

Economic Substance Doctrine Codified: Surviving Scrutiny Under New IRC § 7701(o)

Bryon Christensen
U.S. Dept. of Treasury
Bryon.Christensen@do.treas.gov

Phillip Pillar
Greenberg Traurig
pillarp@gtlaw.com

Jeremiah Coder
Tax Analysts
Jeremiah_Coder@tax.org

Alex Sadler
Crowell & Moring LLP
asadler@crowell.com

Agenda

- How We Got Here
- The New Law's "Substance"
- The New Law's Penalties
- The New Law's Impacts
- Closing Remarks
- Questions & Answers

How We Got Here

The Judicial Landscape
Before IRC Section 7701(o)

What Is the Economic Substance Doctrine?

- A judicial doctrine commonly cited as originating in *Gregory v. Helvering*, 293 U.S. 465 (1935), that has been used to disallow the tax benefits generated by transactions satisfying the literal requirements of the Code but lacking any practical economic significance apart from their tax consequences.
- “The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else.” *Gregory*, 293 U.S. at 470.
- Over the next seven decades the economic substance doctrine and related judicial doctrines (e.g., sham in fact, step transaction, business purpose, etc.) were developed and applied by all the federal courts not merely to interpret the Code but to serve as an “anti-abuse” backstop to the Code.
- *Knetsch v. United States*, 364 U.S. 361 (1960); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Rice’s Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985)

Leading Pre-Codification Cases by Circuit

First: *Deweese v. Commissioner*, 870 F.2d 21 (1st Cir. 1989)

Second: *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282 (2d Cir. 2002); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966)

Third: *In re CM Holdings*, 301 F.3d 96 (3d Cir. 2002); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998)

Fourth: *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985)

Fifth: *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001)

Sixth: *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006); *American Elec. Power, Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003)

Leading Pre-Codification Cases by Circuit

Seventh: *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008); *N. Indiana Pub. Serv. Co. v. Commissioner*, 115 F.3d 506 (7th Cir. 1997); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988)

Eighth: *IES Indus. v. United States*, 253 F.3d 350 (8th Cir. 2001); *Shriver v. Commissioner*, 899 F.2d 724 (8th Cir. 1990)

Ninth: *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995)

Tenth: *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1995)

Eleventh: *United Parcel Serv. of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001); *Winn-Dixie Stores and Subs. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001)

D.C.: *ASA Investering Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992)

Federal: *Coltec Indus. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006)

Judicial Convergence:

Doctrinal Limits, Purpose, and Burden

- “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.” *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) (Hand, J.), *aff’d*, 293 U.S. 465 (1935).
- But on a case-by-case basis federal courts developed and applied the “Economic Substance Doctrine” to deny the tax benefits flowing from transactions lacking any “purpose, substance, or utility” apart from their tax consequences. The taxpayer bears the burden of proving that a disputed transaction possesses economic substance.
- Economic substance (objective): Transaction changes taxpayer’s economic position in meaningful way apart from federal tax effects
- Business purpose (subjective): Taxpayer has substantial purpose for engaging in transaction apart from federal tax effects

Judicial Divergence: Scope of the Inquiry

Compare

“In applying these principles, we must view the transactions ‘as a whole, and each step, from the commencement . . . to the consummation . . . is relevant.’ *ACM*, 157 F.3d at 247.

With

“[T]he first asserted business purpose focuses on the wrong transaction –the creation of Garrison as a separate subsidiary to manage asbestos liabilities [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 upon sale.” *Coltec*, 454 F.3d at 1358.

Judicial Divergence:

Tests for Determining Economic Substance

Conjunctive Test

- Transaction must have practicable economic effects apart from tax savings (objective economic substance) *and* a non-tax business purpose (subjective economic substance).
- “[A] lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer’s sole motive is tax avoidance.” *Coltec*, 454 F.3d at 1356.
- Applied in First, Seventh, Eleventh, and Federal Circuits

Judicial Divergence: Tests for Determining Economic Substance

Disjunctive Test

- Transaction must have objective *or* subjective economic substance to survive scrutiny.
- “To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.” *Rice’s Toyota World*, 752 F.2d at 91-92.
- Applied in the Second, Fourth, Eighth, and D.C. Circuits

Judicial Divergence:

Tests for Determining Economic Substance

Flexible Inquiry Test

- “[T]he consideration of business purpose and economic substance are simply more precise factors to consider We have repeatedly and carefully noted that this formulation cannot be used as a ‘rigid two-step analysis.’” *Sacks*, 69 F.3d at 985.
- Applied in the Third, Fifth, Sixth, Ninth, and Tenth Circuits

Judicial Divergence: Outcomes

Key Taxpayer Wins

Compaq

IES

UPS

Northern Indiana

Several trial court
decisions

Key Government Wins

ACM

Coltec

Dow Chemical

AEP

CM Holdings

Klamath

Many others

Path to Codification

- Legislation introduced beginning in 1999 to codify economic substance; bills proposed each Congress thereafter
- Senate passes codification proposals in 108th, 109th, 110th sessions
- Support mostly from Capitol Hill; seen as revenue raiser
 - High score of \$17 million; dropped to \$5 million
- IRS/Treasury and tax bar opposed to proposals
 - worry codification would limit judicial discretion
- Part of President's 2010 and 2011 budget proposals

New Economic Substance Tests

Statutory Conjunctive Test – Section 7701(o)(1)

- 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—
 - the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, *and*
 - the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

- Consequently, the conjunctive economic substance test now applies in all circuits.

