Quis Custodiet Ipsos Custodes? or Protecting the Tax System from I.R.S. Abuse

by Samuel D. Brunson*

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I. INTRODUCTION

Taxpayers dislike and distrust tax collectors. This dislike and distrust seems to transcend both time and culture. In ancient Egypt, for example, the government leased tax collection to the highest bidder; the tax collector had to remit a set amount to the government, irrespective of its collections. To protect taxpayers from abuse, the government required these tax collectors to provide receipts to taxpayers.[1] The authors of the New Testament categorized tax collectors alongside extortioners, adulterers, and the unjust.[2] A thousand years later, Byzantine peasants fled the "merciless tax collector."[3] In eighteenth-century Wales, tax men attempting to collect the excise tax on spirits found

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[1] William Harms, *Chicago Demotic Dictionary Refines Knowledge of Influential Language*, UCHICAGONEWS, http://news.uchicago.edu/article/2012/09/17/chicago-demotic-dictionary-refines-knowledge-influential-language (Sept. 17, 2012).

[2] William O. Walker, Jr., *Jesus and the Tax Collectors*, 97 J. BIBLICAL LITERATURE 221, 229 (1978).

[3] Charles M. Brand, *Two Byzantine Treatises on Taxation*, 25 TRADITION 35, 38 (1969).

themselves attacked, horsewhipped, robbed, killed, and disfigured.[4] And, in the United States in the nineteenth century, tax collectors earned the public's disdain through incompetence and corruption.[5]

This dislike has not gone away in the modern world. In Tanzania, taxpayers hide in the bush to evade tax collectors and, when tax collectors use more coercive means to collect taxes, taxpayers reciprocate by, among other things, attacking tax collectors and burning their offices.[6] Anecdotal evidence suggests that tax collectors broadly accept bribes in Taiwan, India, Nepal, and Thailand.[7]

The dislike and distrust of tax collectors in the modern world is not limited to developing economies. The I.R.S. collects taxes, and people dislike tax collectors.[8] For a select few, this dislike leaves the world of the reasonable and extends itself into the hyperbolical.[9] But dislike and distrust of the I.R.S. is not the exclusive realm of the conspiracy theorist and the tax protestor. Taxpayers remain aware that President Nixon attempted to use the I.R.S. to harass his political enemies.[10] And they remain aware that, should they be unlucky enough to catch the I.R.S.'s notice, it could bring its full administrative powers to bear against them.

In September of 1997, the Senate Judiciary Committee heard three days of testimony about the unchecked abuses of taxpayers at the hands of the I.R.S. [11] A retired priest testified that the I.R.S. wrongly assessed $18,000 in taxes from his mother's estate.[12] A California woman testified that $7,000 in back taxes ballooned to $16,000 while the I.R.S. only sent notices to her ex-husband.[13] I.R.S. employees, their identities hidden, testified that "they had witnessed colleagues bullying taxpayers into submission, using unethical tactics to collect money, and retaliating against IRS workers who tried to correct mistakes."[14] I.R.S. agents reviewed the tax records potential witnesses and of

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[4] THOMAS P. SLAUGHTER, THE WHISKEY REBELLION 13 (1986).

[5] HARRY EDWIN SMITH, THE UNITED STATES FEDERAL INTERNAL TAX HISTORY FROM 1861 TO 1871 282 (1914).

[6] Odd-Helge Fjeldstad, *Taxation, Coercion and Donors: Local Government Tax Enforcement in Tanzania*, 39 J. MODERN AFRICAN STUDIES 289, 295 (2001).

[7] Jean Hindricks, Michael Keen, & Abhinay Muthoo, *Corruption, Extortion and Evasion*, 74 J. PUB. ECON. 395, 396 n.1 (1999).

[8] *See* Pat Widder, *Fairness & Abuse: A Delicate Balance*, CHI. TRIB., Sept. 28, 1997, at C1 ("The IRS is a tax collector, and nobody likes the tax collector.").

[9] *See, e.g.*, Erika Hayasaki, *Evading Death and Taxes*, L.A. TIMES, Jul. 20, 2007, at A1 (tax protestor Ed Brown calls I.R.S. "the most brutal, ruthless organization out of all there is.").

[10] *See, e.g.*, Joseph J. Darby, *Confidentiality and the Law of Taxation*, 46 AM. J. COMP. L. 577, 579 (1998) (stating that Nixon administration used I.R.S. information to harass political opponents).

[11] Tom Herman, *IRS Staffers Tell of Wrongdoing by Fellow Aides*, WALL ST. J., Sept. 26, 1997, at A4.

[12] John M. Broder, *Director of I.R.S. Issues an Apology for Agent Abuses*, N.Y. TIMES, Sept. 25, 1997, at A1.

[13] Albert B. Crenshaw, *Senate Panel Told of IRS Abuses*, WASHINGTON POST, Sept. 25, 1997, at E03.

[14] Herman, *supra* note 11, at A4.

jurors in tax cases.[15] They also browsed the tax returns of celebrities, relatives, and potential dates, that agents were evaluated based on their total tax collections, and that managers routinely covered up abusive behavior by collection agents.[16]

These alleged abuses by the I.R.S.[17] were salient enough to the legislators and public led to a number of reforms of the I.R.S., including the idea of splitting the I.R.S. into two agencies, one of which would collect tax returns and provide advice to taxpayers and the other which would be responsible for audit and enforcement.[18] Ultimately, Congress responded to the horror stories it had heard with the Taxpayer Bill of Rights 3, a collection of over 70 provisions intended to make the I.R.S. more "customer-friendly."[19] These reforms attempted to keep the I.R.S. in check, preventing future abuses and requiring the I.R.S. to treat taxpayers fairly. In general, these changes have made the I.R.S. into a friendlier agency, albeit one with a diminished ability to enforce the tax law.[20]

Ultimately, Congress targeted the I.R.S.'s abusive behaviors toward taxpayers. In spite of the oversight to which Congress has subjected the I.R.S. vis-à-vis its treatment of taxpayers,[21] it has not created similar oversight to prevent the I.R.S. from misusing the tax system. If the I.R.S.'s abuse of the tax system also harm one or more taxpayers, those taxpayers may have recourse to challenge the I.R.S. (though they may have limited incentive to do so), but where no taxpayer suffers harm, nothing in the tax law prevents the I.R.S. from misinterpreting or ignoring the law as written.

This Article will examine the I.R.S.'s ability to ignore, misapply, and otherwise abuse the tax law, and propose a way for the tax law to constrain this ability, much as the various Taxpayer Bills of Rights constrained the I.R.S.'s ability to abuse individual taxpayers. Parts II and III will present two stories of the I.R.S.'s abuse of the tax system. Part II presents the easy story: where the I.R.S. attempted to misapply the tax law in a manner disadvantageous to taxpayers. Although taxpayers ultimately challenged the I.R.S.'s interpretation and won, their victory came at a cost that may dissuade future taxpayers from challenging abusive behavior.

Part III presents a much more complicated story, exploring the I.R.S.'s misapplication of the tax laws in a manner beneficial to taxpayers. Without a taxpayer who is hurt, nobody has an incentive or standing to challenge the I.R.S.'s tax system

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[15] Ralph Vartabedian, *IRS Will Review Complaints, End Quotas for Audits*, L.A. TIMES, Sept. 26, 1997, at A1.

[16] Broder, *supra* note 12, at A1.

[17] "Alleged" because subsequent investigations by the government demonstrated that many of the allegations were either untrue or exaggerated. *See* Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KANSAS L REV. 971, 979 (2003).

[18] Vartabedian, *supra* note 15, at A1.

[19] Lederman, *supra* note 17, at 980-81.

[20] *Id.* at 982 ("Not surprisingly, the post-RRA '98 reallocation of resources resulted in (or at least coincided with) a significant decline in enforcement activity.").

[21] *See infra* Section IV.A.

abuse. To illustrate this type of victimless abuse, Part III will discuss the I.R.S.'s treatment of commodities mutual funds. Though the tax rules governing mutual funds do not permit mutual funds to invest any substantial amount of their assets in commodities, the I.R.S. has blessed their investment in commodities-linked derivatives and offshore commodities holding companies.

Part IV will examine three oversight models that currently exist, teasing out the details of those models that would provide effective protection to the tax system from those that would not apply in this situation. Finally, Part V will use the analysis of the three models to propose the outline and some necessary details of a way to police the I.R.S. as it enforces the tax law. This policing will attempt to balance the need to follow the tax law against the need for flexibility and certainty in its administration.

II. READING *AND* AS *OR*

The story of the I.R.S. adopting an incorrect reading of the tax law is not a complicated story to tell or, theoretically to resolve. The tax law is complicated and, in places, ambiguous. At times, the I.R.S. will err in its interpretation of the interplay between the language of the Code and what Congress intended for the Code. When it does and uses that misinterpretation to impose a higher tax burden on taxpayers, the affected taxpayers will sue and the courts will overturn the I.R.S.'s misinterpretation. While the process of correcting an I.R.S. misreading of the tax law can follow this narrative, however, the process is often less clean and more problematic than the story would indicate, as illustrated by the I.R.S.'s misreading of the telephone excise tax.

In 1898, Congress enacted a telephone excise tax to help fund the Spanish-American War.[22] Initially, the one-cent tax applied to long-distance calls that cost more than 15 cents.[23] Congress repealed the telephone excise tax in 1902, but reinstated it in 1914, as the country began to prepare for World War I.[24] Repealed again in 1924, it was once again reintroduced in 1932 to make up for diminished federal revenues resulting from the Great Depression.[25] Though Congress has altered its rate structure and base in the years since 1932, the telephone excise tax has continuously applied since then.[26]

Today, the telephone excise tax imposes a three percent tax on three types of "communication services":[27] local telephone service, toll telephone service, and teletypewriter exchange service.[28] Although the Code specifically defines each type of

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[22] LOUIS ALAN TALLEY, CONG. RESEARCH SERV., THE FEDERAL EXCISE TAX ON TELEPHONE SERVICE: A HISTORY 1 (2001), *available at* http://assets.opencrs.com/rpts/RL30553_20050630.pdf.
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] I.R.C. § 4251(a)(1), (b)(2) (2006).
[28] *Id.* § 4251(b)(1).

communication service,[29] the I.R.S. has not seen itself bound by the Code's definitions. In 1979, the I.R.S. released a ruling addressing whether the telephone excise tax applied to satellite calls from ships or other offshore locations to landlines in the United States.[30]

The Code defines toll telephone service as telephone service where the telephone company calculates the price of a call based on the distance and elapsed time of the call.[31] The I.R.S. acknowledge that the satellite phone service did not "[l]iterally . . . come within the definition of 'local telephone service' or 'toll telephone service' as those terms are currently defined in section 4252 of the Code."[32] Nonetheless, it determined that such calls were subject to the tax because the legislative history underlying the tax "indicates that the type of service at issue here is within the intended scope of taxable 'toll telephone service.'"[33]

During the 1990s, telephone companies began to broadly offer flat-rate long distance telephone service, with rates based solely on the elapsed time of the call.[34] Based on its ruling, the I.R.S. imposed the telephone excise tax on these calls in spite of the cost not including a distance component.[35] In a series of cases in the mid-2000s, taxpayers challenged the I.R.S.'s practice and demanded refunds of the telephone excise taxes they had paid on services.[36] The I.R.S. argued that Congress's use of *and* in the definition of toll service was ambiguous and could function either as a conjunctive or disjunctive.[37] It even issued a proposed regulation that would officially read the *and* in the Code as an

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[29] *Id.* § 4252(a)-(c) (2006).
[30] Rev. Rul. 79-404, 1979-2 C.B. 382.
[31] I.R.C. § 4252(b)(1).
[32] Rev. Rule. 79-404.
[33] *Id.*
[34] Timothy Deering, Note, *A Taxing Statute: Costly Conjuncts and Their Logical Fallout*, 7 CARDOZO PUB. L. POL'Y & ETHICS J. 207, 210 (2008).
[35] Rev. Rul. 79-404 ("The service in this case is essentially 'toll telephone service' as described in section 4252(b)(1) of the Code, even though the charge for calls between remote maritime stations and stations in the United States vary with elapsed transmission time only."); *see also* I.R.S. Notice 2005-79, 2005-2 C.B. 952; I.R.S. Notice 2004-57, 2004-2 C.B. 376.
[36] *See* MBNA Am. Bank, N.A. v. United States, 2006 WL 1431070 (D. Del. 2006); PNC Bank, N.A. v. United States, 2006 WL 1604678 (W.D. Penn. 2006); ServiceMaster Co. v. United States, 2006 WL 1343436 (N.D. Ill. 2006); America Online, Inc. v. United States, 64 Fed. Cl. 571 (Fed. Cl. 2005); Honeywell Int'l, Inc. v. United States, 64 Fed. Cl. 188 (Fed. Cl. 2005); Hewlett-Packard Co. v. United States, 2005 WL 1865419 (N.D. Cal. 2005); Reese Bros. v. United States, 2004 WL 2901579 (W.D. Penn. 2004); Nat'l R.R. Passenger Corp. v. United States, 338 F. Supp. 2d 22 (D.D.C. 2004); Fortis, Inc. v. United States, 420 F. Supp. 2d 166 (S.D.N.Y. 2004); Office Max, Inc. v. United States, 309 F. Supp. 2d 984 (N.D. Ohio 2004); Am. Bankers Ins. Group, Inc. v. United States, 308 F. Supp. 2d 1360 (S.D. Fla. 2004).
[37] *See, e.g.*, National R.R. Passenger Corp., 338 F. Supp. at 26 ("The IRS does not really contest this point, instead focusing on why the Court should construe 'and' to mean 'or' (so that the definition is fulfilled when a toll charge varies in amount with distance or time).").

or.[38] Although it won in the first decided case,[39] it lost each of its subsequent cases.[40] Moreover, the I.R.S.'s sole victory was reversed at the appellate level.[41] Ultimately, taxpayers won in every court of appeals that heard challenges to the I.R.S.'s application of the telephone excise tax.[42]

In May 2005, after its string of losses, the I.R.S. announced that it would no longer litigate these telephone excise tax cases.[43] In 2006, it announced that it would acquiesce to the courts' rulings.[44] In that announcement, it also informed taxpayers of the process they had to follow to request and receive a refund of their overpayed excise tax.[45] The I.R.S. stated that it would refund the tax on nontaxable telephone services billed after February 28, 2003, and before August 1, 2006.[46] Individuals could request either a safe harbor amount or the actual amount of telephone excise tax that they had overpaid.[47] Business entities had no safe harbor, but could claim a refund for the amount they had overpaid.[48] However, taxpayers had to claim the refund on their 2006 tax return.[49]

The I.R.S.'s misreading of the tax law differs in certain significant ways from its its victimless abuse of the tax system.[50] Most saliently, its misreading—in this case, the extra-statutory imposition of the telephone excise tax—not only abused the tax system, it also increased taxpayers' tax bills. As such, some taxpayers had both incentive and standing to challenge the I.R.S.'s position.[51]

In many cases, however, that incentive and standing may fail to provide taxpayers with sufficient incentive to police the I.R.S. Only large corporations challenged the imposition of the telephone excise tax, likely because only large corporations paid

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[38] 68 Fed. Reg. 15690 (Apr. 1, 2003) ("For a communications service to constitute toll telephone service described in section 4252(b)(1), the charge for the service need not vary with the distance of each individual communication.").

