TAX MANAGEMENT REAL ESTATE JOURNAL

a monthly professional review of current tax, legislative and economic developments

Reproduced with permission from Tax Management Real Estate Journal, Real Estate Journal, 04/07/2010. Copyright © 2010 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Developments in Economic Substance: How Codification and New Case Law Will Change the Rules

by Stuart J. Bassin, Esq., and John R. Lehrer II, Esq.[*]

From relatively humble origins in a few phrases in the landmark *Gregory v. Helvering* [1] case, the economic substance doctrine has developed into one of the most important topics in the world of tax litigation and tax planning. Review of the doctrine's history shows how courts and the Internal Revenue Service (IRS) have developed a relatively simple idea into a rapidly growing, multi-faceted series of rules for determining whether specific transactions have sufficient economic substance. Especially during the past decade, the contours of those rules have been the subject of continuing debate and litigation, often leaving practitioners with doubts regarding whether any particular transaction can survive an economic substance challenge.

In recent years, Congress has debated whether the economic substance doctrine should be codified as part of the Internal Revenue Code (the Code). Much of the debate has centered on whether codification is good policy; questions regarding the technical formulation of the doctrine to be codified have received considerably less attention. Congressional passage of legislation codifying economic substance now appears imminent,[2] and the formulation of the doctrine and related pen-

[*] Stuart Bassin is a partner and National Tax Litigation Team Leader at Baker & Hostetler LLP, Washington, D.C. John Lehrer is a tax attorney at Baker & Hostetler LLP. Earlier in his career, Mr. Bassin served as counsel for the United States in several of the cases discussed in this article. The authors thank Mike Desmond, Jeff Paravano, and Paul Schmidt for their helpful comments.

[1] 293 U.S. 465 (1935).

[2] Codification of the economic substance doctrine is included in the American Workers, State, and Business Relief Act of 2010, H.R. 4213 (as passed by the Senate on Mar. 10, 2010) at §421, and is also included in the House's Substitute Amendment (Health Care and Education Affordability Reconciliation Act of 2010) for H.R. 4872, Reconciliation Act of 2010, in Combination With Senate-Passed H.R. 3590, Patient Protection and Affordable Care Act (as passed by the House on Mar. 21, 2010) at §1409. (For simplicity, the House's Substitute Amendment will be referred to as "H.R. 4872" throughout the remainder of this article.) The language of H.R. 4872 §1409 ("House bill") is nearly identical to the language

alty provisions under consideration can be usefully compared to the judicial precedent to evaluate the basic question of whether codification will change existing legal requirements.

The simple concept enunciated by the *Gregory* Court in 21 words — ''the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended'' — has evolved into an edifice of rules that, when reduced to legislative language, requires several hundred words to elucidate.[3] All of that verbiage reflects numerous subsidiary issues that have been addressed in the hundreds of cases that have defined the parameters of the economic substance doctrine during the past 75 years. By focusing on those subsidiary issues and their treatment in the proposed legislation, practitioners can better advise their clients regarding the reach of the economic substance doctrine, regardless of whether Congress ultimately enacts any of the current proposals.

DEVELOPMENT OF THE ECONOMIC SUBSTANCE DOCTRINE

The phrase ''economic substance'' is often loosely employed to describe a group of interrelated rules that alter the tax consequences of transactions otherwise dictated by the mechanical form chosen to document a transaction and a literal application of the Code. Depending on the situation, the case law refers to some combination of what have been labeled as the ''judicial doctrines'' such as the economic substance doctrine, business purpose rule, substance over form principle, and step transaction doctrine. In some cases, the rules produce recharacterization of a transaction to conform to its economic realities notwithstanding the form of the transaction selected by the parties and recorded in the transactional documents. In other cases, the taxpayer is denied the tax benefits that might arguably flow from the form of a transaction and the statutory language of the Code. Regardless of which doctrine is invoked, taxpayers and planners should recognize that all of the doctrines have their roots in the same early precedents and reflect a judicial determination that a taxpayer and a transaction had pushed the limits too far.

The modern-day economic substance doctrine has developed *ad hoc* over the decades. Starting with the handful of Supreme Court cases on the subject, succeeding generations of primarily appellate courts have applied the basic principles enunciated by the Supreme Court and their visceral aversion to particular transactions to develop the body of case law that we now think of as the economic substance doctrine. Over time, courts have addressed many subsidiary questions in discussing the basic economic substance concept enunciated in *Gregory*. Congress' resolution of the subsidiary issues in the proposed legislation codifying the economic substance doctrine and related penalties undoubtedly will have an even greater impact on taxpayers than Congress's decision to codify the doctrine.

The Supreme Court Cases

The Supreme Court has addressed the economic substance doctrine in three major cases — two cases won by the government and one won by a taxpayer. Review of those cases elucidates some basic principles, but also shows just how many questions remain unresolved.

Gregory

The granddaddy of all cases discussing economic substance is the Supreme Court's decision in *Gregory v. Helvering*. That case arose out of Mrs. Gregory's efforts to profit by selling appreciated shares that she owned indirectly through her wholly owned corporation, United Mortgage Company (''United''), while avoiding the tax that otherwise would be due on a direct transfer of the stock to her as a dividend. She executed a two-part transaction — (1) United formed a new corporation (''Newco'') and transferred the appreciated shares to Newco in exchange for all of Newco's stock and transferred the Newco shares to Mrs. Gregory in a tax-free spin-off, and (2) Newco then liquidated, leaving Mrs. Gregory directly holding the appreciated shares — which she contended avoided the corporate-level tax otherwise due on sale of the appreciated shares. The IRS challenged the transaction.

The IRS faced the obstacle that the transaction appeared to comply with the literal requirements of the Code governing tax-free spin-off transactions and liquidations. Accordingly, the case raised the inherent conflict between a taxpayer's right to minimize taxes through intelligent tax planning, and the general principles applicable to taxation of corporate distributions that Congress intended to establish through the statutory language of the Code. The Second Circuit explained in one of the most oft-cited passages in the case law that —

> [a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best

---

of H.R. 4213 §421 (''Senate bill'').

[3] See H.R. 4872 §1409 (''House bill''); H.R. 4213 §421 (''Senate bill'').

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

> pay the Treasury; there is not even a patriotic duty to increase one's taxes.[4]

Later in the same paragraph, the court stated —

> [i]t does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. . . [T]he meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.[5]

Ultimately, the Second Circuit decided the case in favor of the IRS, and the taxpayer appealed to the Supreme Court.

The Supreme Court affirmed the Second Circuit's decision, ruling that strict statutory compliance was not enough. In so doing, the Court affirmed that the ''legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, *by means which the law permits*, cannot be doubted.'' [6] Viewed from that perspective, the Court stated that ''the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.'' [7] Describing the form of Mrs. Gregory's transaction as ''nothing more than a contrivance,'' the Court stated that ''the transaction on its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.'' [8]

The ruling in *Gregory* resolved a fundamental question about the nature of the tax law. The Supreme Court could have ruled that tax law is codified in statutes and that language always controls; if Congress determines that creative tax planners have discovered an unintended loophole in the statutory language, Congress can amend the Code.[9] Instead, the Court chose a different path, stating that technical compliance with the statutory language will not insulate transactions from further scrutiny and that some results will not be abided. Tax practitioners continue to ponder how this principle applies to individual transactions.

[4] 69 F.2d 809, 810 (2d Cir. 1934).

[5] *Id.* at 810–11.

[6] 293 U.S. 465, 468 (1935) (emphasis added).

[7] *Id.*

[8] *Id.* at 470.

[9] Indeed, three dissenting justices in *Knetsch v. U.S.* advocated this view. 364 U.S. 361, 371 (1960).

