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THE SUBSTANCE OF ECONOMIC SUBSTANCE: WHAT DOES NEW SECTION 7701(O) REALLY DO?

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BIOGRAPHICAL INFORMATION

John R. Hunter, partner with The Blum Firm, P.C. with law offices in Fort Worth and Dallas, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning.

Mr. Hunter, an attorney and certified public accountant, is Board Certified by the Texas Board of Legal Specialization in Tax Law. He received his undergraduate degree in Economics and his Master's Degree in Accounting cum laude from Rice University. Mr. Hunter received his law degree cum laude from The University of Houston Law Center.

Mr. Hunter has practiced in both the private sector and with the government, where he represented the Commissioner of Internal Revenue before the United States Tax Court. He is a frequent speaker on estate planning and tax topics.

Mr. Hunter is consistently included on Texas Monthly magazine's annual list of "Texas Super Lawyers" – a list consisting of only five percent of all attorneys in the state, and Fort Worth, Texas magazine has recognized him as one of Tarrant County's "Top Attorneys" in Tax Law. Mr. Hunter was also honored as Professional of the Year for 2009 by the Community Foundation of North Texas and currently serves as an Officer of the Fort Worth Business and Estate Council.

Mr. Hunter and his wife, Carmen, live in Fort Worth with their three children.

The Economic Substance Doctrine

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Economic Substance Codification

- On March 30, 2010, the Health Care and Education Reconciliation Act of 2010, H.R. 4872 (the “Health Care Reconciliation Act”) was signed by President Obama.
  - Section 1409 of the Health Care Reconciliation Act “codified” the economic substance doctrine (the “ES doctrine”).
  - The statute adds new subsection 7701(o), “Clarification of Economic Substance Doctrine.”
  - The statute provides for a strict liability penalty for transactions that lack ES.
- The statute generally applies to transactions entered into after the date of enactment. See section 1409(e) of the Health Care Reconciliation Act.

Economic Substance Codification

- The Health Care Reconciliation Act does not as a technical matter codify the ES doctrine but rather codifies standards for the ES doctrine, if the doctrine is first determined to be “relevant.” Further, the provision imposes penalties, which is a critical feature of the enactment.
- The codification ultimately results from a combination of influences: (1) it carries a $4.5B revenue estimate (over 10 years) and so was used to help offset the cost of the health care bill, of which it was a part; (2) eliminates differences among courts in applying the ES standard; (3) politically it is viewed as part of a crack down on abusive taxpayers; and (4) it was a political football, first in favor during the last days of the Clinton administration, then out of favor during the Bush administration, then Senator Obama co-sponsored one of the earlier bills in 2007, then it passed during the Obama administration, after having been included in the President’s 2010 Budget proposal.
- The most thorough official review of the ES doctrine and codification proposals is in JCS-3-09 (Sept. 2009) Description of Revenue Provisions in 2010 Budget, Part Two, pp. 34-72 (“JCT 9/09”).
- The JCT explanation was continuously refashioned as various bills were introduced, ultimately resulting in JCX-18-10 (3/21/2010), with the final bill; see also H. Rep. No. 111-443 (3/17/2010) (describing a prior version of the ES provision, and less detailed, but containing a “reasons for change” section).

Economic Substance Codification

The JCT 9/09 Description stated the goals of codification as follows:

- provide partial certainty by resolving the lack of uniformity in different judicial versions of the tests;
- possibly lead to more IRS success in asserting ES doctrine by overruling courts that require taxpayers to satisfy only one “prong” of test;
- increase level of profit and business purpose required relative to some tests stated by courts;
- not change the “existing judicial framework” under which applicability of ES doctrine is determined;
- no intent to modify the application or development of other interpretive rules or prevent the IRS from proceeding on multiple grounds;
- change taxpayers’ cost-benefit analysis and deter some aggressive taxpayer behavior; and
- not displace the common law ES doctrine in cases to which the statute is inapplicable (such as individual non business/investment activities).

Economic Substance Codification

- The statute does not contain certain provisions that were included in prior versions:
  - A statement that other common law doctrines are not affected by codification of the ES doctrine,
  - A grant of general authority to issue regulations to carry out the purposes of the codified ES doctrine,
  - A revision of the penalty rules for certain large and publicly-traded corporations,
  - A prerequisite that a court determine that the ES doctrine is relevant, and
  - A requirement that IRS Chief Counsel assert the strict-liability penalty (which applied to understatements rather than underpayments).

Economic Substance – Section 7701(o)

New Section 7701(o)

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—

(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) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(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 of subparagraphs (A) and (B) of paragraph (1) 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.

(B) TREATMENT OF FEES AND FOREIGN TAXES.— Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

New Section 7701(o)

(3) STATE AND LOCAL TAX BENEFITS.—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) ECONOMIC SUBSTANCE DOCTRINE.— The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—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.

(D) TRANSACTION.—The term ‘transaction’ includes a series of transactions.

When Does the Doctrine Apply -- In General

- A number of considerations must be taken into account in applying the ES doctrine –
  - Whether the ES doctrine is relevant
    - Does the transaction tested satisfy the terms of the Code and Treasury regulations
    - Whether the benefits claimed are consistent with a Congressional purpose or plan
    - What step(s) of the transaction are to be tested
    - Whether any "safe harbors" can be applied
    - Whether the transaction has been respected under longstanding judicial and administrative practice, based on meaningful economic alternatives based on comparative tax advantages
    - Whether the transaction falls under the exception for individual transactions
  - How the IRS will audit transactions and assert the ES doctrine in light of codification
  - Where the burden of proof will fall on the taxpayers and the IRS
  - Whether it is the ES doctrine that may be relevant (as, for example, compared to other judicial doctrines)

- If the ES doctrine is determined to be relevant, then it must be decided whether the transaction satisfies the codified ES statute:
  - The taxpayer's economic position must change in a meaningful way
  - The taxpayer must have a substantial non-tax purpose

<u>When Does the Doctrine Apply -- In General</u>

- <u>Definition of ES doctrine</u>
  - The statute defines the ES doctrine as the “common law doctrine” under which benefits “under subtitle A” are not allowable if the transaction does not have “economic substance <u>or</u> lacks a business purpose.” (emphasis added.) <u>See</u> section 7701(o)(5)(A).
  - What is the purpose of this definition? The statute says that the determination of whether the ES doctrine is relevant shall be made as if the statute was never enacted. <u>See</u> section 7701(o)(5)(C).

When Does the Doctrine Apply – Congressional Plan or Purpose

- The statute does not define when the doctrine will be treated as relevant.
- Statute and JCT report (JCX-18-10) states that "[t]he determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted."
  - The JCT report further confirms that the provision "does not change present law standards in determining when to utilize an economic substance analysis."
- Footnote 344 in the JCT report states that "[i]f the realization of the tax benefits of a transaction <u>is consistent</u> with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed." (emphasis added.)
  - JCT reports for prior versions of ES codification used the term "clearly consistent."
  - In effect, the "safe harbor" defines the ES doctrine as applying to tax benefits that IRS perceives not to be consistent with purposes of the particular Code provision the taxpayer relies on for the tax benefits.

When Does the Doctrine Apply – Congressional Plan or Purpose

- What does being consistent with Congressional purpose or plan mean?
  - Congress may not use language that reflects its intent and purpose.
  - Without an explicit statement by Congress, its intent and purpose may be defined narrowly or broadly.
  - Will the IRS view all benefits that are “unintended” or even “not contemplated” by Congress to be inconsistent with Congressional purpose and intent and subject to the ES doctrine?
  - If a taxpayer satisfies the technical requirements of the Code and regulations, should the ES doctrine apply if no clear statutory purpose or plan is circumvented?
- How does the IRS agent determine the intent or plan?
  - Rev. Proc. 64-22, 1964-1 C.B. 689: “It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is “protecting the revenue.” The revenue is properly protected only when we ascertain and apply the true meaning of the statute.”
  - “The proper method for conveying the positions of the Office and the policies of the Service is through published guidance. In contrast, litigation should be used as an enforcement tool to advance and defend established positions, not as a vehicle for making policy.” I.R.M. 31.1.1.1.3(1).

When Does the Doctrine Apply – Congressional Plan or Purpose

Application of the ES doctrine to landmark cases:

- *Cottage Savings*: Overall transaction of mortgage pool interest swaps had no possible economic profit and no business purpose; motivated entirely by desire for tax benefit of loss recognition, and losses were not booked for accounting purposes. [may be an allowed "longstanding choice" discussed below]
- *Esmark, Inc. v. CIR*, 90 T.C. 171, aff'd, 886 F.2d 1318 (7th Cir. 1989): overall transaction had business purpose and economic effect, but arguably not the steps by which Mobil purchased Esmark stock from public, followed by stock's redemption for stock of Vickers subsidiary of Esmark; not economically different from sale of Vickers by Esmark.
- *Chamberlin v. CIR*, 207 F.2d 462 (6th Cir. 1953): No business purpose to distribute preferred pro rata on common, with plan for preferred to be bought by friendly insurance company. Ruled for taxpayer; congress had to change law (sec. 306).
- *Cumberland Public Service*: Same overall business purpose as in Gregory v. Helvering, but no business purpose for step of distributing assets before their sale, allegedly by shareholders; no economic impact of steps on either corporation or shareholders other than tax reduction.
- *Frank Lyon*: No business purpose for Lyon's seller/lessee (the bank) not to have borrowed the money and built its own building; alleged lease economically similar to that result; no economic savings but tax savings.
- *Gitlitz*: taxpayer allowed to deduct presumably real losses on account of phantom income providing basis; is this protected from ES doctrine simply because taxpayer and S corp. did not engage in any "transaction" that they could control in the year at issue? Should the timing of the discharge of indebtedness of the S corp in that year have been questioned?

When Does the Doctrine Apply - Certain Credits

- The JCT report (JCX-18-10) footnote 344 further provides that "it is not intended" that certain tax credits (*e.g.*, section 42, 45, 45D, 47, and 48 credits) be disallowed in a transaction "pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage."
  - The footnote does not cite, but is similar to Rev. Rul. 79-300 (section 183 not applicable to low income housing partnership even though cannot make any money, but depends on tax benefit of losses).
- Does the structure of the investment or the taxpayer's intent matter if an investment encouraged by Congress is made?
- Does the same standard for credits apply for deductions and other tax benefits?