[39] Am. Bankers Ins. Group, Inc., 308 F. Supp. at 1373 ("For the foregoing reasons, the Court finds that the statutory language of 26 U.S.C. § 4252(b)(1) is ambiguous and that the clear intent of Congress from before the 1965 amendment up to the present day has been to tax all long-distance telephone service, regardless of whether the toll rate for that service varied only by distance, only by elapsed time, or by both.").

[40] Deering, *supra* note 34, at 211.

[41] Am. Bankers Ins. Group v. United States, 408 F.3d 1328, 1330 (11th Cir. 2005).

[42] Annette Nellen, *What's New in Telecom Challenges What's Old in Taxes*, BUS. ENTITIES, Jul.-Aug. 2006, at 4, 8.

[43] *Id.* at 10.

[44] I.R.S. Notice 2006-50 § 1, 2006-1 C.B. 1141.

[45] *Id.* § 5(a)(1).

[46] *Id.* § 5(b).

[47] *Id.* § 5(c)(1).

[48] *Id.*§ 5(d)(3)(i).

[49] *Id.* § 5(a)(2).

[50] *See infra* Section III.

[51] Contrast this with the case of the I.R.S.'s treatment of commodities mutual funds, where nobody who has standing has reason to challenge the I.R.S.'s position. *See infra* notes 185-188 and accompanying text.

enough to justify taking the challenge to court. Although it would be difficult to determine how much the I.R.S.'s interpretation of the telephone excise tax cost non-corporate taxpayers, the tax rate was only 3 percent of the cost of the long-distance service.[52] The I.R.S. set its safe harbor refund amount at not more than $60 per year.[53] The potential for getting a refund or credit of $180 would not justify the time and expense of bringing suit for individual taxpayers. The Code imposes a $60 filing fee on taxpayers who file a case in the Tax Court.[54] If the taxpayer would prefer to file her refund suit in a federal district court or the Court of Federal Claims, she would have to pay a filing fee of $350.[55]

Even corporations with significant potential refunds may not find a challenge to the I.R.S.'s interpretations worth the cost, however. After the I.R.S. released its refund procedures, several taxpayers sued the I.R.S., arguing that its refund procedure was inadequate because it undercompensated many taxpayers and because it failed to comply with the Administrative Procedure Act's ("APA") notice-and-comment requirements.[56] The court held that the I.R.S. had violated the APA's procedural requirements.[57] It prospectively vacated the I.R.S. notice and remanded the matter to the I.R.S.[58]

Although the plaintiffs won, however, their victory proved costly. The court ultimately denied plaintiffs' interim request for $6.5 million in attorneys' fees.[59] Without attorneys' fees, though, plaintiffs won a procedural, but not a financial, victory. Although the suits started as refund suits, the refund portion of the suits "long since been dismissed."[60] As a result, the taxpayers' victory in having the I.R.S. process vacated was counterbalanced by the cost to the plaintiffs of achieving that result.

The story of the telephone excise tax demonstrates that taxpayers can police the I.R.S. when it incorrectly interprets the tax law, provided the I.R.S.'s interpretation increases the taxpayers' tax liability in comparison to what they should have paid. But it also demonstrates that such policing imposes a cost—potentially significant—on

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52 I.R.C. § 4251(a)(1), (b)(2).
53 I.R.S. Notice 2007-11 § 3(b)(2). The I.R.S. based a taxpayer's safe harbor amount on the number of exemptions on her 2006 tax return. *Id.* § 3(b)(1). A taxpayer with one exemption could request a credit or refund for $30, with two exemptions could request $40, with three could request $50, and with four or more could request $60. *Id.* § (3)(b)(2).
54 I.R.C. § 7451 (2006).
55 28 U.S.C. §§ 1914(a), 1926(a) (2006). Moreover, because of the individualized nature of tax refund lawsuits, courts are hesitant to certify class action refund claims. *See, e.g.*, Saunooke v. United States, 8 Cl. Ct. 327, 330 (1985) ("This case is particularly ill-suited for class certification by virtue of its status as a tax refund claim.").
56 In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig., 853 F. Supp. 2d 138, 141 (D.D.C. 2012).
57 *Id.* at 143.
58 *Id.* at 146.
59 In re Long-Distance Tel. Sev. Fed. Excise Tax Refund Litig., --- F. Supp. 2d ---, 2012 WL 5353554 (D.D.C. Oct. 29, 2012).
60 *Id.*

taxpayers. As a result of this cost, they may not have sufficient incentive to challenge the I.R.S.'s misinterpretations, even if the court ultimately finds that the I.R.S. erred. If, instead, Congress provided for some sort of I.R.S. oversight that focused on ensuring that the I.R.S. respected the tax law and preventing it from abusing the law, Congress could limit the expense to taxpayers and the government of litigating the case, and ameliorate the harm to the tax system.

III. VICTIMLESS I.R.S. ABUSE

The I.R.S. deliberately misreading "and" as "or" is a simple and straightforward story. Its impact on taxpayers and the tax system in general is similarly straightforward. By contrast, the story of the I.R.S. permitting commodities mutual funds is complicated and requires significantly more explanation, both to understand what happened and why the result harms the tax system. This Section will lay out the tax rules governing mutual funds, then discuss judicially-created doctrines that overlay the tax system in general. Next, it will explain how commodities mutual funds violate both the statutory mutual fund rules and the common law tax doctrines and how the I.R.S. has abetted this violation. Finally, it will explain why the I.R.S. cannot, under current law, be prevented from permitting this kind of victimless abuse of the tax system.

A. The Mutual Fund Tax Regime

Current law generally taxes corporate income twice. First, corporations pay taxes when they earn income.[61] Then, when they distribute their profits to shareholders as dividends, the shareholders pay taxes on the distribution.[62] Because mutual funds are domestic corporations,[63] this double taxation would put investors at a significant disadvantage compared with direct portfolio investors or investors in investment partnerships.[64]

To make a mutual fund investment similar to a direct investment, the tax law permits qualifying mutual funds to deduct from their taxable income the amount of dividends they pay.[65] To qualify for this quasi-passthrough tax treatment, however, a fund must meet stringent diversification and income requirements. A mutual fund that fails to meet these requirements loses its tax-favorable status and pays an entity-level tax, without the ability to deduct its dividends.

The diversification requirements prevent a mutual fund both from concentrating its assets too tightly in the securities of one company and from becoming a large

[61] I.R.C. § 11(a) (2006).
[62] *Id.*§ 61(a)(7).
[63] *Id.* § 851(a).
[64] *See* Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Gap* 8-9, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2131405.
[65] I.R.C. § 852(b)(2)(D) (2006).

shareholder in any one company. To comply with the diversification requirement, a mutual fund must evaluate its portfolio at the close of each taxable quarter and ensure that its portfolio meets two significant criteria.

The first criterion forces a mutual fund to invest in a diversified portfolio. In order to qualify, at least half of the value of the mutual fund's assets must consist of cash, government securities, shares of other mutual funds, and other securities.[66] Furthermore, the mutual fund faces a diversification requirement with respect to these "other securities." In this half of the mutual fund's portfolio, the securities of a single issuer cannot make up more than 5 percent of the value of the mutual fund's total assets.[67] Moreover, in this half of its portfolio, the mutual fund cannot own more than 10 percent of the voting shares of a single issuer.[68]

The second criterion, while permitting more concentration than the first, protects mutual fund shareholders from too much exposure to any one company or industry. Under this criterion, a mutual fund cannot invest more than 25 percent of the value of its assets in the securities of a single issuer.[69] Moreover, it cannot invest more than 25 percent of the value of its assets in the securities of two or more issuers which it controls and which engage in the same trade or business.[70] (Here, "control" means ownership of at least 20 percent of the issuer's voting shares.[71]) And it cannot invest more than 25 percent of the value of its assets in publicly traded partnership.[72]

These two criteria provide mutual funds with a significant amount of leeway in making their investment decisions. On the diversification side, the tax law does not tell mutual funds what the can and cannot invest in. Instead, it tells mutual funds that, as they assemble their portfolios, they need to make sure that they make a significant number of small bets. The rules also allow mutual funds to make larger bets, but even the permissible larger bets cannot represent too large a portion of a fund's portfolio. The diversification requirements thus ensure that mutual funds generally cannot be mortally wounded if one investment goes poorly.

In addition to meeting the diversification rules, a mutual fund must earn specific types of income. In essence, a mutual fund must derive at least 90 percent of its income from securities and foreign currencies.[73] It can earn interest or dividends, it can realize gains from the sale of securities, and it can even earn derivative income, as long as that

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[66] *Id.* § 851(b)(3)(A).
[67] *Id.* § 851(b)(3)(A)(ii).
[68] *Id.*
[69] *Id.* § 851(b)(3)(B)(i). Note that the 25 percent limitation does not apply to government securities or the securities of other mutual funds. As such, a mutual fund could qualify for the advantageous tax treatment if its full portfolio consisted of Treasury securities and shares of one mutual fund.
[70] *Id.* § 851(b)(3)(B)(ii).
[71] *Id.* § 851(c)(2).
[72] *Id.* § 851(b)(3)(B)(iii).
[73] I.R.C. § 851(b)(2)(A).

income is related to an investment in securities.[74] Prior to 1986, though the tax law required mutual funds to derive a significant portion of their income from securities, it contained no definition of "securities."[75]

To fill the gaps left by such an important undefined term, the I.R.S. had "often gone beyond the literal terms of the statute," permitting mutual funds to earn money not specifically sanctioned by the Code.[76] To fill the gaps, Congress added a definition of sorts to the Code. Rather than directly define "securities," though, Congress instead inserted a cross-reference to the definition from the Investment Company Act of 1940 (the "1940 Act").[77] The 1940 Act defines "security" to include, among other things, notes and other evidences of indebtedness, stock and other evidences of equity interest, and certain derivatives linked to securities.[78] Congress apparently intended this cross-reference to exclude commodities from the set of investments that produces qualifying income.[79]

Nowhere is there a compelling explanation of why Congress wanted prevent mutual funds from investing in commodities. At best, we can speculate about its motivations. Perhaps, for example, Congress believed that trading in commodities constituted a trade or business.[80] Because mutual funds are passive investment vehicles,

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[74] *Id.*

[75] *See, e.g.*, Internal Revenue Code of 1954 § 851(b)(2) (to qualify as a RIC, "at least 99% of its gross income is derived from dividends, interest, and gains from the sale or other disposition of stock or securities").

[76] Letter from J. Roger Mentz, Acting Assistant Secretary (Tax Policy), to The Hon. Ronnie G. Flippo, House of Representatives, 132 Cong. Rec. 4047, 4047-48 (Mar. 7, 1986).

[77] Tax Reform Act of 1986, P.L. 99-514, § 653(b).

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> "Security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 80a-2(a)(36) (2006).

[79] *See, e.g.*, Mentz, *supra* note 76, at 4048 ("[W]e would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment."); Rev. Rul. 2006-1 ("The foregoing indicates that Congress did not intend for the cross-reference to the '40 Act to incorporate into section 851(b)(2) an expansive construction of the term 'securities.'").

[80] Lee A. Shepard, *Mutual Fund Taxation: Putting Square Pegs in Round Holes*, 108 TAX NOTES 58, 60 (2005).

commodity income would be antithetical to the passive nature of mutual funds.[81] If, however, Congress viewed investments in commodities as a trade or business, it erred in relation to at least some commodities investments; today, an investor can use commodity-linked derivatives to make a purely speculative bet on commodities prices.[82] Such a bet does not require the investor to own or otherwise deal with commodities, and looks more like a passive investment than an active one.

Perhaps, alternatively, Congress believed that the limiting mutual funds to securities kept them within the realm of expertise of the Securities and Exchange Commission ("SEC"), which regulates both securities and mutual funds.[83] If mutual funds could only invest in securities, their investments would line up with their key regulator. But such a justification ultimately proves unconvincing: the SEC would continue to regulate commodities mutual funds; moreover, the mutual fund's would be regulated. Rather than fulling under the SEC's jurisdiction, though, a mutual fund's commodities investments would fall under the jurisdiction of the Commodities Futures Trading Commission, just like any other investor's commodities investments.[84]

Congress may have acted with a paternalistic impulse, instead. Mutual funds "are designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund's portfolio."[85] As a result, the regulation of mutual funds intends to "protect[] the public, whose funds have been intrusted to the investment managers."[86]

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[81] Investors who wanted fractional interests in commodities were not entirely out of luck: they could still invest in publicly traded partnerships. In generally, publicly traded partnerships lose their pass-through treatment and are taxed as if they were corporations. If, however, a publicly traded partnership earns at least 90 percent of its income from passive sources—including commodities—it will qualify for pass-through treatment even if it is traded on an exchange.