Knetsch

Nearly 30 years later, the Court again addressed the same concepts. In *Knetsch v. U.S.*,[10] the taxpayer purchased $4 million worth of deferred annuity savings bonds, paying a nominal amount of cash and used nonrecourse annuity notes secured by the bonds to pay for the balance. The terms of the annuity bonds allowed the taxpayer to borrow against the bonds' appreciation to pay the interest due on the nonrecourse notes. By exercising this right, the taxpayer was able to pay almost all of the interest due on its nonrecourse notes without an out-of-pocket cash outlay. The taxpayer nonetheless reported interest expense deductions for the entire amount of the interest due (and not just its out-of-pocket cost), contending that the interest deductions were specifically authorized under the Code as interest on indebtedness incurred to purchase annuity bonds. The IRS disagreed, and litigation ensued.

The Supreme Court recognized the conflict between the mechanical form of the transaction and its economics, framing the legal issue as requiring a determination of whether the transaction created ''indebtedness'' within the meaning of the Code.[11] The Court concluded that it did not. The central passage in the Court's reasoning stated that the —

> transaction with the insurance company did 'not appreciably affect [Knetsch's] beneficial interest except to reduce his tax. For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction.[12]

The Court did not, however, use the phrase ''economic substance''; rather, its critical determination was phrased in terms of an ''appreciable effect'' on the taxpayer's ''beneficial interest.'' Interestingly, the Court explicitly ''put aside'' the trial court's findings regarding the taxpayer's tax motivation and it did not employ the trial court's phrasing of the test in terms of non-tax profit potential.[13] While the result under the fairly abusive facts of *Knetsch* was not surprising, the Court left it to tax lawyers to figure out what constitutes an ''appreciable effect'' on a taxpayer's ''beneficial interest'' under different facts.

Frank Lyon

The last major milestone in the Supreme Court precedent involved a fairly conventional sale-leaseback of a commercial building—a far closer case from a

[10] 364 U.S. 361 (1960).

[11] 364 U.S. at 365.

[12] 364 U.S. at 366.

[13] *Id.* at 365.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

factual perspective. In *Frank Lyon v. U.S.*,[14] a bank arranged for the taxpayer to borrow money to construct a building that the bank rented from the taxpayer under a long-term lease in a transaction structured to ensure that the bank's rent payments precisely covered the taxpayer's interest obligations. The taxpayer technically owned the building and claimed depreciation deductions, but had relatively little other involvement with the building. The IRS challenged the claimed deductions, viewing the transaction as an artifice to provide the taxpayer with little more than bare legal title and grounds for contending that the taxpayer was entitled to the disputed deductions as the owner of the building, notwithstanding the bank's beneficial ownership of the building.

The Supreme Court ruled in favor of the taxpayer, rejecting the IRS's attempt to recharacterize the transaction under the substance over form principle.[15] While recognizing the basic design of the transaction, the Court ruled that ''[t]here are simply too many contingencies [in the transaction] . . . to permit the conclusion . . . which the Government now urges.'' [16] Accordingly, the Court allowed the claimed deductions and respected the form of the transaction as developed by the taxpayer, concluding:

> Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.[17]

Frank Lyon established that transactions that make economic sense only after consideration of tax benefits may survive an economic substance challenge in certain cases. The decision, however, was based on a specific set of facts and does not purport to create a general rule regarding the relative amount or type of business economics required for the claimed tax benefits to be allowed.

Appellate Court Rulings

Appellate courts have gone a long way toward answering economic substance questions in the years since *Frank Lyon* was decided. A flurry of decisions during the 1980s developed the now-familiar ''objective/subjective framework'' for applying the economic substance analysis. The IRS's renewed attention to the economic substance doctrine in response to the wave of more sophisticated tax products/shelters that have proliferated during the past decade has led a series of courts to add new layers of analysis. Some of the major decisions and the subsidiary issues to the basic economic substance analysis addressed in those decisions are discussed below.

Rice's Toyota World

The Fourth Circuit decision in *Rice's Toyota World v. Comr.*[18] involved a structured transaction in which a computer rental company (''Finalco'') entered into a sale-leaseback transaction with a tax-motivated party (''Rice's'') in which Rice's ostensibly purchased computers from Finalco, leased the computers back to Finalco, and then Finalco rented the computers to Finalco customers. Rice's claimed that it was the owner of the computers, deducting both depreciation and interest payments on nonrecourse debt used to purchase the computers. The IRS disallowed the deductions, asserting that the transaction lacked economic substance, and Rice's filed suit.

The Fourth Circuit, upholding the IRS's and Tax Court's disallowance of the deductions, enunciated a test for evaluating economic substance containing both subjective and objective components. The subjective inquiry is whether a taxpayer has a business purpose for entering into a transaction other than obtaining the intended tax benefits. The analysis focuses on the taxpayer's motives for entering into a transaction based on facts and circumstances. The objective inquiry is whether a reasonable possibility existed for profit from the transaction apart from the intended tax benefits. The analysis requires at least an informal mathematical evaluation of the results the transaction will produce.[19] Many other circuits have adopted similar but not identical formulations of the economic substance test.

This generation of decisions spawned a long debate about the relationship of the objective and subjective prongs of the economic substance doctrine. Many argued that the two prongs of the analysis were disjunc-

[14] 435 U.S. 561 (1978).

[15] While *Frank Lyon* did not specifically involve the economic substance doctrine, the Court's analysis of non-tax ''substance'' for purposes of determining whether claimed tax benefits were permitted is essentially the same inquiry presented in classic ''economic substance'' cases.

[16] 435 U.S. at 579–80.

[17] *Id.* at 583–84.

[18] 752 F.2d 89 (4th Cir. 1985).

[19] *Id.* at 94.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

tive — if a taxpayer passed one prong of the test, then its transaction had economic substance regardless of whether it failed the other prong. Others argued that the two prongs were conjunctive — a transaction would survive scrutiny only if it satisfied both prongs of the test. To at least some extent, that debate continues until this day, with the answers varying from circuit to circuit.

Contingent Installment Sales Transactions ("CINS")

The CINS transaction was developed by Merrill Lynch ("Merrill") as a vehicle for sheltering unrelated capital gains through a transaction designed to generate capital losses, but not economic losses. At its core, a CINS transaction involved the formation of a partnership that would have three partners — a foreign entity, a U.S. taxpayer, and Merrill. Each partner contributed cash to the partnership with the foreign entity contributing the majority of the cash. The partnership then utilized the cash to purchase short-term securities that it sold to an unrelated party for cash plus an installment note. Through application of the installment sale rules, gain arguably could be recognized by the partnership during the year of the sale (and largely allocated to the foreign partner). The foreign partner would then exit the partnership and, in the following years, loss would be recognized by the partnership (and allocated to the U.S. partner).

The courts have repeatedly found that CINS transactions lack economic substance. Most prominently, in *ACM Partnership v. Comr.*,[20] both the Tax Court and the Third Circuit rejected a CINS transaction involving subsidiaries of Colgate Palmolive. The Tax Court had found that the factual record did not support Colgate's stated business purpose for the CINS transaction — to make an interim investment in the CINS assets with the proceeds from an unrelated profitable divestiture before using the proceeds to pay down Colgate's debt.[21] The appellate court, upholding the Tax Court's decision but not its reasoning, focused on whether the transaction had any net economic effect on Colgate's financial position. Ultimately, it found that there were only "nominal, incidental effects on ACM's net economic position" because the transaction "involved only a fleeting and economically inconsequential investment in and offsetting divestment from the [short-term] notes." [22] As both the transaction costs and the claimed tax benefits dwarfed this economic change, the court concluded that the transaction lacked economic substance.