When Does the Doctrine Apply – "Safe Harbors"

- According to the JCT report: "The provision is not intended to 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. Among these basic transactions are[:]

  (1) the choice between capitalizing a business enterprise with debt or equity;

  (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;

  (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and

  (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied."

- What does the choice between <u>meaningful economic alternatives</u> require?
- Will the IRS expand the list of "safe harbor" transactions?
- Noteworthy that these four "safe harbors" provide taxpayers with the ability to avoid or defer US tax.
- Often, these "safe harbors" may form part of a larger transaction that will (or will not) pass the two prong test in the codified ES statute.

When Does the Doctrine Apply – "Safe Harbors"

1. The choice between capitalizing a business enterprise with debt or equity --
   - The use of debt is the biggest "tax shelter" there is, due to the interest deduction; why is it excluded? What does this say about perceived Congressional view of debt? Will this be useful in future debt/equity disputes? Does it matter that the creditor is related (not according to later "safe harbor")?
   - Note that the "safe harbor" applies to using debt to capitalize an entity rather than the use of debt in transactions that the IRS has viewed as "tax shelters" – e.g., Knetsch; Rice's Toyota; ACM.
   - What is a "business enterprise"? Is the term limited to entities or does it include sole proprietorship -- what if the undertaking being financed is an investment and not a business?
   - Does this "safe harbor" support the disaggregation approach since capitalizing a business enterprise may form part of an integrated transaction that passes the two prong test?
2. A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
   - Once again, this "safe harbor" shows the ES doctrine dodging the 2nd biggest "tax shelter": the ability to defer income offshore.
   - Does this mean that the "reality" of foreign corporations will be unquestioned?
     - JCX-18-10 fn. 347 indicates *Bollinger* agent exception.

When Does the Doctrine Apply – “Safe Harbors”

3. The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;
   - How does this square with IRS position when it cites *Caruth*, 688 F. Supp. 1189, for “business purpose” requirement for sec. 351?
   - How about Mrs. Gregory, cited in footnote 348 in JCX-18-10?
   - JCX-18-10 justifies this “safe harbor” by fact that IRS Chief Counsel will not give comfort rulings on these transactions?
   - Does the “choice” for tax-free treatment include transactions structured to avoid such treatment?

<u>When Does the Doctrine Apply – “Safe Harbors”</u>

4. The choice to “utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied.”
   - Why are not all related party transactions particularly suspect?
     - This “safe harbor” appears inconsistent with *Coltec* analysis.
   - Is a related party partnership safer to use than a related party corporation?
   - Doesn’t section 482 rule for intangibles assume that arm’s length prices cannot be trusted between related parties?
   - Does ES doctrine defer totally to section 482?
   - Who determines whether the arm’s length standard and the applicable concepts are satisfied – the IRS, a court?
   - Footnote 349 in JCX-18-10 cites to *National Carbide* and *Moline Properties* and contrasts *Aiken Industries* (back-to-back loans); section 7701(l) and the conduit regulations; and *Bollinger* (losses imputed to shareholder from nominee corporation).
     - Are these examples of the “other applicable concepts” referred to in the footnote?
     - <u>Note</u> Reg. 1.881-3(a)(4) (being related is primary way to trigger conduit financing regs)
     - How about *Gregory*, *Higgins v. Smith* (sale of loss property to wholly-owned corporation), *McWilliams* (“indirect” sales of loss shares between related parties)?

When Does the Doctrine Apply -- Disaggregation

- The statute defines the “transaction” as including a series of transactions.
- The JCT report supports not only the aggregation of a series of steps but also a disaggregation of multiple steps to an isolated step.
- According to the JCT report: “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.”
  – The statute as enacted does <u>not</u> provide for a disaggregation approach.
  – The JCT report endorses the *Coltec* approach to disaggregating a transaction in contrast to other authorities. <u>Cf</u>. Notice 98-5; <u>but</u> <u>see</u> *Shell Petroleum* 2008-2 USTC ¶50,422 (S.D. Tex. 2008) (refused “slicing and dicing”).
  – Does the JCT report accurately summarize how courts have historically applied the ES doctrine?
    - If not, can the disaggregation approach be squared with the general principle that “present law standards” of applying the ES doctrine not be changed?
    - The IRS will likely assert a narrow definition of the transaction.
    - Will the IRS approach and legislative history lead courts to shift toward a disaggregate approach (<u>i.e.</u>, will a court be more likely to disaggregate post-codification as compared to prior periods)?

If the ES Doctrine is Determined to be Relevant
The Two Prong Test --
The Objective Component

- The transaction must change the taxpayer's economic position in a meaningful way (apart from Federal income tax effects). See section 7701(o)(1)(A).
- The taxpayer can rely on profit potential to satisfy the objective prong 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." See section 7701(o)(2)(A).
  - Satisfaction of the substantial net profit standard in section 7701(o)(2)(A) does not ensure that objective component is met.
  - Note that can rely on profit potential if profit is "reasonably expected" but need to show "actual" economic change to satisfy the objective prong.
  - What else would a taxpayer be required to show? Can a taxpayer satisfy the prong without actual profit?

The Two Prong Test -- The Objective Component

- A taxpayer may rely on measures other than profit potential to establish that the objective prong is satisfied.
  - When would a taxpayer need to rely on an alternative measure to show meaningful change in economic position?
    - Examples given in JCS-3-09, but not in the final JCT explanation: financial transactions and reorganizations may not have quantifiable profit aims.
      - A tax free-reorganization should already fall within the “safe harbor” in the JCT report.
      - What about “financial transactions”? Wouldn’t this normally refer to straddles, hedges, notional principal contracts?
    - Transactions designed to claim tax credits may also present difficulties in proving a pre-tax profit.
      - Like tax-free reorganizations, however, these transactions may have another basis to avoid ES analysis (*i.e.*, consistent with statutory intent and plan).
  - If necessary, how would a taxpayer show a meaningful change in economic position absent profit potential?

The Two Prong Test -- The Objective Component

- Reliance on pre-tax profit
  - How much profit is required?
    - There is no absolute minimum dollar amount of profit required.
    - However, a small amount of profit may not be treated as substantial in relation to the tax benefits claimed.
  - What does “reasonably expected” mean?
    - JCS-3-09, p. 45, indicates intended to be higher standard than “reasonable possibility,” used in Rice’s Toyota;
    - Note: “reasonable possibility” is too high a standard for sec. 183, which requires only “objective to make a profit”
  - How to calculate present value amounts?
    - What is the appropriate discount rate?
    - Can the taxpayer rely on its normal internal method?
  - What does it mean for net profit to be “substantial” relative to net federal tax benefits?
    - Treas. Reg. § 1.170A-9(f) defines substantial as 1:3.
    - Notice 98-5 – 1:12 and ~ 1:8 deemed insubstantial.
    - Old “tax shelter” cases in 1980s – any amount of profit may be sufficient
    - *Con Ed* decided on relatively small profit.

The Two Prong Test -- The Objective Component

- Reliance on pre-tax profit (con't)
  - Fees and transaction expenses must be counted in determining net pre tax profit. See section 7701(o)(2)(B).
    - Consistent with historic approach to ES doctrine.
  - Statute provides that the Secretary "shall" issue regulations to treat foreign taxes same way in "appropriate cases."
    - Treatment of foreign taxes changes repeatedly during days up to codification: "shall be" treated as expenses, to no reference, to "shall" treat in appropriate cases.
    - JCT explanation (JCX-18-10) indicates belief that foreign taxes should be treated as expenses.
      - However, there is no clarity as to what the "appropriate cases" will be. Transactions described in Notice 98-5?
      - The "shall" delegation in the statute should not be treated as self-executing. But see footnote 357 in JCX-18-10.
    - Cf. Notice 98-5: proposed to deny foreign tax credits to transactions that were not entered into for profit and to deduct foreign taxes as an expense in that analysis; withdrawn by Notice 2004-19.
    - Contra Compaq and IES, which applied ES doctrine to pre-foreign tax profits.
      - Theory is that US taxes are not counted, and so neither should foreign taxes that are creditable.

The Two Prong Test -- The Subjective Component

- The taxpayer must have a substantial purpose (apart from Federal income tax effects) for entering into such transaction. See section 7701(o)(1)(B).
  - What was original purpose of this prong in the caselaw? (likely to protect transactions such as incorporation that could not logically be related to profit motive?) Has this purpose been lost?
  - Do courts treat the subjective prong as equal to the objective prong?
  - JCT viewed this as the "dominant issue" and an "absolute requirement." JCT 9/09
- The taxpayer can rely on the substantial net profit standard to satisfy the subjective prong as well as the objective prong. See section 7701(o)(2)(A).
  - Can the two prongs be collapsed into a single prong? See *Coltec Industries Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006); *Consolidated Edison of NY, Inc. v. United States*, 2009-2 USTC ¶50,696 (Ct. Fed. Cl. 2009).
  - Note that, as with the objective prong, the satisfaction of the substantial net profit standard technically does not ensure that the subjective prong is satisfied.
    - Is anything else needed to be shown?
  - If there is no substantial non-tax purpose for the transaction, but the transactions results in a substantial profit, is the subjective prong satisfied?
- Who is the taxpayer tested for subjective intent?
  - For example, a partner in a partnership should be the taxpayer. What if the activities or motive in question relate to the other partner or the partnership?

The Two Prong Test -- The Subjective Component

- What does “substantial” mean?
    - Compare Reg. section 1.701-2(a)(1), the partnership anti-abuse rule, requires a transaction be entered into for a substantial business purpose;
    - Cf. Reg. section 1.355-2(b)(1), which in effect requires a substantial business purpose for a spin-off: a “substantial part” business purpose is thought not to require either a primary or more than 50% purpose; 1/3 purpose seems sufficient.
    - Cf. Reg. section 1.355-2(b)(2), as to non federal tax benefits.
- Financial accounting benefits derived from federal income tax savings and state tax benefits that are related to the federal tax benefits will not be accepted.
    - Accounting benefit concern derived from Enron usage of accounting profits attributable to additions to deferred tax asset account for future expected acquisition of depreciable property, for example.
- Closer to core business the better?
    - Compare Consolidated Edison Co. v. United States, 104 AFTR 2d 2009-XXXX (Fed. Cl. 2009) (LILO case won where property leased was used in same business Con Ed was in); Shell Petroleum, Inc. v. United States, 102 AFTR 2d 2008-5085 (SD Tex 2008) (property sold was business property)
    - But sec. 7701(o) says nothing about usual course of business transactions.
        - Query: does not fact that Congress chose to make the test a profits test, and to allow it to satisfy both prongs indicate that Congress understands all businesses and investors intend to make money any way they can, and so there should be no “regular course of business” test? Cf. sec. 162.

