"[34]

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principles espoused in *Virginia Historic* are applicable here" and that "*Virginia Historic* is telling because the disguised-sale analysis in that case touches on the same risk-reward analysis that lies at the heart of the bona fide-partner determination" (internal quotation marks and citations omitted)).

28 TIFD III-E, Inc. v. United States, 459 F.3d 220, 231 (2d Cir. 2006) (concluding that the "interest was overwhelmingly in the nature of a secured lender's interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits").

29 *Historic Boardwalk*, 694 F.3d at 461.

30 *Id.* at 454–55 ("*Castle Harbour*'s analysis that concluded that the banks' 'indicia of an equity participation in a partnership' [were] only 'illusory or insignificant,' and *Virginia Historic*'s determination that the limited partner investors did not face the 'entrepreneurial risks of partnership operations,' are both highly relevant to the question of whether [the taxpayer] was a partnership in which [the investor] had a true interest in profit and loss, and the answer to that question turns on an assessment of risk participation" (internal citations omitted)).

31 Comm'r v. Culbertson, 337 U.S. 733, 742 (1949). Some experts have questioned the continuing relevance of *Culbertson*. *See, e.g.*, Ethan Yale, *Defining "Partnership" for Federal Tax Purposes*, 131 TAX NOTES 589, 589 (2011) (concluding that the belief that "taxpayer purpose is central to a finding of partnership validity" is "misguided"). Despite such concerns, *Culbertson* plays a key role in defining partnerships for tax purposes. *See* Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 978 (2006) (describing *Culbertson* as a "bellwether[] in defining tax partnership").

32 *Historic Boardwalk*, 694 F.3d at 455 (concluding that "it was, for all intents and purposes, certain to recoup the contributions it had made to [Historic Boardwalk Hall] and to receive the primary benefit it sought—the [historic rehabilitation tax credits] or their cash equivalent").

33 *Id.* at 459–60 (noting that "[e]ven [Historic Boardwalk Hall's] own rosy financial projections from 2000 to 2042, which (at least through 2007) had proven fantastically inaccurate, forecasted no residual cash flow available for distribution" to the investor).

34 *Id.* at 462 (internal citation omitted).

II
TAX EXPENDITURES AND ECONOMIC SUBSTANCE

At one level, the conflict described above simply reflects the inevitable challenges presented by the unlikely combination of historic preservation and tax credits. At another, the questions it raises highlight the turbulence produced by a pair of profound structural changes in the law, each decades in the making. First, tax expenditures such as the rehabilitation credit have become—in the era of budget deficits and fiscal crises—increasingly popular fiscal policy tools.[35] Second, the elevation of the ESD from judicial doctrine to statute represents a long-awaited response to decades of tax-motivated transactions.

The rehabilitation credit starkly illustrates the challenge tax authorities face in an era in which both tax-motivated transactions and tax expenditures have proliferated. By its terms, the rehabilitation credit is permissive.[36] Lacking the express limitations imposed on other tax expenditures, the rehabilitation credit statute relies on market frictions to limit monetization transactions and other potential abuses.[37] As market innovations erode those frictions, authorities are confronted with the task of distinguishing abusive transactions from those consistent with the congressional aims of the rehabilitation credit.

Unfortunately, as is true whenever Congress uses a tax expenditure to promote a socially desirable activity, familiar landmarks that practitioners use to navigate the tax laws become unreliable. Although the ESD is as close to a basic law as any a tax lawyer knows, it breaks down when applied to a subsidized transaction.

Insisting that the purchase of a home yield a positive economic pre-tax return in order to be eligible for the home mortgage interest deduction makes little sense.[38] In the context of the rehabilitation

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35 *See* Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 17 (2010) ("Tax expenditures today constitute a truly extraordinary proportion of Government intervention in the allocation of capital and labor in the private markets. Tax expenditures have grown at rates much faster than explicit Government spending and at rates that exceed even increases in mandatory spending.").

36 The renewable energy credit provides a phaseout that reduces the subsidy when prices rise beyond a specified amount. *See* I.R.C. § 45(b)(1) (2011). The low-income housing credit provides detailed limitation and allocation provisions, calculated in part based on state populations. *See* I.R.C. § 42(h) (2011).