The *ACM Partnership* decision's economic substance analysis was interesting for several reasons. It placed its own gloss on the conjunctive/disjunctive debate, ultimately explaining:

> These distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance. [23]

The court also rejected the taxpayer's contention that a potential substantial future payment could help establish the profit potential of its transaction, employing present value concepts to discount the worth of future payments.[24] Finally, the court concluded that transaction costs, particularly the promoters' fees, must be considered in evaluating whether a transaction had a profit potential.[25]

Corporate Owned Life Insurance ("COLI") Cases

The corporate taxpayers in these cases generally purchased COLI policies covering the lives of their employees in which the corporations were the beneficiaries of any death benefits. The taxpayers paid the premiums on the policies in large part by borrowing against the account value of the policies and argued that the interest they "paid" on the loans was deductible. The IRS disagreed, asserting the economic substance doctrine and arguing that the COLI policies lacked a valid business purpose and any profit potential outside of the claimed tax benefits.

In *Winn Dixie v. Comr.*,[26] the court upheld the IRS's position and determined that the COLI program lacked economic substance. The Eleventh Circuit adopted the Tax Court's findings that the high interest rate on the borrowings combined with high transactions costs led the taxpayer to inevitably lose money on a pre-tax basis. Further, no finding of the Tax Court even suggested that the COLI program served any business need of the taxpayer because the corporation itself was the beneficiary of the policies and the program's costs overwhelmed the taxpayer's pre-tax

[20] 73 T.C.M. 2189 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998).

[21] 157 F.3d at 249.

[22] 157 F.3d at 250.

[23] *Id.* at 247.

[24] *Id.* at 259–60.

[25] *Id.* at 257. Following *ACM Partnership*, the D.C. Circuit rejected substantially similar CINS transactions, albeit on different grounds. In those cases, the courts focused on whether the taxpayer had the requisite intent to organize a partnership for a non-tax business purpose. In both cases, the courts held that the partnerships were not organized or operated for non-tax business purposes and should therefore be disregarded for tax purposes. *BOCA Investerings Partnership v. U.S.*, 314 F.3d 625 (D.C. Cir. 2003); *ASA Investerings Partnership v. Comr.*, 201 F.3d 505 (D.C. Cir. 2000).

[26] 254 F.3d 1313 (11th Cir. 2001).

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 8755-0628

claim recoveries. The court, therefore, held that the COLI program lacked economic substance and the claimed deductions were disallowed.[27]

Several other courts later denied similar claims by taxpayers involved in COLI programs, separately rejecting a variety of taxpayer arguments intended to demonstrate an adequate profit potential. The court held that the fact that tax savings from the COLI program allowed the taxpayer to fund other employee benefit programs did not produce adequate substance because ''[m]oney generated by means of abusive tax deductions can always be applied to beneficial causes, but the eventual use of the money thus generated is not part of the . . . analysis.''[28] Finally, in *Dow Chemical Co. v. U.S.*,[29] the Sixth Circuit rejected the taxpayer's argument that its program's design created the opportunity for profit if the taxpayer injected substantial amounts of cash into the program in subsequent years, stating that ''Courts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct.'' As the court found no basis for assuming that Dow would contribute the $300+ million to the COLI program required to generate this future profit, it found the transaction lacked profit potential and economic substance.[30]

American Depository Receipt (''ADR'') Cases

In two appellate decisions, *Compaq Computer Corp. v. Comr.*,[31] and *IES Industries, Inc. v. U.S.*,[32] courts upheld tax benefits arising from transactions involving purchases and sales of American Depository Receipts (so-called ''ADRs''), reversing Tax Court decisions in favor of the IRS based on economic substance analysis. ADRs are U.S. investment instruments that represent stock in foreign companies; ADR holders receive distributions when the underlying stock pays dividends. In these transactions, the taxpayer purchased ADRs just before the record date for payment of a dividend on the foreign stock and would sell the ADRs soon after the record date, collecting the dividend, but recognizing a capital loss when the value of the ADRs declined to reflect payment of the dividend. The dividend was taxable in the foreign country and the foreign tax was creditable in the United States, thereby reducing the net cash received by the taxpayer by the amount of the foreign tax paid, which was, in turn, partially offset economically by a foreign tax credit.

An interesting economic substance issue in these cases involved the treatment of the taxpayer's obligation to pay foreign taxes on the dividends. In *Compaq*,[33] the Fifth Circuit concluded that the transaction could produce the required profit, employing a profitability analysis that subtracted the capital losses from the gross dividend to demonstrate that the transaction produced a gain. That analysis, however, disregarded the cost of the foreign tax paid on the dividend — a factor that would have made the transaction unprofitable. In so holding, the appellate court ruled:

> If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to cash flow. To be consistent, the analysis

---

[27] Interestingly, on the same day it decided *Winn-Dixie*, the same panel of the Eleventh Circuit rejected the IRS's economic substance challenge to a corporate restructuring. *United Parcel Service v. Comr.*, 254 F.3d 1014 (11th Cir. 2001). Before the restructuring, shippers could pay premiums to UPS for insurance on shipped packages and UPS would recognize income and pay U.S. federal income tax on the excess of the premiums over the claims paid. In the restructuring, UPS organized a captive Bermuda insurance subsidiary (''OPL'') and distributed the shares of OPL to UPS shareholders. Thereafter, UPS entered into a conventional insurance contract with a third-party insurer to provide the excess value insurance, and the insurer reinsured those risks with OPL. The restructuring left OPL (and its shareholders) in much the same economic position as UPS (and much the same group of shareholders) had previously filled with the important difference that the profit from the excess value insurance business was now recognized in Bermuda, where it was not subject to U.S. federal income tax.

The Tax Court had held that the UPS transaction did not have economic substance, but the appellate court reversed, concluding that the transaction had both real economic effects and a business purpose. The critical determination made by the appellate court was that OPL was a distinct, unrelated third-party, notwithstanding the common ownership of UPS and OPL. Accordingly, the transaction had real economic effects because UPS shifted its insurance risk to OPL through genuine enforceable insurance obligations. Concluding that the transaction had a non-tax business purpose, the court stated:

> A ''business purpose'' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a ''business purpose,'' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business.

254 F.3d at 1019. In the end, *UPS* was more about transfer pricing than economic substance. The IRS and UPS ultimately settled the case.

[28] *American Electric Power Co., Inc. v. U.S.*, 326 F.3d 737, 744 (6th Cir. 2003). The trial court also had rejected a taxpayer argument that it had a non-tax business purpose because the COLI program produced financial accounting benefits derived from the treatment of the anticipated tax benefits.

[29] 435 F.3d 594, 601 (6th Cir. 2006), *cert. denied* 127 S. Ct. 1251 (2007).

[30] *See also In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002).

[31] 277 F.3d 778 (5th Cir. 2001).

[32] 253 F.3d 350 (8th Cir. 2001).

[33] *Compaq Computer Corp. v. Comr.*, 277 F.3d 778 (5th Cir. 2001).

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

> should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable.[34]

The *Compaq* court also supported its decision with a determination that the transaction was also profitable after tax, because the foreign tax paid would be offset by a U.S. foreign tax credit.[35]

Contingent Liability Transactions

Two cases, *Coltec* and *Black & Decker*,[36] involved the contingent liability transaction described in Notice 2001-17,[37] and later legislatively prohibited through enactment of §358(h). In both cases, the taxpayer assigned a future contingent liability (future asbestos liabilities in *Coltec* and future health care liabilities in *Black & Decker*) to a subsidiary along with a corporate note with a comparable value in exchange for shares in the subsidiary, claiming a basis in the subsidiary's shares equal to the face amount of the note unreduced by the amount of contingent liabilities assumed, notwithstanding the negligible fair market value of the shares. When the taxpayer subsequently sold the high-basis shares for their fair market value, it claimed its technically duplicated tax loss, which the IRS disallowed, in part, based on the economic substance doctrine.