[82] Cristie Ford & Carol Liao, *Power Without Property, Still: Unger, Berle, and the Derivatives Revolution*, 33 SEATTLE UNIV. L. REV. 889, 907 (2010) ("The U.S. Congress changed this in 2000 with the adoption of the Commodity Futures Modernization Act . . ., which confirmed the legal recognition and enforceability of purely speculative OTC derivatives.").

[83] *See, e.g.*, Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1032 (2009) ("SEC regulation of the securities industry is often described as heavy-handed, overly intrusive and enforcement dominated."); Roberta S. Carmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate*, 80 NOTRE DAME L. REV. 909, 912 (2005) ("[T]he SEC regulates mutual funds . . . .").

[84] While the Securities and Exchange Commission ("SEC") regulates securities, the Commodity Futures Trading Commission fills that role for commodities futures. Jerry W. Markham, *Prohibited Floor Trading Activities Under The Commodity Exchange Act*, 58 Fordham L. Rev. 1, 4 (1989). The SEC also regulates mutual funds. Elizabeth F. Brown, *E Plurubus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 18 (2005).

[85] Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 20 (1991).

[86] COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. Rep. No. 1455, 73d Cong., 2d Sess. 363 (1934).

Commodities markets, however, tend to be volatile and risky.[87] Congress may have decided to protect mutual fund investors from the volatility inherent in commodities investments by preventing mutual funds from significantly investing in commodities.

B. Substance Over Form

Formally, the tax law is based firmly in statute, not the common law.[88] As a statutory regime, courts have traditionally construed the language of the tax law strictly against the government.[89] Justice Story explained courts construed tax statutes strictly against the government "because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import."[90]

Today, however, a taxpayer who strictly follows the requirements of the Code may not receive the tax treatment she desires. Shortly after the birth of the modern federal income tax in 1913, courts created a common-law overlay on the tax law, distinguishing between the "form" and the "substance" of transactions.[91] By 1921, the Supreme Court had "recognize[d] the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder."[92] No more would merely aligning a transaction with the language of the Internal Revenue Code suffice: where a transaction's form fails to comport with its substance, courts can ignore ignore the taxpayer's chosen form and base the taxpayer's tax liability on the transaction's substance.[93] As a result, substance-over-form principles can override a taxpayer's technical compliance with the black letter of the Code.[94]

Over the years, courts have developed several judicial doctrines requiring taxpayers in certain circumstances to do more than just comply with the letter of the law. substance-over-form doctrines.[95] The substance-over-form doctrine allows courts to

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[87] Robert S. Pindyck, *Volatility and Commodity Price Dynamics*, 24 J. FUTURES MARKETS 1029, 1029 (2004).

[88] *See* Ernest J. Brown, *The Growing "Common Law" of Taxation*, 34 S. CAL. L. REV. 235, 235 (1961) ("[W]e all know that the law of taxation is purely statutory.").

[89] *See, e.g.*, Cahoon v. Coe, 57 N.H. 556, 570 (N.H. 1876) (stating that strict construction of tax statutes "is founded so firmly upon principles of equity and natural justice, as not to admit of reasonable doubt.").

[90] United States v. Wigglesworth, 28 F. Cas. 595, 597 (C.C.D. Mass. 1842).

[91] *See* Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOWARD L.J. 693, 703 (1978) ("When today's federal income tax was still in its swaddling clothes, the Supreme Court treated the superiority of substance over form as a well-settled principle in tax matters . . . .").

[92] United States v. Phellis, 257 U.S. 156, 168 (1921).

[93] *See, e.g.*, Wells Fargo & Co. v. U.S., 641 F.3d 1319, 1325 (Fed. Cir. 2011) ("The substance-over-form doctrine provides that the tax consequences of a transaction are determined based on the underlying substance of the transaction rather than its legal form.").

[94] Allen D. Madison, *The Tension Between Textualism and Substance-Over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 717 (2003) ("Substance-over-form principles can override a result achieved by a technical reading of the Internal Revenue Code.").

[95] *Id.*

"determine the true meaning of a transaction disguised by formalisms that exist solely to alter tax liabilities."[96] By looking to the substance, a court can recast the transaction for tax purposes according to that substance.

Another judicially-created substance-over-form doctrine is the step-transaction doctrine. Under the step-transaction doctrine, the government can disregard the tax consequences of each individual step in an integrated transaction, treating them instead as parts of a larger transaction.[97] In cases where the government invokes the step-transaction doctrine, each step, viewed separately, might escape taxation, but the transaction, viewed as a whole, has tax consequences for the taxpayer.[98]

The government can also use the sham transaction, business purpose, and economic substance doctrines to challenge the tax consequences of a taxpayer's formal choices. The sham transaction doctrine permits the government to ignore a taxpayer's transaction in determining her tax liability.[99] Under the business purpose doctrine, the government can disregard any transaction that lacks business purpose beyond reducing the amount of tax a taxpayer owes.[100] And the economic substance doctrine provides courts with yet another method of disregarding transactions that have no economic reality.[101]

If these various doctrines look hopelessly intertwined, it is because they are. They overlap significantly, and it can be difficult to determine which doctrine applies to a particular transaction.[102] Still, these substance-over-form doctrines are important enough in the administration of the tax law that they have been adopted both by the Treasury department and by Congress. For example, the regulations promulgated under subchapter K include an anti-abuse provision, requiring, among other things, that partnership transactions comport with substance-over-form rules.[103] If a partnership tries to rely on

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[96] Slone v. Comm'r, 103 T.C.M. (CCH) 1265 *8 (T.C. 2012).

[97] Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983).

[98] Crenshaw v. United States, 450 F.2d 472, 476 (5th Cir. 1971).

[99] *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985).

[100] *See, e.g.*, Stobie Creek Investments, LLC v. United States, 82 Fed.Cl. 636 (2008) ("In evaluating a transaction's economic reality, the Supreme Court and the Federal Circuit, along with other courts of appeals, look for a business purpose, beyond reducing taxes, to support a transaction; a transaction without a business purpose lacks economic reality and must be disregarded.").

[101] *See, e.g.*, Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006) ("Over the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality.").

[102] *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, AS AMENDED, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT, at 142 (2010) [hereinafter JOINT COMM., TECHNICAL EXPLANATION] ("These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants."). Judge Learned Hand decried courts' uses of "form" and "substance" as being "anodynes for the pains of reasoning." Comm'r v. Sansome, 60 F.2d 931, 933 (2d Cir. 1932).

[103] Treas. Reg. § 1.701-2(a)(2) (as amended in 1995).

formal considerations that fail to reflect the actual substance of a transaction, the IRS can disregard the partnership, one or more partners, the partnerships method of accounting, can reallocate its tax attributes, or can otherwise modify or adjusted the partnership's claimed tax treatment.[104]

Beyond the Treasury department's recognition of the primacy of substance, in 2010, Congress codified the economic substance doctrine, one important substance-over-form doctrine.[105] The economic substance doctrine allows courts to look at transactions and determine whether they have economic substance and a non-tax business purpose.[106] Prior to codification, some circuits would disregard a transaction's form if it did not have both economic substance *and* business purposes; other circuits required that a transaction have one of the two.[107] Codification implemented the conjunctive test, requiring a transaction to have both economic substance and a business purpose.[108]

In codifying the economic substance doctrine, Congress recognized that the various substance-over-form doctrines "serve an important role in the administration of the tax system."[109] Even as these doctrines increase the complexity and predictability of tax compliance, they provide the government with an anti-abuse trump card. And ultimately, they appear to increase the fairness of the tax law. If the government can reject technical compliance with the tax law, a taxpayer who can afford tax advice will not always have a tax advantage over a taxpayer who cannot afford such advice.

In spite of the primacy of substance over form, form sometimes still manages assert itself and govern the tax treatment of a transaction. In general, although the government can argue that a taxpayer's form should be disregarded, courts will not allow taxpayers to disavow their form.[110] Even where the taxpayer admits that the form of her transaction is illusory, she chose the form and must face the consequences attendant to it.[111]

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[104] *Id.* § 1.701-2(b).

[105] Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411, 412 (2010).

[106] *Id.* at 416.

[107] *Id.*

[108] I.R.C. § 7701(o).

[109] JOINT COMM., TECHNICAL EXPLANATION, *supra* note 102, at 142.

[110] William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381, 384 (1991) ("The principle that the government alone may appeal to the substance of a transaction pervades federal tax law.").

[111] *See, e.g.*, Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (U.S. 1974) ("[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not."); Insilco Corp. v. United States, 53 F.3d 95, 98 (5th Cir. 1995) (taxpayer precluded from "recharacterizing its transaction and reaping favorable tax benefits."); Spector v. Comm'r, 641 F.2d 376, 381 (5th Cir. 1981) ("[A]s a general rule, [the Commissioner may] bind a taxpayer to the form in which the taxpayer has cast a transaction.");.

Moreover, in certain circumstances, the tax law not only permits, but encourages, taxpayers to elevate a transaction's form without requiring that the transaction evince any substance. The Code contains hundreds of explicit tax elections.[112] For example, in 1997, the Treasury department enacted the check-the-box regulations, permitting most business entities to expressly elect whether they will be taxed as corporations or as partnerships.[113] To make the election, an eligible entity must file a timely Form 8832 with the I.R.S.[114] Beyond filling out the necessary paperwork, there exist no substantive requirements an entity must meet to qualify as a corporation or partnership. This, and other, elections significantly affect a taxpayer's tax liability, though they do not affect the taxpayer's "relations with the outside world."[115]

Still, although tax elections give among other benefits, the formal nature of tax elections improves the simplicity and administrability of the tax law.[116] Prior to the check-the-box regulations, for example, an entity with sufficient corporate characteristics was classified as a corporation for tax purposes; otherwise, the tax law treated it as a partnership.[117] But even under a corporate resemblance test, entity classification was elective, at least for well-advised taxpayers.[118] By moving entity classification into the world of express elections, the I.R.S. hoped to significantly reduce the burden—both on taxpayers and on the I.R.S.—of determining the appropriate tax classification of entities under the corporate resemblance test.[119] This increase in simplicity and administrability perhaps justifies the departure from the primacy of substance represented by express elections.

C. Commodities Mutual Funds Violate the Code and the Common Law

Although Congress excluded commodities from the assets that produced qualifying mutual fund income, retail investors wanted access to commodity returns.[120] Historically, mutual funds had provided investors with indirect exposure to commodities

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[112] Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 24 n.14 (2010).

[113] *See* Heather M. Field, *Checking in on Check-the-Box*, 42 LOYOLA L.A. L. REV. 451, 453-54 (2009).

[114] Treas. Reg. § 301.7701-3(c)(1)(i) (as amended in 2006).

[115] Bittker, *supra* note 91, at 704.

[116] Field, *supra* note 112, at 25.

[117] Field, *supra* note 113, at 458.

[118] Henry J. Lischer, Jr., *Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations*, 51 SMU L. REV. 99, 105 (1997) ("Furthermore, entity classification had become essentially elective for well-advised taxpayers who could achieve - by choice of entity and careful drafting of the organizational documents of the entity - the classification they desired under the Kintner regulations.").

[119] I.R.S. Notice 95-14, 1995-1 C.B. 297, 298.

[120] *See, e.g.*, Tim Gray, *Sold on Pork Bellies (and Other Commodities)*, N.Y. TIMES, Oct. 10, 2010, at BU13 (stating that "commodities have become an investing vogue"); Conrad de Aenlle, *Have Commodities Become the New Tech Stocks?*, N.Y. TIMES, Feb. 5, 2006, at Section 3 p.5.

by investing in the stock of companies that dealt in those commodities.[121] However, the return on commodity companies deviates significantly from the return on commodities futures.[122] Research in the mid-2000s, however, suggested that direct commodity investments dampened the volatility generally associated with commodities.[123] And by the mid-2000s, a number of mutual funds had stepped in to fill that demand.[124]

Though mutual funds faced significant impediments on their ability to invest in commodities, they attempted to circumvent the prohibition by investing in swaps on commodity indices. A commodity index is essentially a basket of commodities, with each commodity assigned a certain weight within the basket.[125] The index reflects the value of the specified commodities; it does not, however, constitute an ownership interest in those commodities.[126] A swap is a financial instrument that seeks to provide synthetic (though not legal) ownership of a financial asset or index. One party to the swap—the long party—believes that the asset will increase in value, while the other—the short party—bets that its value will fall.[127]

Under the terms of these commodity index swaps, a commodity mutual fund would take the long position in the swap, agreeing to pay its counterparty interest and any depreciation on the index. In return, the counterparty would pay the amount of any appreciation in the index to the mutual fund.[128] By investing in these swaps, a commodity mutual fund synthetically recreates an investment in the basket of commodities represented by its chosen index. Its investors have direct exposure to the value of the commodities, rather than an indirect approximation of their return through equity investments in commodity-producing companies.

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[121] Tim Gray, *Is It Too Late to Ride the Energy Bandwagon?*, N.Y. TIMES, Oct. 9, 2005, at Section 3 p. 25. ("He says he has reduced the fund's ups and downs by allocating fewer dollars to oil-related stocks than many of his peers, instead favoring such companies as Newmont Mining, a gold producer, and even Nucor, a steel maker.").

[122] Gary Gorton & Geert Rouwenhorst, *Facts and Fantasies about Commodity Futures*, FIN. ANALYSTS J., Mar.-Apr. 2006, at 47, 60 ([T]he correlation between [commodities futures and commodity companies] was only 0.40.").

[123] *Id.* ("[T]he historical risk of an investment in commodity futures has been relatively low . . . .").

[124] *See, e.g.*, Gray, *supra* note 121, at Section 3 p. 25 ("Several companies, including Pimco in Newport Beach, Calif., and OppenheimerFunds in New York, offer mutual funds that invest in commodities.").

[125] Ke Tang & Wei Xiong, *Index Investment and Financialization of Commodities* 6 (NBER, Working Paper No. 16385), *available at* http://papers.nber.org/tmp/16489-w16385.pdf.