ES Doctrine
Individual Exception

- The statute carves out transactions of individuals unless “entered into in connection with a trade or business or an activity engaged in for the production of income.”
  - As a technical matter, section 7701(o)(5)(B) only excludes “personal transactions” from the two prong test set forth in section 7701(o)(1).
  - Thus, the ES doctrine, as codified, technically can still apply to these transactions. What is the effect?
- The exception presumably would not cover transactions where there is an expectation of gross income (as in sec. 212)
  - Thus, section 212, the section 183 hobby loss rule, and ES doctrine can all apply to activity expected to produce gross income
  - Note that section 183 much easier for taxpayer to prove out of than ES doctrine (need not even have reasonable expectation of profit)
- Does the exception cover transactions designed to reduce taxes?
  - Charitable contribution planning

Economic Substance – Strict Liability Penalty

ES Codification -- Penalties

Section 6662(b)(6) (20% accuracy-related penalty)

Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

Section 6662(i) -- INCREASE IN PENALTY IN CASE OF NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTION

(1) IN GENERAL.—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—For purposes of this subsection, the term 'nondisclosed noneconomic substance transaction' means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) SPECIAL RULE FOR AMENDED RETURNS.—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

ES Codification -- Penalties

Section 6664(c)(2):

Paragraph (1) [reasonable cause exception for underpayments] shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).

Section 6664(d):

(2) EXCEPTION.—Paragraph (1) [reasonable cause exception for reportable transaction understatements] shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6)

Section 6676(c) (erroneous claim for refund penalty):

(c) NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.

Section 6662A(e)(2) (coordination of section 6662A penalty with 40% nondisclosed noneconomic substance transaction penalty)

This section [section 6662A] shall not apply to any portion of an understatement on which a penalty is imposed under section 6662 if the rate of the penalty is determined under subsections (h) or (i) of section 6662.

ES Codification -- Penalties

- The 20% penalty for noneconomic substance transaction applies to any underpayment attributable to the disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or *failing to meet the requirements of any similar rule of law*.
  - What is “any similar rule of law”? Not defined in the statute.
  - *See* JCX-18-10, fn 359: “It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”
    - Prior JCT reports did not contain this clarification.
    - Based on JCT report, a “similar rule of law” must mean the disallowance of tax benefits through application of the ES doctrine but not in name (e.g., where the court referred to the ES doctrine incorrectly (perhaps “sham transaction doctrine” or “business purpose doctrine”).
    - The phrase “similar rule of law” should not mean “sham transaction doctrine” or even lack of “economic substance,” when those terms actually refer to fact finding (for example, the business was not actually operated in the corporation), or if they refer to interpreting a requirement into the statute (“business purpose doctrine”) as in case of Gregory v. Helvering.
    - Beware tendency of IRS to view all fact finding methods (step transaction doctrine, etc.) and interpretive methods as “similar rule of law.”

<u>ES Codification -- Penalties</u>

- <u>Strict Liability Penalty</u>
  - An opinion from an outside tax advisor does not provide protection.
  - How should the circular 230 rules apply to transactions raising issues of ES?
- <u>Calculation of the Penalty</u>
  - The 20% applies to the underpayment attributable to a disallowance of claimed tax benefits by reason of a transaction lacking economic substance.
    - What is the connection between the assessment and disallowance required? "But for" standard?
  - Prior versions of ES contained penalties based on understatement (<u>i.e.</u>, under section 6662A).
    - The section 6662A penalty may apply to a non-ES transaction if it is a listed transaction or reportable transaction with significant purpose of tax avoidance or evasion. <u>See</u> section 6662A(b)(2).
    - The section 6662 penalty normally only applies to the excess of the substantial understatement over the reportable transaction understatement. <u>See</u> section 6662A(e)(1).
    - If the transaction is not disclosed and the 40% penalty applies, then the section 6662A penalty will not apply to that portion of the understatement. <u>See</u> section 6662A(e)(2)(B).

ES Codification -- Penalties

- Coordination with the fraud penalty
  - The strict liability penalty does not replace the fraud penalty (a 75% penalty on the underpayment). See section 6663.
  - The ES penalty will not apply to the extent the fraud penalty applies. See section 6662(b) (flush language)
- Coordination with the gross valuation misstatement penalty
  - Does the section 6662(h) gross valuation misstatement penalty apply in economic substance cases?
- Amended returns
  - Coordination with section 6676
    - The strict liability penalty applies equally if the taxpayer claims benefits on an amended return.
    - Compare treatment of “tax shelters” – reasonable basis to avoid penalty on amended return but MLTN to reduce understatement under section 6662.
  - Cannot disclose a transaction to reduce the strict liability penalty to 20% after first contact.
    - Limitation applies even if examination has not raised the issue of ES.
  - What happens if a taxpayer files an amended return after first contact to claim no tax benefits?

ES Codification -- Penalties

- 40% penalty
  - Requires adequate disclosure on return or in statement attached to return
  - This is same language as used in section 6664(d)(2)(A) with respect to reportable transactions.
    - Under section 6664(d)(2)(A), the relevant facts affecting the tax treatment of the item must be adequately disclosed in accordance with the regulations prescribed under section 6011.
    - The section 6011 regulations provide a form for disclosure of (a) the expected tax treatment and all potential tax benefits, (b) any tax result protection, and (c) describe the transaction in sufficient detail for the IRS to be able to understand the structure and identify the parties.
- IRS assertion of the strict liability penalty
  - Can the IRS assert the ES doctrine and not assert the strict liability penalty?
    - If so, can the IRS then assert the substantial understatement penalty?
  - Can the IRS abate the penalty proportionately to the abatement of the tax? No indication in the bill.
  - What is the last point at which IRS can assert the strict liability penalty? Does it inevitably follow assertion of the ES doctrine and not have to be separately assessed?

Economic Substance – Practice and Procedure

When Does the Doctrine Apply -- Practice and Procedure

- Does the IRS have to assert the doctrine?
  - The statute only states that the ES doctrine will apply when relevant.
  - Can a court apply the ES doctrine if the IRS does not raise the issue?
    - "..if economic substance as such is not explicitly stated as one of the grounds for disallowance of tax benefits, the application of the companion penalty provisions may be in doubt." JCS 9/09 at p. 47.
  - Will a court be likely to independently raise the ES doctrine given the strict liability penalty?
- What is the proper time to raise the doctrine?
  - Can the doctrine be raised for the first time in litigation? In appeals?
  - Is RAR expected to be the proper place for assertion of ES doctrine?
  - What legal consequences hinge on timely assertion?
    - Applicability vel non – will the doctrine apply?
    - The burden of proof shifts to IRS in Tax Court if the doctrine is raised after the petition is filed. See Tax Court Rule 142(a).
    - The ES doctrine or any similar rule of law must be asserted in order to apply the 40% penalty (even though a 20% penalty may be applied for a substantial understatement apart from a non-ES transaction).

When Does the Doctrine Apply -- Practice and Procedure

- How will the IRS administer the ES doctrine
  - What role will LMSB / Chief Counsel have in determinations as to whether tax benefits are (i) consistent with Congressional plan or purpose, (ii) respected under longstanding practice, or (iii) permitted under specified safe-harbors
    - Should IRS exam make these decisions? Must these decisions be confirmed with LMSB / Chief Counsel
    - Will LMSB / Chief Counsel provide guidelines to IRS exam?
  - Will taxpayers be able to obtain advance certainty on transactions
    - There will be a strict liability penalty that cannot be avoided by obtaining opinions from counsel
    - Will the IRS entertain PLRs? Pre-filing agreements? Technical advice?

When Does the Doctrine Apply -- Practice and Procedure

- IRS guidance on ES doctrine
  - Definition of critical terms (e.g., substantial profit, calculation of pre-tax profit, substantial purpose)
  - Clarification of the scope of the ES doctrine –
    - Confirmation that deductions and other benefits treated as credits cited in JCT report
    - Expansion of the four “safe harbors” listed in the JCT report
    - List of general criteria that will not cause the ES doctrine to apply
    - Reliance on anti-abuse rules
      - Should the doctrine be applied when anti-abuse applies and ES doctrine not traditionally at issue?

<u>When Does the Doctrine Apply -- Practice and Procedure</u>

- <u>How will the IRS audit transactions in practice under the ES doctrine?</u>
  - Assert the doctrine any time the two prong test is viewed as failed
  - Assert the doctrine any time it is relevant
- <u>Default Possibility # 1 -- Assert the doctrine any time the two prong test is viewed as failed</u>
  - Example: IRS auditor concludes transaction (a) resulted in favorable tax reporting; (b) did not have business purpose; (c) was not expected to make much money.
    - Isn’t that likely to be the end of the auditor’s analysis?
    - Isn’t the “relevance” issue likely to be skipped or assumed?
    - Once the deficiency is set up, what realistic opportunity will taxpayer have to prove satisfaction of law as written and prove facts as occurred, or to contest ES doctrine relevance short of court?
    - JCS 9/09 and 2007 S. Rep. say flunking 2 prong test not dispositive, but isn’t it likely to work out that way in practice?

When Does the Doctrine Apply -- Practice and Procedure

- Default Possibility # 1 -- Assert the doctrine any time the two prong test is viewed as failed
  - In fact, courts do not necessarily determine that the taxpayer's facts satisfy the law as written before applying the ES doctrine, nor do they spend much time analyzing the relevance of the ES doctrine.
    - Country Pine Finance LLC v. Commissioner, T.C. Memo. 2009-251 (CARDS case; analysis portion of opinion only involved application of ES doctrine, citing Am. Elec. Power)
    - Am. Elec. Power Co. v. United States, 326 F.3d 737, 741 (6th Cir. 2003) (rejected trial court "sham in fact" finding, while applying 6th Cir. version ES doctrine).
    - Two recent BLISS cases analyze and decide only ES doctrine: Palm Canyon, T.C. Memo 2009-228; New Phoenix Sunrise Corp., 132 T.C. No. 9 (2009).
- Default Possibility # 2 -- Assert the doctrine any time it is relevant
  - Assuming the IRS agent will not tend to assert the ES doctrine unless the agent perceives a tax motivated transaction (which is not hard to perceive), is it likely as a practical matter that the dispute may be over once the "relevance" issue is resolved by the agent/LMSB?
  - IRS Chief Counsel cannot advise agent on the factual analysis specifically.
  - Chief Counsel, or LMSB, or agent, or Appeals determination of relevance will be determinative absent litigation?
- Isn't the threshold decision made by the agent to assert the ES doctrine likely to go unchanged absent litigation?