In both cases, the trial courts ruled in favor of the taxpayer and the respective courts of appeals reversed based on an economic substance analysis. In *Coltec*, the appellate court rejected the lower court's suggestion [38] that the economic substance doctrine violated constitutional separation of powers, stating that the

> doctrine represents a judicial effort to enforce the statutory purposes of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality.[39]

Emphasizing the objective nature of the economic substance inquiry, the court stated that:

> the economic substance of a transaction must be viewed objectively rather than subjectively. . . While the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of the transaction . . .[40]

Expanding on this point, the court ruled separately that the

> subjective views of Coltec's executives, even if credited, as they were by the Court of Federal Claims, are insufficient to establish economic substance. . . . [E]conomic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers.[41]

Most notably, the court made clear that ''the transaction to be analyzed is the one that gave rise to the alleged tax benefit.'' [42] The taxpayer contended that the contingent liability transaction served the purpose of improving management of the firm's asbestos liability by placing that function in a separate subsidiary and that, by placing that responsibility in a separate subsidiary funded by an intra-group note, it had added a barrier to veil-piercing claims against the parent company. The court focused the economic substance analysis on that latter alleged purpose, explaining that —

> The government does not dispute that the transfer of management activities may have had economic substance. The transfer of man-

---

[34] 277 F.3d at 785.

[35] *Id.* at 785–87. Neither court was swayed by the fact that the transactions had been designed to virtually eliminate any exposure of the taxpayer to risk due to unexpected changes in the market prices of the ADRs. In fact, the *IES* court stated:

> We are not prepared to say that a transaction should be tagged a sham for tax purposes merely because it does not involve excessive risk. IES's disinclination to accept any more risk than necessary in these circumstances strikes us as an exercise of good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions.

IES, 253 F.3d at 355. Some commentators have noted that any economic substance analysis in *Compaq* and *IES* may have been misguided given that credits follow ownership. The IRS was unwilling to argue that *Compaq* or *IES* should not be treated as owners for purposes of determining eligibility for claiming the related tax credits in those cases. *See* Jeffrey H. Paravano & Paul M. Schmidt, Tax Shelters: ''Evaluating Recent Developments,'' 872 *PLI/Tax* 651 at 703 (2009).

[36] *Coltec Industries, Inc. v. U.S.*, 62 Fed. Cl. 716 (2004), *rev'd*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007); *Black & Decker Corp. v. U.S.*, 340 F. Supp. 2d 621 (D. Md. 2004), *rev'd*, 436 F.3d 431 (4th Cir. 2006).

[37] 2001-1 C.B. 730.

[38] 62 Fed. Cl. at 756.

[39] 454 F.3d at 1354.

[40] *Id.* at 1356.

[41] *Id.* at 1359.

[42] *Id.*

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

> agement activities, however, is not the transaction at issue. . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit on sale. That transaction is [the subsidiary's] assumption of . . . asbestos liabilities. . . . [I]t is this exchange on which we must focus.[43]

Concluding that there was no objective basis for concluding that the liability assumption would ameliorate the veil-piercing problem, the court determined that the taxpayer had failed to demonstrate any purpose for the liability assumption and transfer of the intra-group note. [44]

The courts in *Coltec* and *Black & Decker* made three observations regarding their application of the economic substance doctrine. First, the decisions noted that an objective evaluation of reasonably expected profits from a transaction was the centerpiece of an economic substance analysis. Second, the testimony of taxpayers regarding their subjective purpose for engaging in a transaction was largely disregarded and was evaluated for reasonableness, even in the absence of direct contrary evidence of the taxpayer's purpose. Finally, and perhaps most importantly, the *Coltec* court insisted on evaluating the profit potential of only the step in the transaction that produced the tax benefits.

Lease-In/Lease-Out ("LILO") and Sale-In/Lease-Out ("SILO") Transactions

These cases involve structured leasing transactions. In *BB&T Corp. v. U.S.*,[45] an American bank leased a Swedish wood pulp manufacturing facility from a Swedish entity for 36 years and simultaneously subleased the facility back to the Swedish entity for a term of 15.5 years. The Swedish entity operated the facility throughout the sublease period and had a right to reacquire the bank's interest in the facility at the end of the sublease term. The cash flows under these agreements were extremely complex. Critically, only a small amount of cash was transferred at the outset; the remainder of the purchase price consisted of debt. Further, the agreements contained mechanisms designed to ensure that neither the American bank nor the Swedish entity had to make any significant out-of-pocket expenditures to pay the rent and service the debt. Similarly, in *AWG Leasing Trust v. U.S.*,[46] a partnership owned by two U.S. banks purchased a 75-year lease in a foreign waste-to-energy facility [47] from a foreign municipality for cash and notes issued by foreign banks, while simultaneously leasing back the facility to the foreign municipality for an initial term of 35 years with a purchase option at the end of the initial term.

Notwithstanding the thousands of pages of documents executed by the participants in the deals, both the trial courts and the appellate courts found that the reciprocal leases left the foreign corporations in substantially the same position as before the LILO/SILO transactions. Analyzing the documents and the economics, the courts determined that the rights, obligations and risks of ownership had not been transferred.

The court determined that the complex payment mechanisms resulted in nothing more than a circular transfer of funds, and there was no economic incentive for the foreign corporation to cede control of the equipment to the taxpayer at any point during the term of the initial lease. Relying largely on an analysis of the impact of foreign taxes on the foreign municipality's decision to exercise its purchase option, the court determined that the municipality retained ownership and that the purported lessor therefore was not entitled to the tax benefits claimed. Neither the pulp manufacturing equipment nor the waste-to-energy facility would ever leave the control of the foreign entity.

In addition, the court determined that the notes utilized in the transaction were not true indebtedness, despite the form reflected in the documents, because the Swedish entity and foreign municipality immediately deposited almost the full amount of the loan with an affiliate of the lender at the beginning of the transaction such that the lender was not economically impacted by the loan during the purported term of the loan. In *AWG*, the court characterized the financing as "loop debt." Consequently, neither the LILO transaction in *BB&T* nor the SILO transaction in *AWG* was respected as a valid leasing arrangement and the claimed depreciation deductions were disallowed, along with the claimed interest expense deductions.

---

[43] *Id.* at 1358.

[44] *Id.* at 1359. The trial court in *Black & Decker* likewise set a very low hurdle for taxpayers seeking to defeat an economic substance challenge, stating that a "corporation and its transactions are objectively reasonable [and satisfy the objective prong of the economic substance analysis], despite any tax avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." 340 F. Supp. 2d at 623–24. The Fourth Circuit, in reversing that opinion, applied *Rice's Toyota World* and noted that the objective prong of the analysis "focuses on reasonable expected profits from a transaction" and observed that a taxpayer's " 'mere assertion' of subjective belief in the profit opportunity from a transaction" was not enough. 436 F.3d at 442–43.

[45] 523 F.3d 461 (4th Cir. 2008).

[46] 592 F. Supp. 2d 953 (N.D. Ohio 2008).

[47] Although the documents described this transaction as a lease, the taxpayer contended that it was a sale for U.S. federal tax purposes.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

Recent Trial Court Decisions

During the past six months, three separate trial courts have ruled that transactions were erroneously characterized as "tax shelters" by the IRS. *Southgate Master Fund v. U.S.*[48] involved a distressed debt transaction, *Consolidated Edison Co. v. U.S.*[49] involved a LILO transaction, and *TIFD III-E, Inc. v. U.S.* ("*Castle Harbour*")[50] involved an aircraft financing transaction. These cases demonstrate how taxpayers may still establish that a transaction has economic substance.

