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Dodging the Taxman: Why the Treasury's Anti-Abuse Regulation is Unconstitutional

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To combat abusive tax shelters, the Department of the Treasury promulgated a general anti-abuse regulation applicable to all of subchapter K of the Internal Revenue Code of 1986. The Treasury targeted subchapter K because unique aspects of the partnership tax laws—including its aggregate-entity dichotomy—foster creative tax manipulation. In the anti-abuse regulation, the Treasury attempted to "codify" existing judicially- created anti-abuse doctrines, such as the business-purpose and economic-substance doctrines. Also, and more surprisingly, the Treasury directed those applying subchapter K to use a purposivist approach to interpretation and to reject textualism.

In this article, I demonstrate that the Treasury exceeded both its constitutional and statutory authority. Congress neither expressly nor implicitly delegated to the Treasury the power either to direct a method of statutory interpretation or to codify the judicially developed anti-abuse doctrines. Hence, the regulation is unconstitutional. Alternatively, even if Congress validly delegated either power to the Treasury, the

[*] Ellison Capers Palmer Sr. Professor of Law in Tax, Mercer University School of Law. I am deeply indebted to Professor James Repetti for his support, suggestions, and comments. Professors Philip Hackney, Steve R. Johnson, Leandra Lederman, Ronald Levin, Gail Richmond, Sidney Shapiro, Gary Simson, Louis Virelli, Eugene Volokh, and tax attorneys Ivy Cadle, Ryan Kelly, G. Boone Smith, IV, and Christopher Steele all offered invaluable suggestions. Special thanks to librarian James Walsh and research assistant, Rachel Turnbull, JD expected 2015, who both provided excellent research and editing assistance.

anti-abuse regulation exceeded the scope of any delegated power and is, thus, ultra vires.

INTRODUCTION

Imagine that tomorrow the Treasury promulgated a new regulation that directs all taxpayers to ignore the words in the Tax Code and instead pay the amount of taxes that Congress expects them to pay. Further, imagine that the regulation empowers the Commissioner of the Internal Revenue Service ("Commissioner" and "Service") to reject tax returns that comply with the literal language in the Code, but violate its spirit. Finally, imagine that Congress never delegated the authority to the Treasury to promulgate such a regulation. Would this be a legitimate executive response to perceived tax abuse or an unconstitutional power grab?

There is no need to imagine. In 1994, the Treasury promulgated a regulation almost identical to the hypothetical one in response to the abusive tax shelters of the 1990s. Treasury Regulation 1.701-2, the anti-abuse regulation, applies to subchapter K, the partnership chapter of the Internal Revenue Code of 1986. Greatly simplified, the anti-abuse regulation permits the Commissioner to recast any partnership transaction that is inconsistent with "the intent of subchapter K. . . ."[1] The regulation defines the intent of subchapter K by referencing judicially developed anti-abuse doctrines unique to tax law, including the business-purpose doctrine and the substance-over-form principles.[2]

The anti-abuse regulation does two unusual things. First, it imposes an overarching standard on top of subchapter K's rules, and in doing so, it fundamentally changed existing law. Second, and more surprisingly, the anti-abuse regulation directs those interpreting subchapter K to use purposivism and to reject textualism. This directive squarely raises the questions of how tax statutes ought to be interpreted and of who ought to choose the interpretive method. At bottom, the regulation pits textualism against purposivism, rules against standards, and the judiciary against the executive.

In 2010, Congress codified the economic-substance doctrine.[3] Oddly, Congress did not clearly identify when its new statute applies; rather, courts have complete discretion regarding the statute's application.[4] Because the statute provides no guidance, the Treasury and the courts may well turn to the anti-abuse regulation to fill the

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1 Treas. Reg. § 1.701-2 (1995).

2 *Id.* §1.701-2(a).

3 I.R.C. § 7701 (West 2014).

4 Pursuant to § 7701(o)(1), the economic substance doctrine applies whenever it is "relevant." *Id.* § 7701(o)(1). Relevancy is not defined; however, the statute states that the decision of "whether the economic[-]substance doctrine is relevant to a transaction shall be made in the same manner as if [the codified economic-substance doctrine] had never been enacted." *Id.* § 7701(o)(5)(C).

gaps when applicability of the economic-substance statute is uncertain. Indeed, in *Nevada Partners Fund, L.L.C. v. United States*, the Service did just that.[5]

However, the anti-abuse regulation should not fill those gaps because it is unconstitutional or, alternatively, *ultra vires*. In this Article, I explain that because Congress never delegated authority to the Treasury to issue the anti-abuse regulation, the regulation is unconstitutional. Moreover, even if Congress implicitly delegated such authority, the Treasury's regulation exceeded the bounds of that delegation, making the regulation *ultra vires*. In exploring these concerns, I examine a question never before addressed in either the academic literature or jurisprudence: when agencies discern the legislative intent or statutory purpose for a group of related statutes, in this case seventy-two separate statutes making up subchapter K, is their determination entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*?[6] In my opinion, the answer to that question is no; agencies are entitled to *Chevron* deference when they interpret ambiguous statutory language in a statute, not when they discern the statutory purpose or legislative intent for a group of statutes.

In Part I of this Article, I introduce the problem that led to the regulation: *abusive* tax shelters of the 1990s. Because the tax shelters of the '90s differed from those of the '70s and '80s, a new approach was needed.[7] To combat this new form of tax shelter, the Treasury chose a standards-based approach.[8] In Part II, I explain why the agency selected a standards-based approach and why the agency targeted subchapter K. While abusive tax shelters were not unique to partnerships, subchapter K was a logical chapter for the Treasury to target because tax avoidance is one reason taxpayers choose this particular business entity.[9] Moreover, unique aspects of the partnership tax laws—including its aggregate-entity dichotomy—allow for innovative tax manipulation.[10]

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5 Nev. Partners Fund, L.L.C. *ex rel.* Sapphire II, Inc. v. United States *ex rel.* IRS, 720 F.3d 594, 606 (5th Cir. 2013).

6 Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984).

7 *See infra* note 41.

8 *See infra* text accompanying notes 66–74.

9 *See* Cottage Sav. Ass'n v. Comm'r, 890 F.2d 848, 853 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991).

10 *See infra* notes 59 & 64.

Next, in Part III, I describe the proposed regulation, the outrage it caused, the changes that were made, and the final regulation. The final regulation permits the Commissioner to recast a partnership transaction used in a manner inconsistent with "the intent of subchapter K."[11] The final regulation included two provisions that raise constitutional questions: (1) one directs interpreters of subchapter K to use purposivism, and (2) the other defines the "intent of subchapter K" by adopting and significantly modifying the judicially developed anti-abuse doctrines.[12]

While the controversy and hullabaloo over the regulation's promulgation were fierce, the regulation's validity has been virtually ignored since its promulgation. Thus, in Part IV, I demonstrate that the Treasury exceeded both its constitutional and statutory authority. Congress neither expressly nor implicitly delegated to the Treasury the power either to direct a method of statutory interpretation or to codify the judicially developed anti-abuse doctrines. Hence, the regulation is unconstitutional. Alternatively, even if Congress validly delegated either power to the Treasury, the anti-abuse regulation exceeded the scope of any delegated power and is, thus, *ultra vires*.

Finally, I conclude by conceding that abusive tax shelters are a problem and will continue to be a problem for a long time to come. While the Treasury's goal in trying to stop the abuse is laudable, its response is a bold and unconstitutional power grab.

I. IDENTIFYING THE PROBLEM: ABUSIVE TAX SHELTERS

Tax avoidance is as "American" as apple pie and baseball. Indeed, tax protesting predated the imposition of income tax in this Country; after all, the Boston Tea Party was an organized revolt against the imposition of a tax on tea. More recently, instead of dumping dried green leaves into a harbor, marijuana enthusiasts distributed 600 free joints as an organized revolt against Colorado's attempt to impose a tax on that drug.[13]

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11 Treas. Reg. § 1.701-2(b)(1) (1995).

12 *Id.* § 1.701-2(b), (e)(1).

13 Michael Winter, *Tax Opponents Hand Out Free Pot in Denver*, USA TODAY (Sept. 9, 2013, 10:53 PM), http://www.usatoday.com/story/news/nation/2013/09/09/denver-free-marijuana-tax-protest/2790133/.

Since the federal government began collecting taxes, taxpayers have sought ways to minimize or avoid paying them, including employees from the Service.[14] Taxpayers are reasonable people and, if given a choice, will choose transactions that minimize their tax obligations and maximize their income; their choice becomes improper when the transaction is one that is chosen only to avoid taxes.[15]

Tax planning and minimization are inevitable, unavoidable,[16] and even acceptable.[17] "[P]lanning to reduce taxes is not only proper, it is the *sine qua non* of a sound business plan."[18] To reduce taxes, taxpayers turn to the language of the tax laws. The tax code is a "complex and detailed set of statutes subject to traditional interpretive analysis."[19] How much tax reduction and avoidance is legitimate? Tax experts fundamentally disagree, and their disagreement

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[14] Josh Hicks, *IRS Paid Bonuses to Tax-delinquent Employees, Report Says*, WASH. POST (Apr. 23, 2014), http://www.washingtonpost.com/blogs/federal-eye/wp/2014/04/23/irs-paid-bonuses-to-tax-delinquent-employees-report-says/?tid=hpModule_308f7142-9199-11e2-bdea-e32ad90da239.

[15] Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1949–50 (2005).

[16] Scott A. Schumacher, MacNiven v. Westmoreland *and Tax Advice: Using "Purposive Textualism" to Deal with Tax Shelters and Promote Legitimate Tax Advice*, 92 MARQ. L. REV. 101, 107 (2008) ("[T]ax planning and minimization are both inevitable and unavoidable.").

[17] *See* Comm'r v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."); United States v. Isham, 84 U.S. (17 Wall.) 496, 506 (1873) (stating that when tax avoidance "is carried out by the means of legal forms, it is subject to no legal censure"); Knetsch v. United States, 364 U.S. 361, 365 (1960) ("The legal right of a taxpayer to decrease the amount of . . . his taxes, or altogether avoid them, by means which the law permits, cannot be doubted . . . .") (quoting *Gregory*, 293 U.S. at 469); *see also* Edwin S. Cohen, *Tax Avoidance Purpose as a Statutory Text in Tax Legislation*, 9 PROC. ANN. TUL. TAX INST. 229, 230 (1960).

[18] Herman J. Marino, *The Final Partnership Anti-Abuse Regulation: The Treasury Redefines the "Intent of Subchapter K"*, 73 TAXES 171, 172 (1995).

[19] Linda D. Jellum, *Codifying and "Miscodifying" Judicial Anti-Abuse Doctrines*, 33 VA. TAX REV. 579, 589 (2014) [hereinafter Jellum, *Judicial Anti-Abuse Doctrines*]; *see* Elizabeth Garrett, *Viewpoint: Remarks on Anti-Abuse Rules*, 74 TAXES 197, 199 (1996); Brian Galle, *Interpretative Theory and Tax Shelter Regulation*, 26 VA. TAX REV. 357, 358 (2006). Tax exceptionalism—the notion that tax statutes should be interpreted differently from other statutes—has largely been rejected. *See* Kristin E. Hickman, *Goodbye Tax Exceptionalism*, 12 ENGAGE: J.

stems, in part, from a controversy regarding the best way to interpret the tax code.[20]

Textualists wish to hold Congress and the Treasury strictly to the words in the Code.[21] They argue that if a transaction complies literally with the law, then that transaction should be upheld, even if it is inconsistent with the law's spirit or intent.[22] They see no reason

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FEDERALIST SOC'Y PRAC. GROUPS 4, 4–5 (2011) [hereinafter *Goodbye*]; *see generally* Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537 (2006).

[20] Like the controversy surrounding statutory interpretation more generally, the controversy surrounding tax law interpretation has exploded in the last twenty years. *See, e.g.,* Steve R. Johnson, *Preserving Fairness in Tax Administration in the* Mayo *Era*, 32 VA. TAX REV. 269, 322–23 (2012); Steve R. Johnson, Auer/Seminole Rock *Deference in the Tax Court*, 11 PITT. TAX REV. 1, 4 (2013); Steve R. Johnson, *Deference to Tax Agencies' Interpretations of Their Regulations*, 60 ST. TAX NOTES 665, 665 (2011); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 699 (2009); Steve R. Johnson, *The Two Kinds of Legislative Intent*, 51 ST. TAX NOTES 1045, 1045 (2009); Steve R. Johnson, *Use and Abuse of the 'Plain Meaning'*, 49 ST. TAX NOTES 831, 831 (2008); Allen D. Madison, *The Tension Between Textualism and Substance-over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 716–18 (2003); Andre L. Smith, *The Deliberative Stylings of Leading Tax Law Scholars*, 61 TAX LAW. 1, 2 (2007); Andre L. Smith, *Formulaically Describing 21st Century Supreme Court Tax Jurisprudence*, 8 HOUS. BUS. & TAX L.J. 37, 41–42 (2007); David F. Shores, *Textualism and Intentionalism in Tax Litigation*, 61 TAX LAW. 53, 53 (2007); David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent*, 53 TAX LAW. 579, 580–81 (2000); *Goodbye*, *supra* note 19, at 4; Deborah A. Geier, *Commentary*: *Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 450 (1993); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986); Ernest J. Brown, *The Growing "Common Law" of Taxation*, 34 S. CAL. L. REV. 235, 236–37 (1961) (describing the harm that can arise from undeviating literalness). For a general discussion of the merits of tax literalism and tax nonliteralism, *see generally* Zelenak, *supra* note 20 (urging the Supreme Court to provide better guidance on resolving nonliteral tax issues).

[21] *See, e.g.*, Garrett, *supra* note 19, at 199 ("[T]he language of the statute is the law, and if it is clear, in most cases it should be applied by the Service and by the courts."). For an example of a textualist majority opinion and a purposivist dissenting opinion, see Gitlitz v. Comm'r, 531 U.S. 206, 213, 222 (2001) (majority concluded that the text of the statute was clear, while the dissent reasoned that policy considerations should be taken into account).

[22] Peter L. Faber, *Faber Offers Views on Partnership Antiabuse Reg.*, 94 TNT 167-9, Aug. 25, 1994, LEXIS; Lee A. Sheppard, *Partnership Antiabuse Rule: Dirty Minds Meet Mrs. Gregory*, 64 TAX NOTES 295 (1994) (describing a public hearing regarding the proposed regulations).

for courts to apply the judicially created anti-abuse doctrines[23] that allow the Service to reconfigure business transactions based on their economic impact, as opposed to their literal form.[24]

In contrast, non-textualists argue that textualism, particularly in its literalist form, fosters sham transactions that undermine the legitimacy of the Code.[25] The detailed and highly complex nature of the tax laws create loopholes, allowing taxpayers to pay less in taxes or, in some cases, avoid paying income taxes altogether.[26] Thus, non-textualists believe that textualism encouraged the proliferation of tax shelters by offering them legitimacy.[27]

Non-textualists further lament that this approach to tax compliance involves little peril for taxpayers because the most they risk is paying taxes that they would have had to pay anyway.[28] While the Treasury can assess penalties, the reasonable/good-faith exception hinders this option's effectiveness.[29] More commonly, taxpayers

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[23] *See* Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 589–604 (detailing these doctrines).

[24] *See* Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 25–26 (2004) ("The courts would not have developed the economic substance doctrine if they had been using the textualist method of statutory interpretation.").

[25] *Id.* at 20; *see* Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. REV. 1641, 1644–45 (2012) (noting that one problem for the government is that the sham activities are entirely consistent with the letter of the law); Schumacher, *supra* note 16, at 101 (claiming that hyper-textualism "led too many advisors and their clients to review a position on a 'can I get away with this' analysis"); Zelenak, *supra* note 20, at 633; McCormack, *supra* note 20, at 699 (arguing that "courts should ask whether the results of the transactions (meaning the tax savings claimed) are within the purposes of the Code"); Brown, *supra* note 20, 236–37 (describing the harm that results from literalness).

[26] John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1523 (1997).

[27] Cunningham & Repetti, *supra* note 24, at 2, 20 ("The ascendancy of textualism has had its greatest impact by facilitating the promotion and sale of 'abusive' tax shelters.").

[28] Chirelstein & Zelenak, *supra* note 15, at 1940.

[29] The reasonable/good-faith exception allows taxpayers to claim that they relied on legal opinions from tax lawyers to avoid paying penalties. *See, e.g.*, I.R.C. § 6664(c)(1) (West 2010) ("No penalty shall be imposed . . . with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."). If audited, a taxpayer can "honestly assert that he sought the opinion

who are caught pay less than they would have paid had they not "cheated."[30]

Tax shelters involve transactions that allow a taxpayer to avoid paying taxes that are otherwise due.[31] Just as tax avoidance is not *per se* unacceptable, tax shelters are not *per se* illegitimate.[32] Congress regularly allows taxpayers to avoid paying taxes to encourage specific behaviors. Likely, you have benefited from one of these arrangements. For example, legitimate ways to shelter income include retirement plans, Roth IRA accounts, deductions for home mortgage interest, the Hope scholarship credit, and deductions for small business research and development.[33] Congress creates these tax programs to encourage specific social and economic behavior: the government wants people to save money for retirement, buy homes, go to college, and invest in the research needed to develop new companies.[34] These tax laws allow taxpayers to protect, or shelter, income from immediate federal taxation; hence, they are called tax shelters. Yet, they are not abusive. Abusive tax behavior involves more than

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of reputable counsel and was assured thereby that the tax shelter scheme was consistent with the requirements of the law." Chirelstein & Zelenak, *supra* note 15, at 1941; *see also* LEANDRA LEDERMAN & STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE 472–79 (3d ed. 2009) (discussing the reasonable cause exception for avoiding tax penalties); Schumacher, *supra* note 16, at 123–29 (describing opinion letters and relevant regulations).

[30] For example, in March 2013, Ernst & Young LLP agreed to pay the United States $123 million to resolve a criminal fraud investigation into that firm's alleged use of tax shelters to evade at least $2 billion in taxes. *See* Press Release, Dep't of Justice, *Manhattan U.S. Attorney Announces Agreement with Ernst & Young LLP to Pay $123 Million to Resolve Federal Tax Shelter Fraud Investigation* (Mar. 1, 2013), http://www.justice.gov/usao-sdny/pr/manhattan-us-attorney-announces-agreement-ernst-young-llp-pay-123-million-resolve.

[31] Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 584.

[32] *Id.*

[33] *See* Leandra Lederman, *W(h)ither Economic Substance*?, 95 IOWA L. REV. 389, 395–96 (2010) [hereinafter Lederman, *Economic Substance*].