37 David Schizer borrows the term "frictions" from the economics literature to describe factors such as "high transaction costs, adverse financial accounting, or unappealing regulatory treatment" that constrain taxpayer behavior, creating implicit limits that supplement the explicit requirements of statutes and regulations. David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315 (2001).

38 The codified ESD explicitly excludes personal transactions. *See infra* note 60 and

credit, if Congress expected investments in historic structure renovations to yield returns of the type that would attract private capital without regard to tax benefits—which is essentially what the ESD demands—enacting a tax subsidy to attract those investments would be equally odd. When deprived of such signposts, even the most seasoned advisor or tax agent can find it difficult to know whether a particular transaction meets muster.

The litigation discussed above highlights the most significant fault lines that have emerged between would-be investors and tax authorities on the question of rehabilitation credit eligibility. Although they center on complex transactions, the question they raise is simple: how robust an economic stake in a rehabilitation project must an investor hold to capitalize on these state and federal incentives? In any other context, the ESD would guide taxpayers and tax authorities towards an answer.

When a tax expenditure like the rehabilitation credit fuels a transaction, the ESD—like the ordinarily dependable HAL—becomes unreliable. In a conventional transaction, taxpayers satisfy the ESD by demonstrating that an investment would have been made even without tax benefits.[39] Subsidized transactions inevitably fare poorly under that standard. The next Part describes an alternative vision of the ESD that would offer the same guidance for the growing pool of subsidized transactions long available to conventional transactions.

III
RECONCILING CONFLICTING CONGRESSIONAL MANDATES

Tax expenditures have seized a central role in today's policymaking environment. This Part describes two avenues through which the ESD might be reconciled with tax subsidies such as the rehabilitation credit, orienting the taxpayers and tax authorities now feeling their way through a tangle of conflicting obligations. Legislative action offers the best hope of a comprehensive solution. The codification of the ESD also raises the possibility that courts might offer a vision of the doctrine that accommodates subsidized transactions.

Congress clearly has the power to impose ex ante limits on the availability of tax subsidies. For proof, one need look no further than the legislation underlying the tax expenditures themselves. The statute creating the low-income housing credit provides a detailed allocation mechanism for a circumscribed pool of available credits.[40] The renewable energy credit does not impose a cap but provides a

accompanying text.

39 *See infra* note 56.

40 *See* I.R.C. § 42.

subsidy that shrinks as prices rise, targeting support to the projects most likely to need it.[41]

The rehabilitation credit statute, by contrast, provides little in the way of ex ante guidance regarding which rehabilitation projects deserve support. Any renovation of a sufficiently old building, so long as it preserves the bulk of the building's physical structure, for example, is a "qualified rehabilitated building."[42] Lacking much in the way of such express limitations, the rehabilitation credit makes a ripe target for tax planning.

The only significant constraints on the availability of the rehabilitation credit are implicit. Namely, rehabilitation credits are not refundable and cannot be sold.[43] As a result, not every "substantial" renovation of a "qualified rehabilitated building" will generate a credit. Only those both participating in such a renovation *and* owing a significant amount of tax will enjoy the full subsidy provided by the credit.

In a conventional transaction, the ESD would lend teeth to those implied limits. For example, a taxpayer merely posing as an owner but insulated from the economic consequences of ownership would be stripped of tax benefits generated by the property in question. But when Congress creates a tax benefit that invites taxpayers to behave in ways that they otherwise would not, the ESD can no longer distinguish fact from fiction by scrutinizing a taxpayer's motives.

Simply put, in any subsidized transaction an investor's motives are necessarily tainted. Accelerated depreciation, for example, stimulates investment in business assets.[44] Purchases that business motives alone would not sustain yield a positive return once depreciation is taken into account. Ordinarily, the ESD rejects transactions inspired by tax benefits rather than profits, but stripping tax benefits such as depreciation from a subsidized transaction because a taxpayer claimed the proffered subsidy would be perverse.