The *Southgate* decision addressed a distressed debt transaction involving a portfolio of Chinese nonperforming loans. In *Southgate*, a partnership purchased loans for their fair market value, which was less than 2% of their face amount, in a transaction that provided Southgate basis in the loans equal to their face amount. As a result, when Southgate sold some of the loans for their fair market value, the transaction produced a tax loss in excess of the cash price Southgate paid for the loan portfolio. The IRS challenged the claimed loss deductions on several bases, including economic substance.

The district court, while upholding the IRS's disallowance for other reasons, concluded that the basic distressed debt investment transaction satisfied the economic substance doctrine. Southgate's nonperforming loan investment, while not actually producing a profit for the investor, was designed with a "very reasonable expectation of profit." The expert testimony showed, for example, that other market participants had earned non-tax profits from similar investments. Further, the attention the taxpayer gave to tax planning was not dispositive because:

> [T]he Court cannot conclude the transaction was shaped *solely* by tax-avoidance features. Although the deal appears structured to capture *both* profit as it is traditionally understood and any potential tax savings — [the taxpayer] wanted to have his cake and eat it too — such deals do not automatically offend the economic substance doctrine.[51]

In sum, the core of the distressed debt deal had economic substance, although other actions taken by the taxpayer failed under several judicial doctrines.[52] The case is now on appeal to the Fifth Circuit, and a ruling on that appeal is many months away.

In *Consolidated Edison*, a domestic utility, Consolidated Edison (Con Ed) was allowed to recognize tax benefits arising out of its participation in a LILO transaction with a Dutch utility involving an interest in a cogeneration plant. A trust controlled by the taxpayer leased the plant from the Dutch utility, making a large lump-sum rental payment to the Dutch utility at the outset of the transaction funded primarily with a loan from a foreign bank. The Dutch utility subleased the plant back from the trust, agreeing to make annual rental payments to the trust. The rental obligations were funded through a deposit account held by another foreign bank (not coincidentally, the deposit holder was an affiliate of the bank that made the original loan to the trust). The various cash flows under the structure largely netted to zero, but Con Ed claimed rental expense deductions for the payment it made to the Dutch utility and the interest payable on the loan from the foreign bank. The litigation arose out of the IRS's disallowance of the claimed deductions.

The Court of Federal Claims reviewed the underlying facts and determined that the transaction should not be recharacterized based on substance over form principles. The court found that the IRS had not established, as it had in the earlier LILO/SILO cases, that the foreign utility would exercise its option to terminate the transaction before the more economically robust portions of the deal came into play. Rather, the court gave significant weight to the testimony of Con Ed executives who explained that Con Ed would obtain significant, but largely unquantifiable, benefits through an investment in a foreign utility in terms of technology transfer and easing entry into the European market — benefits that bank investors, like the taxpayers in *BB&T* and *AWG*, could not obtain. The court refused to employ a present value analysis to discount the value of future benefits that Con Ed would obtain from the deal and rejected the government's attempt to disregard a series of allegedly circular loans and payments, primarily because of the corporate separateness of the various banks and the possibility that the bankruptcy of one of the entities might defeat the alleged circularity of payments. Given the credible taxpayer testimony regarding business purpose, the plausibility of a utility engaging in a transaction involving a foreign utility property, and the failure of the government's experts to establish their contentions regarding the purported circularity of the cash flows, the court treated Con Ed as the tax owner of the property and upheld the claimed deduc-

---

[48] 651 F. Supp. 2d 596 (N.D. Tex. 2009).

[49] 90 Fed. Cl. 228, 2009-2 USTC ¶50,696 (2009).

[50] 660 F. Supp. 2d 367 (D. Conn. 2009).

[51] 651 F. Supp. 2d at 655.

[52] The controlling owner's outside basis in its Southgate interest was insufficient to allow him to deduct of most of the loss. That owner contributed GNMA repurchase agreements in a manner that preserved both upside and risk of loss for the contributor. The court ruled that the contribution did not have economic substance, 651 F. Supp. 2d at 656–57, and the taxpayer was not allowed to recognize the claimed deductions.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 8755-0628

tions.[53] A government appeal of this ruling is likely, but the notice of appeal will not be filed for some time.

The *Castle Harbour* case arose out of the restructuring of the ownership of a fleet of commercial aircraft owned and leased by a subsidiary of the General Electric Co. The subsidiary entered into a transaction whereby cash, commercial aircraft, and other assets were transferred to a newly formed limited liability company, Castle Harbour, and interests in Castle Harbour were sold to two Dutch banks for approximately $50 million in cash. At the time of the contribution, these commercial aircraft were fully depreciated assets for tax purposes. The Dutch banks were not subject to U.S. federal income taxation. Castle Harbour was a self-liquidating partnership — a substantial portion of its gross income was allocated to the Dutch banks and used to ''buy out'' their interests over an expected eight-year period (although Castle Harbour remained in operation for only five years). During this five-year period, the Dutch banks were allocated approximately 98% of the taxable income from the commercial aircraft, while the General Electric Co. subsidiary recognized more of the book income.

The IRS challenged the transaction, focusing on the role of the Dutch banks in an effort to demonstrate that the banks were lenders to Castle Harbour, not partners. The district court, in its first decision in 2004, determined that the transaction had both an objective economic effect and a subjective business purpose.[54] On appeal, the Second Circuit reversed[55] and, on remand, the trial court again respected the form of the transaction and treated the Dutch banks as partners in Castle Harbour.[56] The Dutch banks' role in the venture was clearly limited, but it had sufficient substance that the district court would not disregard their role and upheld the taxpayer's claims. In early January 2010, the government filed a notice of appeal to challenge the district court's ruling on remand.

Collectively, these cases show that taxpayers may overcome an economic substance challenge. In each case, the court viewed the economic substance inquiry as primarily objective and the taxpayer was able to present credible testimony and expert analysis to satisfy the objective prong of the economic substance analysis. The fact that tax considerations played a substantial role in the design of the transactions was not dispositive.

Penalties

The IRS frequently seeks to impose penalties in economic substance cases — most often, the §6662 penalties for understatement of income tax, valuation misstatements, and negligence. These penalties, which typically are asserted in the alternative and are non-stacking, apply at the rate of 20 or 40% of the resulting understatement of tax. In 2007, Congress added to the Code a new penalty provision, §6676, applicable to refund claims for excessive amounts except to the extent a reasonable basis exists for the excess claimed. Taxpayers frequently defend themselves against penalty assertions by relying on the reasonable cause or good faith defenses in §6664(c) of the Code and the regulations thereunder, along with the related notions of reasonable basis and substantial authority under §6662(d)(2)(B) and §6676(a) of the Code and Regs. §1.6662-4. Most often, taxpayers have cited the advice of counsel, generally in the form of a written opinion letter, to support their defenses. (Most of these cases deal with the period before the enactment of the disqualified opinion and disqualified advisor statutes.)

The case law is mixed regarding a taxpayer's ability to overcome asserted penalties. For example, in *Klamath Strategic Investment Fund v. U.S.*,[57] the taxpayer involved in a Son of BOSS transaction successfully relied on advice of counsel, primarily a Jenkins & Gilchrist opinion letter, to support a reasonable cause defense. Conversely, in *Stobie Creek Investments, LLC v. U.S.*,[58] another taxpayer involved in a similar Son of BOSS transaction failed in obtaining a similar result, primarily because the court concluded that its tax advisors were tainted by their participation in development of the transaction and the taxpayer should have recognized that its opinion letter relied on false factual assumptions regarding the expected profitability of the deal. Further disparities are likely to arise as more of the individuals involved in Son of BOSS transactions pursue partner-level actions assert-

---

[53] Earlier this year, the Court of Federal Claims issued a separate ruling in favor of the government in another SILO case, *Wells Fargo & Co. v. U.S.,* No. 06-628T (Fed. Cl. 1/8/10). The reasoning of the *Wells Fargo* court generally followed the *AWG* court's reasoning. Just as the *Consolidated Edison* court factually distinguished the *AWG* decision, the *Wells Fargo* court factually distinguished *Consolidated Edison*. While taxpayers may scour the three decisions to find the critical factual differences, it appears that the cases were decided largely on the basis of the respective courts' views regarding the facts, including the persuasiveness of the experts presented by the government. The government employed one set of common experts in both *Wells Fargo* and *AWG*, and the courts found their analyses persuasive. In contrast, the government employed a different set of experts in *Consolidated Edison*, and the Court of Federal Claims was not persuaded by their analyses.