[34] *See generally id.* at 394–95 (explaining that tax law seeks in some situations to measure taxpayer income and in others to alter taxpayer behavior); *see also* Kristin E. Hickman, *Administering the Tax System We Have*, 63 DUKE L.J. 1717, 1725 (2014) [hereinafter Hickman, *Administering the Tax System*] (noting that many features in the code further social welfare and regulatory goals in addition to seeking revenue).

simply accepting government incentives to protect income; it involves exploiting the tax laws.[35] Examples of abusive tax transactions include those that shift or strip income or basis, including foreign companies,[36] those that creatively arrange financing, and those that involve sale-lease back arrangements.[37]

So, exactly when is a tax shelter illegal? The line between legal and illegal tax shelters is blurred, so blurred that the Service characterizes improper shelters as "abusive" rather than "illegal."[38] Because they can take so many different forms, there is no single definition or prototype of an abusive tax shelter. Consequently, rather than provide one global definition, the Code contains multiple definitions.[39] However, a common theme runs through these definitions:

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[35] Tax avoidance differs from tax evasion. Tax avoiders use the tax laws to reduce the amount of taxes due by lawful means, while tax evaders deliberately misrepresent the true state of their affairs to the tax authorities to reduce their tax liability. *See* Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 994 (2004); Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 696 (1978) ("[I]t is more common to contrast 'tax avoidance' with 'tax evasion,' the former phrase denoting lawful modes of minimizing or avoiding tax liability, while the latter implies fraudulent behavior.").

[36] Because tax rates differ in different countries, companies can set up subsidiaries to absorb tax gains in countries that have no corporate tax, such as the British Virgin Islands. While companies generally pay a registration fee, they pay little to no corporate taxes. *See* PKF INT'L LTD., BRITISH VIRGIN ISLANDS TAX GUIDE 2013 1 (2013), http://www.pkf.com/media/1954323/british%20virgin%20islands%20pkf%20tax%20guide%202013.pdf.

[37] *Interview Carl Levin*, TAX ME IF YOU CAN, PBS (Feb. 19, 2004), http://www.pbs.org/wgbh/pages/frontline/shows/tax/interviews/levin.html.

[38] In 1999, the Treasury identified some common characteristics of *illegitimate* tax shelters: (1) Lack of economic substance or business purpose; (2) Inconsistent financial accounting and tax treatments; (3) Participation by tax-exempt entities or entities that receive a substantial fee to enter into the transaction; (4) Marketing activity; (5) Confidentiality; (6) Tax-saving fee structures; and (7) High transactions costs. U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS v–vi (July 1999), http://www.treasury.gov/press-center/press-releases/Pages/report3095.aspx.

[39] *See, e.g.*, I.R.C. § 6662(d)(2)(C)(ii) (West 2015) ("[T]he term 'tax shelter' means—(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."); *see also id.* § 448(d)(3); *id.* § 6111(c).

abusive tax shelters are business arrangements where "a significant purpose of such . . . arrangement is the avoidance or evasion of Federal income tax."[40]

Regardless of how they are defined, abusive tax shelters were not new in the '90s, but their character changed in two fundamental ways from the tax shelters of the '70s and '80s: (1) the '90s tax shelters exploited more tax laws and involved more sophisticated entities, and (2) tax advising became a profit-seeking activity.[41]

The case of *ACM Partnership v. Commissioner*[42] illustrates both the characteristics of the abusive tax shelters of the '90s and the new role that tax professionals had assumed. The case involved two well-known corporations: Colgate-Palmolive Co. (Colgate) and its tax advisor, Merrill Lynch & Co., Inc. (Merrill Lynch).[43] The two formed an offshore partnership with a foreign corporation in which the foreign corporation held approximately an eighty-three percent interest, Colgate held approximately a seventeen percent interest, and Merrill Lynch held a nominal interest of less than one percent.[44] The partnership acquired $205 million worth of securities, which it then sold to a third party for $140 million cash and a $35 million

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40 I.R.C. § 6662(d)(2)(C)(ii).

41 The abusive tax shelters of the 1970s and 1980s typically involved upper-middle income taxpayers who deducted non-economic losses from wages and investment income. Chirelstein & Zelenak, *supra* note 15, at 1951; Del Wright Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (and How the IRS Helps Them)*, 45 ARIZ. ST. L.J. 611, 626–27 (2013). For example, a profitable lawyer or doctor might become a partner in a farming business to offset legal or medical income. Because these tax shelters exploited specific loopholes in the Code, Congress used a rule-based approach to close these loopholes. Section 469 of the 1986 Tax Reform Act limited a taxpayer's ability to deduct losses from businesses in which that taxpayer did not materially participate. Chirelstein & Zelenak, *supra* note 15, at 1951; *see* I.R.C. §§ 501(b), 469(a)(1) (West 2014) (called "passive loss rules"). The abusive tax shelters of the 1990s differed in significant ways from these abusive tax shelters; the new tax shelters exploited more tax laws and involved more sophisticated entities. *See* Chirelstein & Zelenak, *supra* note 15, at 1951–52; McCormack, *supra* note 20, at 707–08.

42 ACM P'ship v. Comm'r, 73 T.C.M. (CCH) 2189, 1997 WL 93314 (1997), *aff'd in part and rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

43 *Id.* at *5.

44 *Id.* at *12.

multi-year installment note.[45] The partnership realized a huge capital gain from this purchase and sale, but because the foreign corporation owned eighty-three percent of the partnership interest, most of that gain was not subject to tax in the United States.[46] After the sale, the partnership redeemed the foreign corporation's interest so that Colgate then held ninety-nine percent of the partnership interest.[47] After acquiring the foreign corporation's interest, Colgate sold the installment note, which resulted in a $110 million deductible loss, which Colgate used to reduce capital gains it had earned on the sale of a subsidiary in that same year.[48] The Service disallowed the loss, claiming that Colgate's sole purpose for the transaction was to reduce its taxes; therefore, the transaction lacked economic substance.[49] Colgate filed suit. Although the transaction complied literally with the language of the tax law, the Tax Court disregarded the transaction because it failed the economic-substance test.[50]

As abusive tax shelters like these proliferated, the Treasury struggled to respond.[51] Previously, the Treasury and the courts had used the judicially developed anti-abuse doctrines to combat tax abuse.[52] However, as tax shelters proliferated and changed, these doctrines proved ineffective, and repeated amendments to the tax laws proved fruitless.[53] The Code had increased in length, detail, and

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45 *Id.* at *15.

46 *Id.* at *19–20.

47 *Id.* at *23–24.

48 Chirelstein & Zelenak, *supra* note 15, at 1943.

49 *ACM P'Ship*, 1997 WL 93314, at *35.

50 Chirelstein & Zelenak, *supra* note 15, at 1945. In this case, the economic-substance doctrine served as an extra-statutory requirement, meaning that in addition to complying with the statute, the taxpayer had to comply with the economic-substance doctrine. *See* Brief of Amicus Curiae Professor Amandeep S. Grewal in Support of Neither Party at 14–20, United States v. Woods, 134 S. Ct. 557 (2013) (No. 12-562) (explaining "the differences between the extrastatutory and interstitial approaches to economic substance issues").

51 Chirelstein & Zelenak, *supra* note 15, at 1946.

52 Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5 (2000) (citing Treas. Reg. § 1.701).

53 *See* Chirelstein & Zelenak, *supra* note 15, at 1962 ("[E]conomic substance doctrine is simply too weak a barrier to protect the collection of income tax from assault by abusive shelter planners."); McCormack, *supra* note 20, at 704.

complexity, as Congress attempted to address each creative new tax avoidance scheme.[54]

Requiring the Service to respond using existing law forced it to play catch up to address each latest tax shenanigan.[55] The Service would identify an abusive transaction, request a legislative response, wait for legislation or draft new regulations, and then apply the new rules prospectively.[56] During this sometimes lengthy process, taxpayers continued to use the abusive transactions. Because the government was "unable to keep pace with the imagination of tax professionals and the sheer volume of taxpayer maneuvers [designed] to avoid the application of increasingly complex tax laws[,]"[57] something stronger was needed.[58] The Treasury set its sights on subchapter K.

II. FORMULATING A REMEDY

A. *Targeting Subchapter K*

Because the Government simply could not craft enough targeted rules to stem the abuse, the Treasury decided to develop a general anti-abuse standard for subchapter K.[59] "An obvious question that

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54 N.Y. State Bar Ass'n Tax Section, *Report on the Proposed Partnership Antiabuse Rule*, 64 TAX NOTES 233, 233–35 (1994) (noting that the partnership tax law grew incredibly complex as the government attempted to address abusive transactions).

55 *See* Chirelstein & Zelenak, *supra* note 15, at 1951.

56 *See* Joseph Bankman, *The Proposed Partnership Antiabuse Rule: Appropriate Response to Serious Problem*, 64 TAX NOTES 270, 270 (1994) [hereinafter Bankman, *Proposed Partnership Antiabuse Rule*].

57 William H. Caudill, *Ninth Circuit Invalidates Anti-Abuse Rule; Is Reg. 1.701-2 Similarly Flawed?*, 83 J. TAX'N 380, 380 (1995) [hereinafter Caudill, *Ninth Circuit*].

58 The Treasury believed that regulating was needed to stop the "abusive" tax schemes. *See* Marino, *supra* note 18, at 172.

59 In 1954, Congress enacted the first version of subchapter K to simplify and add flexibility to partner taxation. Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 159 (2001) (citing H.R. REP. NO. 83-1337, at 65 (1954)). "Because of the hybrid nature of partnerships as a combination of entity and aggregate features in a highly flexible mix, it [was] inherently impossible to adopt specific rules that [would] prohibit all types of abusive partnership transactions." N.Y. State Bar Ass'n Tax Section, *supra* note 54, at 236.

arises in analyzing the partnership anti-abuse rules is why the choice was made to focus on partnerships. That is, why was there no anti-abuse rule developed for Subchapter C and other types of entities that are taxed under the Code?"[60]

Certainly, abusive tax shelters were not unique to partnerships; however, many of the abusive tax shelters at that time involved partnerships in some form.[61] Taxpayers choose this business entity, in large part, to minimize their tax obligations.[62] Subchapter K was a preferred vehicle for abusive tax schemes, in part, because of its highly technical nature and its tax-avoidance features.[63] For example, partnerships are generally treated as pass-through, or flow-through, entities, such that the partnership entity pays no income taxes.[64] The Government did not include these features to encourage taxpayers to minimize their tax obligations or to encourage the proliferation of tax shelters;[65] however, taxpayers used the features in this way. Thus, the Treasury focused its regulatory reform efforts on

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[60] "The simple answer appears to be that partnerships are what were on fire at the time. That is, many of the transactions in the late 1980s and early 1990s that were perceived as 'abusive' and that involved potentially significant deficiency amounts involved partnerships, and the partnership anti-abuse rules were seen as a way to put this 'fire' out." James B. Sowell, *The Partnership Anti-Abuse Rules: Where Have We Been and Where Are We Going?*, 89 TAXES 69, 98–99 (2011); *see generally* Cunningham & Repetti, *supra* note 24.
Sowell, *supra* note 60, at 98–99 (noting that the Treasury may have avoided crafting a similar regulation for other chapters of the Code because it received such an extremely negative reaction from the bench and bar when it enacted the partnership anti-abuse regulation). For a discussion of the controversy, see *infra* Section IV.A.

[61] *See* Sheldon I. Banoff, *Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 66 TAX NOTES 1859, 1860 (1995) (stating that "[p]artnerships have become the tax shelters of the '90s").

[62] Partnerships are generally treated as pass-through entities; the partnership—as an entity—does not pay taxes, which helps minimize tax obligations. *See* JOHN A. MILLER & JEFFREY A. MAINE, THE FUNDAMENTALS OF FEDERAL TAXATION: PROBLEMS AND MATERIALS 530 (3d ed. 2013). There are other tax avoidance features as well. For example, because partnership formation is a non-taxable event, formation has no immediate tax impact. *See id.* This is also true for corporate formations. *See id.*

[63] Cunningham & Repetti, *supra* note 24, at 4.

[64] *See* MILLER & MAINE, *supra* note 62, at 530.

[65] Internal Revenue Service, *Partnership Industry Coordinated Issue Subchapter K Anti-Abuse Rule Regulation Section 1.701-2*, 95 TNT 124-10, June 19, 1995, LEXIS.

subchapter K. A question remained: how should the Treasury address the problem?

B. *Choosing a Standard, Rule, or Both*

In general, the Code contains a complex, detailed set of rules rather than a compilation of general standards.[66] Rules and standards differ in significant ways, but "[t]he principal difference between the two is that the substantive content of the law is known before an individual acts in the case of rules, while the content of the law becomes known only after the individual acts in the case of standards."[67]

While the Treasury could have tried to combat abusive tax shelters by drafting additional, narrowly-targeted rules, crafting more rules to combat this particular abusive behavior seemed foolhardy for a number of reasons. First, because tax abusers do their best to conceal their behavior, the Treasury is not always aware of abuse until long after it starts.[68] Second, rule-based responses apply prospectively, leaving the Treasury one step behind as it constantly tries to address the "latest tax gimmick."[69] Third, more rules add clutter and complexity to an already cluttered and complex area of the law.[70] Finally, specific rules invite taxpayers to find new ways around the fixes.[71] For these reasons, the Treasury rejected the rule-based approach and instead added a standard on top of the existing rules.[72] With its standard, the Treasury specifically targeted textualism, especially literalism, because tax professionals had used it to

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[66] Coverdale, *supra* note 26, at 1521–22.

[67] Cunningham & Repetti, *supra* note 24, at 55.

[68] Daniel L. Halperin, *The Partnership Antiabuse Reg: A Reasonable Step in the Right Direction*, 64 TAX NOTES 823, 824 (1994).

[69] Cunningham & Repetti, *supra* note 24, at 6 (noting that the Treasury can address the shenanigans in the tax-shelter area better by using a standard like the anti-abuse regulation). While rule-retroactivity could help, Congress has to specifically grant the Treasury the authority to issue retroactive regulations. *See* I.R.C. § 7805(b)(6) (West 2015); *see also* Hickman, *Administering the Tax System*, *supra* note 34, at 1719–20.

[70] George W. Bush, Remarks in Colorado Springs, Colorado, 3 PUB. PAPERS 2466, 2469 (Oct. 12, 2004) ("Speaking about the Tax Code, it is a complicated mess. It's a million pages long.").

[71] Halperin, *supra* note 68, at 824.

[72] Cunningham & Repetti, *supra* note 24, at 56.

become increasingly creative with tax avoidance.[73] In sum, because the traditional rule-based approach had not stopped the abuse, the Treasury turned to a standards-based approach and promulgated the anti-abuse regulation.[74]

III. PROMULGATING THE REMEDY: THE ANTI-ABUSE REGULATION

A. *The Draft Regulation*

On May 12, 1994, the Treasury and the Service issued a Notice of Proposed Rulemaking ("NPRM") pursuant both to I.R.C. § 7805(a),[75] its general authority to issue regulations, and to I.R.C. § 701,[76] which subjects partners, rather than partnerships, to federal income taxation.[77] According to the NPRM, the regulation was being enacted to curtail the inappropriate use of subchapter K's flexibility.[78]

The NPRM contained Proposed Regulation 1.701-2, which contained two rules, collectively referred to as the partnership anti-abuse regulation, or rules:[79] (1) the Abuse-of-Subchapter-K rule, and (2) the Abuse-of-Entity rule. The proposed Abuse-of-Subchapter-K rule provided that if entities formed a partnership or used one

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73 Kenneth W. Gideon, *Use, Abuse, and Anti-Abuse: Policy Considerations Affecting the Nature of Regulatory Guidance*, 73 TAXES 637, 638 (1995).

74 Caudill, *Ninth Circuit*, *supra* note 57, at 380.

75 Section 7805(a) provides in relevant part: "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." I.R.C. § 7805(a) (West 2015).

76 Section 701 provides in full: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." § 701.

77 Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1). The NPRM indicated that proposed anti-abuse rules would be added to subchapter K "to prevent the use of a partnership to circumvent the intended purpose of a provision of the Code." *Id.*

78 *See* Internal Revenue Service, *supra* note 66.

79 Sowell, *supra* note 60, at 69 (noting that the rules are also called the "partnership anti-abuse rules"); *see, e.g.*, I.R.M. § 4.35.2.5.2.6 (2006). Because the term "regulation" is confusing when it is pluralized in this context, I use the plural "rules" or the singular "regulation" when referring to Treas. Reg. § 1.701-2.

in a transaction or series of transactions such that a principal purpose was to substantially reduce a partner's federal tax liability in a way that was inconsistent with *the intent of subchapter K*,[80] the Commissioner could recast the transaction.[81] Similarly, the Abuse-of-Entity *language*[82] provided that taxpayers should not be able "to use the existence of the partnerships to avoid the purposes of other provisions of the Code."[83]

Citing the legislative history of the Internal Revenue Code of 1954[84] and the implicit intent of subchapter K for support, the NPRM generally stated that the intent of subchapter K was "to permit taxpayers to conduct business for joint economic profit through a flexible arrangement that accurately reflects the partners' economic agreement without incurring an entity-level tax."[85] The NPRM stated further that Congress had not intended for taxpayers to use partnerships to achieve tax results that were "inconsistent with

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[80] Unfortunately, the Treasury did not use terminology precisely or consistently. *Compare* Treas. Reg. § 1.701-2(a)–(b) (1995) (using terminology such as "*intent* of subchapter K") (emphasis added), *with* Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (using terminology such as "the intended *purpose* of a provision of the Code" and "the *purposes* of other provisions of the Code") (emphasis added). "The 'intent' language is confusing because a collection of statutes cannot form an *intent*; rather, legislators, who are individuals, may form an intent regarding a statute they are enacting." Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 606; *see* Gunn, *supra* note 59, at 163 n.21. Statutes, which are inanimate things incapable of thinking, can have a purpose or purposes but cannot form intent. While related, purpose and intent are not interchangeable, and this language caused and continues to cause confusion and controversy. *See, e.g.*, Garrett, *supra* note 19, at 199 (arguing that legislative intent does not exist). Critics pounced on the imprecise terminology, in part, because the idea of legislative intent is highly controversial. As one tax professional challenged, "One cannot discern a legislative intent for even one provision of the partnership tax laws; moreover, one cannot legitimately ascribe an intent to an entire subchapter [subchapter K] enacted incrementally over the course of many Congresses." *Id.* at 198. Likely, the Treasury did not mean "intent"; rather, the agency meant "purpose" but used terminology imprecisely.

[81] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581.

[82] These rules were coupled in the proposed regulation, but were ultimately separated in the final regulation. Thus, in the NPRM, the Abuse-of-Entity rule was no more than Abuse-of-Entity language.

[83] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581.

[84] Specifically, S. REP. NO. 83-1622 (1954); H.R. REP. NO. 83-1337 (1954); H.R. REP. NO. 83-2543 (1954) (Conf. Rep.); and S. REP. NO. 94-938 (1976).

[85] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581.

the underlying economic arrangements of the parties or the substance of the transactions, or to use the existence of the partnerships to avoid the purposes of other provisions of the Code."[86] Notably, the proposed regulation did not refer to the judicial anti-abuse doctrines in any way.