When Does the Doctrine Apply -- Practice and Procedure

- Venue
  - Does the choice of circuit matter?
    - The mechanics of the test have been standardized – e.g., conjunctive test.
    - Will judicial application of the codified statute lead to differences between circuits?
      - Will some courts be more reluctant to apply the doctrine given the strict liability penalties
  - Will taxpayers choose Tax Court to avoid paying heavy penalties first?
    - Note that, if not raising separate grounds to challenge the penalty, prepayment of the penalty may not be required. See *Shore v. United States*, 9 Fed. 3d 1524 (Fed. Cir. 1993).
    - What grounds are there to challenge the penalty?

When Does the Doctrine Apply -- Practice and Procedure

- Burden of Proof
  - As to the “consistent with” purposes of the code, this is a legal issue, not a factual issue.
  - The IRS is asserting a rule contrary to statute and regulations and so should have some sort of burden to justify that.
  - Will *Chevron* deference play a role in the application of the ES doctrine?
  - Even if taxpayer has normal burden of proof as to the two prong test if ES doctrine is asserted, the taxpayer should not be tasked with any burden to counter the IRS’s assertion of the generally applicability of the ES doctrine, but rather the court should carry out its duty to determine the true meaning of the law.

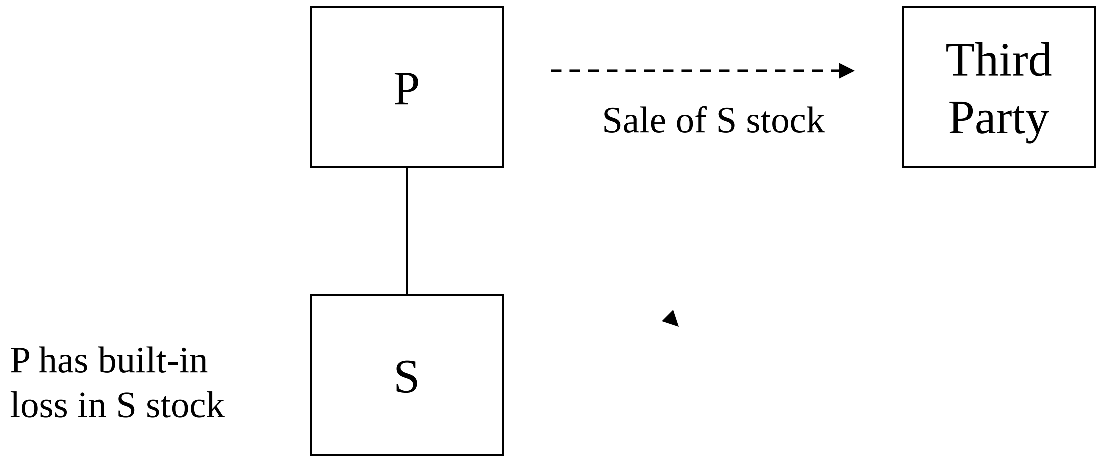
ES Doctrine – Summary

ES Doctrine – Summary

- Historically, courts applied the ES doctrine if a transaction satisfied the literal Code requirements but was inconsistent with the statutory intent or purpose
  - Recently, courts have looked only to application of the factors of the ES test
- The codified ES doctrine requires that the ES doctrine be relevant
- The legislative history identifies two exceptions to the application of the ES doctrine --
  - Whether the benefits claimed are consistent with a Congressional purpose or plan
  - Whether the transaction has been respected under longstanding judicial and administrative practice, based on meaningful economic alternatives based on comparative tax advantages
    - A safe-harbor may be available
- Will the IRS adopt other approaches to determine when the ES doctrine is relevant
  - Adopt a similar approach as under 355(e) regulations – general safe-harbor, specific safe-harbors, factors indicating plan / non-plan
  - What characteristics can be used –
    - Reliance on significantly detailed statute or regulations (e.g., consolidated return regs)
    - Anti-abuse rules that are relevant but satisfied (e.g., Treas. Reg. § 1.701-2; section 269)
    - Involving an area that has been well considered (e.g., election for taxable treatment)
    - Electivity permitted under the law (e.g., a section 332 liquidation, COBE regulations).
- Early guidance from the IRS
  - The IRS must issue early guidance to provide some certainty for taxpayers entering into transactions post-codification – Rev. Rul., Rev. Proc., Announcement
  - The IRS will continue to issue private letter rulings on substantive issues in transactions
    - What level of confidence will these rulings provide for taxpayers on the risk of ES doctrine

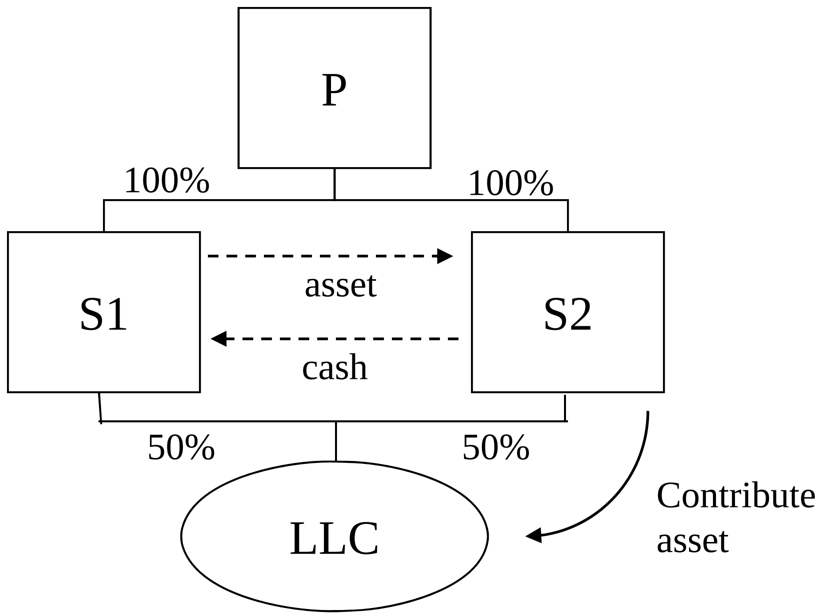
Transaction Planning

Sale to Recognize Loss



- May a taxpayer sell stock solely to recognize a loss under the Federal Circuit's analysis in Coltec? No profit, no business purpose. Presumably non contrary to intent of Congress? How do you know that?
- The Supreme Court in *Cottage Savings* allowed a taxpayer to exchange mortgage securities for other mortgage securities and recognize a loss. The transaction was done solely for tax purposes and was disregarded for regulatory purposes.

Accelerating a Built-In Gain

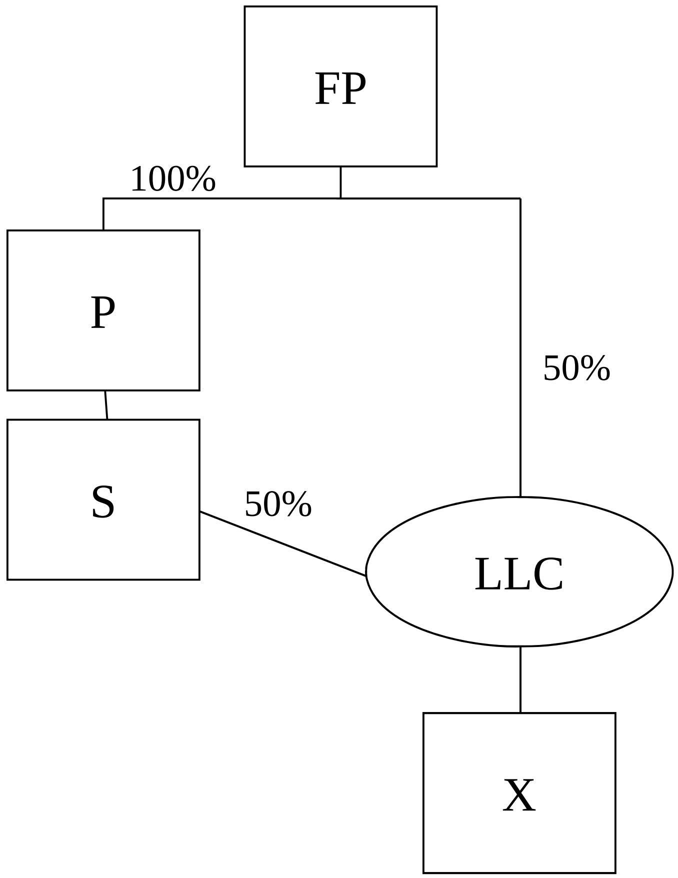


Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2, and they file a consolidated return. In Year 1, S1 sells an asset to S2 for cash, resulting in a deferred intercompany capital gain. In Year 3, the P group has a capital loss that it would like to use, so S2 contributes the asset to a newly formed LLC owned by S1 and S2.

Result: Because the asset is no longer owned by a member of the P consolidated group, the deferred capital gain should be triggered, which P wants in order to utilize other losses.

Analysis: No business purposes, no profit potential from contribution. Contrary to intent of Congress?

Busting Consolidation -- Example 1

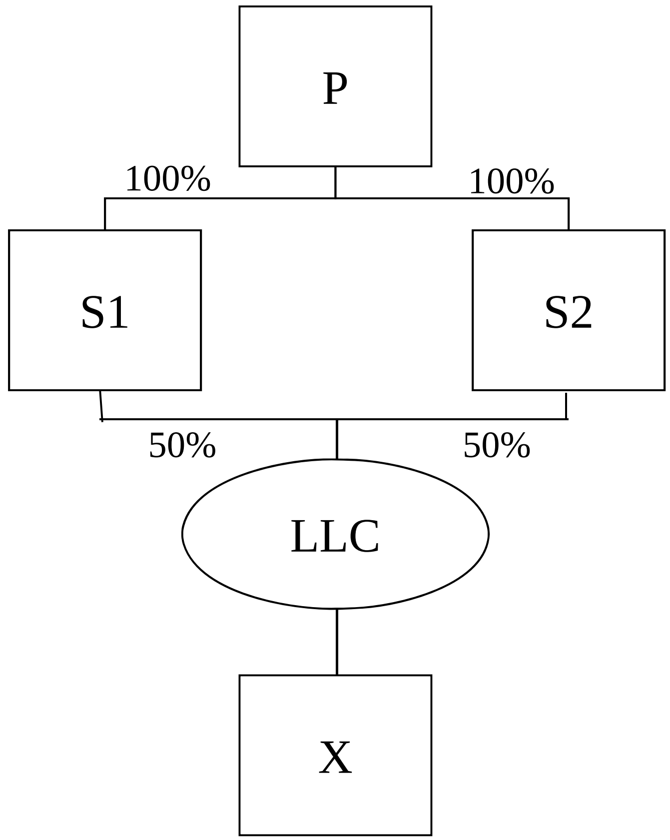


Facts: FP, a foreign corporation, owns 100% of the stock of P, which owns all of the stock of S, which owns all of the stock of X. P, S, and X file a consolidated return. In order to deconsolidate X, S contributes the stock of X to an LLC formed by S and FP.