[54] *TIFD III-E Inc. v. U.S.*, 342 F. Supp. 2d 94 (D. Conn. 2004).

[55] *TIFD III-E, Inc. v. U.S.*, 459 F.3d 220 (2d Cir. 2006).

[56] 2009-2 USTC ¶50,676 (D. Conn. 10/7/09), *as amended by* No. 3:01-cv-01839, 2009 U.S. Dist. LEXIS 98,884 (D. Conn. 10/23/09).

[57] 568 F.3d 537, 548 (5th Cir. 2009).

[58] 82 Fed. Cl. 636, 715–21 (2008).

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

ing their personal reasonable cause penalty defenses based on the opinion letters they received — arguments they could not previously raise because of the jurisdictional limitations on TEFRA partnership proceedings. Indeed, so long as the law looks to reasonable reliance based on all of the facts and circumstances, taxpayers cannot know the value of opinion letters obtained from independent advisors.

The net effect of these decisions has been to substantially develop the basic principle enunciated in *Gregory*, collectively raising (and, sometimes answering) many questions regarding application of the economic substance doctrine. This piecemeal and fact-intensive focus in the development of the law has not produced uniform results — some issues have been resolved differently in different circuits and many more issues have been answered in only one or two circuits, leaving open the possibility that the next court confronted with the issue will reach a different result. Indeed, practitioners frequently debate whether particular circuits might be more strict or lenient in applying the economic substance analysis. Uncertainty regarding whether a well-drafted and non-disqualified opinion letter will establish a reasonable cause defense to a penalty assertion further complicates matters.

PROPOSED CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

The idea of codifying the economic substance doctrine has been debated for more than a decade. With that question now apparently decided in favor of codification, practitioners must consider how the economic substance legislation that emerges from Congress will, as a practical matter, alter the existing law on economic substance and the advice they give to clients.

Congress has considered several different bills involving codification over the past few years.[59] The current legislative proposal would codify the doctrine by adding a new subsection to §7701. In addition, the proposed legislation would modify the penalty regime to impose new penalties for noneconomic substance transactions. The proposed legislation would require taxpayers to pass both an objective and a subjective economic substance test:[60]

> (1) **Application of Doctrine.** — In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if —
>
> (A) the transaction changes in a meaningful way (apart from Federal income tax effects [61]) the taxpayer's economic position, and
>
> (B) the taxpayer has a substantial purpose (apart from Federal income tax effects [62]) for entering into such transaction.

Recognizing that many taxpayers will attempt to satisfy this rule by showing that their transaction has an adequate profit potential, the proposed legislation articulates the required level of profit potential required to satisfy these tests:[63]

> (2) **Special Rule Where Taxpayer Relies on Profit Potential.** —
>
> (A) *In General.* — The potential for profit of a transaction shall be taken into account in determining whether the requirements . . . are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

The proposed legislation also requires taxpayers to consider professional fees, other transaction costs, and

[59] For example, on Nov. 7, 2009, the House passed a different version of economic substance codification in the Affordable Health Care for America Act, H.R. 3962 at §§562-563, and the Senate Finance Committee passed a different version of economic substance codification as part of the never-enacted Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242 (110th Cong., 1st Sess.), and that proposed language was incorporated into Senator Levin's proposed Stop Tax Havens Act, S. 506 (111th Cong., 1st Sess.).

[60] Proposed Code §7701(o)(1), House's Substitute Amendment (Health Care and Education Affordability Reconciliation Act of 2010) for H.R. 4872, Reconciliation Act of 2010, in Combination With Senate-Passed H.R. 3590, Patient Protection and Affordable Care Act (as passed by the House on Mar. 21, 2010) (''House bill'') at §1409(a) and H.R. 4213 (''Senate bill'') at §421(a).

For simplicity, the House's Substitute Amendment will be referred to as ''H.R. 4872'' throughout the remainder of this article.

[61] For this purpose, any state or local income tax effect that is related to a federal income tax effect is treated as a federal income tax effect. H.R. 4872 at §1409(a) and H.R. 4213 at §421(a) (proposed Code §7701(o)(3)).

[62] *Id.*

[63] H.R. 4872 at §1409(a) and H.R. 4213 at §421(a) (proposed Code §7701(o)(2)(A)).

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

foreign taxes in computing profit potential,[64] and disregards financial accounting benefits arising out of tax benefits in determining whether the taxpayer has a substantial purpose for entering into a transaction (or series of transactions).[65]

The proposed legislation amends the §6662 penalty rules to separately impose a penalty for underpayments resulting from transactions that lack economic substance. Underpayments attributable to undisclosed noneconomic substance transactions would be subject to a 40% penalty (reduced to 20% for disclosed transactions).[67] Strict liability would apply to these penalties, and the reasonable cause defense under §6664(c) and §6664(d) generally would be unavailable for noneconomic substance transactions (as defined in proposed §6662(b)(6)).[68] The existing penalty coordination rules would continue to apply, ensuring that the new penalty would not be stacked with other existing penalties. In addition, §6676 would be amended to impose a 20% penalty on the excessive amount of any refund claim attributable to a noneconomic substance transaction, and no reasonable basis or good faith defense would be available to that penalty.[69]

IMPACT OF CODIFICATION UPON EXISTING LAW

Codification of the economic substance doctrine, of course, is a largely academic matter, except to the extent that it changes the law. The following pages evaluate the proposed legislation by reference to the existing case law, demonstrating not only the principal changes resulting from the legislation and highlighting the questions left unresolved by the legislation and case law.

Continuing Vitality of the Judicial Doctrines and Case Law

Codification would resolve forever any doubts regarding whether the economic substance doctrine should be part of the tax law. The absence of a clear Supreme Court endorsement of various portions of what we now view as the economic substance doctrine would no longer matter and any skepticism regarding application of ''judge-made law'' would be gone. Moreover, on a more subtle level, codification would convince even ''strict constructionists'' that the doctrine is as much a part of the tax law as any other statutory language.

Codification may have an even greater impact because a statutory economic substance doctrine would need to be considered in essentially every transaction. In fact, the judicial economic substance doctrine has, over the years, been the rationale for deciding cases fairly rarely. Moreover, the IRS has invoked the economic substance doctrine in a fairly narrow class of cases, sparing most transactions from analysis under the doctrine. The statutory economic substance doctrine would be much harder for both the courts and the IRS to frequently ignore. The only apparent limitation would be the statutory language applying the doctrine only in ''cases of any transaction to which the economic substance doctrine is relevant.''

More interesting questions would arise concerning the vitality of the existing case law on economic substance after codification. The Senate bill provides that codification shall not be construed as ''altering or supplanting any other rule of law'' and that it ''shall be construed as being in addition to'' existing law.[70] Notwithstanding such language, it would be difficult for the IRS, as a practical matter, to assert that a transaction that satisfied the rather rigorous requirements of the economic substance statute still lacked economic substance under the preexisting judicial doctrine. Indeed, starting with *Gregory*, the economic substance doctrine has been justified as reflecting something implicit in the statutory language of the Code. Once Congress has comprehensively and explicitly codified the doctrine, courts may not be receptive to an argument that a transaction that satisfies the statutory economic substance rule does not satisfy a separate (and implicit) economic substance doctrine.

