THE ECONOMIC SUBSTANCE DOCTRINE: A U.S. ANTI-ABUSE RULE

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INTRODUCTION

Major corporate transactions typically reflect at least two separate elements. One is the business arrangement agreed to by the parties. The other is tax planning that is designed to minimize taxes while allowing the business arrangement to be consummated. In order to strike the appropriate balance, advisors must consider the potential impact of the economic substance doctrine. This doctrine constitutes a major tool for the I.R.S. to counter tax abusive transactions, because a transaction that has no economic substance will not be respected for income tax purposes in the U.S.

When the tax plan follows the business plan, taxpayers have wide latitude to choose a structure that reduces or defers tax for the seller. A simple example is that a taxpayer may choose to pursue a tax-free reorganization as the form of the transaction rather than a taxable sale of assets. At times however, the tax planning may go beyond the business deal or the underlying transaction may have no purpose other than a reduction of taxes. See, for example, *ACM Partnership v. Commr.*[1] and related cases.[2] Each involved the creation of an arrangement to produce losses for a U.S. taxpayer in order for it to reduce an equivalent amount of gains from an unrelated transaction, and each was created by financial engineers at a large financial institution. In such cases, the courts and the I.R.S. have imposed limits on tax planning when a tax reduction turned out to be the sole driver for a transaction.

COMMON LAW EVOLUTION

The economic substance doctrine is a common-law creation that has been part of U.S. tax law for over 85 years.

Its origins can be traced to *Gregory v. Helvering*,[3] in which the Supreme Court recognized a taxpayer's right to minimize their tax exposure as long as Congress intended those tax benefits.[4]

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which

1 TC Memo. 1997-115, affd. 157 F.3d 231 (3d Cir. 1998).

2 *ASA Inversterings Partnership v..Commr.*, T.C. Memo. 1998-305 affd, 201 F3d 505 (DC Cir. 2000); *Boca Investerings Partnership v. U.S.*, 314 F.3d 625 (D.C. Cir. 2003), revg. 167 F Supp 2d 298 (D.D.C. 2001); and *Saba Partnership v. Commr.* 273 F.3d 1135 (D.C. Cir 2001).

3 293 US 465 (1935).

4 Citing *U.S. v. Isham*, 17 Wall. 496, 506; *Bullen v. Wisconsin*, 240 U.S. 625, 630.

> the law permits, cannot be doubted. * * * But the question for deter mination is whether what was done, apart from the tax motive, was the thing which the statute intended.

In the case, the taxpayer was the owner of all the stock of Corporation A, which held appreciated shares of Corporation B. The taxpayer wanted to sell the Corporation B shares at favorable capital gains tax rates. She therefore formed Corporation C, which acquired from Corporation A all the shares it owned in Corporation B in a tax-free reorganization. Corporation C was immediately liquidated and distributed the Corporation B shares to the taxpayer. Under the law in effect at the time, the liquidation of Corporation C was a tax-free event, much like the reorganization by which the Corporation B shares were acquired. All steps required by law were followed. The question was whether the reorganization should be ignored for tax purposes because the taxpayer never intended for Corporation C to continue in business. The Supreme Court answered in the negative and treated the taxpayer as if she received a taxable dividend from Corporation A, taxed as ordinary income.

"The doctrine of economic substance becomes applicable . . . where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings."

Since this case, courts have sought to differentiate legitimate tax planning (*i.e.*, that which has substance) from tax abusive structures, which are compliant with the letter of the law but contrary to its spirit. The principle has been invoked in different iterations and has evolved over the years:

- The incidence of taxation depends upon the substance of the transaction and not mere formalism.[5]
- Taxation is not so much concerned with refinements of title as it is with actual command over the property.[6]
- A mere transfer in form, without substance, may be disregarded for tax purposes.[7]
- A given result at the end of a straight path is not made a different result because reached by following a devious path.[8]
- Where a taxpayer embarks on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction.[9]

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5 *Commr. v. Court Holding Co.*, 324 U.S. 331, 334 (1945).