Special Rules for Applying the New Tests

- A taxpayer may rely on factors other than profit potential to demonstrate a meaningful change in economic position.
- A taxpayer relying on profit potential to establish economic substance does not have to show a minimum return. However—
 - the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected, *and*
 - in determining pre-tax profit, transaction fees and other expenses shall be taken into account as expenses, and the Secretary shall issue regulations on when foreign taxes should be treated as expenses.

Section 7701(o)(2)(A), (B).

Special Rules for Applying the New Tests

- For purposes of the economic substance determination—
 - Any State or local income tax effect related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect. Section 7701(o)(3).
 - For purposes of establishing a substantial business purpose, achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the original of such benefit is a reduction in Federal income tax. Section 7701(o)(4).
 - The determination of whether the doctrine is relevant to a transaction shall be made in the same manner as if section 7701(o) had never been enacted. Section 7701(o)(5)(C).
 - The term “transaction” includes a series of transactions. Section 7701(o)(5)(D).
 - The codified rules are applicable to transactions “entered into” after March 31, 2010. Health Care and Education Reconciliation Act of 2010 (“HCRA”), Pub. L. No. 111-152, § 1409(e)(1).

Technical Explanation

- The Joint Committee on Taxation’s technical explanation provides that the new rules are not intended to alter the tax treatment of certain “basic transactions:”
 - the choice between capitalizing a business enterprise with debt or equity;
 - a U.S. person’s choice to use a foreign corporation or domestic corporation to make a foreign investment;
 - corporate organizations and reorganizations; and
 - the choice to use a related-party entity in an arm’s length transaction.
- The above examples are illustrative and not exclusive.

Technical Explanation

- It is also not intended that the codified doctrine will disallow tax benefits where the realization of such benefits is consistent with the Congressional purpose or plan the benefits were designed to effectuate.
- Examples: section 42 (low-income housing credit); section 45 (production tax credit); section 45D (new markets tax credit); section 47 (rehabilitation credit); and section 48 (energy credit).

Technical Explanation

- “The provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”

New Economic Substance Tests - Open Issues

- For purposes of the effective date, when does a taxpayer “enter into” a transaction?
- When is the codified doctrine “relevant” for purposes of section 7701(o)?
- What constitutes a “transaction” for purposes of the codified rules?
- What represents a “meaningful” change in a taxpayer’s economic position?
- How “substantial” does the present value of expected non-tax benefits have to be in relation to the expected tax benefits?

New Economic Substance Tests - Open Issues

- When are foreign taxes taken into account in computing pre-tax profit?
- What tax benefits must be taken into account in computing “net tax benefits” for purposes of satisfying the profit potential test?
- What represents a “substantial” non-tax business purpose?
- What are other “basic transactions” the tax treatment of which is not impacted by the new rules?
- What are other sanctioned tax benefits created to effectuate a Congressional plan or purpose?

The New Law's Penalties

“The Hammer?”

Pre-Codification Penalty Regime

- Section 6662 accuracy-related penalty for underpayments due to negligence, substantial tax understatements, and valuation misstatements, subject to “reasonable cause” exception of section 6664(c).
 - Tests for “Substantial Authority,” “Reasonable Basis,” and “Tax Shelter Items”
- Section 6676 imposes comparable penalty on frivolous refund claims.
- Section 6694 return preparer penalty for unreasonable tax return positions leading to understatement of taxpayer’s tax.

Pre-Codification Penalty Regime

- Section 6707A penalty for understatements of “reportable transactions.” No reasonable cause defense.
- Section 6662A accuracy-related penalty for listed tax avoidance transactions and reportable transactions identified as having the potential for tax avoidance.
- The penalty rate and available defenses for the section 6662A penalty vary depending on whether the transaction was adequately disclosed.

HCRA Changes to the Penalty Regime

- Creates a new 20-percent accuracy-related penalty on any underpayment attributable to a transaction lacking economic substance. HCRA § 1409(b).
- The amount of the penalty is increased to 40 percent where the relevant facts affecting the tax treatment of the transaction are not adequately disclosed in the return or a statement attached thereto. *Id.*
- Eliminates the reasonable cause exception of section 6664(c) and reasonable basis defense of section 6676 for transactions lacking economic substance. HCRA §§ 1409(c), (d).

Penalties - Open Issues

- In what circumstances will IRS apply the new strict liability penalty?
- What guidance is being given to IRS and to taxpayers?
- What is adequate disclosure?
- What impact will the new strict liability penalty have on tax planning and tax opinions?