The NPRM's preamble noted the Treasury's concern that taxpayers were increasingly using partnership transactions to create tax benefits inconsistent with subchapter K and other provisions of the Code.[87] Further, the NPRM expressed the agency's concern about the rise of literalism to avoid tax obligations.[88] Due to these concerns, and somewhat astonishingly, the proposed regulation stated explicitly that, even if a transaction complied with the literal language of the Code and regulations, the Commissioner could recast the transaction to further the intent of subchapter K.[89]

The Treasury characterized the proposed regulation as merely "clarify[ing]" existing law and suggested that it would "affect a relatively small number of abusive large partnership transactions . . . ."[90] The Treasury claimed that its purpose in promulgating the anti-abuse regulation was to target the limited number of taxpayers who were entering "into partnerships for the sole purpose of reducing their . . . tax liability, especially packaged partnership transactions."[91]

Despite the Treasury's assertions that the proposed regulation was merely a clarification and would affect only a small number of transactions, the regulation was highly controversial and was perceived as administrative over-reaching and over-reacting.[92] Indeed,

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86 *Id.*

87 *Id.*

88 *Id.* at 25582.

89 *Id.* Recognizing that tax avoidance was inescapable, however, the proposed regulation also acknowledged that reducing a partner's aggregate federal tax liability alone would not violate the intent of subchapter K. *Id.*

90 *Id.*

91 Marino, *supra* note 18, at 172.

92 *See, e.g.*, William F. Nelson, *The Limits of Literalism: The Effect of Substance over Form, Clear Reflection and Business Purpose Considerations on the Proper Interpretation of Subchapter K*, 73 TAXES 641, 641, 651 (1995) (saying that the regulation "provoked unusual, if not unprecedented, opposition from tax professionals" and was "no less than astonishing"); Banoff, *supra* note 61, at 1859 (mentioning "the vociferous response in letters and at tax conferences and professional associations pro and con (largely con); the contentious public hearing; the

the draft regulation caused major angst among tax professionals, whose "reaction was immediate and vociferous . . . ."[93] Tax professionals criticized the decision to recast transactions that complied literally with the language of the tax laws even when those transactions were not consistent with the Service's understanding of the intent of subchapter K.[94] Others challenged the law as "grossly overbroad,"[95] uncertain, and vague.[96] Still others charged that the regulation was simply unnecessary given existing law.[97] A few questioned whether the Treasury could constitutionally promulgate the regulation, but these concerns were vague and imprecise.[98]

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seemingly well-founded allegations of procedural violations in issuing and finalizing the regulation; [and] the reaction to and criticisms of the final regulation"); Robert D. Comfort, *Philadelphia Bar Tax Section Calls for Partnership Rule's Withdrawal*, 94 TNT 140-31, July 20, 1994, LEXIS (noting concern that "very few partnership transactions [would be] clearly safe from challenge under the antiabuse rule").

93 Cunningham & Repetti, *supra* note 24, at 34; *see also* Richard M. Lipton, *The Partnership Anti-Abuse Regs. Revisited: Is There Calm After the Storm?*, 83 J. TAX'N 68, 68 (1995) (noting that "verbal squalls erupted at the public hearing").

94 *See* William H. Caudill, *ABA Tax Section Members Say Antiabuse Rule Is Not a Valid Exercise of IRS Authority*, 94 TNT 146-50, July 28, 1994, LEXIS [hereinafter Caudill, *ABA Comment*]; Marino, *supra* note 18, at 172–73.

95 Comfort, *supra* note 92.

96 *See, e.g.*, Caudill, *ABA Comment*, *supra* note 94; Terence Cuff, *Los Angeles County Bar Urges Withdrawal of Antiabuse Reg.*, 94 TNT 151-40, Aug. 3, 1994, LEXIS; Robert R. Keatinge, *Colorado Bar Association Members Call for Antiabuse Reg's Withdrawal*, 94 TNT 141-29, July 21, 1994, LEXIS; Ralph Weiland, *TEI Urges Withdrawal of Partnership Antiabuse Rule*, 94 TNT 140-21, July 20, 1994, LEXIS.

97 *See, e.g.*, Keatinge, *supra* note 96; Elizabeth A. Case, *Price Waterhouse Says Existing Law is Sufficient to Curb Abusive Partnership Transactions*, 94 TNT 141-33, July 21, 1994, LEXIS; Weiland, *supra* note 96; Marino, *supra* note 18, at 174; Bankman, *Proposed Partnership Antiabuse Rule*, *supra* note 56, at 271. In the revised preamble, the Treasury responded that current laws, which allowed for case-by-case response were inadequate because this approach favored those who were first to engage in arguably prohibited transactions. T.D. 8588, 1995-1 C.B. 109.

98 *See, e.g.*, Caudill, *ABA Comment*, *supra* note 94; Cuff, *supra* note 96 (stating that there "are sufficient statutory and judicial authorities already available"); *cf.* Caudill, *Ninth Circuit*, *supra* note 57, at 380; Bankman, *Proposed Partnership Antiabuse Rule*, *supra* note 56, at 270 (arguing that purpose-based interpretation should have no role in subchapter K (and the companion provisions of Subchapter C and S) because the provisions are so arbitrary as to only allow literal interpretation).

In response, the Treasury made "numerous and significant technical and structural modifications."[99] Relevantly, the Treasury expanded the definition of the intent of subchapter K by, in part, including the judicially developed anti-abuse doctrines.[100] In addition, the Treasury separated the Abuse-of-Entity language into a separate rule.[101] Despite these changes, tax professionals were not mollified: "Considerable controversy continued to swirl even after the Regulations were issued in final form . . . . The debate and rhetoric reached levels of acrimony that had not been seen within the tax community in many years."[102] Even former members of the Service and the Treasury weighed in on the issue, most of whom urged the Treasury to withdraw the regulation.[103]

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99 Sowell, *supra* note 60, at 72.

100 Treas. Reg. § 1.701-2(b)(1) (1995); *see* Caudill, *ABA Comment*, *supra* note 94.

101 Treas. Reg. § 1.701-2(e).

102 Lipton, *supra* note 93, at 68; *see also* Banoff, *supra* note 61 (identifying nine things wrong with the anti-abuse regulation in its final form).

103 The following individuals urged that the regulations be withdrawn: former Commissioners of the Service Donald C. Alexander and Lawrence B. Gibbs; former Chief Counsel of the Service Abraham M. N. Shashy; former Chiefs of the Joint Committee Staff Mark L. McConaghy, Bernard M. Shapiro, and Harry L. Gutman; former Tax Court Judges William A. Goffe, Samuel B. Sterrett, John B. Williams; and former Deputy Assistant Secretary for Tax Policy John S. Nolan. Additionally, Kenneth W. Gideon, former Chief Counsel of the Service and former Assistant Secretary for Tax Policy, criticized the regulations, but stopped short of urging their withdrawal. *See* Donald C. Alexander et al., *Commentators Say Partnership Antiabuse Rule Doesn't Satisfy Fundamental Principles for a Workable Tax System*, 95 TNT 175-28, Aug. 18, 1995, LEXIS; Lawrence B. Gibbs & John S. Nolan, *Partnership Antiabuse Rule is Broader Than Necessary*, 95 TNT 175-27, Aug. 23, 1995, LEXIS; Kenneth W. Gideon, *Wilmer, Cutler & Pickering Attorney Says Partnership Antiabuse Rule Encourages 'Standardless Challenges' by IRS Agents*, 95 TNT 175-26, Aug. 29, 1995, LEXIS.

In contrast, former Chief of the Joint Committee Staff David Brockway wrote to support the regulations. David H. Brockway, *Brockway Sees Necessity for Partnership Anti-Abuse Rule*, 95 TNT 190-24, Sept. 18, 1995, LEXIS; *see also* Samuel C. Thompson Jr., *Ex-Government Officials Challenge Partnership Anti-Abuse Reg: An Analysis*, 69 TAX NOTES 1395 (1995) (explaining, analyzing, and rejecting the criticisms).

These prior officials articulated concerns about fairness, uncertainty, the need for a more targeted approach, and, most relevantly, constitutional overreaching. *See* Alexander, *supra* note 103, at 2.

B. *The Final Regulation*

The final regulation was promulgated on December 29, 1994.[104] The operative rules remained largely unchanged: if taxpayers formed a partnership or used one in a transaction or series of transactions that violated either the intent of subchapter K or the purposes of another Code section, the Commissioner could recast the transaction or disregard the partnership entirely, treating the partnership's assets and activities as belonging to one or more of the partners.[105] The regulation was clear that other statutory and common law doctrines continued to apply,[106] meaning that the promulgation of the regulation did not restrict the Commissioner from continuing to use other tax laws to challenge abusive transactions, including the judicially developed anti-abuse doctrines.

The final regulation included the two separate rules: (1) the *Abuse-of-Subchapter-K* rule, which permitted the Service to recast an abusive transaction for federal income tax purposes to achieve tax results that are consistent with subchapter K;[107] and (2) the *Abuse-of-Entity* rule, which allowed the Service to disregard a partnership entity and treat the partnership as an aggregate of its partners as appropriate to carry out the purposes of *any* provision in the Code or in the regulations.[108] Each rule is described in more detail below.

First, the Abuse-of-Subchapter-K rule authorized the Commissioner to disregard and recast a partnership transaction if (1) *a principal purpose* of the transaction was to reduce substantially the partners' aggregate federal tax liability, and (2) the manner in which the liability was reduced was inconsistent with *the intent of subchapter*

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104 Treas. Reg. §1.701-2. The regulation, as originally drafted, would have applied to the interpretation of any provision of the Code (income, estate, gift, generation-skipping, and excise tax) when relevant to a particular partnership transaction. *See* Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1). The Treasury soon amended the regulation to apply to income taxes only (taxes imposed under Subchapter A). Treas. Reg. § 1.701-2(h).

105 Treas. Reg. §1.701-2(b)(1).

106 *Id.* § 1.701-2(i).

107 *Id.* § 1.701-2(b).

108 *Id.* § 1.701-2(e).

K.[109] To be consistent with "the intent of subchapter K," a transaction had to comply with the following three[110] factors (two of which were adapted from the judicially developed anti-abuse doctrines):

- **The business-purpose factor**: "The partnership must be bona fide and each partnership transaction or series of related transactions . . . must be entered into for a substantial business purpose";
- **The substance-over-form factor**: "The form of each partnership transaction must be respected under substance over form principles"; and
- **The clear-reflection-of-income factor**: "[T]he tax consequences . . . to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement" and the tax consequences must clearly reflect income.[111]

Generally speaking, if a transaction fails to meet any one of these three factors, the Commissioner can recast the transaction.[112] The Treasury claimed that these three factors reflected the intent of subchapter K because, when Congress enacted subchapter K, Congress intended to allow taxpayers to conduct joint business activities using

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109 *Id.* § 1.701-2(b).

110 Because the Treasury subdivided the section into three subsections, most commentators identify only three factors. *See, e.g.*, Marino, *supra* note 18, at 175 (calling the factors "a three-fold requirement"). However, two of the subsections contain two factors, making for a total of five factors. *See* Lipton, *supra* note 93, at 68–69 (identifying five factors). Following the regulation's structure, I use the term "three" rather than "five."

111 Treas. Reg. § 1.701-2(a)(1)–(3).

112 However, the clear-reflection-of-income factor contains an exception. Because some provisions of subchapter K and its regulations were enacted to promote administrative convenience or were enacted for other policy reasons, a particular provision may produce tax results that do not clearly reflect income. Lipton, *supra* note 93, at 68. The clearest examples are basis adjustments under Sections 732 and 754. Marino, *supra* note 18, at 174. For this reason, the regulation states that if the business-purpose factor and the substance-over-form factor are both met, then the clear-reflection-of-income factor is presumed to be satisfied so long as "the ultimate tax results . . . are clearly contemplated by that [tax] provision." Treas. Reg. § 1.701-2(a)(3).

flexible economic arrangements without incurring a tax simply for forming the entity (known as an "entity-level" tax).[113]

In addition to identifying these factors, the Abuse-of-Subchapter-K rule explicitly rejected literalism: "even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can" recast the transaction.[114] In addition, the Abuse-of-Subchapter-K rule also provided more than ten examples illustrating its application.[115]

In sum, the Abuse-of-Subchapter-K rule allows the Commissioner to re-characterize a partnership transaction to achieve tax results consistent with the Treasury's understanding of the intent of subchapter K. In doing so, the Commissioner should consider whether (1) a principal purpose of the transaction was to substantially reduce the partners' aggregate federal income tax liability, and (2) the transaction failed the three-factor test.[116]

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[113] *See* Treas. Reg. § 1.701-2(a); *see also* Internal Revenue Service, *supra* note 65.

[114] Treas. Reg. § 1.701-2(b). Treasury Regulation section 1.701-2(b) identifies the ways that the Commissioner can recast the transaction, including by (1) disregarding the partnership; (2) not treating a purported partner as a partner; (3) adjusting the partner or partnership's methods of accounting to clearly reflect income; (4) reallocating the partnership's income, gain, loss, deductions, or credit; and (5) adjusting the claimed tax treatment.

[115] Marino, *supra* note 18, at 172. Shortly after issuance, the IRS withdrew two of the examples. *Id.* (citing IRS Announcement 95-8, I.R.B. 1995-7 (Jan. 23, 1995) and T.D. 8592 (April 12, 1995). *See* Treas. Reg. § 1.701-2(d) (containing eleven examples). Eight of these examples are safe harbors, meaning that if a transaction is structured similarly to the example, then the Commissioner will not re-characterize it, while five of the examples illustrate transactions subject to recasting.

[116] More specifically, the transaction must fail the three-factor test in light of the pertinent facts and circumstances of the particular transaction. These pertinent facts and circumstances are identified in section 1.701-2(c). Section 1.701-2(c) identifies non-exclusive factors and circumstances for determining whether the "principal purpose test" would be satisfied. *See* Treas. Reg. § 1.701-2(c). These factors include, among others, the purpose for the transaction, the aggregate tax liability of all the partners, and the intent of subchapter K. *Id.* However, the most important factor is the comparison of the business purpose for the transaction with the resulting tax benefits. Cunningham & Repetti, *supra* note 24, at 37–38. *But see* Lipton, *supra* note 93, at 69 ("Because these factors are nonconclusive and are 'result oriented' in that they focus on whether the partners receive a tax benefit from the use of a partnership—which generally will occur when a partnership is

The final regulation also included the Abuse-of-Entity Rule.[117] The Abuse-of-Entity rule provides that "[t]he Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder."[118] However, the Commissioner may not reject a taxpayer's decision to form a partnership to avoid another Code provision if that other provision clearly allows partnership treatment and the ensuing tax consequences.[119] With this proviso, the Treasury backed away from its position in the proposed regulation that an arrangement would be abusive *per se* if the taxpayer intended to "avoid the purposes of other provisions of the Internal Revenue Code."[120]

When the Treasury first proposed the anti-abuse regulation, the tax bar fought back, alleging that the Treasury had exceeded its executive powers and had acted without constitutional or statutory authority.[121] Those who supported the regulation countered these chal-

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used in a transaction—the factors provide little guidance beyond the tests set forth in the Regulations.").

While there are often multiple reasons for structuring a transaction in a particular way, including reducing tax liability, the Treasury was concerned with whether the tax reduction purpose was "a principal purpose." If so, then the regulation will apply and the Service may recast the transaction, although the Service is not required to do so. *See* Treas. Reg. 1.701-2(c). Thus, if the claimed tax benefits are too favorable, even though the transaction served a legitimate business purpose, the Service need not respect the transaction. Cunningham & Repetti, *supra* note 24, at 38.

117 In the final rule, the Treasury moved the Abuse-of-Entity language from the proposed regulation, which entirely ignored taxpayer intent, into a new subsection and modified it. Treas. Reg. § 1.701-2(e).

118 *Id.* §1.701-2(e)(1). Aggregate treatment would not apply when "(i) [a] provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and (ii) [t]hat treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision." *Id.* §1.701-2(e)(2).

119 *Id.* § 1.701-2(e)(2).

120 Marino, *supra* note 18, at 174. The Abuse-of-Entity rule also provided three examples illustrating its application. Treas. Reg. § 1.701-2(f).

121 *See, e.g.*, Caudill, *ABA Comment*, *supra* note 94; Cunningham & Repetti, *supra* note 24, at 5; James A. Gouwar, *The Proposed Partnership Anti-Abuse Regulation: Treasury Oversteps Its Authority*, 11 J. PARTNERSHIP TAX'N 287, 289–90 (1995); Comfort, *supra* note 92; Charles R. Levun, *Chicago Bar Calls*

lenges by suggesting that the Treasury already possessed legal authority to act.[122] Despite the rhetoric, neither side fully explored the constitutional or statutory issues at that time.

Professors Cunningham and Repetti were the first to address these issues in depth.[123] They concluded that the Treasury's promulgation of the anti-abuse regulation was not administrative overreaching but was, instead, a legitimate exercise of executive authority entitled to deference under *Chevron*.[124] Their conclusion rests on two points: First, they declare that Congress has the constitutional power to tell courts to use a specific method of statutory interpretation to analyze a statute.[125] Because Congress chose not to adopt a method, they continue, Congress left a gap in this area for the Treasury to fill.[126] Second, they assert that Congress could have codified the judicially developed anti-abuse doctrines.[127] Because Congress chose not to codify these doctrines, they argue, Congress left a gap in this area as well.[128] Under *Chevron*, agencies have implied delegated power to interpret ambiguous statutory language and fill statutory gaps.[129] From this truism, Professors Cunningham and Repetti assume that Congress's silence in these two areas empowered the

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Partnership Antiabuse Rule Invalid, Urges Withdrawal, 94 TNI 139-17, June 30, 1994, LEXIS.

Critics argued that to the extent that there is uncertainty in the statutory scheme of subchapter K about the role of business purpose, economic substance, and the proper reflection of income, the regulation was not a reasonable interpretation of congressional intent. *See* Cunningham & Repetti, *supra* note 24, at 39 n.196 (collecting sources).

122 *See, e.g.*, Bankman, *Proposed Partnership Antiabuse Rule*, *supra* note 56, at 272 ("The proposed regulation does not add any power the Treasury does not now possess, under a combination of common-law antiabuse doctrines and its residual power to interpret tax laws in light of their underlying purpose."); Halperin, *supra* note 68, at 823 (stating "the Treasury and the IRS have the legal authority to issue the proposed regulation").

123 Cunningham & Repetti, *supra* note 24.

124 *Id.* at 5.

125 *Id.* at 5–6, 53 (citing Nicholas Quinn Rosenkranz, *Federal Rules of Statutory Interpretation*, 115 HARV. L. REV. 2085, 2130 (2002)).

126 *Id.* at 5–6.

127 *Id.*

128 *Id.*

129 Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 844 (1984).

Treasury to issue both rules in the anti-abuse regulation.[130] However, their arguments are flawed.

Their arguments are flawed because an agency cannot legally act beyond its delegated authority. An agency may attempt to exceed its delegated authority in two ways. First, an agency may act unconstitutionally by performing actions that Congress could not or did not delegate to the agency.[131] For example, Congress cannot delegate to the Treasury the power to appoint Supreme Court justices because the Constitution gives that power to the President (with the Senate's consent).[132] And, although Congress could delegate to the Treasury the power to regulate the environment, Congress has not done so.[133] Were the Treasury to do either (appoint Supreme Court justices or regulate the environment), the Treasury's action would be unconstitutional because the Treasury would be acting without any delegated authority.