[126] *See, e.g.*, Wai Mun Fong & Kim Hock See, *Modelling the Conditional Volatility of Commodity Index Futures as a Regime Switching Process*, 16 J. APPLIED ECONOMETRICS 133, 136 (2001) ("The GSCI is an index of 'spot prices' or, more precisely, prices of nearest futures contracts for a basket of commodities representing all commodity sectors such as energy, metals, livestock and agricultural products.").

[127] Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUSTON BUS. & TAX L.J. 1, 8 (2007) ("Very generally, swaps call for . . . payments between counterparties, based on the movement of an objective financial reference.").

[128] Lee A. Sheppard, *Mutual Fund Taxation: Putting Square Pegs in Round Holes*, 108 TAX NOTES 58, 61 (2005).

Of course, this strategy only works if the commodity index swaps qualify as "securities" for tax purposes. Otherwise, a mutual fund cannot derive more than 10 percent of its income from such swaps (and from any other assets it owns that do not qualify as securities). While the SEC did not rule on whether commodity index swaps qualified as securities under the 1940 Act, it had issued no-action letters which permitted funds to treat certain commodity-related dividends as securities for 1940 Act purposes.[129] The commodity mutual funds received opinions of counsel, based on this SEC precedent, that they could treat commodity index swaps as securities for tax purposes, and that they produced qualifying income.[130]

Commodity mutual funds received a blow at the beginning of 2006, though. The I.R.S. released a revenue ruling in which it held that commodity index swaps did not qualify as securities for purposes of the tax law.[131] In its analysis, the I.R.S. determined that no conclusive authority answered the question of whether a commodity index swap qualified as a security under the 1940 Act. It thus looked to Congress's intent in tying the tax law definition to the 1940 Act definition. The I.R.S. determined that Congress had wanted to provide mutual funds with certainty as they sought to qualify but, at the same time, that it did not intend to significantly expand the meaning of "securities." Congress intended, according to the I.R.S., that qualifying income include only gains where the underlying property consisted of securities. Because the returns on commodity index swaps derived from the value of commodities, not securities, excluding them from the set of assets that produced qualifying income fit comfortably within Congress's intent. Thus, the I.R.S. disqualified such swaps.

The failure of commodity index swaps to qualify as securities did not prevent mutual funds from holding them. It did, however, limit the amount of commodity index swaps a mutual fund could hold: not more than ten percent of its net asset value could consist of commodity mutual funds and all other non-securities investments the mutual fund held.[132] Without some other way to gain exposure to commodities, if commodity mutual funds wanted to continue, they would have had to return to their previous attenuated exposure to commodities by investing in equity securities of companies involved in commodities.

Ultimately, though, the funds figured out two paths they could use to gain direct exposure to commodities for their investors. Moreover, not only did the I.R.S. not object to these investments, but it actually blessed them. In spite of the fact that commodities do not fall within the scope of assets producing qualifying income, recognized by the I.R.S.

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[129] *See, e.g.*, Mallory Randall Corp., SEC No-Action Letter, 1980 SEC No-Act. LEXIS 3832, at *1 (Oct. 3, 1980) (treating options on commodities as securities for purposes of section 2(a)(36) of the 1940 Act); Dennis A. Rosen, 1975 SEC No-Act. LEXIS 898, at *2 (May 8, 1975) (same); Far West Futures Fund, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 296, at *1 (Sept. 4, 1974) (same).

[130] Sheppard, *supra* note 128, at 60.

[131] Rev. Rul. 2006-1, 2006-1 C.B. 262.

[132] I.R.C. § 851(b)(2)(A).

itself,[133] the I.R.S. explicitly permitted mutual funds to count such investments as securities for purposes of mutual fund qualifications in violation of the Code and the various substance-over-form rules.

1. Commodity-Linked Notes

Although the I.R.S. eliminated commodity mutual funds' ability to use commodity index swaps to provide investors with exposure to commodities, the revenue ruling specifically addressed only swaps. But other financial instruments can also reproduce the returns on commodities.[134] If the I.R.S. intended to disallow any synthetic recreation of commodity returns from being securities, commodity funds would be out of luck. If, however, the I.R.S. really meant to disqualify only commodity index swaps, mutual funds could turn to other financial instruments to gain exposure to commodity returns.

A commodity-linked note is a debt instrument issued by a corporation. Unlike a standard note, however, a commodity-linked not does not necessarily pay an investor its face amount upon maturity. Instead, when it matures, the owner of a commodity-linked note can exchange that note for the face amount of the bond or the value of the underlying commodities.[135] Like commodity index swaps, commodity-linked notes allow investors to gain exposure to individual commodities or baskets of commodities. Corporations issue commodity-linked notes in order to share the potential appreciation in commodities with investors in exchange for paying a lower interest rate.[136]

Within months of its issuance of Revenue Ruling 2006-1, the I.R.S. had answered the question of whether non-swap financial instruments that provided exposure to commodities would qualify as securities for mutual fund qualification purposes. On April 10, 2006, it released a private letter ruling stating that commodity-linked notes would qualify as securities for purposes of mutual fund qualification.[137] And between 2006 and 2011, the I.R.S. has issued at least 37 more private letter rulings blessing mutual funds' investments in commodity-linked notes.[138]

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[133] Rev. Rule. 2006-1.

[134] *See* Brunson, *supra* note 127, at 12 ("[F]inancial instruments can synthetically recreate any cash flow an investor desires.").

[135] Peter Carr, *A Note on the Pricing of Commodity-Linked Bonds*, 42 J. FIN. 1071, 1071 (1987).

[136] Eduardo S. Schwartz, *The Pricing of Commodity-Linked Bonds*, 37 J. FIN. 535, 535 (1982).

[137] I.R.S. Priv. Ltr. Rul. 2006-28-001 (Apr. 10, 2006).

[138] *See* I.R.S. Priv. Ltr. Ruls. 2011-35-001 (May 23, 2011), 2011-31-001 (Apr. 18, 2011), 2011-13-015 (Dec. 8, 2010), 2011-08-003 (Nov. 15, 2010), 2011-08-018 (Nov. 15, 2010), 2011-04-013 (Oct. 20, 2010), 2011-03-019 (Oct. 14, 2010), 2011-03-033 (Oct 12., 2010), 2011-02-055 (Sep. 22, 2010), 2011-07-012 (Sep. 21, 2010), 2010-43-016 (Jul. 15, 2010), 2010-39-002 (Jun. 22, 2010), 2010-37-012 (Jun. 4, 2010), 2010-30-004 (Apr. 28, 2010), 2010-34-011 ((Apr. 23, 2010), 2010-31-007 (Apr. 13, 2010), 2010-25-031 (Feb. 23, 2010), 2009-52-019 (Sep. 13, 2009), 2009-46-036 (Jul. 8, 2009), 2009-39-017 (Jun. 4, 2009), 2009-31-003 (Apr. 16, 2009), 2009-31008 (Apr. 16, 2009), 2009-12-003 (Nov. 19, 2008), 2008-45-013 (Jul. 30, 2008), 2008-42-014 (Jul. 17, 2008), 2008-40-039 (Jun. 13, 2008), 2008-31-019 (Apr. 18, 2008), 2008-

The fact that the I.R.S. issued private letter rulings does not mean that the tax law recognizes commodity-linked notes as a security for purposes of mutual fund qualification. A private letter ruling is merely a ruling issued by the I.R.S. to a specific taxpayer in response to that taxpayer's request.[139] A private letter ruling issued to one taxpayer has no precedential value to another taxpayer.[140] Still, private letter rulings provide an indication of the I.R.S.'s current position on the law,[141] and, in the quantity the I.R.S. has released its commodity-linked note rulings, it seems to be a position the I.R.S. believes in.

The I.R.S. never explained why it considers commodity-linked notes and to qualify as securities, while it does not consider commodity index swaps to so qualify. The disallowed swaps differ, of course, from the commodity-linked notes, but not in any fundamental way. Under the terms of the swap agreements, the mutual funds would pay an interest rate plus any losses on the commodity index to their counterparties, and the counterparties would pay the mutual fund any gains on the commodity index.[142] By contrast, in the commodity-linked notes, the mutual fund made no payment other than the purchase price of the bond; it received the value of any appreciation.[143] But this difference is essentially immaterial: with the commodity-linked notes, the mutual fund had made an initial investment, while under the swaps, the mutual fund faced no upfront payment. Because swaps do not require an upfront payment, they represent an effectively leveraged position.[144] In order to effectively borrow the money, the mutual funds naturally must pay interest, as opposed to the commodity-linked notes, where, in order to enter into the position, they must make an initial payment. And, while the commodity-linked notes provide that a mutual fund will not be required to make additional payments

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22-012 (Feb. 12, 2008), 2007-45-008 (Aug. 2, 2007), 2007-26-026 (Mar. 16, 2007), 2007-20-011 (Feb. 2, 2007), 2007-05-026 (Oct. 31, 2006), 2007-01-020 (Sep. 26, 2006), 2006-47-017 (Aug. 10, 2006), 2007-45-021 (Jun. 20, 2006), 201206015 (Jun. 13, 2006), 2006-37-018 (Jun. 1, 2006).

[139] *See* Julie A. D. Manasfi, *The Global Shadow Bank - Systemic Risk and Tax Policy Objectives: The Uncertain Case of Foreign Hedge Fund Lending to U.S. Borrowers and Transacting in U.S. Debt Securities*, 11 FLA. TAX REV. 643, 658 n.49 (2011) ("Private Letter Rulings are taxpayer specific rulings furnished by the IRS in response to requests made by taxpayers and cannot be used as precedent.").

[140] I.R.C. § 6110(k)(3); *see also* Rev. Proc. 2012-1 § 11.02 ("A taxpayer may not rely on a letter ruling issued to another taxpayer."); Goodstein v. Comm'r, 267 F.2d 127, 132 (1st Cir. 1959) ("[T]o hold that the Commissioner is bound by rulings specifically addressed to a taxpayer other than the one whose return is questioned would severely limit the usefulness of the long established practice of private administrative rulings.").

[141] *See, e.g.*, *id.* ("The taxpayer contends that although these letters were not addressed to him they were shown to him by Livingstone and he relied upon their approval of transactions which would seem to be essentially undistinguishable from that presented here.").

[142] Rev. Rul. 2006-1.

[143] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2006-37-018 (Jun. 1, 2006).

[144] Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 Nw. U.L. Rev. 225, 244 (2012) ("Because swaps require no initial financial payment, they provide investors with an effectively leveraged return.").

(and, as such, cannot lose more than its initial investment), a fund's losses on swaps are limited to the value of the swap at the time it entered into the swap. A commodity's value cannot fall below $0, so a mutual fund with a long position could not be required to pay its counterparty more than the current value of the commodity index. Although the timing of payments differs between a commodity-index swap and a commodity linked note, the economics of the two are nearly identical.

Even if the economics of the two instruments differed, though, that would not justify treating them differently. The revenue ruling held that a commodity index swap did not qualify as a security because "because the underlying property is a commodity (or commodity index)."[145] The property underlying a commodity-linked note is *exactly the same* as the property underlying a commodity index swap. Commodity mutual funds invest in commodity-linked notes precisely because such notes provide them with exposure to commodities. Because both the economics and the underlying property between commodity index swaps and commodity-linked notes differ only formally, if at all, it would seem incumbent on the I.R.S. to explain its disparate treatment of the two. But it has provided no such explanation.

2. Controlled Foreign Corporations

Shortly after the I.R.S. blessed mutual funds' investments in commodity-linked notes, funds began to explore investing in wholly-owned foreign subsidiaries that, in turn, invested in various commodity-linked instruments. As with commodity-linked notes, the I.R.S. proved willing to issue private letter rulings holding that income from such subsidiaries constituted qualifying income.[146] Through these subsidiaries, mutual funds could access the commodities market using instruments that would not have produced

[145] Rev. Rul. 2006-1.

[146] *See* I.R.S. Priv. Ltr. Ruls. 2012-06-015 (Feb. 10, 2012), 2011-34-014 (Aug. 26, 2011), 2011-32-008 (Aug. 12, 2011), 2011-31-001 (Aug. 5, 2011), 2011-29-002 (Jul. 22, 2011), 2011-28-022 (Jul. 15, 2011), 2011-22-012 (Jun. 3, 2011), 2011-20-017 (May 20, 2011), 2011-16-014 (Apr. 22, 2011), 2011-13-018 (Apr. 1, 2011), 2011-08-018 (Feb. 25, 2011), 2011-08-008 (Feb. 25, 2011), 2011-07-012 (Feb. 18, 2011), 2011-04-013 (Jan. 28, 2011), 2011-03-033 (Jan. 21, 2011), 2011-03-009 (Jan. 21, 2011), 2011-03-017 (Jan. 21, 2011), 2011-02-047 (Jan. 14, 2011), 2011-02-055 (Jan. 14, 2011), 2010-51-014 (Dec. 23, 2010), 2010-49-015 (Dec. 10, 2010), 2010-48-021 (Dec. 3, 2010), 2010-48-022 (Dec. 3, 2010), 2010-43-017 (Oct. 29, 2010), 2010-42-015 (Oct. 22, 2010), 2010-42-001 (Oct. 22, 2010), 2010-41-033 (Oct. 15, 2010), 2010-39-002 (Oct. 1, 2010), 2010-37-012 (Sep. 17, 2010), 2010-37-014 (Sep. 17, 2010), 2010-34-011 (Aug. 27, 2010), 2010-30-004 (Jul. 30, 2010), 2010-26-017 (Jul. 2, 2010), 2010-25-031 (Jun. 25, 2010), 2010-24-003 (Jun. 18, 2010), 2010-24-004 (Jun. 18, 2010), 2010-20-003 (May 21, 2010), 2010-07-044 (Feb. 19, 2010), 2010-05-023(Feb. 5, 2010), 2009-47-026 (Nov. 20, 2009), 2009-47-032 (Nov. 20, 2009), 2009-46-036 (Nov. 13, 2009), 2009-39-017 (Sep. 25, 2009), 2009-36-002 (Sep. 4, 2009), 2009-32-007 (Aug. 7, 2009), 2009-31-003 (Jul. 31, 2009), 2009-31-008 (Jul. 31, 2009), 2009-23-011 (Jun. 5, 2009), 2009-22-010 (May 29, 2009), 2009-12-003 (Mar. 20, 2009), 2008-42-014 (Oct. 17, 2008), 2008-40-039 (Oct. 3, 2008), 2008-22-010 (May 30, 2008), 2007-43-005 (Oct. 26, 2007), 2007-41-004 (Oct. 12, 2007), 2006-47-017 (Nov. 24, 2006).

qualifying income if held directly by the mutual funds, including the commodity index swaps the I.R.S. had previously disallowed.[147]

The commodity mutual fund forms its subsidiary in a foreign country, and the subsidiary files a check-the-box election ensuring that it will be treated as a corporation for federal income tax purposes.[148] The mutual fund capitalizes its subsidiary, and then the subsidiary purchases its commodity-related investments.