6 *Corliss v. Bowers*, 281 U.S. 376, 378 (1930); see also *Commr. v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Griffiths v. Commr.*, 308 U.S. 355 (1939); *Sachs v. Commr.*, 277 F. 2d 879, 882-883 (8th Cir. 1960), affirming 32 T.C. 815 (1959).

7 *Commr. v. P. G. Lake, Inc.*, *supra*; *Commr. v. Court Holding Co.*, *supra*; *Commr. v. Sunnen*, 333 U.S. 591 (1948) *Helvering v. Clifford*, *supra*; *Corliss v. Bowers*, *supra*; *Richardson v. Smith*, 102 F. 2d 697 (2nd Cir. 1939); *Howard Cook v. Commr*, 5 T.C. 908 (1945); *J. L. McInerney v. Commr.*, 29 B.T.A. 1 (1933), affd. 82 F. 2d 665 (6th Cir. 1936).

8 *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

9 *Redwing Carriers, Inc. v. Tomlinson*, 399 F. 2d 652, 654 (5th Cir. 1968); *May Broadcasting Co. v. U.S.*, 200 F. 2d 852 (8th Cir. 1953); *Whitney Corporation v. Commr.*, 105 F. 2d 438 (8th Cir. 1939), affirming 38 B.T.A. 224 (1938); *Commr. v. Ashland Oil & R. Co.*, 99 F. 2d 588 (6th Cir. 1938), reversing *sub nom*. *Swiss*

- Transactions that are challenged as intermediary steps of an integrated transaction are disregarded when found to be so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series.[10]

- The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.

- Whether we respect a taxpayer's characterization of a transaction depends upon whether the characterization represents and is supported by a *bona fide* transaction with economic substance, compelled or encouraged by business or regulatory realities, and not shaped solely or primarily by tax avoidance features that have meaningless labels attached.[11]

At times, the economic substance doctrine has been used in conjunction with the business purpose doctrine. The latter, a subjective doctrine, entails analyzing the purpose of the transaction to determine whether the taxpayer intended the transaction to serve some useful non-tax purpose.[12]

Some degree of uncertainty arose through different applications of the economic substance doctrine by various courts. One of the most cited inconsistencies was that certain courts would examine both the economic substance and the business purpose of a transaction in order to determine a given transaction's economic substance (the "conjunctive test"), while other courts determined that the presence of either economic substance or business purpose was enough in reaching a conclusion (the "disjunctive test").

This uncertainty and lack of uniformity led to the codification of the economic substance doctrine in 2010.

CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

The standards by which the economic substance doctrine is applied were clarified by the enactment of Code §7701(o). Thus, the term "economic substance doctrine"

Oil Corporation v. Commr., 32 B.T.A. 777 (1935), *certiorari* denied 306 U.S. 661 (1939); *Kuper v. Commr.*, 61 T.C. 624 (1974); *Kimbell-Diamond Milling Co. v. Commr.*, 14 T.C. 74 (1950), affirmed *per curiam* 187 F. 2d 718 (5th Cir. 1951), *certiorari* denied 342 U.S. 827 (1951).

10 *American Bantam Car Co. v. Commr.*, 11 T.C. 397, 405 (1948), affd 177 F. 2d 513 (3rd Cir, 1949), *certiorari* denied 339 U.S. 920 (1950); see *Scientific Instrument Co. v. Commr.*, 17 T.C. 1253 (1952), affd *per curiam* 202 F. 2d 155 (6th Cir., 1953).

11 *Frank Lyon Co. v. U.S.*, *supra* at 583-584; *Winn-Dixie Stores, Inc. v. Commr.*, *supra*; *Nicole Rose Corp. v. Commr.*, 117 T.C. 328 (2001), affd 320 F3d 282 (2nd Cir. 2002).

12 Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10, March 21, 2010, p. 143. Herein, referred to as the "Technical Explanation to the 2010 Act."

is defined as the common law doctrine under which income tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

In determining whether a given transaction has economic substance, Code §7701(o) continues to rely on case law. In determining whether a transaction meets the economic substance doctrine, the following points must be considered:[13]

- The economic substance doctrine must be relevant to the transaction.
- Additionally, the following conjunctive two-prong test must be met:
  - The transaction changes the taxpayer's economic position in a meaningful way (apart from Federal income tax effects) (the "economic substance test").
  - The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction (the "business purpose test").