Second, and more commonly, an agency may act *ultra vires* by regulating in a way that exceeds the scope of the authority Congress delegated to the agency. For example, Congress delegated to the Treasury the authority "to regulate the practice of representatives of persons before the Department of the Treasury."[134] Pursuant to that delegation, the Treasury claimed it had power to promulgate a rule regulating tax-return preparers.[135] The D.C. Circuit Court held that the Treasury exceeded its delegated authority because "representa-

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[130] *See* Cunningham & Repetti, *supra* note 24, at 5–6.

[131] Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 134 (1936). All legislative powers are vested in Congress. U.S. CONST. art. I, § 1. Hence, agencies cannot act absent delegation from Congress. Congress may delegate legislative power to an agency pursuant to the necessary and proper clause. U.S. CONST. art. I, § 8. However, Congress must provide an agency with intelligible principles to guide the exercise of any delegated power. *See* J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928); Whitman v. Am. Trucking Ass'n, 531 U.S. 457, 474–76 (2001).

[132] U.S. CONST. art. II, § 2, cl. 2.

[133] Instead, Congress has delegated that power to the Environmental Protection Agency. *See, e.g.*, 42 U.S.C. §§ 7401–7431 (2012) (requiring the EPA to regulate air emissions); *id.* §§ 300f–300j (requiring the EPA to establish minimum standards to protect tap water).

[134] Loving v. IRS, 742 F.3d 1013, 1015 (D.C. Cir. 2014) (citing 31 U.S.C. § 330(a)(1)).

[135] *Id.*

tives of persons before the Department of the Treasury" did not include tax-preparers.[136] Because the Treasury exceeded the power delegated, the agency's action was *ultra vires*.[137] The action was not unconstitutional, however, because Congress delegated some power to the agency, specifically, the authority "to regulate the practice of representatives of persons before the Department of the Treasury."[138]

The Treasury's anti-abuse regulation is unconstitutional or, alternatively, *ultra vires*. The regulation is unconstitutional because Congress cannot and did not delegate the power the agency claimed. Alternatively, if such power were properly delegated, then the Treasury exceeded the bounds of that delegated power and, thus, acted *ultra vires*. In the next two parts of the Article, I explain why the Treasury's act was unconstitutional and why, alternatively, it was *ultra vires*.

IV. PART FOUR: EVALUATING THE REMEDY

The Treasury's promulgation of the anti-abuse regulation is unconstitutional for two reasons. First, Congress cannot delegate power that the legislature does not have. Because Congress does not have the power to tell the judiciary how to interpret statutes, it cannot delegate that power to the Treasury. Second, Congress did not explicitly or implicitly delegate power to the Treasury either to tell the judiciary how to interpret statutes or to codify the judicially developed anti-abuse doctrines. Because the Treasury promulgated a regulation without delegated authority, the anti-abuse regulation is unconstitutional.

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136 *Id.*

137 *Id.* at 1015–16.

138 31 U.S.C. § 330(a)(1).

A. *Congress Cannot Delegate*

Congress cannot delegate power that it does not have,[139] and Congress has no power to enact statutory directives.[140] Statutory directives are laws telling the judiciary how to interpret statutes.[141] More specifically, *theoretical* statutory directives tell judges what theory, or approach, to use to interpret statutes: purposivism, intentionalism, textualism, or something else.[142] The Treasury's regulation includes two theoretical directives. One such directive is located within the Abuse-of-Subchapter-K rule. This directive applies to interpretations of specific provisions within subchapter K. The other directive is located within the Abuse-of-Entity rule. This directive applies to interpretations of the entire code.[143]

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139 *Cf.*, Cass R. Sunstein, *Nondelegation Canons*, 67 U. CHI. L. REV. 315, 323 (2000) ("[A]ny delegation must itself be an exercise of lawmaking authority, operating pursuant to the constitutional requirements for the making of federal law.").

140 *See* Linda D. Jellum, *"Which is to be Master," the Judiciary or the Legislature? When Statutory Directives Violate Separation of Powers*, 56 UCLA L. REV. 837, 886 (2009) [hereinafter Jellum, *Which is to be Master*].

141 *Id.* at 847–48.

142 *Id.* at 848–49. Congress has not enacted a general statutory directive. For examples of state theoretical directives, see the following statutes: TEX. GOV'T CODE ANN. § 311.023 (West 2013) (purposivism); N.Y. STAT. LAW § 92(a)–(b) (McKinney 2014) (intentionalism); CONN. GEN. STAT. § 1-2z (West 2014) (textualism).

143 Professors Cunningham and Repetti suggest that the anti-abuse regulation includes a third purposivist directive as well. *See* Cunningham & Repetti, *supra* note 24, at 37. Specifically, they note that the Abuse-of-Subchapter-K rule includes a three-factor test to define when a transaction is consistent with the "intent of subchapter K." *Id.* The first two factors are required (the business-purpose and substance-over-form factors), while the third factor (the clear-reflection-of-income factor) is required only sometimes. *Id.* The clear reflection of income factor is not always required because certain provisions in subchapter K and its regulations were adopted to promote administrative convenience or for other policy reasons. *Id.* In other words, some provisions were enacted with the recognition that their application to a particular transaction could, "in some circumstances, produce tax results that do not properly reflect income." Treas. Reg. § 1.701-2(a)(3). Thus, pursuant to the Abuse-of-Subchapter-K rule, if the first two factors are met, the third factor is also considered to be met "to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, *are clearly contemplated by that provision*." *Id.* (emphasis added). Professors Cunningham and Repetti conclude that "this provision of the regulation in effect requires that the purposivist method of

The Abuse-of-Subchapter-K theoretical directive tells the Commissioner to reject textualism's kissing cousin, literalism, and to use purposivism. This directive states that "even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can" recast the transaction "to achieve tax results that are consistent with the intent of subchapter K . . . ."[144] In other words, if a literal interpretation would frustrate the purpose of subchapter K,[145] then the Commissioner can ignore literalism in favor of an approach that furthers the purpose of the statute. The Abuse-of-Subchapter-K theoretical directive applies to interpretations of statutes within subchapter K only.[146]

Like the theoretical directive in the Abuse-of-Subchapter-K rule, the Abuse-of-Entity rule similarly instructs the Commissioner to use purposivism.[147] This theoretical directive provides: "The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the *purpose of any provision* of the Internal Revenue Code or the regulations promulgated thereunder."[148] Pursuant to this directive, the Commissioner can determine whether to treat a partnership as an aggregate of its partners or as a separate entity to further the purposes of *any* provisions in the Code or the regulations promulgated thereunder, so long as the tax results of that treatment "are clearly contemplated."[149] Thus, the Abuse-of-

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statutory interpretation be used in analyzing subchapter K." Cunningham & Repetti, *supra* note 24, at 37. Professors Cunningham and Repetti interpreted the phrase "contemplated by the provision" as requiring a determination of the purpose of the statute. *See* Email from James Repetti (Aug. 1, 2014) (on file with author). It is not clear, however, that the statute requires a determination of the purpose. Why, for example, could one not satisfy this provision by determining what the statute contemplated through a textualist analysis of, say, the provision itself or the act as a whole? Hence, I am not convinced that it is a purposivist theoretical directive.

[144] Treas. Reg. § 1.701-2(b).

[145] *See supra* note 80 (discussing how the Treasury inappropriately conflated statutory purpose and legislative intent).

[146] Treasury Regulation section 1.701-2(b) speaks only of subchapter K, while Treasury Regulation section 1.701-2(e)(2) applies more broadly. *See* Treas. Reg. § 1.701-2(b), (e)(2).

[147] *See* Cunningham & Repetti, *supra* note 24, at 38, 51.

[148] Treas. Reg. § 1.701-2(e) (emphasis added).

[149] Additionally, the Code or regulations must specifically allow for entity treatment. Treas. Reg. § 1.701-2(e)(2).

Entity theoretical directive applies broadly to interpretations of statutes in the entire Code and its regulations. In short, both the Abuse-of-Subchapter-K rule and the Abuse-of-Entity rule include purposivist theoretical directives.[150]

As a threshold issue, one might question whether the judiciary would be bound to follow purposivist directives the Treasury issued.[151] The regulation explicitly directs only the Commissioner, not the judiciary, to use purposivism.[152] Likely, the Treasury can tell the Service to use a particular approach to interpretation without violating separation of powers. Moreover, the courts could simply ignore the theoretical directives in the anti-abuse regulation.[153] Yet, were taxpayers to appeal a Commissioner's decision that recasts a particular partnership transaction and denies benefits under either rule in the anti-abuse regulation, a court would have to review the Commissioner's decision. In reviewing that decision, the court would have to (1) determine whether the Commissioner had authority to recast the transaction under the regulation (a *Chevron*-type or *Auer*-type question) and, assuming the Commissioner had that authority, (2) determine whether that decision was valid (an arbitrary-and-capricious-type question).[154] If the Commissioner were to use a purposivist approach to recast a transaction that literally complied with the language of an applicable tax statute, a court refusing to follow the directive might well find the recasting invalid. Hence, although not

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[150] The summary section of the NPRM says specifically, "[t]he rule authorizes the Commissioner of Internal Revenue, in certain circumstances, to recast a transaction involving the use of a partnership to reflect the underlying economic arrangement under subchapter K or to prevent the use of a partnership to circumvent the intended purpose of a provision of the Code." Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1).

[151] Professors Cunningham and Repetti do not address this question but assume the judiciary are bound. *See* Cunningham & Repetti, *supra* note 24, at 5. I agree.

[152] Treas. Reg. § 1.701-2(b), (e).

[153] *See, e.g.*, Evans v. State, 872 A.2d 539, 550 (Del. 2005) (finding that a textualist theoretical directive violated separation of powers and refusing to follow it).

[154] 5 U.S.C. § 706(2) (2012). Standard of review is a particularly murky area. For a discussion of the appropriate level of deference in economic substance cases, see generally Christopher M. Pietruszkiewicz, *Economic Substance and the Standard of Review*, 60 ALA. L. REV. 339 (2009).

explicit, the anti-abuse regulation implicitly directs judicial interpretation as well as executive interpretation. Indeed, if the judiciary were not bound, the regulation would be largely ineffective.

Assuming the judiciary is bound to follow these directives because of judicial review standards, the question becomes: "Where does the Treasury get the authority to instruct a court as to which method of interpretation it should use to interpret a tax statute?"[155] In my opinion, nowhere. Congress has no power to direct courts on how to interpret statutes.[156] Because Congress cannot delegate power it does not have, the Treasury's decision to adopt these directives is unconstitutional.

Professors Cunningham and Repetti acknowledge that "it may seem inappropriate for the Treasury to instruct the judiciary on how and when the courts should apply judicial doctrines and what tools they should use in interpreting statutes."[157] Yet both professors believe that Congress has the constitutional power to enact statutory directives and that its failure to do so left this gap for the agency to fill.[158] To support their claim that Congress has the power to issue such directives, Professors Cunningham and Repetti cite Professor Nicholas Rosenkranz.[159] Professor Rosenkranz has indeed argued that Congress can constitutionally enact theoretical directives.[160] As I have explained elsewhere, and as others have agreed, Professor Rosenkranz's argument is misguided; Congress cannot enact theoretical directives without violating separation of powers.[161]

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155 Cunningham & Repetti, *supra* note 24, at 5.

156 Jellum, *Which is to be Master*, *supra* note 140, at 882–83.

157 Cunningham & Repetti, *supra* note 24, at 5.

158 *Id.* at 53.

159 *Id.* at 53 n.283.

160 *See* Rosenkranz, *supra* note 125, at 2103–10.

161 Jellum, *Which is to be Master*, *supra* note 140, at 847; *accord* ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 245 (2012) (saying that any attempt by Congress to direct statutory interpretation would likely be unconstitutional); Mark Seidenfeld, Chevron*'s Foundation*, 86 NOTRE DAME L. REV. 273, 292 n.85 (2011) ("I entertain the possibility that statutory interpretation involves a judicial function implicit in Article III's vesting of the judicial power in the courts."); Maxine D. Goodman, *Reconstructing the Plain Language Rule of Statutory Construction: How and Why*, 65 MONT. L. REV. 229, 260 (2004) ("I join the ranks in believing construing statutes is what courts do and determining how to best perform this role should remain the prov-

Theoretical directives violate the formalist and functionalist approaches to separation of powers. Were it to issue a theoretical directive, Congress would violate the *formalist* approach to separation of powers quite simply because Congress would be performing a judicial act.[162] Theoretical directives do not affect legal rights;[163] hence, they are not legislative in nature.[164] Indeed, affecting legal rights is not a directive's purpose. Rather, a directive's purpose is to tell the judiciary how to interpret statutes.[165] Yet, interpreting statutes is a quintessential judicial act.[166] Determining what sources to consider when deciding what a statute means is essential to the interpretive process. Were Congress to craft a theoretical directive, like the ones in the anti-abuse regulation, Congress would interfere

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ince of the courts."); Larry Alexander & Saikrishna Prakash, *Mother May I? Imposing Mandatory Prospective Rules of Statutory Interpretation*, 20 CONST. COMMENT. 97, 99–100 (2003); Sarah Rudolph Cole, *Continuation Coverage Under COBRA: A Study in Statutory Interpretation*, 22 J. LEGIS. 195, 210 n.103 (1996) ("One unanswered question is whether Congress could pass a general interpretive law stating that a particular method should be used to interpret certain statutes. Such an approach would likely be unconstitutional because it destroys the concept of separation of powers."); REED DICKERSON, THE INTERPRETATION AND APPLICATION OF STATUTES 263–81 (1975) (noting potential constitutional problems raised by interpretive acts); Alan R. Romero, Note, *Interpretive Directions in Statutes*, 31 HARV. J. ON LEGIS. 211, 221 (1994) ("At least some interpretive directions might violate the principle of separation of powers between the legislative and the judicial branches."); James C. Thomas, *Statutory Construction When Legislation is Viewed as a Legal Institution*, 3 HARV. J. ON LEGIS. 191, 211 n.85 (1965) ("When a statute seeks to control the attitude or the subjective thoughts of the judiciary, the separation of powers doctrine has been ignored.").

162 For a more complete explanation of why theoretical directives violate formalist separation of powers, see Jellum, *Which is to be Master*, *supra* note 140, at 882–83.

163 Article I vests Congress with "[a]ll legislative Powers herein granted . . . ." U.S. CONST. art. 1, § 1. Laws "alter[] the legal rights, duties, and relations of persons . . . outside the Legislative Branch." INS v. Chadha, 462 U.S. 919, 952 (1983). Congress alters legal rights through enacting, amending, and repealing statutes. Hence, legislative power is the power "to promulgate generalized standards and requirements of citizen behavior or to dispense benefits—to achieve, maintain, or avoid particular social policy results." Martin H. Redish & Elizabeth J. Cisar, *"If Angels Were to Govern": The Need for Pragmatic Formalism in Separation of Powers Theory*, 41 DUKE L.J. 449, 479 (1991).

164 *See* Jellum, *Which is to be Master*, *supra* note 140, at 882–83.

165 *Id.* at 848.

166 *Id.* at 888.

with a judicial function: interpreting statutes.[167] "If officials in either [the executive or legislative] branches were given final say over statutory interpretation . . . this would sabotage both the constitutionally prescribed law-making procedures and the constitutional separation of powers."[168]

Additionally, were it to issue a theoretical directive, Congress would violate the *functionalist* approach to separation of powers.[169] Functionalists fear undue encroachment and aggrandizement of one branch at the expense of another.[170] Theoretical directives raise encroachment concerns because these directives impermissibly allow Congress to intrude into a core judicial function: interpreting the law.[171] "Say[ing] what the law means"[172] is not just a core function of the judiciary, "it is the most central constitutionally assigned function of the judiciary, as found in the vesting clause."[173] Theoretical directives raise aggrandizement concerns as well because they expand, or aggrandize, Congress's role in the interpretive process.[174] Thus, theoretical directives violate functionalist as well as formalist approaches to separation of powers. Hence, Congress has no power to issue a theoretical directive.[175] Because Congress has no power to issue such a directive itself, Congress cannot delegate this power to the Treasury.

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[167] Article III of the Constitution vests "[t]he judicial Power of the United States" in the courts. U.S. CONST. art. III, § 1. Judicial power is the power to interpret laws and resolve legal disputes. "[T]o declare what the law is, or has been, is a judicial power, to declare what the law shall be is legislative." Koshkonong v. Burton, 104 U.S. 668, 678 (1881) (quoting Ogden v. Blackledge, 6 U.S. 272, 277 (1804)). Thus, "[t]he interpretation of the laws is the proper and peculiar province of the courts." THE FEDERALIST NO. 78, at 523, 525 (Alexander Hamilton) (Jacob E. Cooke ed., 1961).

[168] Jonathan T. Molot, *Reexamining* Marbury *in the Administrative State: A Structural and Institutional Defense of Judicial Power Over Statutory Interpretation*, 96 NW. U. L. REV. 1239, 1246 (2002).

[169] For a more complete explanation of why theoretical directives violate functionalist separation of powers, see Jellum, *Which is to be Master*, *supra* note 140, at 883–90.

[170] *See id.* at 870, 875.

[171] *Id.* at 883.

[172] Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177 (1803).

[173] Jellum, *Which is to be Master*, *supra* note 140, at 883.

[174] *Id.* at 886–87.

[175] *Id.* at 882–83.

This outcome makes sense. The appropriate theory for judges to use when interpreting statutes is highly complex and controversial.[176] The choice, however, should be left to the judiciary, not usurped by Congress or the Treasury.

In sum, contrary to Professor Rosenkranz's argument, Congress does not have the power to direct the judiciary to use a particular approach to statutory interpretation. Because Congress has no such power, Congress has no capacity to explicitly or implicitly delegate this power to the Treasury. Hence, the Treasury had no delegated authority to issue the directives, and the regulation, or at least the directives within the regulation, are unconstitutional.

B. *Congress Did Not Delegate*

Even if I am wrong, and Congress had the ability to delegate the power to issue theoretical directives to the Treasury, Congress did not do so. Nor did Congress delegate to the Treasury the power to adopt and modify the judicially developed anti-abuse doctrines. The Treasury has no power to act unless and until Congress confers, or delegates, power upon it.[177] In this case, Congress did not do so.

Administrative agencies are part of the executive branch; as such, they execute the laws that Congress enacts.[178] Agencies may

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[176] For the classic debate between Professors John Manning and William Eskridge, Jr., regarding this issue, compare John F. Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 23 (2001), with William N. Eskridge, Jr., *All About Words: Early Understandings of the "Judicial Power" in Statutory Interpretation, 1776–1806*, 101 COLUM. L. REV. 990, 993 (2001) (criticizing Professor Manning's article), and John F. Manning, *Response: Deriving Rules of Statutory Interpretation from the Constitution*, 101 COLUM L. REV. 1648, 1651–53 (2001) (responding to Professor Eskridge's criticism).