More narrowly targeted tax expenditures such as the rehabilitation credit pose a similar challenge. Just as accelerated depreciation prompts investments that would not otherwise be made, a subsidized rehabilitation project may not have a sufficient non-tax motivation. Requiring subsidized transactions to meet the traditional ESD standard would frustrate legislators' desire to put a thumb on the scale in favor of investments in, for example, low-cost housing or

41 *See* I.R.C. § 45(b)(1).

42 I.R.C. § 47(c)(1)(A) (designating any renovation of a building placed in service before 1936 that meets specific quantitative thresholds regarding the preservation of internal and external components as a "qualified rehabilitated building").

43 Treas. Reg. § 1.48-12(c)(ii)(2) (2011).

44 *See* I.R.C. § 168.

renewable energy.[45] The other extreme would produce equally absurd results. If the tax benefit were simply included in the calculation of the investment's pre-tax return, the result would reveal more about the generosity of the subsidy than the nature of the transaction in question.[46]

Congress could easily adapt the ESD's requirements to subsidized transactions. By focusing on an investor's exposure to losses rather than its expectation of profit, a modified economic substance test could distinguish between transactions that represented a meaningful economic commitment on the part of an investor and those better thought of as an illicit purchase of tax benefits.[47]

This is precisely the approach that tax authorities have taken in launching Hollywood-style rescue missions for particular tax expenditures. Their most recent act of derring-do benefitted rehabilitation credit transactions: so long as a transaction steers clear of a litany of prohibited features, taxpayers need not fear that their tax credits will meet the same fate as those in the *Historic Boardwalk* transaction.[48] Prominent among those forbidden elements are

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45 For precisely that reason, the legislative history of the codified ESD notes that "it is not intended that a tax credit (e.g., . . . section 47 (rehabilitation 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." STAFF OF J. COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 152 n.344 (Comm. Print 2010).

46 The American Bar Association has written in support of treating tax credits as cash for this purpose. ABA Tax Section, *Comments on Notice 2010-62* at 33, *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2011/011811 comments.authcheckdam.pdf ("[P]re-tax profit should also include, as a revenue item, any Federal, State, or local tax credits to the extent such credits are specifically intended to encourage a particular activity, and the transaction actually results in that activity.").

47 As the codified economic substance doctrine suggests, a transaction's "profit potential" traditionally plays an important role, possibly being "taken into account in determining whether the requirements" of both its subjective and objective elements have been satisfied. *See* I.R.C. § 7701(o)(2)(A). Despite its traditional importance, profit potential is not essential. *See* Hariton, *supra* note 2, at 241 (noting that "[m]uch confusion has . . . been engendered by a tendency to mistake lack of adequate profit potential . . . for a desideratum in and of itself"). Congress could offer guidance—comparable to § 7701(o)(2)'s guidance on profit potential—as to what degree of risk would satisfy the objective factor of the codified test. A generous test might look for meaningful pre-tax downside risk while a more stringent test would likely take tax benefits into account. That risk of loss could not, however, satisfy the subjective intent-based prong of the test as profit potential currently does. Presumably, a desire to further the congressional objectives of the tax expenditure in question—to rehabilitate historic buildings or produce renewable energy, for example—would satisfy the intent element of the test.

48 *See* Rev. Proc. 2014-12, § 3, 2014-3 I.R.B. 415 (providing that authorities "will not challenge a Partnership's allocations of validly claimed § 47 rehabilitation credits if the Partnership and its partners satisfy the Safe Harbor"). That Revenue Procedure follows in a long line of efforts by tax authorities to help taxpayers find their way. *See, e.g.*, Rev. Proc.

protections against losses by the purported investor.[49]

While welcome, that recently announced safe harbor falls far short of the aid the ESD could provide. Taxpayers can hardly object to the legal equivalent of a manicured lawn hewn out of the confusion they otherwise confront. Still, whenever a transaction ventures beyond the narrow confines of the safe harbor, taxpayers find themselves in the same treacherous landscape as before. An ESD for subsidized transactions would arm taxpayers and tax authorities with a lodestar that they could turn to for guidance anywhere.