Result: Because X is no longer an includible corporation, it should not be a member of P's consolidated group.

Analysis: No business purpose and no profit potential.

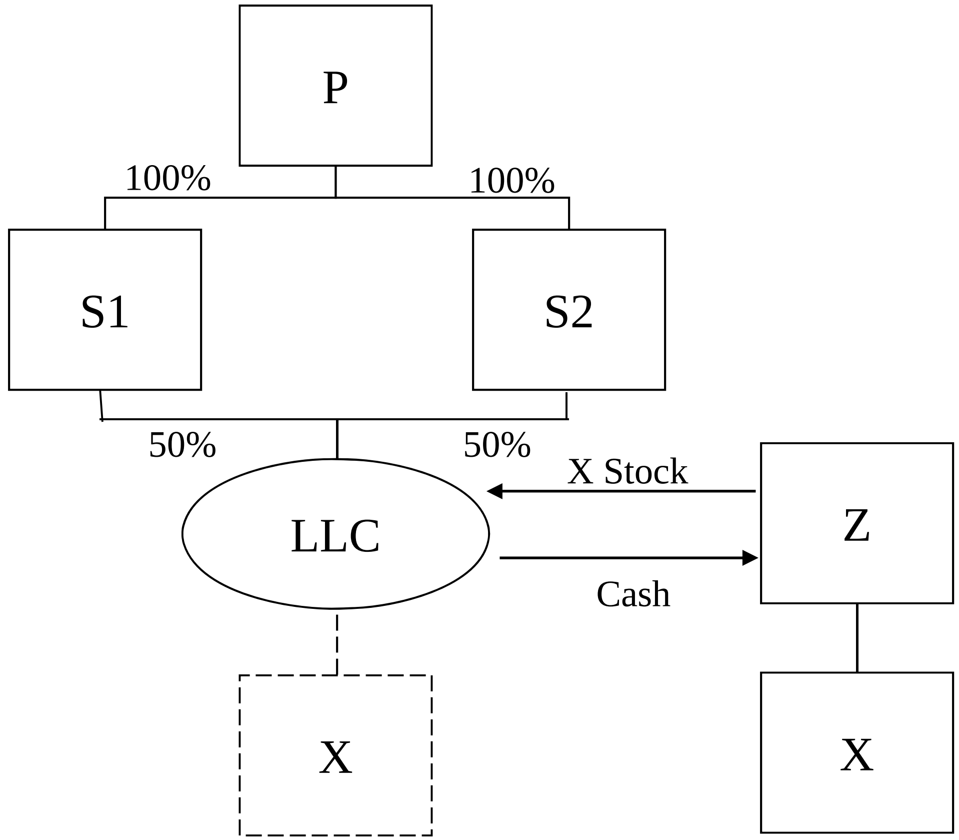
Busting Consolidation -- Example 2



Facts: P, a domestic corporation, owns 100% of the stock of S1, S2, and X, and they file a consolidated return. In order to deconsolidate X, P contributes 50% of the X stock to each of S1 and S2, and S1 and S2 contribute the X stock to a newly formed LLC.

Result: Because X is no longer an includible corporation, it should not be a member of P's consolidated group. No business purpose and no profit potential.

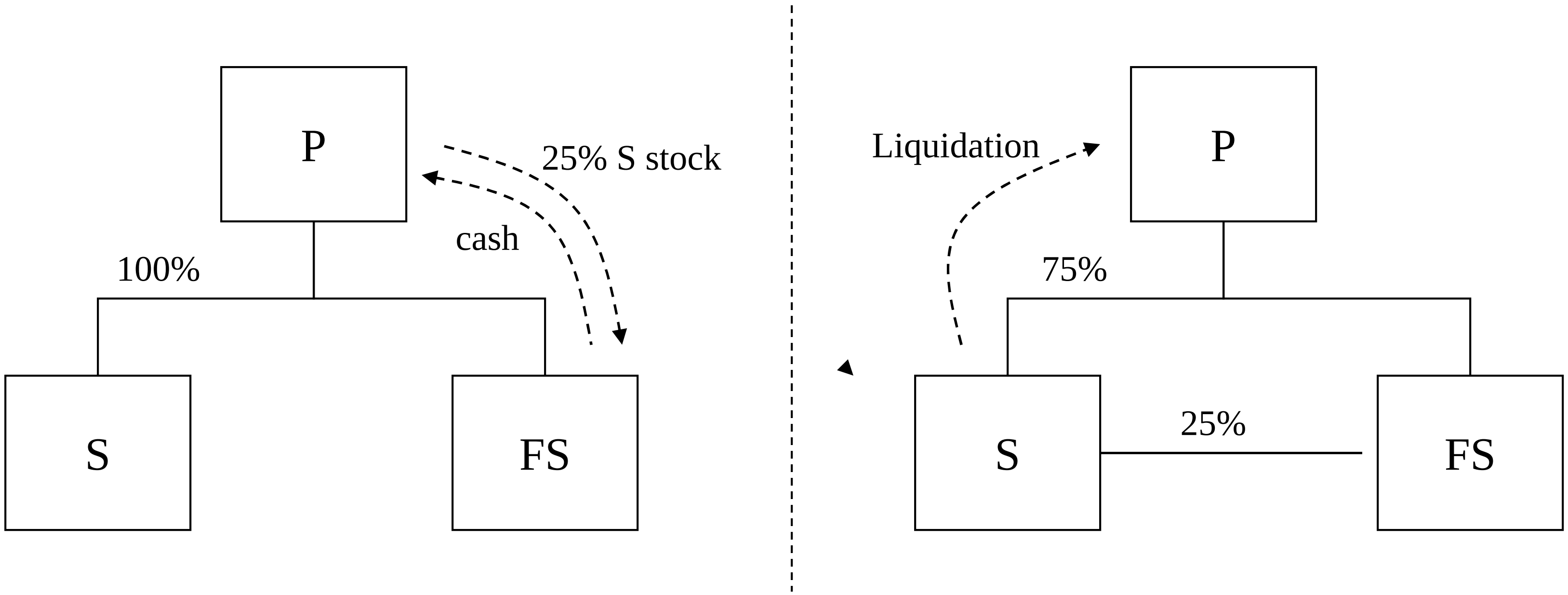
Avoiding Loss Disallowance Rules



Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2. The P group wants to purchase the stock of X from Z, but X has built-in gain assets that could trigger the application of the loss disallowance rules if the P group later disposes of the stock of X. To avoid the potential application of the loss disallowance rules, S1 and S2 form LLC, and LLC acquires the stock of X.

Result: Because X is not an includible corporation, it should not be a member of P's consolidated group. The use of the LLC had no business purpose and no profit potential.

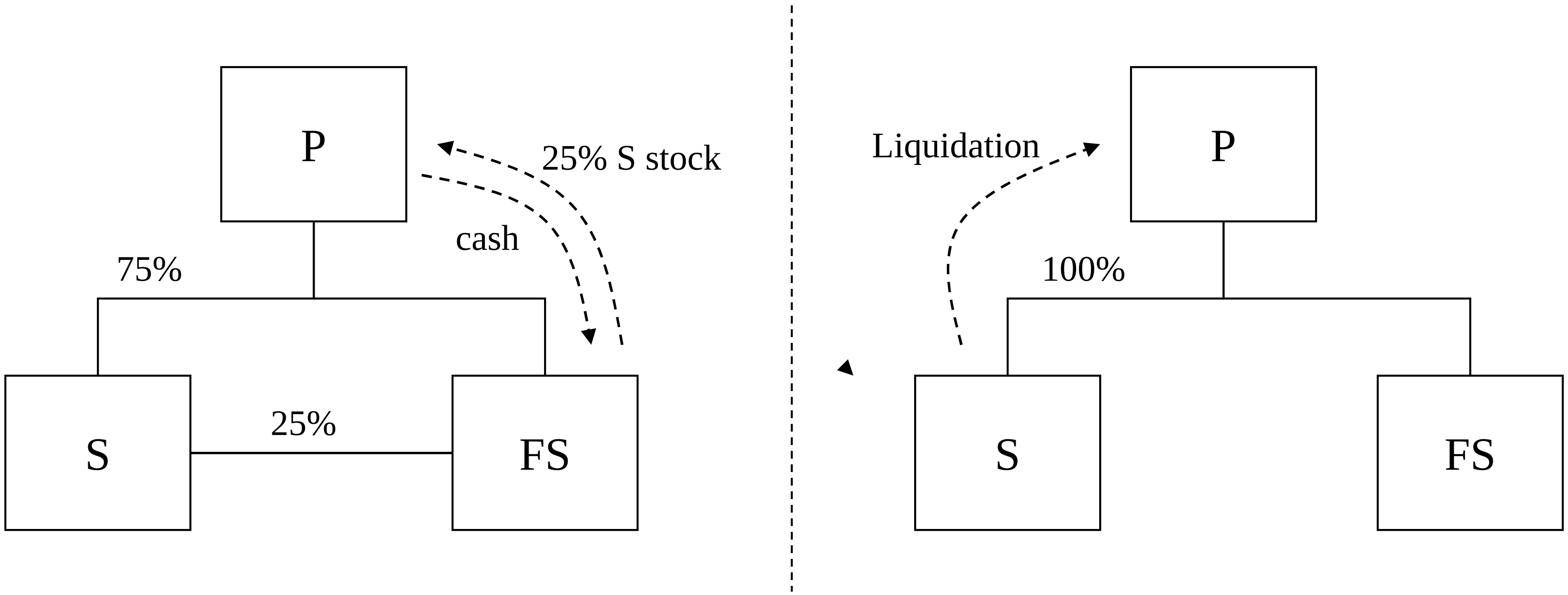
Section 331 Liquidation



Facts: P, a domestic corporation, owns all of the stock of S, which is a domestic subsidiary, and FS, which is a foreign subsidiary. P has a $100 basis in its S stock. The value of its S stock is $10. If P liquidates S, the loss in the S stock will not be realized. P therefore sells 25% of the S stock to FS and, after a period of time, S liquidates into P.