[177] Cal. Indep. Sys. Operator Corp. v. F.E.R.C., 372 F.3d 395, 398 (D.C. Cir. 2004) (citing La. Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 374 (1986)).

[178] Bowsher v. Synar, 478 U.S. 714, 733 (1986); *accord* Redish & Cisar, *supra* note 163, at 480 ("[T]he executive branch must be exercising . . . creativity, judgment, or discretion in an 'implementational' context. In other words, the executive branch must be interpreting or enforcing a legislative choice or judgment; its actions cannot amount to the exercise of free-standing legislative power."); Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 134–35 (1936) (noting that executive power is the power to prescribe rules and regulations to carry into effect congressional will).

exercise only the power that Congress explicitly or implicitly delegates to them.[179] Pursuant to the delegation, or non-delegation, doctrine, Congress explicitly delegates power to agencies to promulgate regulations with the force and effect of law and ostensibly constrains that power by providing "intelligible principles."[180] Intelligible principles guide and limit agency decision-making while also allowing for judicial review.[181] Congress impliedly delegates power to an agency to interpret the laws it administers when it executes those laws.[182] Thus, delegation may be express (explicit) or implied (implicit).

When Congress explicitly delegates power to an agency to elucidate a specific provision of a statute by regulation, courts review the resulting regulation to see if it is arbitrary, capricious,[183] or manifestly contrary to the statute.[184] In contrast, when Congress implicitly delegates power to an agency to fill statutory gaps or resolve statutory ambiguities, then courts review the resulting regulation under *Chevron* to see if the interpretation is reasonable.[185] Notably, however, without an explicit or implicit delegation of authority from Congress, both arbitrary and capricious review and reasonableness

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[179] Lyng v. Payne, 476 U.S. 926, 937 (1986) ("[A]n agency's power is no greater than that delegated to it by Congress."); Transohio Sav. Bank v. Dir., Office of Thrift Supervision, 967 F.2d 598, 621 (D.C. Cir. 1992) ("It is central to the real meaning of the rule of law . . . that a federal agency does not have the power to act unless Congress, by statute, has empowered it to do so.").

[180] *See* J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409–11 (1928).

[181] WILLIAM R. ANDERSEN, MASTERING ADMINISTRATIVE LAW 12 (2010).

[182] *See* Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984).

[183] 5 U.S.C. § 706(2).

[184] Wright v. Everson, 543 F.3d 649, 654 (11th Cir. 2008) (citing *Chevron*, 467 U.S. at 844).

[185] *Chevron*, 467 U.S. at 843–44.

review are inapplicable.[186] Without delegated authority, an agency has no power to act at all.[187]

The next section (Part IV.B.1) explores whether Congress *expressly* delegated either power to the Treasury. The section following (Part IV.B.2) explores whether Congress *impliedly* delegated either power to the Treasury. In both cases, the answer is "no."

1. CONGRESS DID NOT *EXPLICITLY* DELEGATE

Congress may expressly delegate the power to implement legislative policy to an agency so long as Congress constrains that power with intelligible principles.[188] Had Congress *explicitly* delegated the power to the Treasury to adopt an interpretive approach for interpreting subchapter K (assuming Congress had such power to delegate) or had Congress *explicitly* delegated the power to adopt and modify the judicially developed anti-abuse doctrines, then the Treasury would have had the power to enact the regulation at issue. Yet Congress did neither.

In the NPRM, the Treasury identified two statutes as providing authority for the agency to promulgate the anti-abuse regulation: I.R.C. §§ 7805(a) and 701.[189] However, neither statute provides the

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[186] *Id.* (stating that where Congress has left a gap, "there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation"); Citizens to Pres. Overton Park, Inc. v. Volpe, 401 U.S. 402, 415 (1971) ("The court is first required to decide whether the Secretary acted within the scope of his authority."); Michigan v. EPA, 268 F.3d 1075, 1081 (D.C. Cir. 2001) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress.") (quoting Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988)).

[187] All legislative powers are vested in Congress. U.S. CONST. art. I, § 1. Hence, agencies cannot act absent delegation from Congress. Congress may delegate legislative power to an agency pursuant to the necessary and proper clause. *Id.* § 8. However, Congress must provide an agency with intelligible principles to guide the exercise of any delegated power. *See* J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928); Whitman v. Am. Trucking Ass'n, 531 U.S. 457, 474 (2001).

[188] Many suggest that the non-delegation doctrine is dead because the Supreme Court has not invalidated a federal statute on such grounds, notwithstanding a number of opportunities, since 1935; however, Professor Cass Sunstein suggests that the non-delegation constraint has been relocated within interpretation canons rather than abandoned. Sunstein, *supra* note 139, at 315–16.

[189] *See* Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1).

Treasury with an explicit grant of authority to promulgate the theoretical directives or to modify the judicially developed anti-abuse doctrines.

Section 7805(a) does not expressly grant such power. Instead, § 7805(a) delegates power to the Treasury to "prescribe all needful rules and regulations for the enforcement" of the tax laws.[190] Pursuant to this statute, the Treasury has the power to promulgate tax regulations with the force of law.[191] Section 7805(a) is, thus, a general grant of authority to the Treasury to promulgate regulations. But the statute provides no explicit guidance on what those regulations should contain (other than that they be needful and related to tax).[192] Thus, § 7805(a) alone does not explicitly give the Treasury the power to issue theoretical directives, to codify the judicial anti-abuse doctrines, or, for that matter, to enact any specific rule. Hence, the Treasury must find that power in another, more specific provision in the Code, like § 701.

Yet § 701 does not expressly delegate these powers either. Section 701 provides simply that "[a] partnership as such shall not be

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[190] I.R.C. § 7805(a). Professors Cunningham and Repetti might argue that Congress explicitly delegated both powers (and apparently countless others) because the § 7805(a) specifically grants the Treasury the authority to "prescribe *all needful* rules and regulations for the enforcement" of the tax laws]. *See* Cunningham & Repetti, *supra* note 24, at 48 (citing I.R.C. § 7805(a)). In their view, a needful rule for enforcement of the tax laws would include both a method to interpret those rules and the power to codify the judicial anti-abuse rules.

Yet consider the breadth of power the Treasury would have were this argument correct. The Treasury might decide that a needful rule for enforcing the tax code is one in which tax return preparers are subject to licensing, or is one extending the limitations period for the government to assess a deficiency against a taxpayer for overstating the basis in property, or is one allowing employees to carry guns to audits for safety. *See* Loving v. IRS, 742 F.3d 1013, 1015 (D.C. Cir. 2014) (rejecting the Treasury's attempt to regulate tax preparers); United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836, 1839 (2012) (rejecting the Treasury's attempt to extend the limitations period).

It seems unlikely that Congress intended to give the Treasury the power to enact any rule that the Treasury decided was needed. Rather, Congress likely intended to give the Treasury the power to enact rules that Congress decided were needed to implement and enforce statutes. *Cf.* Chamber of Commerce v. NLRB, 721 F.3d 152, 161 (4th Cir. 2013) (holding that despite statutory language granting the NLRB the authority to issue rules "necessary to carry out" the provisions of a statute, the NLRB had no authority to issue a specific rule).

[191] I.R.C. § 7805(a).

[192] *See id.*

subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."[193] Like § 7805(a), § 701 does not explicitly grant to the Treasury either the power to promulgate the theoretical directives or the power to modify the judicially developed anti-abuse doctrines.

Thus, neither of the statutes, considered separately or combined, *explicitly* delegates power to the Treasury either to promulgate statutory directives or to codify the judicially developed anti-abuse doctrines for subchapter K. Thus, if delegation exists at all, it must be implicit.

2. CONGRESS DID NOT *IMPLICITLY* DELEGATE

Not only did Congress not *explicitly* delegate either power to the Treasury, Congress did not *implicitly* delegate such power either. Congress was simply silent, and silence alone is not congressional delegation.[194]

Without a doubt, congressional delegation of authority to an agency need not be express; it may instead be implied.[195] Congress *explicitly* delegates authority to an agency to fill statutory gaps.[196] Congress *implicitly* delegates authority to an agency to resolve statutory ambiguity[197] because courts presume "that when an agency-

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[193] *Id.* § 701.

[194] *Home Concrete & Supply*, 132 S. Ct. at 1843 ("[A] statute's silence or ambiguity *as to a particular issue* means that Congress has not 'directly addressed the precise question at issue' . . . .") (citing Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 (1984)) (emphasis added); *Chamber of Commerce*, 721 F.3d at 159 (noting that there is no presumption that Congress delegated a specific power to an agency based solely on the fact that the legislature did not expressly withhold such power); Feller v. Comm'r, 135 T.C. 497, 535 (2010) (Gustafson, J., dissenting) ("Statutory specificity about one subject cannot sensibly be construed as gap-creating 'silence' about other subjects."); Am. Bar Ass'n v. FTC, 430 F.3d 457, 468 (D.C. Cir. 2005) (stating that requiring agencies to expressly withhold power would give agencies "virtually limitless hegemony").

[195] *Chevron*, 467 U.S. at 843.

[196] *Id.*

[197] As the Supreme Court noted, an agency's power to administer a congressionally developed program "necessarily requires the formulation of policy and the making of rules to fill any gap left . . . by Congress." *Id.* Further, *Chevron* applies, we are told, when a statute is silent or ambiguous with respect to the specific issue before a court. *Id.*

administered statute is ambiguous *with respect to what it prescribes*, Congress has empowered the agency to resolve the ambiguity."[198] Hence, when a statute contains ambiguity and an agency resolves that ambiguity, courts use the two-step deference standard identified in *Chevron* to review the validity of the agency's interpretive choice.[199]

Pursuant to *Chevron*,[200] a court determines at step one "whether Congress has directly spoken to the precise question at issue."[201] In essence, *Chevron*'s first step asks whether Congress implicitly delegated resolution of any ambiguity to the agency or retained that power for itself.[202] When applying this first step, courts do not defer

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[198] Util. Air Regulatory Grp. v. EPA, 134 S. Ct. 2427, 2439 (2014) (emphasis added).

[199] *See Chevron*, 467 U.S. at 843–44. Not all agency interpretations of ambiguous language are entitled to *Chevron* deference; some receive *Skidmore* deference. *See* Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944). Before applying *Chevron*, a court must make sure that the interpretation is one deserving of *Chevron*. Agency interpretations made using *force-of-law* procedures are entitled to *Chevron* deference while those made with less formal process are not. United States v. Mead Corp., 533 U.S. 218, 226–27 (2001); Christensen v. Harris Cty., 529 U.S. 576, 587 (2000). Here, there is no question that the Treasury used force-of-law procedures when promulgating its anti-abuse regulation because the Treasury used notice-and-comment procedures. For a discussion of IRS actions that do not warrant *Chevron* deference, see Kristin E. Hickman, *IRB Guidance: The No Man's Land of Tax Code Interpretation*, 2009 MICH. ST. L. REV. 239, 256–57 (2009).

[200] Congress's general grant of authority to the Treasury under § 7805(a) to issue regulations necessary to enforce the Code provides sufficient authority for the Treasury to issue legislative rules interpreting § 701 and other sections of the Code. The Supreme Court recently held that the Treasury has the power to interpret all the statutes it administers pursuant to its general grant of authority (§ 7805(a)). Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 56 (2011). Further, the Court held that the Treasury's interpretation of a particular statute, like § 701, is owed no less deference when it is contained in a rule adopted under the general grant of authority in § 7805(a) "than when it is 'issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision.'" *Id.* (quoting Rowan Cos. v. United States, 452 U.S. 247, 253 (1981)).

[201] *Chevron*, 467 U.S. at 842. In other words, is Congress's intent clear—however clarity may be discerned—or is there a gap or ambiguity to be resolved? Clarity is determined by "employing traditional tools of statutory construction . . . ." *Id.* at 843 n.9.

[202] United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836, 1843 (2012).

to an agency's interpretation at all. Rather, "[t]he judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent."[203] If the answer to this first question is yes, then that is the end of the matter, "for the court, as well as the agency must give effect to the unambiguously expressed intent of Congress."[204] If the answer is no, however, courts turn to *Chevron*'s second step. At *Chevron*'s second step, courts must accept any reasonable, or permissible, agency interpretation.[205]

Importantly, however, agencies are not entitled to *Chevron* deference for every interpretation they issue. *Chevron* deference is only appropriate when an agency interprets ambiguous statutory language and when Congress has delegated authority to that agency to resolve that ambiguity.[206] When Congress does not delegate such interpretive authority, agencies have no interpretive power, even in the face of ambiguous language.[207] In sum, for *Chevron*'s second step to apply, a court must find at *Chevron*'s first step that Congress implicitly delegated resolution of any ambiguities to the agency.[208]

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203 *Chevron*, 467 U.S. at 843 n.9.

204 Sala v. United States, 552 F. Supp. 2d 1167, 1199 (D. Colo. 2008), *rev'd*, 613 F.3d 1249 (10th Cir. 2010) (*quoting* Chevron, *467* U.S. at 842–43).

205 *Chevron*, 467 U.S. at 843.

206 *See* Michigan v. EPA, 268 F.3d 1075, 1082 (D.C. Cir. 2001) ("Mere ambiguity in a statute is not evidence of congressional delegation of authority."); Sea-Land Serv., Inc. v. Dep't of Transp., 137 F.3d 640, 645 (D.C. Cir. 1998) ("[Chevron] deference comes into play, of course, only as a consequence of statutory ambiguity, and then only if the reviewing court finds an implicit delegation of authority to the agency."); City of Kansas City v. Dep't of Hous. & Urban Dev., 923 F.2d 188, 192 (D.C. Cir. 1991) (noting that "implicit delegation of interpretive authority" and ambiguity are required before *Chevron*-step-two deference is appropriate).

207 King v. Burwell, 135 S. Ct. 2480, 2488-89 (2015) (noting that "[i]n extraordinary cases, however, there may be reason to hesitate before concluding that Congress has intended such an implicit delegation [simply from ambiguous language].") (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 159 (2000)).

208 When Congress *expressly* delegates, then the proper standard of review is arbitrary and capricious review. *Chevron*, 467 U.S. at 843; ABF Freight Sys., Inc. v. NLRB, 510 U.S. 317, 324 (1994) ("When Congress expressly delegates to an administrative agency the authority to make specific policy determinations, courts must give the agency's decision controlling weight unless it is 'arbitrary, capricious, or manifestly contrary to the statute.'") (quoting *id.* at 844).

a. *Silence Is Not Delegation*

Professors Cunningham and Repetti suggest that Congress impliedly delegated both powers to the Treasury through silence.[209] Regarding the judicially developed anti-abuse doctrines, the professors correctly point out that Congress could have codified these doctrines had it wished, but Congress did not do so.[210] Regarding the theoretical directives, the professors erroneously claim[211] that Congress could have enacted theoretical directives telling "courts to use a specific method of statutory interpretation in analyzing a statute . . . ."[212] Again, they note that Congress did not do so.[213] From these two instances of congressional silence, the professors conclude that "the statute does not address the subject matter of the regulation[] . . . ."[214] Because no statute addresses the subject matter of the regulation, Professors Cunningham and Repetti conclude that the first step of *Chevron* is satisfied; Congress did not speak to the precise issue.[215] Hence, the only question remaining is whether the Treasury's interpretation was reasonable, pursuant to the second step of *Chevron*.[216] In short, the professors assert the Treasury had the power to promulgate the anti-abuse regulation merely because Congress did not expressly withhold that power.[217] For the professors, silence satisfies *Chevron*'s first step.[218]

I disagree. A number of courts have rightly rejected the argument that silence alone is sufficient to satisfy *Chevron*'s first step.[219]

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209 Cunningham & Repetti, *supra* note 24, at 53.

210 *Id.* Congress did codify the economic-substance doctrine in 2010. Congress codified the doctrine through § 1409 of the Health Care and Education Reconciliation Act of 2010.

211 I disagree. *See supra* Section IV.A.

212 Cunningham & Repetti, *supra* note 24, at 53.

213 *Id.*

214 *Id.* at 54.

215 *Id.* at 53 (stating only that "[t]he existence of [the common law doctrines] and the use of the purposivist method of statutory interpretation . . . squarely confronted Congress with the issue whether, as a policy matter, the doctrines should apply when interpreting the partnership tax provisions").

216 *Id.* at 54.

217 *See supra* notes 209–215.

218 Cunningham & Repetti, *supra* note 24, at 53.

219 *See, e.g.*, Texas v. United States, 497 F.3d 491, 502 (5th Cir. 2007) ("Courts encountering this kind of 'whatever-it-takes' approach to *Chevron* analysis in the past have rejected it."); Am. Bar Ass'n v. FTC, 430 F.3d 457, 468 (D.C.

For example, in *American Bar Association v. FTC*,[220] the D.C. Circuit rejected this silence-equals-delegated-power argument. The statute at issue in that case empowered the Federal Trade Commission to regulate "financial institutions."[221] The FTC attempted to regulate attorneys, claiming that they were "financial institutions."[222] The issue for the court was whether the FTC's interpretation was entitled to *Chevron* deference. The FTC argued that because the statute was silent on this issue—meaning that it did not contain language specifically exempting attorneys or the practice of law from regulation—the FTC had the power to regulate both.[223] The court was relatively scathing in its rebuke of the agency's silence argument:

> As we have often cautioned, "[t]o suggest, as the [Commission] effectively does, that *Chevron* step two is implicated any time a statute does not expressly *negate* the existence of a claimed administrative power . . . is both flatly unfaithful to the principles of administrative law . . . and refuted by precedent." *Ry. Labor Exec. Ass'n*, 29 F.3d at 671 (emphasis in original). Plainly, if we were "to *presume* a delegation of power" from the absence of "an express *withholding* of such power, agencies would enjoy virtually limitless hegemony . . . ." *Id.* (emphasis in original). . . .
>
> We further recognize that the existence of ambiguity is not enough *per se* to warrant deference to the agency's interpretation. The ambiguity must be such as to make it appear that Congress either explicitly or implicitly delegated authority to cure that ambiguity.

Cir. 2005); *cf.* Sea-Land Serv., Inc. v. Dep't of Transp., 137 F.3d 640, 646 (D.C. Cir. 1998) (noting that "the [statutory] limitation to exporting or importing countries says nothing about the *form* of legal mandate"). *But see* Garcia-Carias v. Holder, 697 F.3d 257, 268 (5th Cir. 2012) (DeMoss, J., dissenting) (noting that Congress's failure to codify the departure rule for immigration cases shows that Congress intended to delegate that decision to the agency).

220 *Am. Bar Ass'n*, 430 F.3d at 468.

221 *Id.* at 470 (citing 15 U.S.C. § 6809(3)(a)).

222 *Id.* at 465–66.

223 *Id.* at 468.