In practical terms, the safe harbor requires taxpayers to demonstrate their bona fides by exposing themselves to potential losses from the subsidized investment. An ESD for subsidized transactions could do the same, broadening the safe harbor's approach to tax expenditure–driven activity in general. Its breadth would necessarily limit its precision—it could hardly offer the detail the safe harbor offers[50]—but, as is generally true of standards, the ESD's strength is not incompatible with ambiguity.[51]

The legislative approach is the obvious one. The tax laws are, after all, congressional handiwork. Still, amending the recently codified ESD to address subsidized transactions offers only one possible solution. Historically, the constitution constrained courts' capacity to invoke the ESD. As a common law doctrine, the ESD fared poorly when confronted by a tax expenditure. Understandably,

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2001-28, 2001-1 C.B. 1156 (specifying "guidelines that the Internal Revenue Service will use for advance ruling purposes in determining whether certain transactions purporting to be leases of property are, in fact, leases for federal income tax purposes"). The leveraged leasing guidance apparently served as a model for key aspects of Revenue Procedure 2007-65 (focusing on subsidized renewable energy transactions) and Revenue Procedure 2014-12.

49 *See, e.g.*, Rev. Proc. 2014-12, § 4.05, 2014-3 I.R.B. 415 (permitting only "unfunded . . . completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants," but not similar guarantees backed by "money or property" or other types of guarantees whether funded or unfunded).

50 Administrative guidance targeted at a specific type of transaction can translate broad principles into the vocabulary of that transaction. For example, the recent rehabilitation tax credit guidance uses terms such as "placed in service" that have a well-understood meaning in such transactions but would not apply in other contexts. *See id.* § 4.03 ("The Investor Minimum Contribution equals 20 percent of the Investor's total expected capital contributions required under the agreements relating to the Partnership as of the date the Building is placed in service.").

51 *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 577 (1992) (comparing strengths and weaknesses of rules and standards). Kaplow notes that, by reducing the up-front burden on government actors, standards may be especially useful "when acts governed by a law vary greatly in relevant characteristics, and each is unlikely to occur." *Id.* at 582. In the tax context, standards help prevent taxpayers from meeting the letter of the law while violating its spirit. Tax authorities need not specify each of a virtually infinite number of possible variations on a particular abusive tax planning strategy in advance.

a court would be reluctant to find an investment lacked economic substance—thereby declaring it inconsistent with congressional aims—simply because a taxpayer was drawn to the transaction by congressional generosity.[52]

Courts' reluctance to invoke the ESD in this context helps explain the Third Circuit's approach in *Historic Boardwalk*. The court found that the purported investment should be disregarded because the investor "lacked a meaningful stake in either the success or failure" of the enterprise.[53] It did not, however, invoke the ESD as the basis of its decision, despite essentially reaching the conclusion that the taxpayer's investment lacked economic substance.[54]

The codification of the ESD in 2010 arguably eliminated the need for such contortions. The clear constitutional hierarchy that gave legislative imperatives primacy over the common law ESD would not have—under ordinary circumstances—survived codification. By elevating the ESD from common law to a statute, codification set tax expenditures and the ESD on a more equal footing from a constitutional perspective.[55]

In crafting the ESD statute, Congress may have legislatively recreated that lost constitutional pecking order. Legislators declined to imbue the ESD with the full measure of their authority. The statute provides that the ESD applies to a transaction when the same would have been true if the ESD statute "had never been enacted."[56]

From one point of view, that caveat strips courts of whatever constitutional advantage congressional action would typically provide. In practice, the proviso's constitutional import depends on whether Congress can—or perhaps whether it intended to—impose separation of powers constraints on courts' ability to deploy the ESD. When evaluating *conventional* transactions, courts have long been free

52 ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 2215 (1997) ("The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.").

53 Historic Boardwalk Hall, LLC v. Comm'r, 694 F.3d 425, 463 (3d Cir. 2012), *reh'g denied*, 2012 U.S. App. LEXIS 24170 (3d Cir. Oct. 22, 2012).

54 The court's idiosyncratic "meaningful stake" analysis permitted it to avoid an obvious constitutional conflict by challenging a statute with the common law ESD.