Result: P should recognize the loss on the remaining 75% of stock in S. There was no business purpose or non-tax profit potential for the division of ownership.

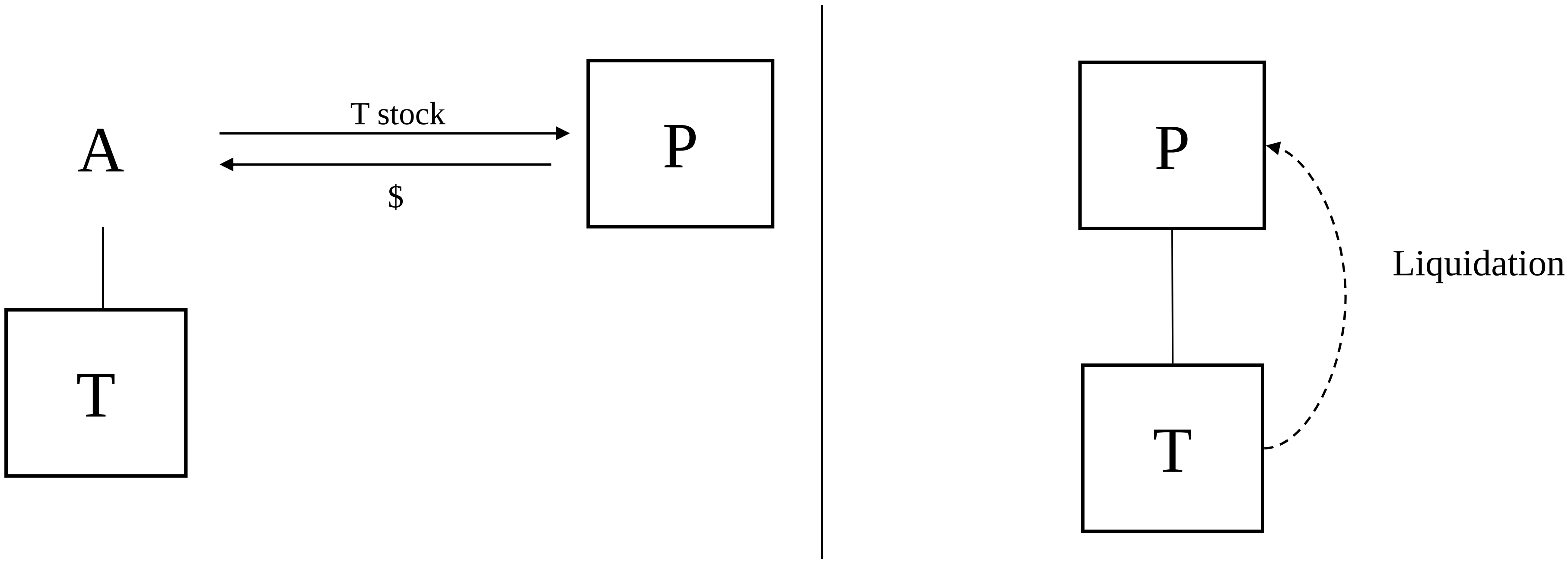
Section 332 Liquidation



Facts: P, a domestic corporation, owns 75% of the stock of S, which is a domestic subsidiary, and 100% of FS, which is a foreign subsidiary. P has a $10 basis in its S stock. The value of its S stock is $100. If P liquidates S, the gain in the S stock will be realized. P therefore purchases 25% of the S stock from FS *before a decision to liquidate is made*, and, after a period of time, S liquidates into P.

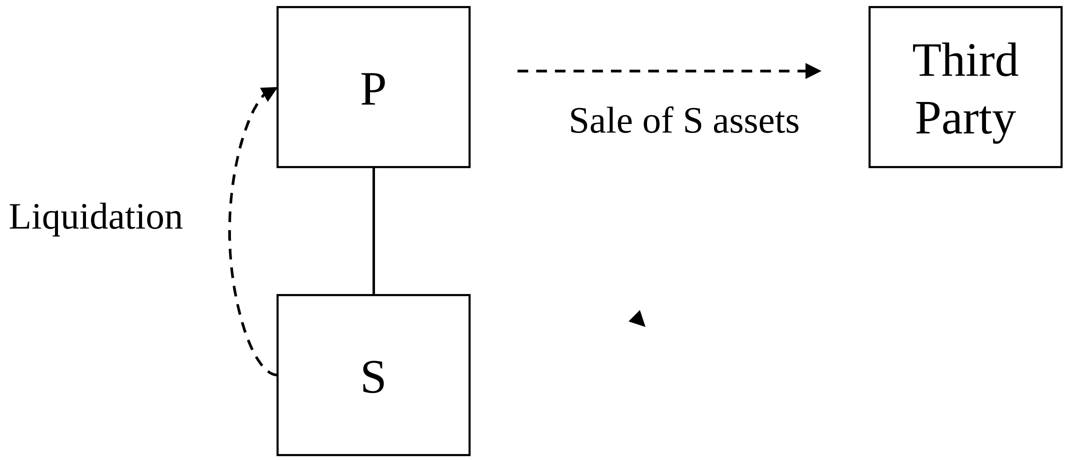
Result: P should not recognize the gain on the liquidation under section 332. Business purpose and non-tax profit potential?

Purchase and Liquidation



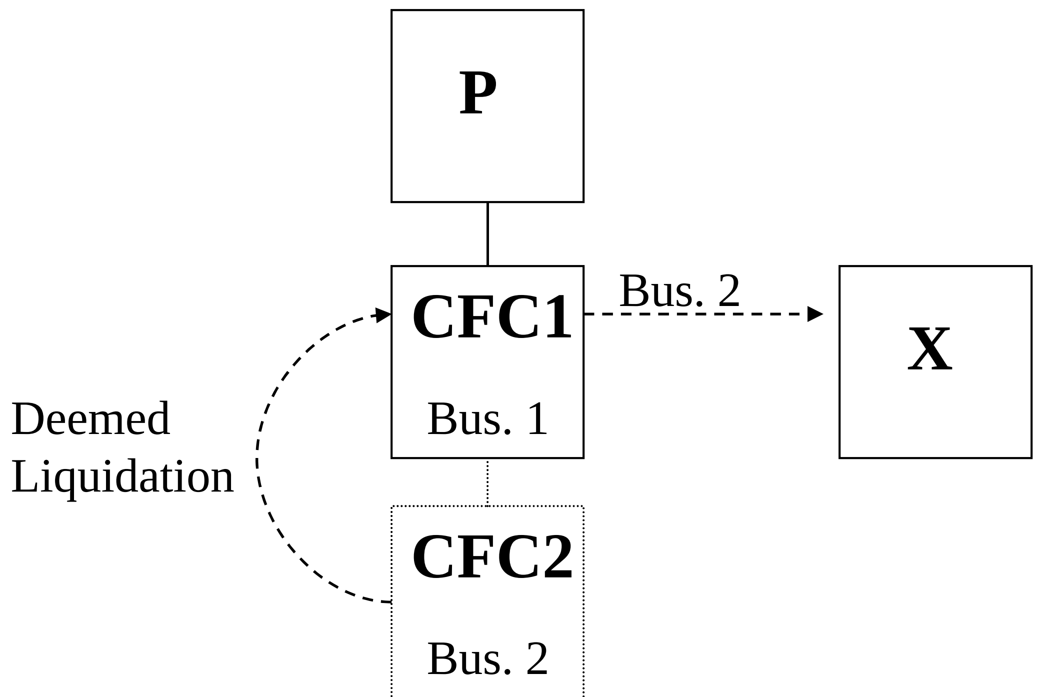
- Section 269(b) states deductions, credits, or other allowances may be disallowed, but only if the liquidation occurs within 2 years after a QSP.
- Does *Coltec* and other recent caselaw replace section 269(b), or mean that a liquidation 2 years and a day after a QSP can result in such a disallowance?

Liquidation and Sale



- In *Commissioner v. Court Holding*, the Supreme Court held that a liquidation of a corporation followed by a sale of the corporation's assets resulted in tax to the corporation because "a sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title." However, five years later, in *U.S. v. Cumberland Public Service Co.*, the Court held that a liquidation followed by a sale did not result in tax to the corporation. The Court stated, "The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."
- In both *Court Holding* and *Cumberland* the sole purpose of the liquidation was to reduce tax; why did Cumberland win? Did the S. Ct. not understand the ES doctrine?