> "Mere ambiguity in a statute is not evidence of congressional delegation of authority." *Michigan v. EPA*, 268 F.3d 1075, 1082 (D.C. Cir. 2001) (citations omitted). The deference mandated in *Chevron* "comes into play, of course, only as a consequence of statutory ambiguity, and then *only* if the reviewing court finds an implicit delegation of authority to the agency." *Sea-Land Serv., Inc. v. Dep't of Transp.*, 137 F.3d 640, 645 (D.C. Cir. 1998) (emphasis added). . . .[224]

Following this rebuke, the court held that Congress did not, through its silence, implicitly delegate power to the FTC to regulate attorneys.[225]

The Fourth Circuit similarly held that silence alone is insufficient to constitute implicit delegation and trigger *Chevron*'s second step.[226] In *Chamber of Commerce v. NLRB*, the court held that the National Labor Relations Board did not have authority to enact a notice-posting requirement.[227] The NLRB argued that it had the power to promulgate its notice-posting regulation simply because Congress had not expressly withheld that authority.[228] In response, the court noted that there is no presumption that Congress delegated a specific power to an agency based solely on the fact that the legislature did not expressly withhold such power.[229] As the court explained, the analysis is "whether Congress intended to grant [an agency] the authority to issue [a] challenged rule—and not whether Congress intended to withhold that power."[230] Thus, the court held that Congress must specifically grant authority for an agency to act, not simply remain silent.[231] In sum, *American Bar Association*,

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224 *Id.* at 468–69.
225 *Id.* at 469.
226 Chamber of Commerce v. NLRB, 721 F.3d 152, 160 (4th Cir. 2013).
227 *Id.* at 154.
228 *Id.* at 159.
229 *Id.* at 160.
230 *Id.*
231 *Id.* (citing Am. Bar Ass'n v. FTC, 430 F.3d 457, 468 (D.C. Cir. 2005)); *accord* Michigan v. EPA, 268 F.3d 1075, 1082 (D.C. Cir. 2001) ("Agency authority may not be lightly presumed. . . . 'Thus, we will not presume a delegation of power based solely on the fact that there is not an express withholding of such

Chamber of Commerce, and other cases have held that congressional silence alone is simply insufficient to show that Congress delegated interpretive authority to an agency. Hence, any ensuing agency regulation is not entitled to deference.[232]

The alternative presumption—silence-equals-delegated-power—would lead to virtually unconstrained agency lawmaking. Such a presumption "would in effect be blank checks drawn to the credit of some administrative officer or board."[233] For example, § 701 does not address the taxation of hedge funds or façade easements or flying to the moon.[234] Under the silence-equals-delegated-power presumption, the Treasury would have power to regulate all three areas because Congress did not withhold such power.

The silence-equals-delegated-power presumption would require Congress to specifically negate any power it did not intend to delegate. "Were courts to *presume* a delegation of power absent an express *withholding* of such power, agencies would enjoy virtually limitless hegemony, a result plainly out of keeping with *Chevron* and quite likely with the Constitution as well."[235] The question at step one of *Chevron* is whether Congress has "directly spoken to *the precise question* at issue,"[236] not, as Professors Cunningham and Repetti contend, whether "the statute addresses the subject matter of

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power.'") (quoting Am. Petroleum Inst. v. EPA, 52 F.3d 1113, 1120 (D.C. Cir. 1995)).

[232] *See, e.g.*, Brown & Williamson Tobacco Corp. v. FDA, 153 F.3d 155, 161 (4th Cir. 1998), *aff'd*, 529 U.S. 120 (2000); Sierra Club v. EPA, 311 F.3d 853, 861 (7th Cir. 2002); *Am. Petroleum Inst.*, 52 F.3d at 1120; Ry. Labor Execs.' Ass'n v. Nat'l Mediation Bd., 29 F.3d 655, 671 (D.C. Cir.), *amended by* 38 F.3d 1224 (D.C. Cir. 1994).

[233] H.R. REP. NO. 79-1980, at 275 (1946) (the legislative history to the APA).

[234] *See* I.R.C. § 701.

[235] Ethyl Corp. v. EPA, 51 F.3d 1053, 1060 (D.C. Cir. 1995) (emphasis in original) (citations omitted); *accord* Texas v. United States, 497 F.3d 491, 502 (5th Cir. 2007); Michigan v. EPA, 268 F.3d at 1082 ("Mere ambiguity in a statute is not evidence of congressional delegation of authority.") (citations omitted); Sea-Land Serv., Inc. v. Dep't of Transp., 137 F.3d 640, 645 (D.C. Cir. 1998) (The deference mandated in *Chevron* "comes into play, of course, only as a consequence of statutory ambiguity, and then only if the reviewing court finds an implicit delegation of authority to the agency."); *Ry. Labor Execs.' Ass'n*, 29 F.3d at 671.

[236] Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 842 (1984) (emphasis added).

the regulation" at all.[237] Whether Congress spoke directly to the precise question at issue is a more complex question than whether Congress was merely silent. Courts should not presume Congress delegated interpretive power to an agency simply because Congress did not expressly withhold such power. Were courts to do so, the potential breadth of implied agency delegation would be simply stunning.

b. *General Words Are Not Delegation*

Not only is silence insufficient to constitute implied delegation, but general words like "necessary" and "needful" are similarly insufficient.[238] Hence, the Treasury cannot successfully argue that its general grant of authority in § 7805(a) to prescribe all needful rules as may be necessary provides implied delegated power.

Agencies are entitled to deference when they interpret identifiable ambiguous language in a statute.[239] When applying *Chevron*, a court asks "whether the regulation is a reasonable interpretation of the statute."[240] For example, in *Chevron*, the issue for the Supreme Court was whether the Environmental Protection Agency's interpretation of the term "stationary source" in a provision of the Clean Air Act was valid.[241] The language the agency interpreted was identifiable: "stationary source."[242]

This axiom is true in the tax world as well; to illustrate, in *Atlantic Mutual Insurance Co. v. Commissioner*, the Court applied *Chevron* to uphold the Treasury's interpretation of the term "reserve strengthening" in § 1023(e)(3)(B) of the Tax Reform Act of 1986.[243] In both *Chevron* and *Atlantic Mutual*, and in thousands more, courts

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[237] Cunningham & Repetti, *supra* note 24, at 51.

[238] *See infra* text accompanying notes 250–258.

[239] United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836, 1843 (2012) ("*Chevron* and later cases find in unambiguous language a clear sign that Congress did *not* delegate gap-filling authority to an agency; and they find in ambiguous language at least a presumptive indication that Congress did delegate that gap-filling authority.").

[240] Cunningham & Repetti, *supra* note 24, at 51.

[241] *Chevron*, 467 U.S. at 840.

[242] *Id.*

[243] Atl. Mut. Ins. Co. v. Comm'r, 523 U.S. 382, 391 (1998); *accord* Loving v. IRS, 742 F.3d 1013, 1016–17 (D.C. Cir. 2014) (rejecting the Treasury's interpretation of the phrase "representatives of persons before the Department of the Treasury" as including tax-return preparers).

have applied *Chevron* to evaluate an agency's interpretation of identifiable, ambiguous language in a statute or act.[244]

As noted earlier,[245] the Treasury claimed that two statutes provided the agency with interpretive authority: I.R.C. §§ 7805(a) and 701.[246] However, the Treasury did not actually interpret specific language in either statute.

First, the Treasury did not interpret identifiable language in § 7805(a). Section 7805(a) provides in relevant part: "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."[247] This statute is a general grant of authority to the Treasury to issue rules and regulations as "needful" and "necessary" to enforce the tax code.[248] Section 7805(a) does not mention the words "partnerships," "the intent of subchapter K," the judicially developed anti-abuse doctrines, "purposivism," "literalism," or even "subchapter K." Thus, the regulation does not interpret any identifiable word or words in § 7805(a).[249]

The Treasury might argue that it interpreted the words "needful" and "necessary."[250] Making this argument, the Treasury might claim that the regulation was necessary and needful because those forming partnerships were running amok and abusing the tax rules. However, general words like "needful" and "necessary" are insufficient alone

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[244] For example, in *Home Concrete & Supply*, 132 S. Ct. at 1839, the majority identified and italicized the relevant statutory language: "*omits from gross income an amount properly includible therein* . . . ." *See generally* William N. Eskridge, Jr. & Lauren E. Baer, *The Continuum of Deference: Supreme Court Treatment of Agency Statutory Interpretations from* Chevron *to* Hamdan, 96 GEO. L.J. 1083, 1094 (2008) (cataloguing all 1014 Supreme Court cases decided between *Chevron* and *Hamdan* in which a federal agency interpreted a statute).

[245] *See supra* Section V.B.

[246] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1).

[247] I.R.C. § 7805(a).

[248] *Id.*

[249] *See id.*

[250] Professors Cunningham and Repetti did not make this argument in their article. *See* Cunningham & Repetti, *supra* note 24, at 53–54 (failing to address § 7805(a)). However, Professor Cunningham has subsequently raised this argument with me. *See* Email from James Repetti (Aug. 1, 2014) (on file with author).

to provide the ambiguity needed to reach *Chevron*'s second step, as the Fourth Circuit held in *Chamber of Commerce v. NLRB*.[251]

In *Chamber of Commerce*, the statute at issue provided the NLRB with the "authority from time to time to make, amend, and rescind . . . such rules and regulations as may be *necessary* to carry out the provisions of [the National Labor Relations Act]."[252] The NLRB promulgated a regulation requiring "[a]ll employers . . . [to] post notices to employees, in conspicuous places, informing them of their NLRA rights, together with Board contact information and information concerning basic enforcement procedures."[253]

The NLRB argued that the statute authorized the agency "to issue rules that [were] 'necessary to carry out' the provisions of the Act."[254] The NLRB contended that the word "necessary" was inherently ambiguous and, thus, that the court must uphold the agency's reasonable interpretation of that term pursuant to *Chevron*'s second step.[255] In essence, the NLRB contended that because the word "necessary" was ambiguous, Congress implicitly delegated interpretive power to it.

The court disagreed and explained that "'[t]he ambiguity must be such as to make it appear that Congress either explicitly or implicitly delegated authority to cure that ambiguity [to the agency].'"[256] Examining the rest of the relevant Act, the court concluded that Congress had not granted the NLRB the power to issue the notice-posting rule.[257] In other words, the court held that the ambiguity in a general word like "necessary" was insufficient to constitute implied delegation.[258] This holding makes sense: consider how expansively the Treasury might regulate if the terms "needful" and "necessary" justified any action the agency wanted to take.

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[251] Chamber of Commerce v. NLRB, 721 F.3d 152, 161 (4th Cir. 2013).

[252] *Id.* at 155 (citing 29 U.S.C. § 156) (emphasis added).

[253] *Id.* at 156 (citing 29 C.F.R. § 104.202(a)).

[254] *Id.* at 160 (citing 29 U.S.C. § 156). This language is almost identical to § 7805(a), which gives the Treasury the power "to prescribe all needful rules and regulations for the enforcement of [the tax laws] . . . ." I.R.C. § 7805(a).

[255] *Chamber of Commerce*, 721 F.3d at 161.

[256] *Id.* at 161 (quoting Am. Bar Ass'n v. FTC, 430 F.3d 457, 469 (D.C. Cir. 2005)).

[257] *Id.* at 162.

[258] *Id.* at 161.

More recently, in *King v. Burwell*,[259] the Supreme Court again concluded that a general grant of authority was insufficient. The issue in the case involved a requirement in the Affordable Care Act[260] that tax credits "be allowed" for any "applicable taxpayer,"[261] but only if the taxpayer has enrolled in an insurance plan through "an Exchange *established by the State*."[262] Many states chose to let the federal government establish their exchanges.[263]

The Act provided, "The Secretary [of the Treasury] shall prescribe such regulations as may be *necessary* to carry out the provisions of this section . . . ."[264] The Treasury promulgated a regulation[265] interpreting the language—"an Exchange established by the State"—as allowing tax credits "regardless of whether the Exchange [was] established and operated by a State . . . or by HHS."[266] Two lower courts had split regarding whether the Treasury's interpretation was entitled to deference, but both courts applied the *Chevron* analysis.[267]

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[259] 135 S. Ct. 2480 (2015).

[260] Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119.

[261] *King*, 135 S. Ct. at 2487 (citing 26 U.S.C. § 36B(a)).

[262] 26 U. S. C. §§ 36B(b)–(c) (emphasis added).

[263] At the time of the litigation, only sixteen States and the District of Columbia had established exchanges, while thirty-four States opted to have the federal government do so. Brief of respondents Sylvia Burwell, Secretary of Health and Human Services, et al., No. 14–114, at 11 (filed Jan. 21, 2015).

[264] I.R.C. § 36B(g). Some commentators have argued that this broad, general grant of authority should be sufficient. Leandra Lederman & Joseph C. Dugan, King v. Burwell: *What Does it Portend for* Chevron*'s Domain?*, 43 PEPP. L. REV. 75 (citing Syd Gernstein, King v. Burwell: *A Win for the President, but a Loss for the IRS?*, FED. TAX BLOG (June 25, 2015), http://www.bna.com/king-burwell-win-b17179928783/; Andy Grewal, *Brown & Williamson vs. Congressional Intent*; YALE J. ON REG.: NOTICE & COMMENT (June 30, 2015), http://www.yalejreg.com/blog/brown-williamson-vs-congressional-intent-by-andy-grewal).

[265] Treas. Reg. § 1.36B-2 (2014). The Supreme Court mistakenly calls the regulation an "IRS rule." *Id.* at 2487.

[266] *Id.* at 2487 (citing 45 CFR §155.20).

[267] The Fourth Circuit rejected their arguments. Applying *Chevron* deference, the court first concluded that the statute was ambiguous, and then found Treasury's interpretation to be reasonable under *Chevron*'s second step. King v. Burwell, 759 F.3d 358, 363 (4th Cir. 2014), *cert. granted* 135 S. Ct. 475 (2014). In contrast, the D.C. Circuit had concluded just the opposite in another case at nearly the same time. The D.C. Circuit found the statute clear at *Chevron*'s first step and

The Supreme Court, refused to apply *Chevron* at all, calling *King* an "extraordinary case[]."[268] The Court reasoned that the question of whether plaintiffs had to purchase health care was one of such "deep 'economic and political significance' [and was so] central to this statutory scheme," that if Congress wished to assign resolution of that question to an agency, "[Congress] *surely would have done so expressly.*"[269] Because the majority did not find a clear expression of congressional intent to delegate this issue to the Treasury or IRS, the agencies had no such power.[270] Instead, the Court interpreted the statutory language without regard to the agency's regulation.[271] Thus, general grants of authority are simply insufficient to demonstrate congressional intent to delegate interpretive authority.

Here, not only did the Treasury not interpret specific language in § 7805(a), the Treasury did not interpret specific language in § 701.[272] Section 701 provides: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."[273] Admittedly, this section contains a number of potentially ambiguous words and phrases that the Treasury could have interpreted: for example, what is a "partnership," and "when are persons carrying on business as partners"? Undoubtedly, Congress implicitly delegated power to the Treasury to interpret these terms. Had the Treasury interpreted either of these terms, then *Chevron* would be the appropriate standard to apply.

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never reached step two. Halbig v. Burwell, 758 F.3d 390 (D.C. Cir. 2014), *reh'g en banc granted, judgment vacated*, No. 14–5018, 2014 WL 4627181 (D.C. Cir. Sept. 4, 2014).

[268] *King,* 135 S. Ct. at 2488.

[269] *Id.* at 2489 (emphasis added).

[270] *Id.*

[271] *Id.*

[272] Professors Cunningham and Repetti do not specifically explain how § 701 provides implicit authority to the Treasury. Rather, they seem to suggest that Subchapter K as a whole provides such authority. *See* Cunningham & Repetti, *supra* note 24, at 53–54 (discussing the legislative history of subchapter K, and then noting that "the statute [§ 701] does not address the subject matter of the regulations . . . ."). Subchapter K contains more statutes than just § 701; it is a collection of seventy-two different sections.

[273] I.R.C. § 701.

The Treasury might argue that it interpreted one or more of these terms by codifying the judicially developed anti-abuse doctrines.[274] Making this argument, the Treasury might contend that those businesses that met the regulation's three requirements would be valid "partnerships" and their owners would be recognized as "persons carrying on business as partners," while those businesses that did not meet the regulation's requirements would be recast, or disregarded. Especially given that § 7805(a) allows the Treasury to prescribe all "needful" and "necessary" rules for tax purposes, this argument at first glance appears to have some force.

There are two problems with it, however. First, even if this argument were accurate, at best it supports the conclusion that the Treasury had interpretive authority to codify and modify the judicially developed anti-abuse doctrines to define valid partnerships; it provides no support for the conclusion that the Treasury had interpretive authority to issue the theoretical directives.

Second, the Treasury never claimed to be interpreting either term in § 701. Rather, the Treasury claimed to be interpreting "the intent of subchapter K."[275] Thus, the Treasury expects deference for discerning statutory purpose, or legislative intent, for subchapter K. To my knowledge, no court has ever applied *Chevron* to defer to an agency's characterization of congressional intent or statutory purpose, nor should one.[276] An agency's construction of ambiguous statutory language receives deference because courts presume that

[274] Professors Cunningham and Repetti note that "[t]he regulation provides a working definition of 'the intent of subchapter K.' According to the regulation, subchapter K is intended 'to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax.'" Cunningham and Repetti, *supra* note 24, at 37 (citing Treas. Reg. § 1.701-2(a)).

[275] Treas. Reg. § 1.701-2(b). Further, the NPRM was very clear that "[the anti-abuse regulation] clarifies the authority of the Commissioner of Internal Revenue to recast those transactions that exploit and misuse the provisions of subchapter K in an attempt to avoid tax." Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1).

[276] An email inquiry to the administrative law listserv proved unsuccessful at identifying any cases in which a court had applied *Chevron* deference to an agency's determination of statutory purpose or legislative intent or in which an agency had received *Chevron* deference even though it had not interpreted ambiguous statutory language. *See* Email from Linda D. Jellum (Apr. 24, 2014) (on file with author along with responses).

Congress would want the administering agency, rather than the courts, to resolve any ambiguity.[277] The agency should resolve these ambiguities because deciding the meaning or the reach of a statute involves reconciling conflicting policies.[278] Agencies are experts in their fields and are better than courts at reconciling policies.[279] If an agency's choice represents a reasonable accommodation of the conflicting policies, and if Congress committed resolution of that choice to the agency, then courts should not disturb the agency's resolution unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned.[280] In contrast, judges, who are experts in statutory interpretation, are better suited to determine statutory purpose and legislative intent.[281]

With the possible exception of textualists, most judges would agree that an agency should consider statutory purpose and legislative intent in construing the meaning of ambiguous statutory language.[282] While an agency may use its understanding of legislative intent and statutory purpose to interpret ambiguous statutory language, the agency's discernment of that intent and purpose is not entitled to *Chevron* deference. Indeed, an agency's discernment of purpose and intent is not entitled to deference of any kind. Thus, an agency's interpretation of ambiguous language is entitled to *Chevron* deference, but an agency's determination of the statutory purpose or the legislative intent is not.