Although the private letter rulings redact the names of the countries in which mutual funds form their wholly-owned subsidiaries, it is fair to assume that the subsidiaries are formed in tax haven jurisdictions. Why a tax haven jurisdiction? In the case of mutual funds, largely because investing through a wholly-owned tax haven subsidiary is almost identical to investing directly for tax purposes, but the I.R.S. allows the interposition of the foreign corporation to launder a mutual fund's commodity investments.

The Organisation for Economic Co-operation and Development identifies four criteria central to determining whether a jurisdiction qualifies as a tax haven; for mutual funds, the most salient feature is low (or no) tax.[149] The subsidiary's facing no tax is essential for the mutual fund to earn a return on its commodities investments commensurate with a direct investment in commodities instruments. If the mutual fund held these instruments through a domestic corporation, that corporation would owe taxes on any commodities return it earned.[150] These taxes would reduce the mutual fund's return by 35 percent.[151] If the mutual fund owned the commodities interest directly, it would not face this 35-percent tax. As a result, a mutual fund that invested in commodities through a domestic corporation (or a foreign corporation that owed taxes in its country of residence) would provide its investors with a return that did not reflect commodity returns.

To the extent that the foreign corporation is organized in a tax haven jurisdiction, however, it owes no entity-level taxes. A foreign corporation only owes U.S. taxes under two circumstances. If it engages in a U.S. trade or business, it owes taxes on the net income associated with that trade or business at a top marginal rate of 35 percent, in the

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[147] *See, e.g.*, Priv. Ltr. Rul. 2012-06-015 ("Each Subsidiary will invest primarily in commodity index swap agreements and fixed income securities, and may also invest in other commodity-linked instruments, including swap agreements on commodities, options, futures contracts, options on futures, and commodity-linked notes.").

[148] *See, e.g.*, Priv. Ltr. Rul. 2012-06-015 ("Subsidiary will file an election on Form 8832, Entity Classification Election, to be taxed as a corporation for federal income tax purposes pursuant to § 301.7701-3 of the Procedure and Administration Regulations."

[149] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 23 (1998). The other factors are lack of effective information exchange, lack of transparency, and lack of substantial activities. *Id.*

[150] I.R.C. § 11(a) (2006).

[151] *Id.*

same manner as a domestic corporation.[152] If it does not engage in a U.S. trade or business, but it earns certain types of passive U.S.-source income, it owes taxes at a flat 30 percent rate on the gross amount of that U.S.-source income.[153] The Code includes a safe harbor for foreign commodities investors, providing that investing in commodities (of a type traded on a commodities exchange) does not constitute a U.S. trade or business.[154] As such, the subsidiaries will not owe taxes on their net commodities income.

Moreover, they will likely not owe taxes at the 30-percent rate. Although in general this 30-percent tax applies to U.S.-source interest, dividends, and similar passive income,[155] there are some exceptions to this withholding. And the various commodities instruments in which these mutual fund subsidiaries invest should often qualify for these exceptions. For example, the tax does not apply to a foreign corporation's receipt of "portfolio interest."[156] And, in general, income from a commodity-linked note qualifies as portfolio interest.[157]

If, instead, the mutual fund wants to invest in commodity index swaps through its subsidiary, it will also pay no taxes on any income it derives from the swaps. Swap income is not exempt as an exception from the ordinary rules; rather, swap income is sourced to the residence of the payee.[158] Similarly, if the subsidiary held actual commodities, as opposed to commodity-linked derivatives, it would owe no taxes on gains from the sale of such commodities. When a foreign corporation sells personal property, its income from the sale of that property is sourced outside of the United States.[159] In general, then, the subsidiaries will owe no U.S. or foreign taxes on their commodities income.

Although their subsidiaries will not owe taxes on the commodities income they earn, the mutual funds must include that income as they calculate their investment company taxable income. True, corporate shareholders can generally defer paying taxes on their portion of corporate income until the corporation distributes its income as a dividend.[160] But commodity mutual funds, as shareholders of wholly-owned foreign subsidiaries, operate under the controlled foreign corporation ("CFC") anti-deferral regime.

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[152] *Id.* §§ 11(d), 881(a) (2006).
[153] *Id.* § 882(a) (2006).
[154] *Id.* § 864(b)(2)(B) (2006).
[155] *Id.* § 881(a)(1).
[156] *Id.* § 881(c)(1).
[157] *See* H.R. Rep. No. 103-111, at 726-27 (1993) ("[T]he committee intends to clarify that, for example, portfolio treatment is not denied in the case of a debt instrument that pays interest in an amount determined by reference to the value of a commodities index . . . .").
[158] Treas. Reg. § 1.863-7(b)(1) (as amended in 2012).
[159] I.R.C. § 865(a)(2) (2006).
[160] *Id.* § 301(c)(1) (2006); *see also* MARTIN A. SULLIVAN, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 33 (2011) ("If current profits are not paid out as dividends, they are not immediately subject to individual tax.").

In order to classify a foreign corporation as a CFC, "United States shareholders" must own more than 50 percent of the corporation's stock.[161] For purposes of these rules, "United States shareholder" does not merely refer to a United States resident; instead, it means a United States person who owns enough stock in the foreign corporation providing her with at least 10 percent of the vote on that corporation.[162] Because the commodities subsidiaries are wholly-owned by their respective mutual funds, they qualify to be treated as CFCs.

United States shareholders lose much of their ability to defer taxation on a CFC's income. The tax law requires United States shareholders to include in their gross income their pro rata share of the CFC's subpart F income in the year the CFC earns that income, whether or not the CFC distributes that income.[163] Though subpart F income does not include all types of income that a foreign corporation could earn, it does include most passive income, including income from commodities transactions.[164]

As a result of the CFC rules, a commodities mutual fund will not be able to defer the U.S. taxation of its subsidiary's commodities-related income. Instead, it must include its subsidiary's income as it calculates its investment company taxable and distribute the (deemed) income to shareholders, who will pay taxes on their share of the income. However, by interposing a CFC between the mutual fund and the commodities investments, the mutual fund transforms income that does not meet the income requirement into income that does.[165]

Holding commodities investments in a wholly-owned CFC differs in small ways from holding them directly. Some differences make an indirect investment worse than a direct investment. For example, although CFCs pass their subpart F income through to United States shareholders, the tax law does not permit a CFC to pass its losses through to shareholders.[166]

Other differences from direct investment may benefit shareholders. As exempted limited companies, though, the subsidiaries provide the commodities mutual funds with limited liability.[167] As a result, if a subsidiaries defaults on its obligations under a

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[161] I.R.C. § 957(a) (2006).
[162] *Id.* § 951(b) (2006).
[163] *Id.* § 951(a).
[164] *Id.* § 954(c)(1)(A), (C) (2006).
[165] *See, e.g.*, Priv. Ltr. Rul. 2012-06-015 ("We rule that income derived by Fund and Portfolio from their investments in Subsidiaries, whether or not attributable to subpart F income, is income derived with respect to Fund's and Portfolio's business of investing in the stock of Subsidiaries and thus constitutes qualifying income to Fund and Portfolio under section 851(b)(2) of the Code.").
[166] *See* David L. Forst, *The U.S. International Tax Treatment of Partnerships: A Policy-Based Approach*, 14 BERKELEY J. INT'L L. 239, 269 (1996) ("Controlled foreign corporations that earn Subpart F income, however, are partnership-like only in a limited sense since their Subpart F losses do not flow through to their U.S. shareholders.").
[167] *See, e.g.*, Priv. Ltr. Rul. 2012-06-015 ("Under the laws of Country, an exempted limited company provides for limited liability for all holders of shares.").

commodities instrument, its counterparty cannot require the parent mutual fund to make the counterparty whole.[168] The mutual fund only risks the amount it has invested in its subsidiary.[169] If a bet on commodities in a foreign subsidiary goes too badly, the mutual fund and its shareholders are protected from the downside.

These differences between direct and indirect investments are more formal than substantive, however. Although the subsidiary cannot pass its losses through to the commodities mutual fund, it only passes its net commodities gains through to the commodities mutual fund.[170] The losses reduce the amount of subpart F income that the commodities mutual fund must recognize currently. As a result, to the extent a subsidiary's gains exceed its losses, the mutual fund receives the full benefit of any losses.

Moreover, if the subsidiary's losses exceeded its gains, the commodities mutual fund could electively realize those losses when it wanted to. The commodities mutual fund could sell its subsidiary if a buyer existed. To the extent the subsidiary's sole assets consisted of commodities-related instruments, and it had a net loss, the commodities mutual fund would realize a loss on the sale, unlocking the loss that its subsidiary had faced.[171] Alternatively, if the parent mutual fund could not find a buyer for the subsidiary, it could cause the subsidiary to sell its investments and distribute the cash in liquidation. Again, provided the cash distributed did not exceed the mutual fund's basis in its subsidiary, the mutual fund could realize the loss suffered by the subsidiary.[172]

The protection limited liability offers commodities mutual funds with wholly-owned subsidiaries is also more illusory than real. While a counterparty cannot compel the mutual fund parent to make it whole, in most cases it does not need to. Rather, derivatives clearinghouses generally require parties to derivatives—including commodities-related dividends—to put money into a margin account when they enter into a transaction.[173] The margin account serves to ameliorate the risk that the subsidiary will not meet its obligations. And, while a margin account does not undo limited liability, it does require that the commodities mutual fund capitalize its subsidiary sufficiently to meet the margin requirement. Because the mutual fund has to capitalize its subsidiary at a

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[168] *See* John H. Matheson, *Why Courts Pierce: An Empirical Study of Piercing the Corporate Veil*, 7 BERKELEY BUS. L.J. 1, 3 (2009) ("This concept of limited liability means that a business owner's potential personal loss is a fixed amount, namely, the amount invested in the business, usually in the form of stock ownership.").
[169] *Id.*
[170] I.R.C. § 954(c)(1)(C) (subpart F income includes the "excess of gains over losses from transactions . . . in any commodities").
[171] *Id.* § 1001(a) (2006).
[172] *Id.* § 331(a) (2006).
[173] *See* Adam H. Rosenzweig, *Imperfect Financial Markets and the Hidden Costs of a Modern Income Tax*, 62 SMU L. REV. 239, 255 (2009) ("[T]he clearinghouse requires investors to post margin with the clearinghouse prior to investing in a derivative, which serves as security on the embedded contingent liability in the derivative position.").

higher rate, it puts more of its own capital at risk, and, as such, more of its assets are at risk on the commodities transactions.

Although the economics of direct investment and investment through a wholly-owned tax haven subsidiary differ little, mutual funds do face limitations on how extensively they can invest trhough subsidiaries. Mutual funds must still meet the diversification requirements in order to qualify for their tax-advantageous status. And the diversification requirements require that 25 percent or less of a mutual fund's assets be invested in corporations that the mutual fund controls.[174] If a commodities mutual fund's wholly-owned subsidiaries represented more than a quarter of the value of its assets, the mutual fund would not qualify for its advantageous tax treatment. Still, because a mutual fund could not invest directly in these instruments without losing its advantageous tax treatment, the ability to invest 25 percent of its assets indirectly in commodities instruments appears generous.

D. Nobody Can Prevent This Victimless Tax Abuse

The I.R.S.'s use of private letter rulings to contravene the usual privileging substance over form for commodities mutual funds is problematic in a number of ways. Not only has the I.R.S. failed to provide any compelling reason that a formal approach works better when applied to commodities mutual funds, but, in this context, private letter rulings are inefficient and administratively burdensome. Moreover, they only provide commodities mutual funds with limited certainty.

A commodities mutual fund does not have to apply for a private letter ruling to invest in commodity-linked notes or in a tax haven subsidiary, of course. It is, however, unclear whether such investments produce qualifying income, notwithstanding the dozens of private letter rulings the I.R.S. has issued blessing such strategies.[175] Private letter rulings are taxpayer-specific: only the taxpayer to whom the I.R.S. addressed the private letter ruling can rely on it.[176] Moreover, even for the taxpayer who receives the ruling, it only applies to the particular transaction it addresses; a taxpayer cannot rely on its own private letter ruling for a substantially similar transaction it later enters into.[177]

And applying for a private letter ruling requires a significant investment, both of time and money, from the taxpayer requesting the ruling. A private letter ruling can cost a

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[174] I.R.C. § 851(b)(3)(B)(ii).

[175] In fact, given the number of private letter rulings that the I.R.S. has issued permitting commodities mutual funds to invest in commodity-linked notes and/or subsidiaries, and the inefficiency and unfairness of regulating mutual funds by private letter ruling, some commentators have begun to suggest that the I.R.S. should issue formal guidance—guidance that would apply to all taxpayers—blessing these strategies. *See* David H. Shapiro & Jeffrey W. Maddrey, *IRS Implicitly Rules on Economic Substance*, 130 TAX NOTES 1461, 1464 (2011) ("[A]fter more than 40 private rulings, it's time to publish a revenue ruling (or a revenue procedure) on the topic [of commodities mutual fund investments], if for no other reason than to free up taxpayer and IRS resources.").

[176] Rev. Proc. 2012-1, 2012-1 I.R.B. 1, 51 § 11.07; Treas. Reg. § 601.201(l)(6) (as amended in 2002).