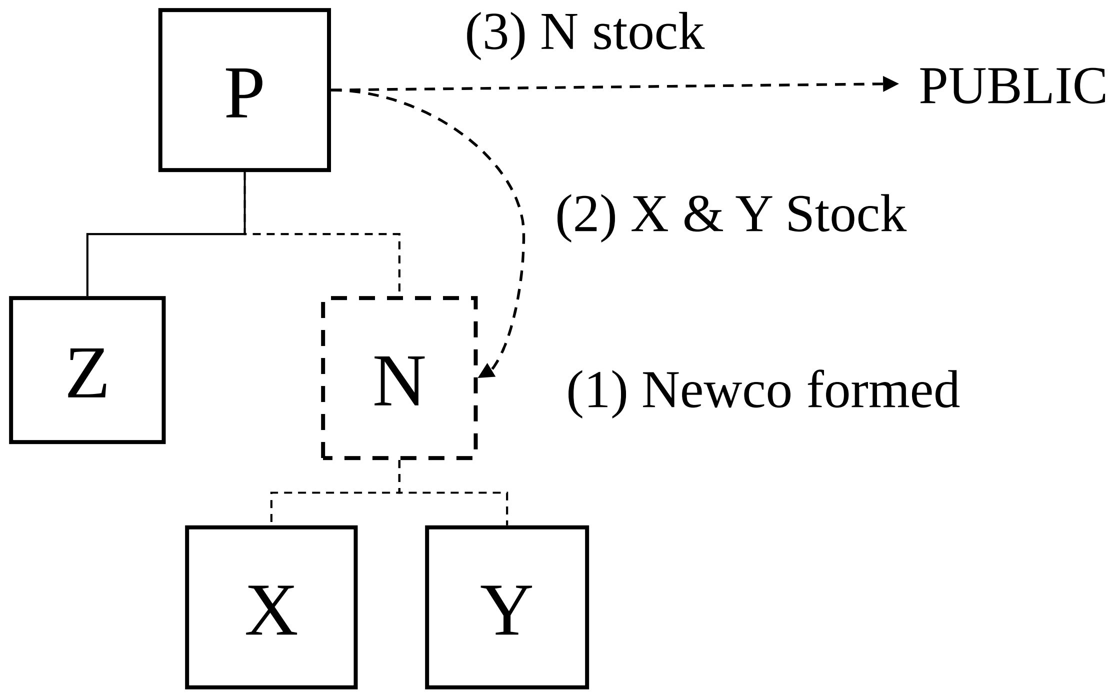
Check-and-Sell Transaction



Facts: P owns 100 percent of CFC1, which engages in business 1. CFC1 owns 100 percent of CFC2, which engages in business 2. CFC1 and CFC2 are controlled foreign corporations incorporated in the United Kingdom. On Date 1, P causes CFC1 to check-the-box for CFC2, which results in a deemed section 332 liquidation of CFC2. Immediately thereafter, P causes CFC1 sells all of the assets of business 2 (i.e., CFC2 assets) to X for cash.

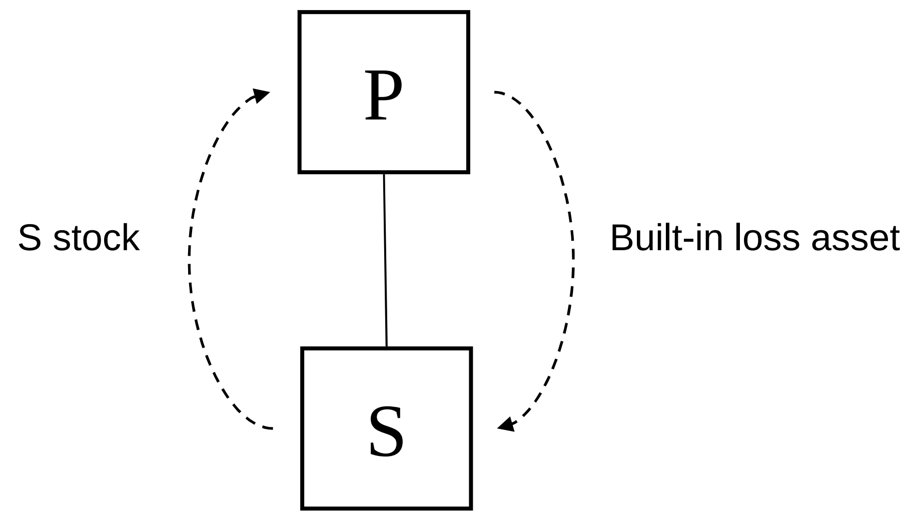
Issue: Under the rationale of *Dover Corp. v. Commissioner*, 122 T.C. 134 (2004), the income generated from the sale does not constitute Subpart F income. Was there a business purpose or profit potential from checking the box?

Busted Section 351 Transaction to Make Section 338(h)(10) Election



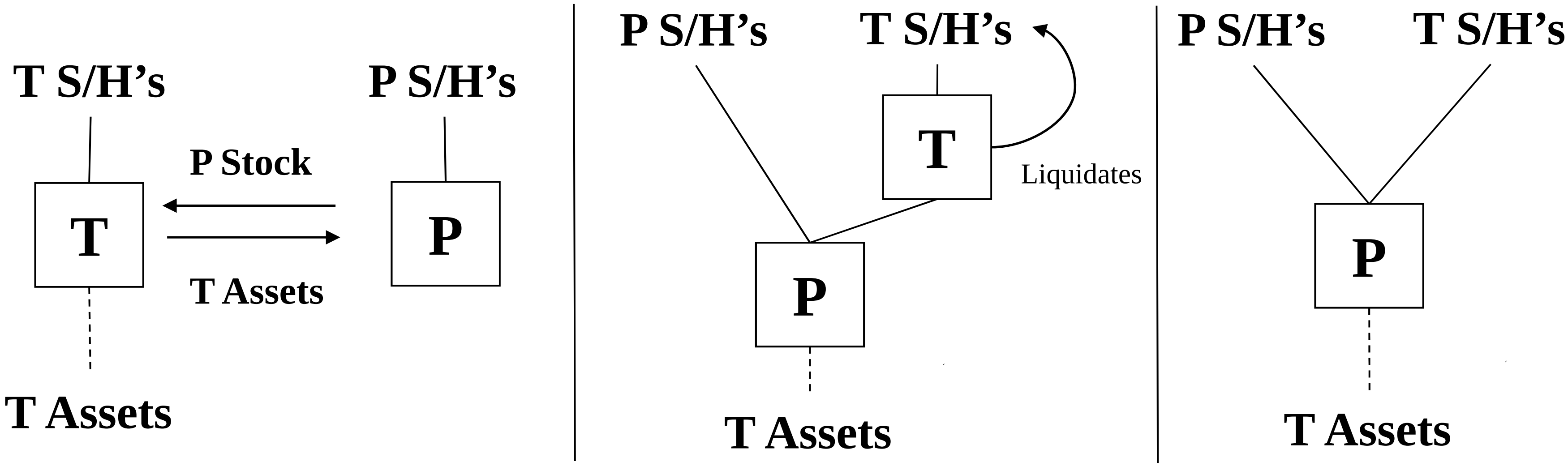
- A corporation transfers stock of a subsidiary to a newly formed subsidiary ("Newco") for its stock and sells that stock to the public to "bust" the section 351 transaction and to be eligible to make the section 338(h)(10) election for Newco.
- Was there a business purpose or profit potential for the step of busting the 351?

Section 351 Transaction with Built-in Loss Asset



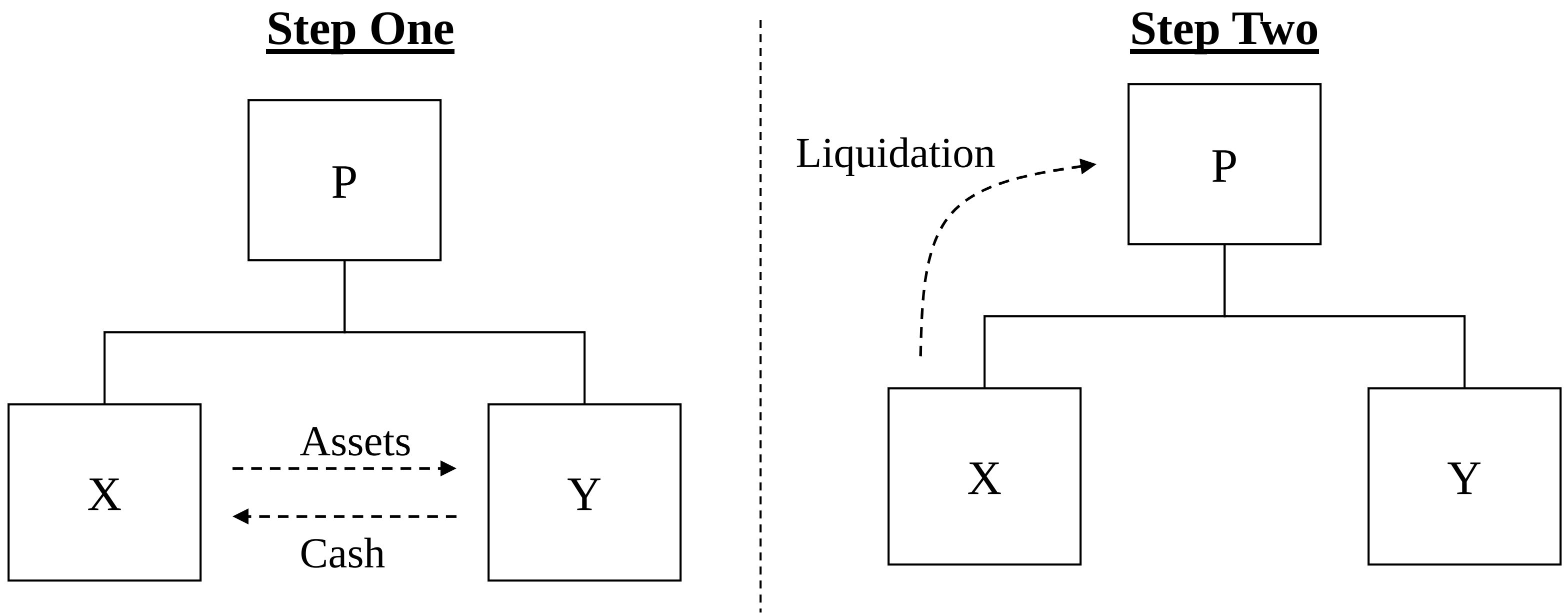
- A corporation transfers an asset with a built-in loss to its subsidiary in exchange for subsidiary stock. Does S hold the transferred asset with a carryover basis and/or does P obtain the S stock with an exchanged basis?
- Is duplicating a loss through a corporation inherently subject to ES doctrine, despite enactment of section 362(e)(2)?
- What if section 362(e)(2) does not apply? See *Shell Petroleum Inc. v. United States*, 2008-2 USTC ¶50,422 (S.D. Tex. 2008); *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009).

“C” Reorganization



- What if, as is likely the case, certain steps are undertaken solely to come within the reorganization provisions in section 368? For example, assume that substantially all of a target corporation’s assets are acquired by another corporation solely in exchange for voting stock. If that corporation liquidates following the asset transaction to come within the terms of a “C” reorganization, is the liquidation step subject to risk because it occurred solely for tax reasons?