Moreover, the Treasury did not just discern statutory purpose or legislative intent for one statute or a few related statutes; the Treasury attempted to discern that purpose or intent collectively for the seventy-two separate statutes that comprise an entire subchapter of

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[277] *See* Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 (1984).

[278] *Id.* at 844–45.

[279] *See* ABF Freight Sys., Inc. v. NLRB, 510 U.S. 317, 324 (1994).

[280] *Chevron*, 467 U.S. at 843–44.

[281] *See* Judith S. Kaye, *Things Judges Do: State Statutory Interpretation*, 13 TOURO L. REV. 595, 597 (1997) ("Overwhelmingly what federal judges do is interpret federal statutes and federal regulations.").

[282] *See* Frank H. Easterbrook, *What Does Legislative History Tell Us?*, 66 CHI.-KENT L. REV. 441, 442 n.4 (1990) (quoting Justice Scalia as saying, "I play the game like everybody else . . . . I'm in a system which has accepted rules and legislative history is used . . ."); John M. Walker, Jr., *Judicial Tendencies in Statutory Construction: Differing Views on the Role of the Judge*, 58 N.Y.U. ANN. SURV. AM. L. 203, 232 (2001).

the Code. Congress enacted subchapter K as part of the 1954 overhaul of the Internal Revenue Code.[283] The Internal Revenue Code of 1954 is 907 pages long; the new partnership laws were just one subpart of this massive act, which was amended in 1986.[284] In 1994, when the Treasury issued the anti-abuse regulation, the agency did not interpret language in just one or even a few specific sections within the Tax Reform Act of 1954; rather, the Treasury claimed to discern that purpose for all seventy-two separate codified sections of the partnership chapter.[285] Subchapter K is a collection of statutes, a regulatory regime, if you will. It is unclear whether an agency should receive *Chevron* deference for articulating its understanding of the purpose for an entire subchapter of the U.S. Code.

Even if the Treasury were entitled to *Chevron* deference for discerning congressional intent or statutory purpose collectively for an entire subchapter of the U.S. Code, *Chevron* deference would still be inappropriate, at least as applied to the Treasury's decision to adopt the purposivist directives. *Chevron* deference does not apply to the Treasury's decision to direct interpreters to adopt one statutory interpretation approach in favor of another. To my knowledge, no court has ever applied *Chevron* deference to an agency's issuance of a theoretical directive.

In sum, application of *Chevron*'s second step in this case would be unprecedented and unwarranted. *Chevron* applies when agencies interpret identifiable, ambiguous *language* in a statute that has delegated interpretive power to the agency.[286] In this case, the Treasury interpreted legislative intent and statutory purpose for seventy-two separate sections of the Code. Whether a court would reject *Chevron* altogether and apply a *de novo* standard of review to the Treasury's action[287] or would reject the agency's regulation at *Chevron*'s first step, the anti-abuse regulation is *ultra vires*, at best, and unconstitutional, at worst.

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[283] Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3 (1954).

[284] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[285] In 1994, subchapter K included seventy-two sections, specifically 26 U.S.C §§ 701–71. *See* Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25581 (proposed May 17, 1994) (to be codified at 26 C.F.R. pt. 1). It has since been amended and now includes seventy-eight. *See* 26 U.S.C §§ 701–77 (2012).

[286] *See supra* text accompanying notes 239–244.

[287] Rather, the appropriate standard is *de novo* under the APA § 706(2)(B).

C. *Chevron's Second Step*

When Congress does not delegate power to an agency and the agency acts anyway, the agency's action is unconstitutional.[288] However, when Congress delegates power to an agency but the agency does not stay within the bounds of that delegated power, then the agency's action is not unconstitutional; it is *ultra vires*.[289]

In the last section of this Article, I demonstrate that Congress did not delegate the power to issue the rules in the anti-abuse regulation. But, if I am wrong and a court were to conclude that Congress delegated power to the Treasury, a question remains: is the regulation *ultra vires*?

When Congress delegates power, an agency must stay within the bounds of its delegated power or the agency's action is *ultra vires*.[290] The agency stays within the bounds of its delegated power when the statute clearly contemplates the regulation issued.[291] To determine whether the statute clearly contemplates the regulation issued,

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[288] *See* Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 134 (1936). The act is unconstitutional because the Federal Constitution vests in the executive the executory powers, not legislative powers. U.S. CONST. art. II, § 1, cl. 1. All legislative powers are vested in Congress. U.S. CONST. art. I, § 1. Hence, agencies cannot act absent delegation from Congress. Congress may delegate legislative power to an agency pursuant to the necessary and proper clause. U.S. CONST. art. I, § 8. However, Congress must provide an agency with intelligible principles to guide the exercise of any delegated power. *See* J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928); Whitman v. Am. Trucking Ass'n, 531 U.S. 457, 474–76 (2001).

[289] Dalton v. Specter, 511 U.S. 462, 472–74 (1994) (explaining the difference between unconstitutional and *ultra vires* executive acts); Robinson v. Salazar, 885 F. Supp. 2d 1002, 1029 (E.D. Cal. 2012); City of Arlington v. FCC, 133 S. Ct. 1863, 1869 (2013) ("Both [agencies'] power to act and how they are to act is authoritatively prescribed by Congress, so that when they act improperly, no less than when they act beyond their jurisdiction, what they do is *ultra vires*."); Elec. Power Supply Ass'n v. FERC, 753 F.3d 216, 225 (D.C. Cir. 2014) (holding that FERC's issuance of a regulation that regulated retail power was an "*ultra vires* agency action."); Nw. Envtl. Advocates v. EPA, 537 F.3d 1006, 1019 (9th Cir. 2008); Iowa League of Cities v. EPA, 711 F.3d 844, 876 (8th Cir. 2013); Loving v. IRS, 742 F.3d 1013, 1015 (D.C. Cir. 2014) (holding that a Service rule regulating non-attorney, non-CPA tax-return preparers was *ultra vires*).

[290] *Robinson*, 885 F. Supp. 2d at 1029.

[291] *Iowa League of Cities*, 711 F.3d at 877 (citing O'Keefe v. McDonnell Douglas Corp., 132 F.3d 1252, 1257 (8th Cir.1998)).

courts generally turn to *Chevron*'s second step.[292] At *Chevron*'s second step, a court must accept any "permissible," or "reasonable," agency interpretation.[293] In this case, the Treasury's "interpretations" were not reasonable because: (1) the theoretical directives conflict with *Chevron*, and (2) the judicially developed anti-abuse doctrines were significantly altered.

1. The Theoretical Directives

The Treasury's decision to adopt purposivism and reject literalism was unreasonable. As noted, the anti-abuse regulation specifically allows the Treasury to recast a transaction "even though the transaction may fall within the literal words of a particular statutory or regulatory provision . . . to achieve tax results that are consistent with the intent of subchapter K."[294] It further allows, "[t]he Commissioner . . . [to] treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder."[295] With these two provisions, the Treasury has directed interpreters to ignore textualism, especially literalism, whenever doing so is inconsistent with the Treasury's understanding of the intent of subchapter K or the purposes of any Code provision. The directives are unreasonable because they conflict with *Chevron*.

Agencies have implied power to interpret statutory language when Congress leaves ambiguity.[296] When Congress is clear at *Chevron*'s first step, agencies have no interpretive power: "*Chevron* and later cases find in unambiguous language a clear sign that Congress did *not* delegate gap-filling authority to an agency . . . ."[297] For example, in *FDA v. Brown & Williamson Tobacco Corp.*, the Supreme Court held under *Chevron*'s first step that "Congress ha[d]

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[292] Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984).

[293] *Id.*; *see* Util. Air Regulatory Grp. v. EPA, 134 S. Ct. 2427, 2442 (2014) ("Even under *Chevron*'s deferential framework, agencies must operate 'within the bounds of reasonable interpretation.'") (quoting *City of Arlington*, 133 S. Ct. at 1868).

[294] Treas. Reg. § 1.701-2(b).

[295] *Id.* § 1.701-2(e).

[296] *Chevron*, 467 U.S. at 843.

[297] United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836, 1843 (2012).

clearly precluded the FDA from asserting jurisdiction to regulate tobacco products."[298] The Court reasoned, in part, that if Congress had intended to "delegate a decision of such economic and political significance" to the agency, then Congress would have delegated far more clearly.[299] Thus, the Food and Drug Administration had no power to interpret the statute.[300]

Where statutory text is unambiguous, an agency has no power to construe it differently, even to further legislative intent or statutory purpose.[301] Agencies cannot rewrite unambiguous statutory language simply to meet bureaucratic policy goals, however laudable those goals may be.[302] An agency's power to administer a federal statute and to prescribe rules and regulations to effectuate that statute is not the power to make law, for Congress can delegate no such power.[303] Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed in the statute.[304] "Agencies exercise discretion only in the interstices created by statutory silence or ambiguity; they must always 'give effect to the unambiguously expressed intent of Congress.'"[305]

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298 FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 126 (2000); *accord* Loving v. IRS, 742 F.3d 1013, 1021–22 (D.C. Cir. 2014) (holding that the Treasury's interpretation of 31 U.S.C. § 330 "fails at *Chevron* step 1 because it is foreclosed by the statute.").

299 *Brown & Williamson Tobacco Corp.*, 529 U.S. at 160.

300 *Id.* at 160–61.

301 *Chevron*, 467 U.S. at 842–43; *see* Barnhart v. Sigmon Coal Co., 534 U.S. 438, 462 (2002) (The agency lacked authority "to develop new guidelines or to assign liability in a manner inconsistent with the statute. In the context of an unambiguous statute, [the Court] need not contemplate deferring to the agency's interpretation."); MCI Telecomms. Corp. v. Am. Tel. & Tel. Co., 512 U.S. 218, 228–29 (1994) (holding that the FCC's interpretation of the word "modify" conflicted with its ordinary meaning); Elec. Power Supply Ass'n v. FERC, 753 F.3d 216, 220 (D.C. Cir. 2014) ("The question is 'whether the statutory text forecloses the agency's assertion of authority.'") (quoting City of Arlington v. FCC, 133 S. Ct. 1863, 1871 (2013)); Adams v. U.S. Forest Serv., 671 F.3d 1138, 1146 (9th Cir. 2012); Am. Petroleum Inst. v. EPA, 52 F.3d 1113, 1119 (D.C. Cir. 1995); Talley v. Mathews, 550 F.2d 911, 919 (4th Cir. 1977).

302 *See* Util. Air Regulatory Grp. v. EPA, 134 S. Ct. 2427, 2445 (2014).

303 *See supra* note 288 and accompanying text.

304 *See* Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 135 (1936).

305 *Util. Air Regulatory Grp.*, 134 S. Ct. at 2445 (quoting Nat'l Ass'n of Home Builders v. Defs. of Wildlife, 551 U.S. 644, 665 (2007)).

Despite this truism, the Treasury's anti-abuse regulation empowers the Commissioner to reject transactions that comply literally with unambiguous statutory text when the Commissioner determines that the transactions violate the "intent of subchapter K." If the Commissioner made such a finding in a particular case and that case were appealed, it is very possible that the reviewing court, particularly a court with a more text-focused judge, would reject the Commissioner's decision as unreasonable. Hence, the anti-abuse regulation, which empowers the Commissioner to ignore clear text, is unreasonable.

2. THE ANTI-ABUSE DOCTRINES

Similarly, the Treasury's adoption and modification of the judicially developed anti-abuse doctrines is unreasonable because the Treasury significantly altered and expanded—rather than echoed and codified—existing statutory and common law.[306]

Under the U.S. Constitution, Congress has the sole authority to make law.[307] When Congress makes law, it broadly chooses policy and then selects the method for achieving that policy. In doing so, Congress may leave gaps for agencies to fill.[308] While the line between gap-filling (law-executing) and law-making (legislating) is admittedly a fine one, regulations that alter existing statutory and common law doctrines cross that line.[309] With the anti-abuse regulation, the Treasury significantly changed existing law by creating tougher versions of the business-purpose doctrine and the economic-substance principle and by combining both into one supersized test.[310]

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[306] Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 610–16; *see* Nelson, *supra* note 92, at 642.

[307] U.S. CONST. art. 1, § 1.

[308] Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984).

[309] *See, e.g.*, Stephenson Trust v. Comm'r, 81 T.C. 283, 287 (1983) (taxpayers challenged the validity of a Subchapter J regulation—the trusts and estates subchapter); *cf.* Coltec Indus., Inc. v. United States, 62 Fed. Cl. 716, 756 (2004) ("[W]here a taxpayer has satisfied all statutory requirements established by Congress . . . the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers."), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006), *quoted in* Chirelstein & Zelenak, *supra* note 15, at 1947.

[310] *See* Banoff, *supra* note 61, at 1864 (noting that "[t]he antiabuse rule appears to extend existing law and go beyond congressional principles.").

When the Treasury promulgated the anti-abuse regulation in 1994, the judicially created anti-abuse doctrines existed, although their boundaries were ill-defined.[311] Generally, these doctrines required tax transactions to satisfy both a tax statute's language as well as its underlying purpose.[312] Satisfying the literal words of a tax law became insufficient.

Collectively, these doctrines permit the Service to reject a taxpayer's characterization of a business transaction that meets the literal terms of a tax statute when the taxpayer simultaneously seeks tax benefits Congress did not intend.[313] These doctrines include the business-purpose doctrine and the substance-over-form principle.[314] Substance-over-form serves as a background principle, supporting a group of related doctrines including the following:[315] the step-transaction doctrine, the "sham entity" doctrine, and the economic-substance doctrine.[316] While it is not my point in this Article to detail

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311 *See* Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 610 (calling the legal landscape in this area "opaque" and their parameters "unclear").

312 *See* Cunningham & Repetti, *supra* note 24, at 20. *See generally* Cohen, *supra* note 17 (describing and criticizing the legislative development of tax avoidance tests).

313 *See* Galle, *supra* note 19, at 362; Cunningham & Repetti, *supra* note 24, at 25–26; Caudill, *ABA Comment*, *supra* note 94 ("Transparent devices totally devoid of any non-tax significance to the parties cannot pass muster even though a literal reading of the statutory language might suggest otherwise.").

314 For a thorough overview of these doctrines as they were in 1978, see Bittker, *supra* note 35, 703–23.

315 True v. United States, 190 F.3d 1165, 1176 n.11 (10th Cir. 1999) (explaining "both the step transaction and sham transaction doctrines are corollaries of the basic substance over form principle"); Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45, 47–48 (2007) ("Generally, the doctrines that have emerged can be divided into two subtests under the substance-over-form doctrine: (i) the economic substance/sham transaction doctrines (with the business purpose doctrine included as the subjective prong), and (ii) the step transaction doctrine.").

316 *See generally* Madison, *supra* note 20, at 718 (discussing the beginnings of these common law doctrines); Blank & Staudt, *supra* note 25, at 1650–51 (describing these doctrines in slightly different terms). The economic substance doctrine was alternatively, and confusingly, called the sham-transaction doctrine for a while. *See* Madison, *supra* note 20, at 718 (noting the overlap: "the jurisprudence of sham entities overlaps with factual substance-over-form principles. In addition, the sham transaction doctrine is often called the economic substance doctrine, and transactions discussed in the context of either the sham transaction

the creation of these doctrines,[317] a brief recap of the law as it existed in 1994 is essential to understand how the Treasury significantly altered that law and why its interpretation is, thus, unreasonable.

The doctrines had their beginnings in 1935, with the seminal case of *Gregory v. Helvering*.[318] In that case, a taxpayer had complied literally with the statutory requirements for reorganization;[319] however, the Service refused to recognize the transaction because the taxpayer's only motive in reorganizing was to avoid paying taxes.[320] In siding with the Service, the Supreme Court developed the business-purpose doctrine.[321] Pursuant to this doctrine, a transaction must serve a bona fide business purpose other than tax avoidance to qualify for beneficial tax treatment.[322]

In *Gregory*, the Court also laid the groundwork for the substance-over-form principle, or doctrine.[323] When denying the tax

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doctrine or the economic substance doctrine are often called economic or substantive shams . . . .").

317 For an article that does so, see Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 589–604.

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

319 The relevant statute was § 112 (g) of the Revenue Act of 1928, ch. 852, Pub. L. No. 70-562, 45 Stat. 791 (1928).

320 *Gregory*, 293 U.S. at 469 (citation omitted).

321 *Id.* (criticizing the transaction as being nothing more than an "operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business").

322 *See* Cunningham & Repetti, *supra* note 24, at 21.

323 The jurisprudence and scholarship use both terms. *Compare* Falconwood Corp. v. United States, 422 F.3d 1339, 1350 (Fed. Cir. 2005) (referring to the "substance-over-form principle"), *and* True v. United States, 190 F.3d 1165, 1176 n.11 (10th Cir. 1999) (same), *and* Estate of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961) (referring to the "substance-over-form" principle), *and* Emily Cauble, *Rethinking the Timing of Tax Decisions: Does a Taxpayer Ever Deserve a Second Chance?*, 61 CATH. U. L. REV. 1013, 1030 (2012) (using the term "substance-over-form principles"), *and* Erick M. Jensen, *Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives*, 57 ST. LOUIS U. L.J. 1, 14 (2012) (same), *with* Rogers v. United States, 281 F.3d 1108, 1115 (10th Cir. 2002) (discussing the "substance-over-form doctrine"), *and* Madison, *supra* note 20, *and* Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 677 (1995) (referring to the "substance over form doctrine"). *But see* Charlene D. Luke, *The Relevance Games: Congress's*

benefits the taxpayer sought, the Court criticized the transaction as "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character . . . ."[324] Pursuant to the substance-over-form principle, the government can tax the substance of a transaction rather than the formal steps a taxpayer uses to complete it.[325]

From the substance-over-form principle, at least two different, but related, doctrines emerged: the step-transaction doctrine[326] and economic-substance doctrine.[327] Both doctrines reflect the idea that if two transactions have the identical economic outcome, they should have the same tax outcome.[328]

Economic substance, the more important doctrine for our purposes, actually began life as a principle[329] and morphed into a doctrine through judicial development.[330] Pursuant to the economic-

Choices for Economic Substance Gamemakers, 66 TAX LAW. 551, 567 n.85, 581 n.142 (2013) (using both terms).

324 *Gregory*, 293 U.S. at 469. Congress added a "no device" requirement to the Code in 1954. I.R.C. § 368; *see generally* Stephen Rigsby, *The Business Purpose Doctrine in Corporate Divisions*, 11 AKRON L. REV. 275, 280–84 (1977) (discussing the distinction between the business purpose doctrine and the "no device" language).

325 *See* Lederman, *Economic Substance*, *supra* note 33, at 391; Cunningham & Repetti, *supra* note 24, at 23.

326 The "step transaction" doctrine permits the Service to disregard steps in a transaction when those steps lack independent significance. Cunningham & Repetti, *supra* note 24, at 23.

327 *See* Madison, *supra* note 20, at 718 n.135 (citing Karen Nelson Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 660–62 (1989)).