55 Before codification, the ESD generally had little hope of overcoming the constitutional separation of powers threshold. Even in an extreme case—had Congress, for example, promised a tax benefit for taxpayers performing backflips—absent a showing that the statute failed to satisfy basic constitutional requirements such as equal protection, courts would be compelled to defer to legislators. The common law ESD—crafted to prevent taxpayers from defying Congress—has no role to play where taxpayers merely accept tax benefits according to a statute's economically meaningless terms.

56 I.R.C. §7701(o)(5)(C) (2011) ("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.").

to reject transactions so "devious" that they "deprive the statutory provision in question of all serious purpose" even though "conducted according to the terms" of a given statute.[57] After codification, courts may no longer need to stand aside—to avoid "violat[ing] the separation of powers"—when scrutinizing an equally devious *subsidized* transaction "where a taxpayer has satisfied all statutory requirements established by Congress."[58]

To the extent that Congress could not—or simply did not—geld the codified ESD, courts themselves can now openly apply the ESD even to subsidized transactions that nominally satisfy the requirements of a subsidy like the rehabilitation tax credit. Under that view, codification made deploying the ESD against a wayward subsidized transaction an exercise in balancing—not defying—statutory mandates.[59] For tax expenditures directed toward individuals, the change made little difference. Even without the statutory exception introduced for "personal transactions of individuals," most such tax benefits would easily survive ESD scrutiny.[60]

For tax expenditures like the rehabilitation credit that are aimed at businesses, lowering that constitutional obstacle to judicial intervention would be more significant. While one home purchase looks much like any other—so that if Congress intended to subsidize one, it presumably meant to subsidize them all—corporate transactions can vary greatly in their details. Simply because Congress intended to benefit some of those transactions need not mean that every transaction in which a nominal owner engages in a rehabilitation project must share in that largesse.[61] A purported investment that—as the Third Circuit found in *Historic Boardwalk*—

57 Gregory v. Helvering, 293 U.S. 465, 470 (1935).

58 Coltec Indus. v. United States, 62 Fed. Cl. 716, 756 (2004), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006).

59 *See* I.R.C. § 7701(o)(1) (requiring a taxpayer to demonstrate that "the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position" and that "the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction"); *see also* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 218 (2002) (concluding that codification alleviates separation of powers concerns).

60 *See* I.R.C. §7701(o)(5)(B) (providing that the ESD "shall apply only to transactions entered into in connection with a trade or business"). It would be odd indeed to question the motives of a taxpayer who purchases a home largely because of a tax incentive that Congress created to encourage precisely such activity.

61 The legislative history of the predecessor of today's credit seems to envision transactions—quite different from the complex transaction scrutinized in *Historic Boardwalk*—in which businesses rehabilitate property they own or lease so that they can then use the rehabilitated properties as "factories, warehouses, office buildings, hotels, and retail and wholesale stores." STAFF OF J. COMM. ON TAX'N, 95TH CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978 (H.R. 13511, 95TH CONGRESS, PUBLIC LAW 95-600) 155 (Comm. Print 1979) (footnote omitted).

failed to provide an investor with a "meaningful economic stake" would almost certainly fall on the wrong side of that divide and should be vulnerable to a challenge under the codified ESD.

Subsidized transactions need the ESD just as conventional transactions do. Although legislators may never squarely take responsibility for the confusion that flows from the clash between the ESD and tax expenditures, the codification of the ESD may offer courts an opportunity to intervene. The stark truth revealed by the lack of downside risk—where the conventional focus remains fixed on profit potential—could help to identify transactions that do not deserve to be subsidized.[62] Truly dangerous astronauts would still be denied access to the airlock, but the innocent could be spared.

CONCLUSION

The increasing importance of tax expenditures as fiscal policy tools has made the inapplicability of the ESD to subsidized transactions more than a nuisance. Fortunately, more catastrophes are not inevitable. Congress or the courts could reorient the ESD to suit subsidized transactions. Tax authorities have shown how to do precisely that by shifting from the doctrine's traditional focus on profits to an examination of a purported investor's risk of sustaining losses.

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62 Profit potential has become a reliable indicator of economic substance but need not be present for a transaction to have economic substance. *See* Hariton, *supra* note 2, at 241.