[177] *Id.*

taxpayer tens of thousands of dollars to obtain.[178] A taxpayer seeking a private letter ruling must pay a fee of $18,000 in 2012.[179] On top of that, a taxpayer must pay the professionals that prepare the ruling request. In addition to the cost, private letter rulings take time to process,[180] which delays a mutual fund's ability to engage in its desired transactions.

Moreover, while a taxpayer can generally rely on a private letter ruling, that reliance has limits. If the I.R.S. determines that the ruling was erroneous, or that it no longer accords with the I.R.S.'s position on the subject, it can revoke the ruling.[181] The revocation is generally prospective only,[182] but even a prospective revocation of a commodities mutual fund's ability to invest indirectly in commodities would wreak havoc on its value.

In spite of the I.R.S.'s use of private letter rulings to undermine the primacy of substance as applied to commodities mutual funds, private letter rulings serve an essential function in the administration of the tax law. The private rulings provide certainty to taxpayers engaging in transactions that Congress did not anticipate when it wrote the law. And private letter rulings provide the I.R.S. with flexibility in administering the law. In general, this certainty and flexibility improve the efficiency of the tax law, rather than impeding taxpayers from engaging in the economic transactions in which they want to engage.

But the flexibility becomes more problematic when the I.R.S. uses private letter rulings to contravene both the law as written and long-standing common-law doctrines.[183] It seems unseemly for the administrative body charged with enforcing the tax law to explicitly permit taxpayers to ignore the law. Currently, though, there are limited avenues of policing the I.R.S. Congress could, of course, legislatively counter private letter rulings with which it disagreed. But it “cannot (and should not) engage in detailed

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[178] Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 356 (2009).

[179] Rev. Proc. 2012-1, 2012-1, 2012-1 I.R.B. 1, 69.

[180] Kelley, *supra* note 178, at 356.

[181] Treas. Reg. § 601.201(l)(7).

[182] *Id.* (the I.R.S. “ordinarily will limit the retroactivity of the revocation . . . to a date not earlier than that on which the original ruling was . . . revoked”).

[183] The shift from Rev. Rul. 2006-1, which banned commodity index swaps, to the private letter rulings, which permitted commodity-linked notes and offshore subsidiaries, provides an interesting illustration of why changing the law through I.R.S. rulings may be problematic. Dale Collinson was the principal author of the revenue ruling, which the I.R.S. released in mid-December 2005. Rev. Rul. 2006-1, 2006-1 C.B. 262. The I.R.S. released its first private letter ruling blessing commodity-linked notes on June 1, 2006. Priv. Ltr. Rul. 2006-37-018 (Jun. 1, 2006). By November 2006, Collinson had left the I.R.S. to join KPMG. *See* http://www.nysscpa.org/conferences/2007/pdfs/taxfinancial.pdf at 4. That Collinson left shortly around the time that the I.R.S. changed its take on commodities mutual funds does not prove, of course, that his leaving opened the door to the I.R.S.'s policy change. It does, however, suggest how fleeting the rules enumerated by private letter rulings not supported by law could be.

oversight of the entire operation of the Service."[184] Congress does not have the time or expertise to review every private letter ruling the I.R.S. issues.[185] As such, requiring it to change the law every time it disagrees with a private letter ruling is an unattractive position to take.[186]

The I.R.S., generally the enforcer of the tax law, is also not in the position to police these rulings. In issuing these private letter rulings, the I.R.S. indicates that it considers the taxpayer's position to be acceptable. If it finds the position acceptable—even if the position favors form over substance—it will not challenge the position. Because the I.R.S. functions both as the promulgator of the rulings and the enforcer of the tax law, it will be ineffective at preventing these types of form-over-substance problems.

Recipients of private letter rulings are also in no position to police the I.R.S. The recipient taxpayer has expended significant time and resources in applying for and receiving the ruling.[187] Moreover, private letter rulings allow the taxpayer to structure her transaction in a specific way, knowing that the I.R.S. will not generally challenge her anticipated tax treatment.[188] Inasmuch as a successfully-obtained private letter ruling provides a benefit to the taxpayer, who received it, that taxpayer has no incentive to challenge the ruling.

That leaves third-party taxpayers. If Congress wants to prevent the I.R.S. from using private letter rulings to favor form over substance, it could enlist these third parties. Under current law, third-parties who may disagree with the I.R.S.'s decision, whether because they compete or because they want a better administration of the tax law, generally lack standing to pursue such a suit.[189] But if Congress wanted to empower them to police the I.R.S.'s issuance of private letter rulings, it could legislatively empower third parties to challenge private letter rulings that favored form over substance.

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[184] Stephanie Hoffer, *Hobgoblins of Little Minds No More: Justice Requires an IRS Duty of Consistency* 2006 UTAH L. REV. 317, 330 (2006).

[185] In 2010 alone, the I.R.S. issued approximately 1,874 private letter rulings, based on the search (advanced: "private letter ruling" & "IRS PLR" & DA(aft 12-31-2009 & bef 01-01-2011)) on WestlawNext.

[186] In fact, a number of Congresspeople have weighed in on the commodities mutual fund private letter rulings, almost universally criticizing the I.R.S. for the rulings. *See* Jeremiah Coder, *Top Tax Officials Grilled on Mutual Fund Commodity Investments*, 134 Tax Notes 524, 524 (2012) (Senators Carl Levin and Tom Coburn "sent a letter to the IRS urging it to permanently extend its moratorium and to 'reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from "securities" under section 851.'"). But Congress itself has not acted to correct the I.R.S.'s course.

[187] *See supra* notes 178-180 and accompanying text.

[188] Treas. Reg. § 601.201(l)(6) (as amended in 2002) ("A ruling issued to a taxpayer with respect to a particular transaction represents a holding of the Service on that transaction only.").

[189] Lawrence Zelenak, *Should Courts Require the Internal Revenue Service to Be Consistent?*, 40 TAX L. REV. 411, 429 (1985) ("Third parties may sue to prevent Service leniency toward other taxpayers (either out of high public mindedness or because the taxpayers favored by the lenient position are competitors), but such suits are almost always dismissed for lack of standing.").

But empowering third parties would also be problematic on several levels. In most cases, third parties would have at best little incentive to challenge a private letter ruling. A competitor to the taxpayer may want to remove from the taxpayer a potential advantage. But to the extent that a transaction favoring substance provides a competitive advantage, the competitor may gain more by imitating the strategy and obtaining its own private letter ruling than by challenging the existing private letter ruling. If, on the other hand, the competitor did not believe the strategy provided any advantages to the taxpayer, the competitor could allow the taxpayer to keep pursuing the strategy.

Non-competitor third parties would have even less incentive to challenge private letter rulings. Because they do not compete with the taxpayers who receive the ruling, they would gain no competitive advantage by preventing the taxpayers from pursuing the strategy. In order to launch the challenge, though, these third parties would need to expend the time to review private letter rulings and the money to launch a challenge. In the end, though, they would receive no upside from the termination of a bad strategy.[190]

And even Congress could overcome the problem of finding a third party willing to police the I.R.S.'s issuance of private letter rulings, potential problems would still exist. A third-party's ability to challenge any private letter ruling could raise the cost, both in money and in time, of receiving a ruling. Moreover, because the ruling could not be challenged until after it became public, it would reduce the taxpayer's certainty in relying on the ruling. But private letter rulings improve the efficiency of administering and of complying with the tax law, especially in areas where the law is unclear as applied to a particular transaction. Such a broad grant of standing would significantly reduce the efficiency of administering the tax law, and could impede taxpayers from engaging in beneficial, but new, transactions.

Moreover, even a targeted grant of standing (for example, only in cases where the private letter ruling favored form over substance) could create these administrative problems. A challenge to a non-form-over-substance private letter ruling could be thrown out, but first the I.R.S. (and/or the taxpayer to whom the ruling was issued) would have to demonstrate that the private letter ruling did not fit within the scope of the standing granted by Congress. Overall, the problems with granting third-party standing likely outweigh any benefits that it would provide.

IV. OVERSIGHT AND THE I.R.S.

As the prior two Sections have demonstrated, the I.R.S. does not always enforce the tax law as written. Sometimes the I.R.S.'s departure from the law as written harms

[190] In fact, when the tax law tries to enlist other taxpayers to assist the I.R.S. in its enforcement, it recognizes the incentive problem. As a result, for example, whistleblowers who disclose tax evasion by others are entitled to between 15 and 30 percent of the proceeds collected as a result of her information. I.R.C. § 7623(b)(1) (2006).

taxpayers; even when it does not, however, it harms the tax system and violates Congress's intent.

The I.R.S.'s departure from Congressional intent is a standard principal-agent problem.[191] Congress, as the principal, promulgates the tax law. It does not, however, actively participate in the law it has promulgated; rather, it leaves the administration and enforcement to the I.R.S. which, in spite of being an executive agency, functions as Congress's agent.[192] Congress does not, however, have the resources to fully oversee the I.R.S., and must therefore establish incentives to ensure that the I.R.S. enforces the tax law in the manner Congress desires.[193]

Although the I.R.S. generally succeeds in fulfilling its duties in administering the tax law, as the prior two Sections have demonstrated, the current incentive system functions imperfectly. Whatever the reason, at times the I.R.S. will misinterpret or ignore wholesale the law it has been charged with administering.[194] To prevent such behavior, Congress needs to modify the I.R.S.'s incentives. One method Congress could use to realign the I.R.S.'s incentives would be to establish effective oversight with an eye toward protecting the tax system.

Currently, then, there is no party that can fill this oversight role with respect to the I.R.S. Such a role is too time-consuming for Congress. And nobody else has the standing or incentive to fill such a role. As a result, it is necessary to introduce a new actor. Such a oversight group could be located inside the I.R.S., or it could be an outside group. Each has advantages, and each disadvantages. Whichever it chooses, though, Congress would need to formalize both its mandate and its authority in such a way that it could effectively protect the tax system from the I.R.S. while not interfering unnecessarily with the efficient administration of the tax law. This Section will proceed to summarize three models of agency oversight that currently exist and which provide clues as to how to design the necessary oversight.

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[191] *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7, 7 (1983).

[192] Archie Parnell, *Congressional Interference in Agency Enforcement: The IRS Experience*, 89 YALE L.J. 1360, 1360 (1980) ("[T]he relationship remains one of interdependence, in which Congress depends on the IRS to execute the Internal Revenue Code and collect the revenues necessary to fund the federal government and the IRS depends on Congress to fund and authorize its operations . . . .").

[193] David E. M. Sappington, *Incentives in Principal-Agent Relationships*, 5 J. ECON. PERSP. 45, 45 (1991) ("Incentive theory, however, generally focuses on tasks that are too complicated or too costly to do oneself. Thus, the "principal" is obliged to hire an "agent" with specialized skills or knowledge to perform the task in question.").

[194] At times, of course, Congress itself may impede the I.R.S. from doing its job appropriately, forbidding it to enforce certain provisions of the Code rather than legislatively changing the Code. *See, e.g.*, Parnell, *supra* note 192, at 1361 ("Second, Congress has shown a recent tendency to use a variety of techniques to prohibit the IRS from executing certain aspects of the Code, rather than changing the Code itself.").

A. The Office of the Taxpayer Advocate

With proper design, the I.R.S. itself could fulfill the necessary oversight role. Or, rather, a subset of the I.R.S. In response to various taxpayer complaints about the I.R.S., Congress has enacted various reforms over the last three decades intended to check the I.R.S.'s purported abuses of taxpayers.[195] In 1979, the I.R.S. created the Office of the Taxpayer Ombudsman to coordinate its problem resolution program and to act as an advocate for taxpayers.[196] In 1988, Congress enacted the Taxpayer Bill of Rights, which, among other things, codified the Taxpayer Ombudsman and gave it the ability to issue a Taxpayer Assistance Order.[197] A Taxpayer Assistance Order could require the I.R.S. to release taxpayer property it had levied, prevent collection, and otherwise protect taxpayers suffering significant hardship as a result of the I.R.S.'s administration of the tax law.[198] In addition, Congress required the Taxpayer Ombudsman to make an annual report to the Senate Finance Committee and the House Ways and Means Committee on the quality of taxpayer services.[199]

In 1996, Congress replaced the Office of the Taxpayer Ombudsman with the Office of the Taxpayer Advocate.[200] The Office of the Taxpayer Advocate was supervised by the Taxpayer Advocate, who reported directly to the Commissioner of Internal Revenue.[201] The Code continued to require the Office of the Taxpayer Advocate to make an annual report to Congress and to help taxpayers resolve problems with the I.R.S.[202] In addition, the Taxpayer Bill of Rights 2 charged the newly-created Office of the Taxpayer Advocate with identifying problem areas in taxpayer interaction with the I.R.S. and proposing administrative and legislative changes that could fix those problem areas.[203]

In spite of these changes, many in Congress did not believe that that the Taxpayer Advocate functioned independent from the I.R.S. as it advocated for taxpayers.[204] Their incredulity stemmed, at least in part, "based in part on the placement of the Advocate within the IRS and the fact that only career employees have been chosen to fill the position."[205] In 1998, Congress further tweaked the Office of the Taxpayer Advocate in

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[195] *See supra* notes 17-20 and accompanying text.
[196] Bryan T. Camp, *What Good Is the National Taxpayer Advocate?*, 126 TAX NOTES 1243, 1247 (2010).
[197] Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Pub. L. No. 100-647, Title VI, 102 Stat. 3342, 3733 (1988).
[198] I.R.C. § 7811(b) (1988).
[199] TAMRA, Pub. L. No. 100-647, Title VI, Sec. 6235 (b), 102 Stat. 3342, 3737 (1988).
[200] Taxpayer Bill of Rights 2, 104 P.L. 168, § 101(a), 110 Stat. 1452, 1453 (1996).
[201] *Id.*
[202] *Id.*
[203] *Id.*
[204] NAT'L COMM'N ON RESTRUCTING THE I.R.S., A VISION FOR A NEW IRS [hereinafter, NAT'L COMMISION, VISION] 48 (June 25, 1997).
[205] *Id.*

an attempt to ensure the Taxpayer Advocate's independence.[206] The head of the Office of the Taxpayer Advocate was rechristened the *National* Taxpayer Advocate.[207] Though she continues to report directly to the Commissioner of Internal Revenue,[208] Congress attempted to ensure her independence by prohibiting the appointment as National Taxpayer Advocate of anybody who had worked for the I.R.S. in the prior two years. Moreover, the National Taxpayer Advocate must agree not to accept a job with the I.R.S. for five years after her appointment as National Taxpayer Advocate ends.[209] As a result of these limitations, the National Taxpayer Advocate cannot view her service as "just another assignment . . ., with the Commisioner viewing . . . her performance as determining the next position."[210]