328 Lederman, *Economic Substance*, *supra* note 33, at 435; *see* Cunningham & Repetti, *supra* note 24, at 23.

329 The Supreme Court developed the economic substance principle in *Knetsch v. United States,* 364 U.S. 361 (1960). In that case, the Court denied tax benefits to a taxpayer who paid $91,570 simply to reduce its tax obligation by $233,297.68, potentially netting a profit of $141,727.68. *Knetsch*, 364 U.S. at 365–66. The Court noted that the transaction did "'not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax . . . .' For it is patent that there was nothing of substance to be realized by [the taxpayer] from this transaction beyond a tax deduction." *Id.* at 366 (quoting Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir. 1967) (Hand, J., dissenting)).

330 The economic-substance doctrine at one point was also called the sham-transaction doctrine. "'Sham transaction' terminology is confusing, however, because it encompasses 'shams in fact,' which are transactions that never occurred,

substance *principle*, a court examines whether the transaction had a prospect of profit before taxes.[331] In other words, a transaction must have a meaningful economic purpose or investor risk to be legitimate.[332] And the Service can invalidate a transaction if it lacks economic substance independent of tax considerations.[333]

In *Frank Lyon v. United States*,[334] the Supreme Court combined the business-purpose doctrine and the economic-substance principle into a single two-pronged test—the economic-substance *doctrine*.[335] Under the business-purpose prong, a court assesses the taxpayer's underlying motivation for entering into the transaction.[336] Under the economic-substance prong, a court examines the transaction to determine whether the purported economic activity would have occurred absent the tax benefits.[337] Thus, the business-purpose prong focuses on the taxpayer's intent, while the economic-substance prong focuses on the transaction's effect.[338]

When it combined the business-purpose doctrine and the economic-substance principle, the Court stated:

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as well as 'shams in substance,' which lack economic substance. The substantive sham cases typically apply the same or similar analysis as that used in economic substance cases." Lederman, *Economic Substance*, *supra* note 33, at 391 n.1 (citing Yoram Keinan, *The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine*, 111 TAX NOTES 327, 330–31 (2006), and citing United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001)).

331 *See* Lederman, *Economic Substance*, *supra* note 33, at 391 (arguing that the modern economic-substance doctrine should be replaced with an examination of congressional intent); Bankman, *supra* note 52, at 10 (citing Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684, 720–21 (1999)).

332 *See Knetsch*, 364 U.S. at 364 (discussing the doctrine); Keeler v. Comm'r, 243 F.3d 1212, 1220 (10th Cir. 2001) (same); Salina P'ship LP v. Comm'r, 80 T.C.M. (CCH) 686, 695 (2000) (holding that the transaction in question had "a valid business purpose independent of tax benefits"); Sheldon v. Comm'r, 94 T.C. 738, 767 (1990).

333 *See* ACM P'ship v. Comm'r, 157 F.3d 231, 248 (3d Cir. 1998) (stating that "'the transaction [must have] practical economic effects other than the creation of income tax losses'" (quoting Jacobson v. Comm'r, 915 F.2d 832, 837 (2d Cir. 1990)).

334 Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

335 Madison, *supra* note 20, at 727 (citing *Frank Lyon Co.*, 435 U.S. at 583–84).

336 Lederman, *Economic Substance*, *supra* note 33, at 417.

337 *Id.*

338 Madison, *supra* note 20, at 725.

> [W]here, as here, there is a genuine multiple-party transaction *with economic substance* which is compelled or encouraged by *business* or *regulatory realities*, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[339]

Because this language was unclear regarding the relationship of the two prongs, lower courts developed two versions of the economic-substance doctrine: one conjunctive and one disjunctive.[340] Courts that used the conjunctive test allowed tax benefits only when a transaction had *both* business purpose *and* economic substance.[341] Courts that used the disjunctive test allowed tax benefits when a transaction had *either* business purpose *or* economic substance.[342]

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339 *Frank Lyon Co.*, 435 U.S. at 583–84 (emphasis added).

340 A few courts apply a factors test. *See, e.g.*, Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990) (explaining that "the Court's holding in *Frank Lyon* was not intended to outline a rigid two-step analysis . . . [rather] 'the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis'") (quoting Sochin v. Comm'r, 843 F.2d 351, 354 (9th Cir. 1988)).

341 *See, e.g.*, Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006) ("If the transaction has economic substance, 'the question becomes whether the taxpayer was motivated by profit' . . . [but] '[i]f, however, the court determines that the transaction is a sham, . . . the [subjective] inquiry is never made.'") (quoting Illes v. Comm'r, 982 F.2d 163, 165 (6th Cir. 1992)); Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("[E]ven if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."); Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 544 (5th Cir. 2009) ("[I]f a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations."); Horn v. Comm'r, 968 F.2d 1229, 1237 (D.C. Cir. 1992) (suggesting that the transaction is a sham if it lacks both economic substance and business purpose).

342 *See, e.g.*, United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001) (suggesting that the transaction is a sham if it lacks either economic substance or business purpose); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 95 (4th Cir. 1985) (suggesting that the transaction is a sham if it lacks both economic substance and business purpose); Black & Decker Corp. v. United

When it fashioned the anti-abuse regulation, the Treasury adopted these judicial anti-abuse doctrines; however, as I explained in an earlier article and will re-cap here, when the Treasury adopted these doctrines, it modified them and combined them in new ways.[343] First, the Treasury strengthened the business-purpose requirement. The judicially developed business-purpose doctrine required only that a taxpayer have *some* business purpose[344] and allowed recasting only when bad motive was *the* principal purpose of the transaction.[345]

In contrast, the Treasury's anti-abuse regulation provides that "[t]he partnership must be bona fide and each partnership transaction or series of related transactions . . . must be entered into for *a substantial business purpose*."[346] In addition to requiring that the partnership be bona fide, the anti-abuse regulation permits the Commissioner to recast a partnership if it was "formed or availed of in

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States, 436 F.3d 431, 441 (4th Cir. 2006) (saying when the taxpayer was motivated by no business purposes and the transaction had no economic substance it is a sham) (citing *Rice's Toyota World*, 752 F.2d at 91).

343 Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 610–16.

344 Nelson, *supra* note 92, at 645. For example, in *Cottage Savings Ass'n v. Commissioner*, the taxpayer swapped the participation interests of one mortgage portfolio for another, solely to realize a tax loss. 890 F.2d 848, 849 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991). The Sixth Circuit denied the tax benefits, noting: "What is done for the purpose of tax avoidance must, however, have some business purpose and not be an economic transaction in form only. The courts will not 'exalt artifice above reality.'" *Id.* at 853 (internal citations omitted). The Supreme Court reversed. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 568 (1991). In upholding the transaction, the Court ignored the taxpayer's tax avoidance motive and required very little in the way of a business purpose. *Id.* Similarly, in *Rice's Toyota World, Inc. v. Commissioner*, the Fourth Circuit stated: "To treat a transaction as a sham, the court must find the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction . . . ." *Rice's Toyota World*, 752 F.2d at 91 (describing the business-purpose prong of the economic-substance doctrine).

345 Thompson Jr., *supra* note 103, at 1396 (acknowledging the change, but suggesting that the choice seemed sensible); Cuff, *supra* note 96 ("The proposed regulation changes current law by establishing a general requirement that taxpayers not engage in partnership transactions with 'a principal purpose' of avoiding tax . . . [when] taxpayers have been generally free to engage in transactions with a principal purpose of avoiding tax . . . ."); Comfort, *supra* note 92 (noting that this provision "go[es] far beyond even the most extreme formulations of the business purpose doctrine under existing law").

346 Treas. Reg. § 1.701-2(a)(1) (emphasis added).

connection with a transaction *a principal purpose* of which [was] to reduce substantially" the partners' tax liability.[347] The regulation allows the Commissioner to recast a transaction when *a* principal purpose was tax avoidance rather than, as the judicially developed business-purpose doctrine allowed, when *the* principal purpose of the transaction was tax avoidance.[348] Further, the regulation allows the Commissioner to recast a transaction when the taxpayer does not have a *substantial* business purpose for the transaction rather than, as the judicially developed business-purpose doctrine allowed, *some* business purpose.[349] With these changes, the Treasury increased the standard for taxpayers to meet and thereby strengthened its ability to challenge a taxpayer's motivation.[350]

Strengthening business purpose was not the only change the Treasury made in its regulation. Prior to the regulation's promulgation, no court had included all of the judicially created anti-abuse doctrines and principles in one conjunctive test.[351] The closest such test—the economic-substance doctrine—included just two anti-abuse doctrines, business purpose and economic substance, joined conjunctively or disjunctively.[352] In contrast, the Treasury specifically incorporated all of the judicially developed substance-over-form principles into one single, conjunctive test.[353] And it combined all of these principles without identifying specifically which principles it was including. The regulation provides simply that "[t]he form of each partnership transaction must be respected under substance over form principles."[354] Which substance-over-form principles should be respected is not clear. For example, although the anti-abuse regulation does not separately refer to the step-transaction doctrine or the economic-substance doctrine, presumably, the Treasury intended to include both of these doctrines. Thus, the Treasury combined all of the substance-over-form principles and, thus, supersized the judicially created anti-abuse doctrines.

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[347] *Id.* § 1.701-2(b) (emphasis added).

[348] Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 612.

[349] *Id.*

[350] Sowell, *supra* note **Error! Bookmark not defined.**, at 81–88 (describing transactions to which the Treasury claimed the anti-abuse regulation applied).

[351] *See* Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 611.

[352] *Id.* at 622.

[353] *Id.*

[354] Treas. Reg. § 1.701-2(a)(2).

Strengthening business purpose and joining all of the judicially created anti-abuse doctrines were not the only changes the Treasury made when it promulgated the anti-abuse regulation. The Treasury also included an optional "proper reflection of income" prong.[355] Pursuant to this prong, "the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income . . . ."[356] This "clear reflection of income" prong was never part of the judicially developed anti-abuse doctrines.[357] Although there was some support for this requirement within other statutes in subchapter K, the existing statutes were not quite this broadly applicable.[358] While some have suggested that the clear reflection and allocation of income factors made this prong of the anti-abuse regulation superfluous, the prong actually expanded existing law.[359]

Consequently, with the anti-abuse regulation, the Treasury altered existing law, both statutory and "common law,"[360] in a number of ways. First, the Treasury strengthened the common law's requirement of business purpose by allowing the Commissioner to recast a transaction when *a* principal purpose was tax avoidance and the taxpayer did not otherwise have a *substantial* business purpose for the transaction.[361] Second, the Treasury crafted a super-sized anti-abuse

355 *See id.* § 1.701-2(a)(3).

356 *Id.*

357 *See* Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 611.

358 *See, e.g.*, I.R.C. § 446 ("If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."); *id.* § 482 (allowing the Secretary to allocate income among businesses to "clearly . . . reflect the income of any such . . . businesses").

359 *See* Marino, *supra* note 18, at 174; Nelson, *supra* note 92, at 646–47.

360 Technically, "'[c]ommon law' refers to that body of governing principles, mainly substantive, expounded by the common-law courts of England in deciding cases before them." William B. Stoebuck, *Reception of English Common Law in the American Colonies*, 10 WM. & MARY L. REV. 393, 393 (1968). In this Article, I use the term more colloquially to mean simply judge-made legal doctrine.

361 *See supra* text accompanying notes 344–350.

test, which, while incorporating the common-law anti-abuse doctrines, also combined them in new ways.[362] The super-sized test includes a tougher business-purpose element and all of the substance-over-form principles in one conjunctive test.[363] Moreover, the super-sized test includes an optional third prong—the proper-reflection-of-income prong—which did not exist in this form in the common law or the Code.[364] In sum, the anti-abuse regulation significantly increased the standard taxpayers had to meet to receive tax benefits under subchapter K.

While Professors Cunningham and Repetti suggest that "[t]he implied delegation from Congress necessarily included the ability to modify and adapt judicial doctrines existing in 1954 to changed circumstances,"[365] I disagree. The Treasury's interpretation is unreasonable because it transforms and enormously expands the Treasury's regulatory authority without clear congressional authorization. When an agency discovers in a "long-extant statute an unheralded power to regulate 'a significant portion of the American economy,' [the Supreme Court] typically greet[s] its announcement with a measure of skepticism. [The Court] expect[s] Congress to speak clearly if it wishes to assign to an agency decisions of vast 'economic and political significance.'"[366] Here, the Treasury assumed the power to significantly alter the judicially developed anti-abuse doctrines (thereby assuming the power to recast potentially thousands of partnership transactions) and to select a method of statutory interpretation. Yet Congress did not clearly authorize either power.

Administrative agencies have no power to make law, for Congress can delegate no such power.[367] Rather, agencies administer federal statutes by promulgating rules and regulations to effect the will of Congress as expressed by the governing, or enabling, statute.[368] "A regulation which does not do this, but operates to create a

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[362] *See supra* text accompanying notes 351–355.

[363] *Id.*

[364] Jellum, *Judicial Anti-Abuse Doctrines*, *supra* note 19, at 614.

[365] Cunningham & Repetti, *supra* note 24, at 54.

[366] Util. Air Regulatory Grp. v. EPA, 134 S. Ct. 2427, 2444 (2014) (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 159–60 (2000)).

[367] *See* Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 134 (1936).

[368] *See* Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 (1984) ("'The power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making

rule out of harmony with the statute, is a mere nullity."[369] "Although regulations are entitled to considerable weight, '[the Treasury] may not usurp the authority of Congress by adding restrictions to a statute which are not there.'"[370] Indeed, "the question a court faces when confronted with an agency's interpretation of a statute it administers is always, simply, whether the agency has stayed within the bounds of its statutory authority."[371]

A regulation is unreasonable when it extends beyond the scope of Congress's implied delegation of authority.[372] The anti-abuse regulation is unreasonable because it extends beyond any express or implied congressional delegation. To be precise, the Treasury created new law by combining and altering existing common and statutory law.[373] The Treasury has no authority to make new law;[374]

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of rules to fill any gap left, implicitly or explicitly, by Congress.'") (quoting Morton v. Ruiz, 415 U.S. 199, 231 (1974)).

[369] *Manhattan Gen. Equip. Co.*, 297 U.S. at 134.

[370] Stephenson Trust v. Comm'r, 81 T.C. 283, 288 (1983) (quoting Estate of Boeshore v. Comm'r, 78 T.C. 523, 527 (1982)); *see* Am. Auto. Ass'n v. United States, 367 U.S. 687, 697 (1961) ("[C]ourts should be wary of broad-scale incorporation of the doctrine of 'tax avoidance,' or 'business purpose,' or 'sham' in an area so fraught with its own particular problems and nuances. At the very least, we are required to limit those judicially developed doctrines to the situations which they were intended to cover."), *quoted in Stephenson Trust*, 81 T.C. at 291.

[371] Loving v. IRS, 742 F.3d 1013, 1016 (D.C. Cir. 2014) (quoting City of Arlington v. FCC, 133 S. Ct. 1863, 1868 (2013)); *See id.* at 1022 (holding that the Treasury had no authority to regulate tax-return preparers, especially given that it denied having such power for many years).

[372] Cunningham & Repetti, *supra* note 24, at 49 (citing Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 484–86 (2001), and citing AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 387–92 (1999)).

[373] *Accord* Comm'r v. Acker, 361 U.S. 87, 92 (1959) (invalidating a Treasury regulation because it conflicted with the statute); Coady v. Comm'r, 33 T.C. 771, 779 (1960) (rejecting the Commissioner's interpretation of a statute that was based on a committee report when it differed from the text of the statute), *aff'd*, 289 F.2d 490 (6th Cir. 1961); Koshland v. Helvering, 298 U.S. 441, 446–47 (1936) (invalidating a Treasury regulation that conflicted with the statute); Lynch v. Tilden Produce Co., 265 U.S. 315, 320–22 (1924) (holding that the statutory definition of adulterated butter could not be limited to a percentage of moisture in the butter but required an element of intent to adulterate); Miller v. United States, 294 U.S. 435, 439–40 (1935).

[374] *See* Jensen, *supra* note 323, at 43 (stating that the Treasury "probably does not have authority to issue a general anti-avoidance rule that would apply across the board," but suggesting that the Treasury might have had or claimed to have had authority to do so in the area of partnership taxation).

hence, the anti-abuse regulation is unreasonable and, therefore, *ultra vires*.

CONCLUSION

Abusive tax shelters are certainly a problem, and one that is not going away. The government has strong reasons for wanting to combat the abuse with any legitimate means it can find. The Treasury's frustration with the abuse of the partnership tax laws, in particular, stems from the broad latitude businesses have to structure partnership agreements. Partnerships and other pass-through entities remain a commonly used entity form; however, the partnership laws provide a number of opportunities for tax abuse. The anti-abuse regulation empowers the Service to look at the results of each transaction to see whether abusive behavior has occurred (such as income shifting and abusive deductions). The Treasury's goal to stop abuse was indeed laudable.

While the goal behind the regulation cannot be faulted, the anti-abuse regulation is simply not a legitimate choice to implement that goal. The Treasury assumed power that was never delegated to it; hence, the regulation is unconstitutional or, alternatively, *ultra vires.*

As for the theoretical directives, Congress had authority to delegate the power to promulgate such directives to the Treasury. Some have argued that because Congress could legitimately select an approach to judicial interpretation, Congress, by never making such a choice, implicitly delegated this choice to the Treasury. This argument is flawed. Congress has no such power, and Congress cannot delegate power it does not have. Additionally, Congress cannot delegate power through silence or general words. As for codifying the judicially developed anti-abuse doctrines, Congress neither implicitly nor explicitly delegated this authority to the Treasury.

In addition, even if one could find an implicit delegation of either power to the Treasury, the agency's action was *ultra vires* because the regulation exceeds the limits of any delegated power. Generally, courts turn to *Chevron* deference to determine whether agencies stay within the bounds of implicitly delegated power. Yet, deference is simply inappropriate here. Under *Chevron*, deference is appropriate when an agency interprets ambiguous language in a statute or, perhaps, a few statutes. While agencies have the authority to interpret ambiguous statutory language and fill gaps, courts should not defer to an agency's understanding of the statutory purpose for seventy-two different statutes in the Code or for the intent of the legislative body enacting those seventy-two different sections. The Treasury did not interpret ambiguous language in a statute. Rather, the Treasury discerned purpose and intent for an entire subchapter of the Code, containing seventy-two different statutes. Deference is inappropriate.

Moreover, even assuming deference is appropriate, the Treasury's anti-abuse regulation fails *Chevron*'s second step for two reasons. First, the Treasury included two theoretical directives, which directly conflict with *Chevron*. Second, the Treasury's attempt to codify the judicially developed anti-abuse doctrines was unreasonable because the Treasury significantly expanded existing common and statutory law. While agencies have the power to fill gaps and interpret ambiguous statutory language, they have no power to expand existing common or statutory law without clearly delegated authority. In sum, "we are probably better off with an IRS forced to follow statutory law and to look to Congress to clean up the statutes and to the courts for equity."[375]

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[375] Mark A. Luscombe, *Statutory Interpretation: A Taxpayer-Friendly, and More Flexible, IRS*, 80 TAXES 3, 4 (2002).