In determining whether the taxpayer meets the conjunctive two-prong test, the transaction's potential for profit is taken into account only if the expected pre-tax profits substantially exceed the expected net tax benefits that would be allowed if the transaction were respected (the "profit potential test").[14] For the purpose of computing profit potential, fees and other transaction expenses are to be taken into account as expenses in determining pre-tax profit. In addition, the I.R.S. is authorized to adopt regulations under which foreign taxes will be treated as expenses in determining pre-tax profit in appropriate cases. Note that factors other than profit potential may demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal tax purpose for entering into such transaction. The provision does not require or establish a specified minimum return that will satisfy the profit potential test.

Certain benefits that stem from reducing Federal taxable income can no longer be used as a business purpose. Thus, for example, reductions in state or local income taxes – which are typically counted as deductions when computing taxable income for Federal purposes – are treated in the same manner as a reduction in Federal income taxes if the transaction at issue affects the computation of taxable income for Federal tax purposes in addition to state tax purposes. In addition, entering into a transaction to achieve a financial accounting benefit will not be treated as a valid business purpose for entering into the transaction if the origin of the financial accounting benefit is a reduction of Federal income tax.

The provision does not alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are respected merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.[15] Among these basic decisions are

- the choice between capitalizing a business enterprise with debt or equity,

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[13] Code §§7701(o)(1) and 7701(o)(5)(D).

[14] Code §7701(o)(2)(A).

[15] Technical Explanation to the 2010 Act, JCX-18-10, p. 152.

- the choice between foreign corporations and domestic corporations,
- the treatment of a transaction or series of transactions as a corporate organization or reorganization, and
- the ability to respect a transaction between related parties, provided that the arm's length standard of Code §482 is satisfied.

Nonetheless, Code §7701(o) does not alter a court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the economic substance doctrine. Thus, the court decisions, referenced above, regarding economic substance continue as valid law.

I.R.S. APPLICATION OF CODE §7701(O)

Application of the Conjunctive Test

In applying the conjunctive two-prong test, the I.R.S. will rely on relevant case law under the common-law economic substance doctrine and the business purpose doctrine.[16] In this regard, the I.R.S. will rely on pre-codification authorities and post-codification authorities.[17] The I.R.S. will not issue general administrative guidance regarding the types of transactions to which the economic substance doctrine applies or does not apply,[18] or issue private letter rulings or determination letters on whether a transaction meets the requirements of Code §7701(o).[19]

Definition of "Transaction"

As explained earlier, the economic substance doctrine applies to a transaction or a series of transactions. In Notice 2014-58, the I.R.S. refers to Treas. Reg. §1.6011-4(b)(1) to define a "transaction." Generally, the term includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement. It also includes any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.

Generally, all steps are taken into consideration (*i.e.*, an aggregated approach is applied) when all such steps are interconnected with a single objective. However, when certain steps are taken for tax purposes only, such steps may be isolated and a disaggregated approach may be applied. Notice 2014-58 provided the following disaggregated approach example:

> If transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may

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16 Notice 2010-62. Notice 2010-62 was issued by the I.R.S. to provide interim guidance regarding the codification of the economic substance doctrine and related provisions in the Health Care and Education Reconciliation Act of 2010.

17 Notice 2010-62, B.

18 *Id.*

19 Notice 2010-62, Effect on Other Documents.

take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

Analysis of Relevancy

In Notice 2010-62, the I.R.S. provided guidance as to how it would determine relevancy of the economic substance doctrine to a particular transaction. It stated, in relevant part, that:

The IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o). If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.

The I.R.S. will not issue private letter rulings or determination letters on the issue of relevancy. As a result, the transactions listed in the non-exhaustive list provided in the Technical Explanation to the 2010 Act constitutes the only "angel list" regarding the economic substance doctrine. Aside from that, Notice 2014-58 states that the determination of relevancy requires a factual, case-by-case analysis.