In addition, Congress provided for local taxpayer advocates, including at one for each state.[211] Each of these local offices must have its own phone, fax, and other electronic communication, separate from the I.R.S.[212] Each must inform taxpayers of its independence from any other I.R.S. office at the beginning of its consultation and, importantly, each has the discretion not to disclose to the I.R.S. the fact that a taxpayer had contact with the office or any information provided by the taxpayer.[213]

The Office of the Taxpayer Advocate claims to be the "voice of the taxpayer."[214] Does it manage to effectively pursue taxpayer interests, even where those interests conflict with the I.R.S.'s goals? Though the data is limited, anecdotally, it appears to work. Practitioners praise the Taxpayer Advocate for "get[ing] things done despite the impediments of the systems within the IRS."[215] Moreover, in spite of the tensions inherent in an ombudsman-type role,[216] the Taxpayer Advocate's customer service surveys indicate that even taxpayers who do not obtain the results they wanted feel better about the I.R.S. after working with the Taxpayer Advocate.[217] National Taxpayer Advocate Nina Olson sees the Office of the Taxpayer Advocate successfully navigating

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[206] I.R.S. Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1102, 12 Stat. 685, 697 (1998).
[207] I.R.C. § 7803(c)(1)(B)(i) (2006) (emphasis added).
[208] *Id.* § 7803(c)(1)(B)(iv).
[209] *Id.*
[210] NAT'L COMMISION, VISION, *supra* note 204, at 48.
[211] I.R.C. § 7803(c)(2)(D)(i)(I).
[212] *Id.* § 7803(c)(4)(B).
[213] *Id.* § 7803(c)(4)(A).
[214] NAT'L TAXPAYER ADVOCATE, FISCAL YEAR 2013 OBJECTIVES I-3 (2012), available at http://www.taxpayeradvocate.irs.gov//userfiles/file/FY13ObjectivesReporttoCongress.pdf.
[215] Larry Jones, *Customer Service—We All Want It, But Do We Get It?*, J. TAX PRAC. & PROC., Aug.-Sept. 2003, at 5, 8.
[216] *See, e.g.*, Camp, *supra* note 196, at 1250 ("Few people like being criticized, and there is an inherent distrust within a bureaucracy of a subcomponent like the TAS whose very function is to highlight problems in the system, whether case specific or systemic.").
[217] Nina Olson, *The Taxpayer Advocate Service: Independence Within the IRS*, 126 TAX NOTES 1257, 1261 (2010).

the tension between being an insider and an outsider in part because the Taxpayer Advocate is just that—an advocate, not a decision-maker.[218]

In many ways, the Office of the Taxpayer Advocate provides an excellent model for how to police the I.R.S. Unlike Congresspeople, I.R.S. employees have the time and expertise to focus specifically on issues of tax administration. Moreover, I.R.S. employees would not face the major issues (besides standing) that would impede third parties from challenging the I.R.S.'s placing form over substance. Because the I.R.S. does not manage mutual funds, employees in a watchdog office could not decide to pursue their own private letter ruling rather than challenging the I.R.S.'s promulgation of such rulings. In addition, they would not face the costs of litigating such a case with no hope of monetary relief.

Moreover, placing enforcement in an office in the I.R.S. would present certain advantages over either Congressional or third-party enforcement. As discussed above, in certain cases, the tax law not only permits, but actually encourages, taxpayers to act in a formal way that has no substance.[219] If taxpayers challenged the I.R.S. every time it recognized a taxpayer's compliance with formal requirements that had no substance, administering the tax law would become unwieldy and overly-expensive. The convenience and efficiency of permitting taxpayers to, for example, make entity elections for tax purposes would dissolve, and, in spite of their complexity, the previous facts-and-circumstances test may become a more efficient process. An office in the I.R.S., on the other hand, could develop the expertise necessary to differentiate between permissible and impermissible situations for permitting purely formal actions.[220]

An office within the I.R.S. charged with challenging the I.R.S.'s administration of the tax law would, of course, face significant problems, especially the inside-outside problem and the dissonance of challenging the organization of which it is part. The history of the Office of the Taxpayer Advocate demonstrates that these problems are real and significant. But the current success of the Taxpayer Advocate demonstrates that they are not insuperable. The office must, however, be designed carefully to take into account both the conflicts and the appearance of conflicts.

Although the Office of the Taxpayer Advocate provides a model for creating a watchdog within the I.R.S., the Taxpayer Advocate, as it currently stands, cannot function as that watchdog for a number of reasons. The Office of the Taxpayer Advocate is charged with improving taxpayers' experience in dealing with the I.R.S.; the National Taxpayer Advocate not only needs to have experience with the tax law, but she must have "a background in customer service."[221] Preventing the I.R.S. from recognizing

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[218] *Id.* at 1260.

[219] *See supra* notes 110-119 and accompanying text.

[220] For the group to be able to differentiate permissible and impermissible formal primacy, it necessarily must be composed of individuals with significant knowledge of the tax law and practice. *See infra* Section V.B.

[221] I.R.C. § 7803(c)(1)(B)(iii)(I).

substance-free transactions does nothing to improve an individual taxpayer's interaction with the I.R.S. It maintains the integrity of the tax law, which provides a collective benefit to taxpayers, but the Office of the Taxpayer Advocate was created to provide individual, not collective benefit.

Moreover, the Office of the Taxpayer Advocate would lack the ability to enforce its decisions even if it took on the proposed watchdog role. Currently, the Office of the Taxpayer Advocate essentially does two things: it helps taxpayers resolve their problems with the I.R.S., and it makes an annual report to Congress detailing areas in which taxpayers and the I.R.S. clash and proposing administrative and legislative changes that would ameliorate these clashes.[222] The Office of the Taxpayer Advocate cannot, however, sue the I.R.S. to halt the problems or enforce its proposed solutions.[223] And the limitations on the Office of the Taxpayer Advocate's litigation are not limited to its inability to engage counsel. The Taxpayer Advocate cannot file *amicus curiae* briefs that relate to taxpayer rights.[224] Moreover, although the Taxpayer Advocate can comment on proposed rules and regulations promulgated by the I.R.S., the I.R.S. has no obligation to consider the Taxpayer Advocate's comments.[225]

In light of its limited recourse, any success the Taxpayer Advocate enjoys is a testament to its persuasive abilities. And while the Taxpayer Advocate has successfully pursued its mission, its success probably relies at least in part on the fact that the taxpayers it supports provide a sympathetic picture to other taxpayers. The I.R.S. knows that mistreating taxpayers can lead to a popular backlash, and potentially to legislation such as the two Taxpayer Bills of Rights. The problems of the tax system at large, however, are more metaphysical than personal, and are thus less sympathetic. Without a sympathetic taxpayer to provide the threat of backlash, the Taxpayer Advocate would have less leverage to encourage change.

Even if the Office of the Taxpayer Advocate could find a way to reconcile a mission to protect the integrity of the tax system with its current mission to protect taxpayers *and* could effectively do so in light of its constraints on litigation, this

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[222] *Id.* § 7803(c)(2)(A).

[223] *See, e.g.*, 28 U.S.C. § 516 (2006) ("Except as otherwise authorized by law, the conduct of litigation in which the United States, an agency, or officer thereof is a party, or is interested, and securing evidence therefor, is reserved to officers of the Department of Justice, under the direction of the Attorney General."); 5 U.S.C. § 3106 (2006) ("Except as otherwise authorized by law, the head of an Executive department or military department may not employ an attorney or counsel for the conduct of litigation in which the United States, an agency, or employee thereof is a party, or is interested, or for the securing of evidence therefor, but shall refer the matter to the Department of Justice."). Congress has authorized the Chief Counsel of the I.R.S. to represent the Secretary of the Treasury Department, but only in the Tax Court. I.R.C. § 7452 (2006). But this authorization does not extend to the Taxpayer Advocate's being represented by non-Department of Justice counsel.

[224] NATIONAL TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS 573 (2012), *available at* http://www.irs.gov/pub/irs-utl/irs_tas_arc_2011_vol_1.pdf.

[225] *Id.* at 573-74.

watchdog duty should not be imported into the Office of the Taxpayer Advocate. Currently, Congress underfunds the I.R.S.[226] As it currently stands, the Taxpayer Advocate lacks the resources to deal with its increasing workload without sacrificing quality and timeliness.[227] Adding an additional mandate to an Office of the Taxpayer Advocate already stretched thin would force the Taxpayer Advocate either to further cut their services to taxpayers in need or to limit its watchdog work.

While Congress could increase the scope of the Taxpayer Advocate's mandate, it

B. The Internal Revenue Service Oversight Board

Alternatively, Congress could place the oversight duty and authority outside of the I.R.S. itself. As with an internal oversight group, models already exist. Also like the internal oversight group, Congress would have to adjust these models slightly to meet the specific task of protecting the tax system.

The most obvious model for an outside oversight group is the Internal Revenue Service Oversight Board.[228] Created in the same 1998 law that restructured the Office of the Taxpayer Advocate,[229] the Oversight Board consists of nine members.[230] The president appoints seven members with the advice and consent of the Senate; of those seven, six cannot be federal officers or employees, while the seventh must be a full-time federal employee.[231] These board members were to be "high stature, nonpartisan professionals, with experience particularly relevant to a 100,000 employee organization."[232] The seventh board slot appointed by the President is filled by a full-time federal employee or a representative of federal employees.[233] The Secretary of the Treasury Department and the Commissioner of Internal Revenue fill the other two board seats.[234] The Oversight Board is non-partisan, and its members must have experience and expertise in, among other things, federal tax law, including compliance and administration.[235]

The Code charges the Oversight Board with overseeing the I.R.S. "in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes and tax conventions to which

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[226] *Id.* at vi ("And despite a huge expansion in the IRS's workload, Congress has reduced the IRS's funding in each of the last two years.").
[227] *Id.* at 693.
[228] I.R.C. § 7802(a) (2006).
[229] I.R.S. Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1101(a), 12 Stat. 685, 691 (1998).
[230] I.R.C. § 7802(b)(1).
[231] *Id.* § 7802(b)(1)(A).
[232] NAT'L COMM. ON RESTRUCTURING THE INTERNAL REVENUE SERVICE, REPORT OF THE NAT'L COMM. ON RESTRUCTURING THE INTERNAL REVENUE SERVICE 13 (1997) [hereinafter NAT'L COMM., RESTRUCTURING], *available at* http://www.house.gov/natcommirs/report1.pdf.
[233] I.R.C. § 7802(b)(1)(D).
[234] *Id.* § 7802(b)(1)(B)-(C).
[235] *Id.* § 7802(b)(2)(A)(3).

the United States is a party."[236] More specifically, the Oversight Board must review the I.R.S.'s strategic and operational plans, recommend and oversee the Commissioner of Internal Revenue, review and approve the I.R.S.'s budget, and ensure that I.R.S. employees treat taxpayers properly.[237]

In terms of its composition and its mission, the Oversight Board seems like the ideal outside group to police the I.R.S. and protect the tax system. Its members have the expertise both in tax law and its administration that allows the Oversight Board to understand the I.R.S.'s actions in light of the Code. The majority of the Oversight Board consists of individuals who are not employed by the I.R.S., and therefore do not face the inside-outside tensions that could bedevil an oversight group located within the I.R.S. Moreover, the Oversight Board has the time and resources to oversee the I.R.S.'s issuance of private letter rulings and other administrative actions. Although the Oversight Board is only obligated to meet quarterly,[238] it can engage the staff necessary to fulfill its duties.[239]

Still, as currently constituted, the Oversight Board cannot meet the responsibilities necessary to protect the tax system. Congress specifically carved out of the Oversight Board's purview the authority to "direct tax policy or administration."[240] These carveouts exist because the Congress intended that the Oversight Board play a governance, not a management, role within the I.R.S.[241] And, in fact, the Oversight Board functions more like an advisory board than any type of governing board.[242]

C. The Office of the United States Trustee

An alternative model comes from the bankruptcy, rather than the tax, world.[243] In 1978, Congress established the Office of the United States Trustee to handle the administrative functions of bankruptcy, while also reducing certain abuses within the bankruptcy system as a whole.[244] The U.S. Trustee has the authority both to monitor bankruptcy cases, but to take action when, for example, a case risks undue delay or when parties fail to meet deadlines.[245]

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[236] *Id.* § 7802(c)(1)(A).
[237] *Id.* § 7802(c)(2)-(5).
[238] *Id.* § 7802(f)(2).
[239] *Id.* § 7802(e)(3)(A).
[240] Eric A. Lustig, *IRS, Inc.—The IRS Oversight Board—Effective Reform or Just Politics? Some Early Thoughts from a Corporate Law Perspective*, 42 DUQ. L. REV. 725, 739 (2004).
[241] Nat'l Comm., Restructuring, *supra* note 231, at 14.
[242] *Lustig*, *supra* note 240, at 768.
[243] Thank you to Professor Kara Bruce for suggesting the U.S. Trustee as a potential model for I.R.S. oversight seeking to protect the tax system.
[244] Greg M. Zipes, *Discovery Abuse in the Civil Adversary System: Looking to Bankruptcy's Regime of Mandatory Disclosure and Third-Party Control Over the Discovery Process for Solutions*, 27 CUMB. L. REV. 1107, 1160 (1996).
[245] Mary Jo Heston, *The United States Trustee: The Missing Link of Bankruptcy Crime Prosecutions*, 6 AM. BANKR. INST. L. REV. 359, 383 (1998).