‘D’ Reorganizations – Cash – Rev. Rul. 70-240

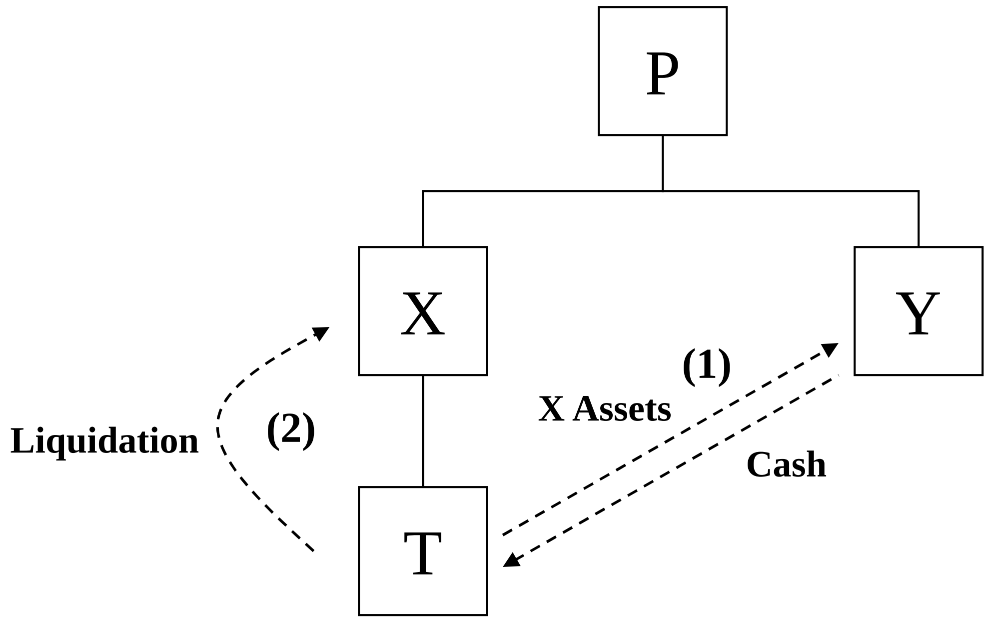


Facts: P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

Result: This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D), according to Rev. Rul. 70-240.

Analysis: Assume the business purpose was to extract cash from Y tax free (under sec. 356, the boot was limited to the gain in the X stock, which here was zero). There was no other business purpose or economic change of ownership.

All-Cash 'D' Reorganizations – Consolidation



Facts: P owns all of the stock of X and Y. X owns the stock of T. P, X, Y, and T are members of a consolidated group. T transfers its assets to Y in exchange for cash and immediately thereafter liquidates into X.

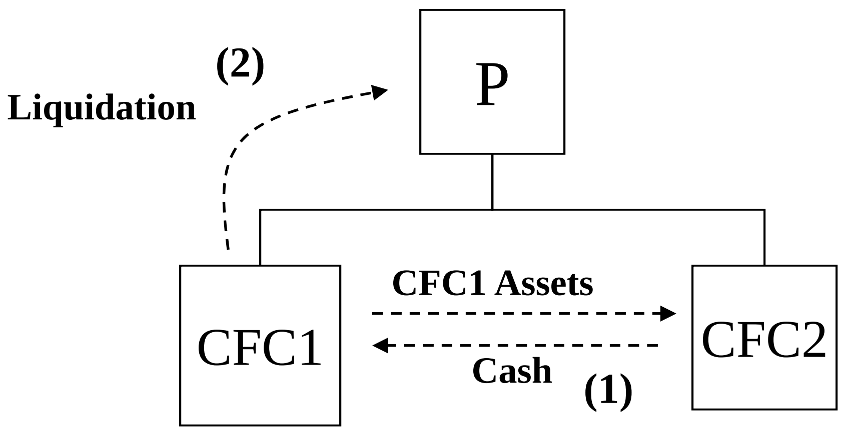
Result: In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to T in exchange for T's assets; (ii) T is treated as distributing the Y stock to X in a liquidation; and (iii) Y is treated as redeeming its stock from X for cash. See Treas. Reg. § 1.1502-13(f) and (f)(7), ex. 3.

The final D regulations confirm that the remaining basis or ELA in the Y stock treated as redeemed will shift to a "nominal share" issued by Y. See Treas. Reg. § 1.368-2(l). An ELA will give rise to a deferred gain when the nominal share is treated as distributed from X to P in order to reflect actual stock ownership.

P may be able to avoid this result by having Y actually issue a single share of stock to T or by contributing a share of Y stock to X.

Question: Does the issuance of the one share have business purpose or economic substance?

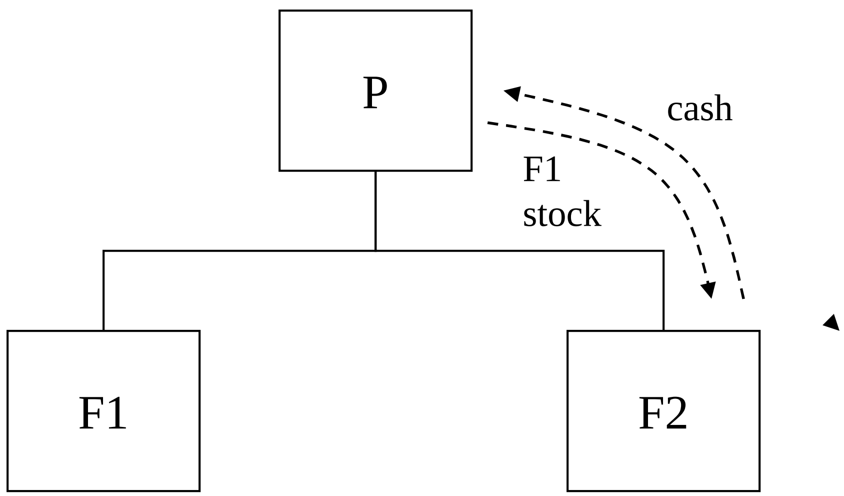
<u>All-Cash 'D' Reorganizations – Foreign-to-Foreign</u>



<u>Facts</u>: P owns all of the stock of CFC1 and CFC 2. CFC 1 and CFC 2 are foreign corporations. CFC 1 transfers its assets to CFC 2 in exchange for cash and immediately thereafter liquidates into P.

<u>Result</u>: This transaction should be treated as a valid "D" reorganization. <u>See</u> Treas. Reg. § 1.368-2(l); <u>but</u> <u>see</u> *Schering-Plough v. Corp. v. United States*, No. 05-2575 (D. N.J. Aug. 28, 2009) (implying that efforts to repatriate foreign income without income inclusion will be rejected under the ES doctrine).

Section 304 Cross-Border Transaction

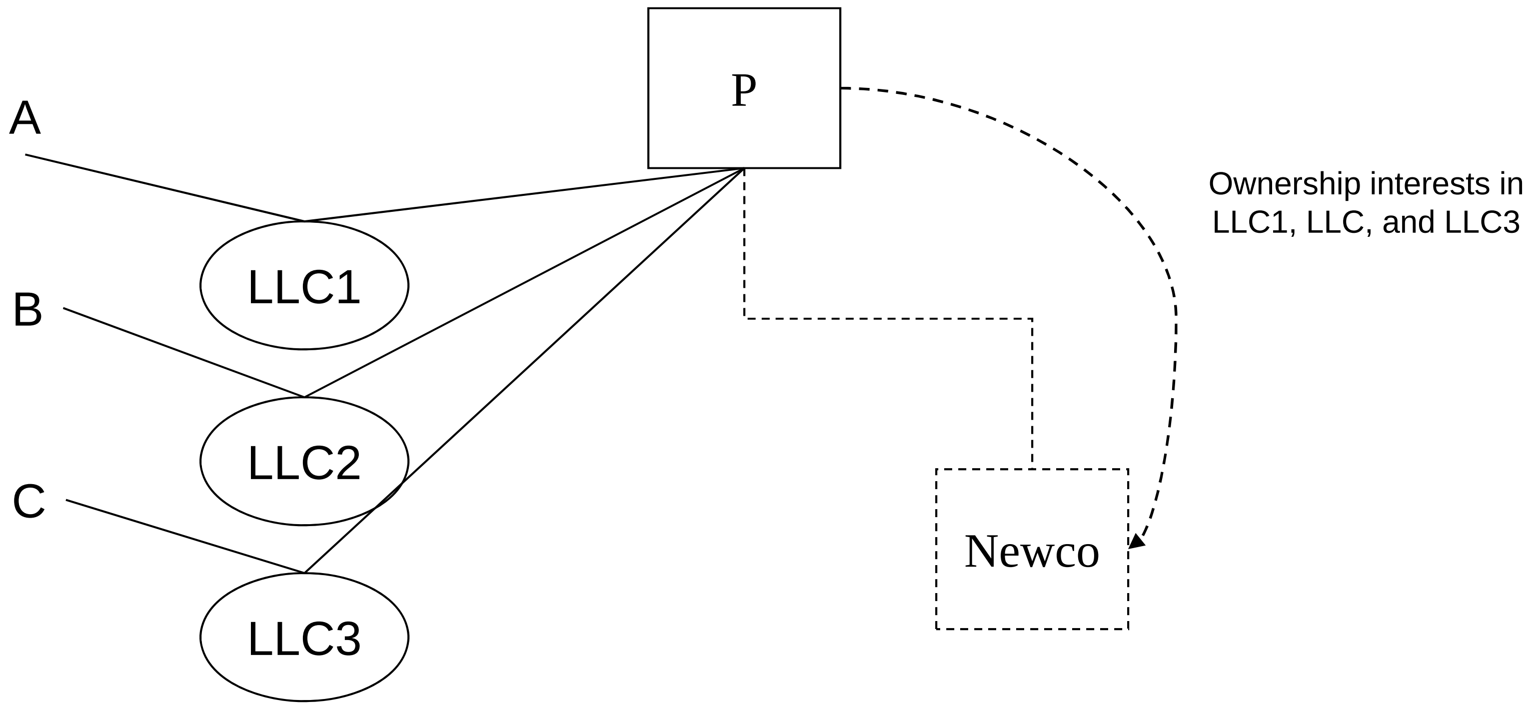


Facts: P, a domestic corporation, owns all of the stock of F1 and F2, both of which are foreign corporations. F2 has excess foreign tax credits. P sells F1 stock to F2 in exchange for cash in a transaction the sole purpose of which is to pull foreign tax credits out of F2.

Result: Section 304 applies to the transaction so that earnings are repatriated and foreign tax credits are pulled out of F2.

Question: Is thus result questionable under the ES doctrine because there was no business purpose or profit potential?

Roll-up Transaction



- Assume that a parent corporation converts several LLCs or partnerships into a corporation in a roll-up transaction. Is this transaction subject to review if the roll-up was done in part to combine income and loss?
- Proposals indicate may be within “safe harbor”?