A comparable issue may arise with respect to the other judicial doctrines, such as business purpose and

[64] The Senate bill authorizes, and the House Bill requires the IRS to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases where the taxpayer relies on profit potential to prove economic substance. *Compare* proposed Code §7701(o)(2)(B) in H.R. 4872 at §1409(a) *with* proposed Code §7701(o)(2)(B) in the H.R. 4213 at §421(a).

[65] H.R. 4872 at §1409(a) and H.R. 4213 at §421(a) (proposed Code §7701(o)(4)). An earlier Senate bill would have explicitly authorized regulations exempting certain types of transactions from the economic substance requirement. S. 506 at §401 (proposed Code §7701(p)(4)). The earlier Senate bill also would have limited the applicability of the economic substance doctrine to cases in which a court determines that economic substance is relevant. S. 506 at §401 (proposed Code §7701(p)(1)(A)). The current House and Senate bills provide that ''the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.'' Proposed Code §7701(o)(5)(C) of the House bill (H.R. 4872 at §1409(a)); Proposed Code §7701(o)(5)(D) of the Senate bill (H.R. 4213 at §421(a)).

[67] H.R. 4872 at §1409(b) and H.R. 4213 at §421(b) (proposed Code §6662(i)).

[68] H.R. 4872 at §1409(c) and H.R. 4213 at §421(c).

[69] H.R. 4872 at §1409(d) and H.R. 4213 at §562(d) (proposed Code §6676(c), after redesignation of existing Code §6676(c) as proposed Code §6676(d)).

[70] Proposed Code §7701(o)(5)(C).

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

substance over form. The language of the proposed legislation again provides that the statute does not supplant existing law on economic substance ''or other similar rule,'' but the fact that Congress codified only the economic substance rule would support the notion that the other doctrines are somehow less firmly a part of the body of tax law. The substance over form rule will almost surely survive, for example, but it may not be as robustly applied by the IRS and the courts.

The General Economic Substance Rule

The economic substance statute would be phrased, at least initially, in terms of a meaningful change in the taxpayer's economic position, apparently incorporating notions developed in *Knetsch*.[71] Profit potential would enter the analysis only if the taxpayer seeks to satisfy the meaningful change in economic position test by showing an expected non-tax profit. While taxpayers presumably will continue to focus upon showing a profit potential quantitatively, they still can satisfy the economic substance test by showing non-quantifiable benefits that meaningfully alter the taxpayer's economic position. For example, they can rely upon qualitative benefits such as easing entry into the European energy market (see *Con Ed*) or improving the corporation's ability to manage its asbestos liability (see *Coltec*).

Codification would also end the long debate over whether the two prongs of the economic substance doctrine reflect a subjective test or an objective test or both. The proposed legislation requires taxpayers to satisfy both a subjective and an objective test. In so doing, the legislation resolves any remaining questions regarding whether a taxpayer need only satisfy one of the prongs of the classic economic substance test.

In retrospect, it is apparent that this debate was of little practical consequence. No appellate court ever found that a transaction satisfied one prong of the test and failed the other. A taxpayer engaged in a transaction economically profitable without regard to tax benefits almost surely had a non-tax business purpose for the transaction. Conversely, a taxpayer engaged in an unprofitable transaction probably did not have a non-tax business purpose. Perhaps there were a handful of cases where a taxpayer mistakenly thought that it was engaged in a profitable transaction when the facts were otherwise, but such cases received little attention.

The existing case law does not explicitly recognize any exemptions to the economic substance doctrine, but an informal system of exemptions is probably implicit in the selection of cases in which the IRS and the courts have considered economic substance. The Joint Committee has written that Congress believes that come categories of transactions should be exempt from the economic substance doctrine — e.g., the choice between capitalizing an enterprise with debt or equity, the choice of using a domestic or foreign corporation for a foreign investment, structuring of a corporate reorganization, and use of a related entity in a transaction.[72] The proposed legislation generally authorizes implementing regulations for the economic substance statute, which presumably could specify certain transactions that would be exempt from the economic substance requirement. These regulations probably will do little more than formalize what has always been the administrative and judicial practice under the case law. Of course, one can expect lengthy debates about the list of exempted transactions to be exempted under whatever regulations are adopted.

Objective Prong of the Economic Substance Doctrine

Taxpayers usually will attempt to satisfy the economic substance doctrine by demonstrating the profit-generating potential of a transaction. The proposed legislation provides that taxpayers can satisfy the rule—

> only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

This formulation of the test resolves a series of issues left open in many circuits by the case law, all in favor of setting a higher standard for taxpayers to satisfy.

The proposed legislation would require that the taxpayer's hope of economic profit must be ''reasonably expected.'' Significantly, Congress explicitly distinguished a ''reasonable expectation'' from a ''reasonable prospect'' of profit,[73] thus requiring rejection of taxpayer contentions of believing there was a remote possibility that they might profit, for example, by hitting a tiny ''sweet spot'' between two offsetting foreign currency positions — the contention raised by the taxpayers in the Son of BOSS cases. Some form

[71] Proposed Code §7701(o)(1)(A).

[72] S. Rpt. 110-206 at 92–93; Technical Explanation of the Revenue Provisions Contained in H.R. 3962, The ''Affordable Health Care for America Act,'' as amended at 90–91 (JCX-47-9, Nov. 5, 2009).

[73] S. Rpt. 110-206 at 95 n. 140.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

of probabilistic analysis of potential outcomes is required, although a formal mathematical computation is not mandated and the required percentage likelihood of economic profit is not specified. Neither the case law nor the proposed legislation dictates the result where, for example, a statistical analysis would demonstrate that an investment is more likely than not going to lose a modest amount of money, but the taxpayer can show that it spotted a legitimate opportunity to profitably bet against the conventional wisdom.

In addition, the proposed legislation requires a present value computation of the profit potential of a transaction. Some early cases had rejected a present value approach, a position recently advocated by the *Consolidated Edison* court. However, most of the more recent appellate cases, such as *ACM*, have employed present value concepts in evaluating long-term transactions that produce substantial economic benefits many years in the future — benefits that might make a transaction seem reasonable without taking the time value of money into account. The proposed legislation would resolve any uncertainty by requiring a present value computation in every case.

Further, the proposed legislation provides that the economic benefits of the transaction must be ''substantial'' in comparison to the tax benefits of a transaction. Previously, the courts in cases such *ACM* and *AWG* had ruled that minimal profit potential was not enough to save transactions designed primarily to produce out-sized tax benefits. Many other cases have not included a comparison of the relative value of the tax and non-tax benefits of a transaction. Codification would remove the uncertainty resulting from the conflicting cases, but would produce new disputes regarding how the ''substantiality'' of the non-tax benefits will be measured.[74]

Consider, for example, a transaction that produces a reasonably expected 7% pre-tax profit under the statutory rules and a 75% after-tax profit. Are the non-tax benefits of the transaction ''substantial?'' Would the result be different if another taxpayer's tax attributes allowed it to receive only a 20% after-tax profit from the same transaction? If so, why should the law distinguish the two taxpayers engaging in identical transactions?

The proposed legislation also addresses many of the mechanics of the profit potential computation. The law has been fairly settled that transaction costs must be considered in computing the profit potential of a transaction, and that rule is incorporated in the proposed legislation. With respect to the impact of foreign taxes, the case law has been inconclusive, with the ADR cases ignoring foreign taxes and cases such as *AWG* paying close attention to the cost of foreign taxes. The proposed legislation requires consideration of the cost of foreign taxes. Likewise, the legislation follows the case law in providing that a taxpayer may not count financial accounting benefits attributable to the claimed tax benefits as a substantial non-tax purpose for entering into the transaction.