As with the Taxpayer Advocate and the Oversight Board, the U.S. Trustee does not present a perfect template for a group charged with protecting the federal tax system. Although its origins include an attempt to reduce fraud, waste, and abuse within the bankruptcy system,[246] its mandate generally requires that it focus on private actors, not on the administrative agency charged with enforcing the tax law. Moreover, though the U.S. Trustee's broadly works to ensure the proper enforcement of the bankruptcy law, it does so on the level of individual bankruptcy cases, rather than focusing on overarching policy development. Nonetheless, the U.S. Trustee has aspects that could easily be carried over to the tax context and that would improve upon the models that already exist in the tax world.

Most centrally, the U.S. Trustee has the ability to intervene in litigation. While it cannot initiate the litigation, it can "move for conversion or dismissal under § 1112(b), at least where the motion advances the trustee's interest in administration of the bankruptcy proceedings."[247] In addition, the U.S. Trustee has the authority to establish and delegate to a panel of private trustees in the pursuit of its duties.[248] Finally, Congress granted the U.S. Trustee "broad statutory authority to fulfill its role."[249] Such broad authority allows the U.S. Trustee flexibility to protect the bankruptcy system even when unanticipated problems arise, because the U.S. Trustee can react with "consistency, creativity, and flexibility."[250]

V. A New Oversight Board

Although each serves a valuable purpose, none of the Taxpayer Advocate, the I.R.S. Oversight Board, or the U.S. Trustee encapsulates exactly what is needed to protect the tax system from I.R.S. abuse. Still, they provide insight into the design and effectiveness of different models of oversight. Using the insights derived from these organizations, this Section will lay out some necessary criteria that would permit an oversight entity to effectively protect the tax system from I.R.S. abuse.

A. The Mandate

The oversight group should have authority to review and comment upon proposed regulations. While the Treasury Department has broad authority to enact regulations,[251] in some circumstances, those regulations can harm to the tax system.[252] In many cases, the oversight group would not be the only one commenting on regulations; the

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[246] *Id.* at 382-83.
[247] In re A-1 Trash Pickup, Inc., 802 F.2d 774, 776 (4th Cir. 1986).
[248] 28 USCS § 586(a)(1).
[249] Heston, *supra* note 245, at 383.
[250] *Id*. at 385.
[251] I.R.C. § 7805(a) (2006) ("[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of this title.").
[252] *See supra* note 38.

Administrative Procedure Act of 1946 ("APA")[253] generally requires a notice-and-comment process for proposed regulations.[254] It excepts interpretive regulations from the notice-and-comment requirement, however.[255] And, although the I.R.S. generally solicits comments when it proposes a regulation, it maintains that most of its regulations qualify as interpretive regulations, and thus technically exempt from the notice-and-comment requirement.[256]

Moreover, even if all regulations were subject to notice-and-comment procedures, the oversight group is tasked with a different goal than others who comment. Presumably, interested taxpayers will comment on how the proposed regulations will affect their business. The Office of the Taxpayer Advocate will highlight the way a proposed regulation will affect taxpayers in their interaction with the I.R.S. But neither is expressly looking at how the proposed regulation affects the tax system as a whole. Moreover, to the extent the proposed regulation is taxpayer-favorable, neither has an incentive to oppose a regulation that violates established tax law. But this would be the oversight group's express purpose: to make sure the regulation does not harm the tax system, especially by violating the tax law as it currently stands.

The authority to simply comment on proposed regulations is insufficient. The Office of the Taxpayer Advocate is currently pressing for a requirement that the I.R.S. actually *consider* its comments.[257] But it is possible that other taxpayers, out of their own self-interest, will echo the Taxpayer Advocate's view on how the proposed regulation will affect taxpayers' interaction with the I.R.S. Because the oversight group will be the only group commenting from the perspective of protecting the tax system, it is even more important that Congress require the I.R.S. to consider its recommendations.

Just reviewing proposed regulations, however, would do very little to protect the tax system. Regulations generally already face notice-and-comment, and interested parties have the ability to object to proposed regulations that veer too far afield of their statutory basis. But, as the I.R.S.'s treatment of commodities mutual funds demonstrates, the I.R.S. can also use other rulings, not subject to notice-and-comment, in a way that damages the tax system.[258] The oversight board charged with protecting the tax system needs the authority to review the I.R.S.'s less-formal rulings, as well, and should also have the authority to look at other I.R.S. actions.[259]

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[253] Pub. L. No. 79-404, 60 Stat. 237 (codified as amended in scattered sections of 5 U.S.C.).

[254] 5 U.S.C. § 553(b)-(c) (2006).

[255] *Id.* § 553(b).

[256] Matthew H. Friedman, *Reviving* National Muffler*: Analyzing the Effect of* Mayo Foundation *on Judicial Deference as Applied to General Authority Tax Guidance*, 107 Nw. U. L. Rev. Colloquy 115, 122 (2012).

[257] *See supra* note 225 and accompanying text.

[258] *See supra* Section III.C.

[259] The oversight group would not have the resources to look at everything that the I.R.S. does, of course. Rather, it would have to prioritize its reviews. Its method of prioritization should include both stricter scrutiny of areas that have had problems in the past and a random assortment of unproblematic areas. *See infra* notes 264-268 and accompanying text.

B. The Composition

For the oversight group to protect the tax system, members must have a deep knowledge and understanding of the tax system, while also having some degree of independence from the I.R.S. The Office of the Taxpayer Advocate ensures the appropriate familiarity with the tax law by appointing to its head a person with significant experience in the tax law.[260]

It is essential that the members of the oversight panel have significant knowledge of and familiarity with the tax law. For example, they need the ability to differentiate between respecting form at the expense of substance *(e.g.*, permitting mutual funds to invest in commodity-linked notes) and respecting form because determining the underlying substance is unimportant or administratively infeasible (*e.g.*, entity election).

In addition to the knowledge base required, members of the oversight board need impartiality. Some of the I.R.S. actions they challenge would likely favor the government, while others would favor taxpayers. To prevent the board from tilting toward or against the government's interests, the board should be split between government employees and individuals working in the private sector.

The members who worked for the government would ideally be selected from the I.R.S., the Treasury Department, or another governmental agency that worked extensively with the tax system. Such individuals would potentially face pressure to act in ways that favored the I.R.S., but such pressure could be counterbalanced by implementing procedures shielding them. In creating the National Taxpayer Advocate, Congress demonstrated that it could provide such shielding.

Moreover, the board members employed in private industry would provide a counterbalance to an overly-government-favorable approach. And from where would the oversight board draw these private industry members? Many tax professional organizations include, in their mission statements, the promotion of an equitable tax system. For example, the American Bar Association's Section of Taxation, for example, works to provide "leadership to support the development of an equitable, efficient and workable tax system."[261] The Tax Section of the New York State Bar Association works to further "the public interest in a fair and equitable tax system."[262] Ensuring that the I.R.S.'s actions do not harm the tax system fits comfortably with these missions.

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[260] Prior to her appointment, Nina Olson, the current National Taxpayer Advocate, worked in private practice representing taxpayers in tax litigation. She also owned a tax planning and preparation firm, and chaired the American Bar Association Section of Taxation's Low Income Taxpayers Committee. National Taxpayer Advocate Bio, *available at* http://www.taxpayeradvocate.irs.gov/Media-Resources/National-Taxpayer-Advocate-Bio.

[261] ABA Section of Taxation, About Us, *available at* http://www.americanbar.org/groups/taxation/about_us.html.

[262] New York State Bar Association Tax Section Purpose, *available at* http://www.nysba.org/AM/Template.cfm?Section=Mission_Statement4.

C. The Motivation

Recently, Congress has shown no interest in properly funding the I.R.S.[263] Given its antipathy toward funding the I.R.S., there is no reason to believe that Congress will provide significant funding to oversee the I.R.S., especially where such oversight does not obviously protect a particular constituency. As a result, the oversight board will not have the resources to review every I.R.S. action to make sure it does no harm to the tax system.

Even with sufficient funding, however, an oversight model that required the overseer to look at every I.R.S. action would be undesirable. It would significantly impact the I.R.S.'s efficiency, and, because the I.R.S. follows the tax law in most cases, such oversight would be unnecessarily broad.

Instead, the oversight group should provide what the literature calls "fire-alarm oversight."[264] Fire-alarm oversight reacts to "a specific stimulus worth of the members' attention."[265] Various flags for this type of reactive oversight could include, among other things, the I.R.S.'s attempting to promulgate rulings or regulations in response to judicial losses. And once a category of ruling or an I.R.S. office that promulgates problematic rulings has been flagged as an issue, the oversight group could look more closely at that category or that office.

The reactive model is backward-looking, however, and does not entirely solve the problem of the I.R.S. harming the tax system. As long as it only looks at areas that have had problems in the past, it will be unable to prevent novel problems that arise. To capture those problems, in addition to its fire-alarm oversight, the oversight board should engage in random audits.

In selecting taxpayers to audit, the I.R.S. largely depends on statistical profiling to ensure that it focuses its scarce resources auditing taxpayers who are likely to owe more than they paid.[266] However, it also selects a small number of taxpayers to audit randomly.[267] These random audits serve a different purpose than its statistical choices: with these random audits, the I.R.S. can gather information about the effectiveness of its enforcement, the size of the tax gap, and other information that will help improve its statistical choices.[268] Similarly, the oversight group needs to choose at random some

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[263] *See, e.g.*, William Hoffman, *Panelists Acknowledge IRS Challenges, Consider Funding*, 135 TAX NOTES 44, 44 (2012) ("The IRS faces myriad challenges posed by the global economy and new mandates from Congress, but its biggest test will be finding the funding that will enable it to meet its increasing workload.").

[264] Morris S. Ogul & Bert A. Rockman, *Overseeing Oversight: New Departures and Old Problems*, 15 LEGIS. STUD. Q. 5, 13 (1990).

[265] *Id.*

[266] Sarah B. Lawsky, *Fairly Random: On Compensating Audited Taxpayers*, 41 CONN. L. REV. 161, 165 (2008).

[267] *Id.* at 166.

[268] *Id.*

I.R.S. actions. Doing so will allow it to find new problems that fire-alarm oversight would miss. It also sends a message to the I.R.S. that a department or individual may be subject to oversight, even with no red flags pointing in that direction.

D. The Location

The various models demonstrate that an oversight body can successfully be located within or without the I.R.S. itself. Congress located the Office of the Taxpayer Advocate within the I.R.S., but instituted firewalls to ensure its independence. Those firewalls included protections against the National Taxpayer Advocate using her office to advance her status and ability. They demonstrate, for example, that such oversight can occur from within the I.R.S. itself, if the office is properly designed and insulated from internal pressures. Alternatively, an outside group can be created and charged with oversight, if the group consists of competent individuals who are familiar with the tax law they are protecting.

While the oversight group could function in either place, locating it outside of the I.R.S. would be preferable. Being part of the I.R.S. would not provide any significant benefits to the oversight group. Being part of the I.R.S. would not guarantee that the I.R.S. would cooperate with the oversight group.[269] Congress would have to take extra care to insulate the board from I.R.S. pressure. And, although the federal government can technically end up on opposite sides of a lawsuit, that door is rarely opened.[270]

An oversight group not housed within the agency it seeks to oversee does not face the same potential pressures. It has more ability to act independently, even without Congressional protection. And, although Congress would have to specifically give it standing and authority to bring cases to court, it would not require permitting the I.R.S. to sue itself. As a result, even though the oversight group could be located within the I.R.S., creating it separately from the I.R.S. makes practical and administrative sense.

VI. CONCLUSION

In general, the I.R.S. does an effective job administering the tax system. It manages to process tax returns and refunds, find and prevent fraud, and otherwise make the tax system function, and does so with relatively few major problems.[271] Moreover, it

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[269] *See, e.g.*, Heather B. Conoboy, Note, *A Wrong Step in the Right Direction:The National Taxpayer Advocate and the 1998 IRS Restructuring and Reform Act*, 41 WM. & MARY L. REV. 1401, 1416 (2000) ("releasing negative statistics about IRS abuses could, if opposed by the IRS, result in a lack of cooperation between the main collection agency and the Office of the NTA.").

[270] Michael Herz, United States v. United States*: When Can the Federal Government Sue Itself?*, 32 WM. & MARY L. REV. 895, 896-97 (1991) ("Because DOJ controls most agency litigation, it is able to keep numerous potential interagency suits from reaching the courts.").

[271] *See generally* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, THE MAJORITY OF INDIVIDUAL TAX RETURNS WERE PROCESSED TIMELY, BUT NOT ALL TAX CREDITS WERE PROCESSED CORRECTLY DURING THE 2012 FILING SEASON (Sep. 26, 2012), *available at* http://www.treasury.gov/tigta/auditreports/2012reports/201240119fr.pdf.

manages to provide the high level of customer service that Congress intended in enacting the various Taxpayer Bills of Rights.[272]

In spite of its effectiveness at guarding against taxpayers' abuse of the tax system and its ability to treat taxpayers well, though, the I.R.S. has the unique ability to abuse the tax system itself. And, in many circumstances, it faces almost no constraints on its ability to do so. Sometimes it violates long-standing tax principles to confer a benefit on specific taxpayers, and nobody has standing to challenge the benefit. At other times, it can apply the tax law incorrectly in a manner that hurts taxpayers, but where the benefit to the individual taxpayers does not justify the expense of challenging its interpretation.

Either way, no current method exists of preventing the I.R.S. from abusing the tax system. No currently constituted oversight group exists with this charge, and no distinct constituency exists to hold the I.R.S.'s feet to the fire.

To protect the U.S. tax system, then, Congress needs to create such an oversight group. Specifically charged with monitoring the I.R.S. vis-à-vis the tax system (rather than taxpayers or revenue or any other specific goal), such an oversight group could ensure that the I.R.S. acted as the agent of Congress and, thus, ensure the continued integrity of the U.S. tax system.

[272] *Id.* at 9-11.