PENALTIES AND ADDITIONAL GUIDANCE

When a taxpayer enters into a transaction that does not meet the economic substance standard and the transaction reduces tax, the portion of the taxpayer's reduction in tax that is attributable to the transaction is subject to a 40% penalty. If the transaction is disclosed in the tax return, the penalty is reduced to 20%. Disclosure is effected on Form 8275, *Disclosure Statement*.[20] The penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed.[21]

The penalty is a strict liability penalty (*i.e.*, the taxpayer cannot benefit from a reasonable cause exception).[22] Because there is no reasonable cause defense available to taxpayers, any proposal to impose a Code §6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations ("D.F.O.").[23]

The I.R.S. Large Business and International ("LB&I") Division has issued internal guidelines for determining when it is appropriate to apply the codified economic substance doctrine. While the Treasury Department has cautioned taxpayers not to rely too heavily on these guidelines, examiners are instructed to carry out the following

[20] Code §6662(b)(6).

[21] Code §6664(b).

[22] Code §6664(c)(2).

[23] LB&I, *Codification of Economic Substance Doctrine and Related Penalties,* LMSB-20-0910-024, September 14, 2010. This directive is effective for transactions entered into on or after March 31, 2010.

four-step inquiry prior to asking a D.F.O. to assert the penalty:

- First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate.
- Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate.
- Third, if an examiner determines that the application of the doctrine may be appropriate, the examiner must make a series of inquiries, provided in the guidance, before seeking approval to apply the doctrine.
- Fourth, if an examiner and his or her manager and territory manager determine that application of the economic substance doctrine is merited, guidance is provided on how to request D.F.O. approval.

"While the economic substance doctrine has certainly been introduced into the Code by Code §7701(o), it has not been entirely codified."

The LB&I guidelines provide examples for every step. These examples are relevant not only for purposes of the penalty regime but also with respect to I.R.S. application of the economic substance doctrine. For example, transactions to which the application of the economic substance doctrine is generally not appropriate include the following ones:

- The transaction is not promoted/developed/administered by a tax department or outside advisors.
- The transaction is not highly structured.
- The transaction contains no unnecessary steps.
- The transaction generates targeted tax incentives that are consistent with Congressional intent in providing the incentives.
- The transaction is at arm's length with unrelated third parties.
- The transaction creates a meaningful economic change on a present value basis (pre-tax).
- The taxpayer's potential for gain or loss is not artificially limited.
- The transaction does not accelerate a loss or duplicate a deduction.
- The transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset).
- The taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction.
- The transaction does not involve a tax-indifferent counterparty that recognizes substantial income.
- The transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years.

- The transaction has credible business purpose apart from federal tax benefits.
- The transaction has meaningful potential for profit apart from tax benefits.
- The transaction has significant risk of loss.
- The tax benefit is not artificially generated by the transaction.
- The transaction is not pre-packaged.
- The transaction is not outside the taxpayer's ordinary business operations.

In the LB&I guidelines, the I.R.S. refers to the four transactions that are not deemed relevant by the Technical Explanation to the 2010 Act, by stating that "it is likely not appropriate to raise the economic substance doctrine if the transaction being considered is related to" these transactions.

CONCLUSION

While the economic substance doctrine has certainly been *introduced* into the Code by Code §7701(o), it has not been entirely *codified*. It is a constantly evolving concept and one that makes abusive tax planning extremely costly through the applicable penalty regime. The likelihood of disclosure of a transaction without economic substance will likely be low for taxpayers that are neither audited under U.S. G.A.A.P. nor subject to analysis by the auditors in accordance with FIN 48, which deals with uncertain tax positions. Without the overview provided in an audit of financial statements under U.S. G.A.A.P., taxpayers may not have a system to report and disclose the transaction. In comparison, if a U.S. G.A.A.P. audit is performed and a reserve is taken with regard to an uncertain tax position, Schedule UTP must be filed with the tax return for the year in which the reserve is established and the taxpayer's assets exceed the $10 million threshold provided in the instructions.