Neither the legislation nor the case law provides a clear answer regarding the treatment of benefits resulting from the inevitable disparities between the treatment of other aspects of transactions under financial accounting, tax accounting, and banking conventions.[75] The tax law has generally allowed taxpayers to arbitrage the differences between the different systems of measuring income, and nothing in the proposed legislation appears to alter that practice.

The legislation also leaves some uncertainty regarding whether the profit potential inquiry should focus upon the particular step that, in a multi-step transaction, produced the disputed tax benefits. That focus was critical to the IRS's attacks on transactions that coupled extraneous profitable steps (e.g., purchase of a T-bill) with an otherwise unprofitable (but tax-advantaged) transaction to generate a combined profit. Neither the House bill nor the Senate bill contains language regarding the proper definition of the relevant ''transaction'' for purposes of the profitability analysis, but the Committee Reports indicate that courts should continue to aggregate, disaggregate, or recharacterize transactions where appropriate in evaluating their profit potential.[76] However, they provide no explanation of when a court should exercise this authority.

Subjective Prong of the Economic Substance Doctrine

In addition to substantial economic change and objective profit potential, codification would require taxpayers to satisfy a subjective business purpose test. Specifically, the Senate bill would require taxpayers to demonstrate that ''the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.'' The House bill contains essentially identical language.

---

[74] One earlier formulation had required that the profit potential must exceed the risk-free rate of return on capital. H.R. 2136 (110th Cong.) at §401. That requirement does not appear in the bills currently under consideration.

[75] For example, many LILO and SILO transactions contained a feature in which a deposit account was funded at the outset of the transaction and the account accrued interest for many years before it was eventually returned to the taxpayer. The interest income was deferred for tax purposes, recognized on an accelerated basis for financial accounting purposes, and banking conventions would accrue interest income under a third methodology.

[76] *See* S. Rpt. 110-206 at 93.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

One question regarding the subjective prong of the test is whether the disputed transaction was a rational means of achieving the taxpayer's stated business purpose. In other words, may a taxpayer satisfy the subjective prong of the economic substance analysis with an honest, but mistaken, belief that a transaction has a substantial business purpose? For example, the trial court in *Coltec* credited the testimony of the taxpayer's chairman that he believed that establishment of a subsidiary to assume the company's asbestos liability would somehow insulate the parent from tort liability, and determined that this testimony established the taxpayer's non-tax business purpose. In reversing the trial court, the Federal Circuit ruled that the transaction lacked economic substance for several reasons, including its conclusion that the taxpayer could not, as a matter of law, escape preexisting tort liability by assigning that liability. An earlier version of the proposed legislation would have required taxpayers to demonstrate that they had a "substantial non-tax purpose for entering into such transaction" and also that "the transaction is a reasonable means of accomplishing such purpose." [77] That latter requirement is not present in the current versions of the bill, leaving future generations of litigators to debate the treatment of well-intentioned, but mistaken, purposes for a transaction.

Regardless, the subtleties of the subjective prong of the economic substance doctrine probably have little practical effect. All but the most unsophisticated of taxpayers and planners will be able to assert some business purpose or profit motive for their transactions and provide testimony to support that assertion. While the IRS surely will question that testimony, it will be a rare case where the IRS can proffer the equivalent of a confession proving that the taxpayer did not subjectively believe the testified-to business purpose or profit motive. Few (if any) taxpayers who can satisfy the objective prong of the economic substance doctrine will fail the subjective business purpose prong of the test.

The New Penalty Regime

At present, transactions that are found to lack economic substance may produce penalty assessments equal to 20% or 40% of underpayments under several different subsections of §6662 of the Code (e.g., valuation misstatement, substantial understatement of income tax, and negligence). Those penalties apply alternatively and are not stacked; a taxpayer pays only one penalty even if its transaction produces both a valuation misstatement and a substantial understatement of income tax. Taxpayers generally may defend against a penalty assessment if they can establish that they acted in good faith and had a reasonable belief that the law supported their return position.

The proposed legislation contains new penalty provisions for transaction found to lack economic substance. This new penalty would apply alternatively with the existing penalty rules. The impact of the new provision would be minimal because relatively few transactions would generate a penalty as a noneconomic substance transaction while not generating a penalty under the existing §6662 penalties.[78]

The proposed legislation imposes virtual strict liability by excepting its noneconomic substance transaction penalty from the existing reasonable cause and good faith defenses. A good faith belief that a particular position was correct, even if backed by an opinion letter, would not provide a defense. In addition, §563 of the House bill would separately limit the availability of the reasonable cause defense for publicly traded and other large corporations where other §6662 penalties are imposed.[79] Practically speaking, a strict liability penalty that applies automatically if economic substance is lacking, but only if a court believes economic substance is "relevant," may lead judges to avoid basing their rulings on economic substance and to instead use other tools to decide individual cases.

Further, the proposed legislation contains a provision that would amend the frivolous claim penalty under §6676(a) of the Code to impose the noneconomic substance transaction penalty in every case where a taxpayer unsuccessfully files a refund claim or suit asserting a position that is later determined to lack economic substance. This change would represent a ma-

[77] H.R. 2136 (110th Cong.).

[78] The earlier Senate bill, S. 506, would have made far greater changes to the potential amount of penalties by enacting a new §6662B to impose a new 20% or 30% penalty for underpayments attributable to noneconomic substance transactions. This penalty would have applied "in addition to" the existing §6662 penalties. As a result, a taxpayer found to have engaged in an undisclosed noneconomic substance transaction that produced a gross valuation misstatement under §6662(h) could have faced a combined 70% penalty — 30% under the new §6662B and 40% under the existing §6662(b) penalty for gross valuation misstatement. Moreover, S. 506 would have prevented taxpayers from deducting interest they paid on any underpayment of tax attributable to a noneconomic substance transaction — adding to the potential economic cost of a penalty assessment. Concerns regarding the potential overuse of S. 506's §6662B penalty would have been mitigated, somewhat, by the requirement of high-level IRS Chief Counsel approval of any noneconomic substance penalty assertion. S. 506 (proposed Code §6662B(d)).

[79] The earlier House bill that was passed by the House on Nov. 7, 2009 (H.R. 3962) additionally would have limited the availability of the reasonable cause defense for publicly traded and other large entities. Under that bill, the reasonable cause defense would have been available only if the publicly traded or large entity had a reasonable belief that its tax treatment of the item "more likely than not" was the proper tax treatment. *See* H.R. 3962 at §563.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

jor departure from the existing system, which generally allows taxpayers to avoid penalties by filing their returns in accordance with the IRS's positions and later filing refund claims taking the more aggressive position. While the penalty imposed under current §6676 has its roots in penalties assessed by courts against taxpayers asserting frivolous claims, the proposed legislation is not so narrowly confined. However, the rationale for the change is not explained, and the change would seem to raise constitutional or systemic issues regarding the right of taxpayers to petition the courts for relief from government action.

Collectively, enactment of the proposed penalty regime would raise the stakes for taxpayers considering a position potentially subject to an economic substance challenge. Taxpayers contemplating aggressive transactions would face higher penalties than under current law and a greater risk that a challenge to the economic substance of a transaction would result in a penalty assessment. The new penalty regime would almost certainly have a substantial deterrent impact on taxpayers, reducing the likelihood that taxpayers would engage in transactions with debatable economic substance.

CONCLUSION

The preceding discussion demonstrates that the formulation of the economic substance doctrine and the related penalty provisions chosen by Congress will have a far greater impact upon taxpayers and their decision-making than resolution of the basic issue of whether codification is good policy. Codification will resolve a series of questions regarding the application of the doctrine, generally in favor of imposing higher standards upon taxpayers. Adoption of a new penalty regime for transactions lacking economic substance will more substantially alter existing law and will alter the calculus of taxpayers and their advisors when they consider transactions potentially subject to economic substance challenge.

© 2010 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628