Impact of New Provisions

In Transactions
&
On Controversies

Impact – In Transactions

- What is the “Transaction?”
- IRC Section 7701(o)(5)(D): includes “a series of transactions”
- *Coltec?*
- *ACM?*
- Court may “aggregate, disaggregate or otherwise recharacterize” a transaction, per JCT

Impact – In Transactions

- When must IRC Section 7701(o) be considered, i.e., “relevant?”
- IRC Section 7701(o)(5)(C): Determined in same manner as if not enacted
- Under “present law standards,” according to Legislative History

Impact – In Transactions

- When should IRC Section 7701(o) not be considered, i.e., “not relevant?”
- Legislative History:
 - “Consistent with Congressional purpose or plan”
 - Example: Tax credits for investment intended to encourage
 - “Certain basic business transactions” under “longstanding judicial and administrative practice”

Impact – In Transactions

- What is “substantial” non-federal income tax purpose?
 - Exclude related state and local tax effects
 - Exclude financial accounting benefits attributable to tax effects
- How is “profit potential” determined?
 - Present value must be “substantial”
 - Exclude costs
 - Foreign taxes in “appropriate cases”

Impacts - Audit and Litigation Landscape

- By their nature, economic substance controversies typically—
 - are highly fact-intensive;
 - relate to complex structured financial transactions and products;
 - are heavily coordinated within LMSB and Appeals;
 - involve extensive document discovery (IDRs, document requests) and oral discovery (interviews, depositions);
 - involve expert testimony; and
 - turn on the facts, quality of the fact and opinion evidence, and the ultimate fact-finder.

Relevant Common Law Principles

➤ Tax planning is permissible.

- “These cases recognize that there is a material difference between structuring a transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction without a business purpose, in order to create a tax benefit (which is illegitimate). *Coltec*, 454 F.3d at 1357.
- “A taxpayer’s subjective intent to avoid taxes . . . will not by itself determine whether there is a business purpose for the transaction.” *IES*, 253 F.3d at 355.
- “The fact that IES took advantage of duly enacted tax laws in conducting the ADR trades does not convert the transactions into shams for tax purposes.” *Id.* at 356.
- “The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax avoidance motive.” *UPS*, 254 F.3d at 1020.

Relevant Common Law Principles

- The entire transaction is relevant to the economic substance analysis.
 - “[T]he transaction[s] must be viewed as a whole, and each step, from the commencement of negotiations to the to the consummation of the sale, is relevant.” *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945).
 - *Accord IES*, 253 F.3d at 355-56; *ACM*, 157 F.3d at 247; *Salina Partnership LP v. Commissioner*, 80 T.C.M. (CCH) 686, 695 (2000) (declining to break up transaction into constituent parts); *Shell Petroleum, Inc. v. United States*, 102 A.F.T.R.2d 2008-5085 (S.D. Tex. 2008) (declining to “slice and dice”).
 - *But see Coltec*, 454 F.3d at 1356-58.

Relevant Common Law Principles

- A meaningful change in economic position does not necessarily require pre-tax profitability.
 - “[W]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.” *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).
 - “[I]t is also well established that where a transaction objectively affects the taxpayer’s net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.” *ACM*, 157 F.3d at 248 n.31.

Questions?

Biographies

- **Bryon Christensen** is Deputy Tax Legislative Counsel (Legislative Affairs) in the Treasury Department's Office of Tax Policy, where he also has responsibility for tax procedure and administration issues. Before joining the Treasury Department, Mr. Christensen was an associate in the Washington, D.C. office of Skadden, Arps, Slate, Meagher & Flom, where he worked on a variety of tax controversy matters. He is also an adjunct professor at Georgetown University Law Center.

Biographies

- **Jeremiah Coder** is a contributing editor at Tax Analysts and writes regularly for Tax Analysts publications on a wide variety of tax law issues with a particular focus on tax practice and procedure. Before joining Tax Analysts in 2007, he worked at several accounting firms conducting tax research and clerked at the United States Tax Court.

Biographies

- **Phillip Pillar** is a Shareholder in the Philadelphia & Washington Offices of Greenberg Traurig, LLP. Phil's practice concentrates on representing and advising clients in federal, state and international tax issues before tax authorities and courts. Phil is a frequent speaker and commentator on tax topics and is also a former Chair, Administrative Practice Committee of the American Bar Association's Section of Taxation. Prior to joining Greenberg Traurig, Phil was a Director of Tax Controversy and Risk Management Services Practice at Ernst & Young and a senior litigator in the Office of the Chief Counsel, IRS.

Biographies

- **Alex Sadler** is a Partner in the Tax Group of Crowell & Moring LLP in Washington, DC. Specializes in representing corporate taxpayers in tax audits, appeals, and litigation. Formerly a trial attorney in the Civil Trial Section, Northern Region, Tax Division, U.S. Department of Justice, where he received the Attorney General's Distinguished Service Award and Tax Division's Outstanding Attorney Award. Has represented both taxpayers and the Government in high stakes, fact-intensive tax cases in the Tax Court and various refund tribunals. Frequent speaker and author of several articles in CCH's *Journal of Tax Practice and Procedure*.

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