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BUSINESS TAX COUNSELING & STRUCTURING

ECONOMIC SUBSTANCE DOCTRINE: IRS GUIDANCE IS WELCOME BUT LEAVES UNANSWERED QUESTIONS

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The IRS has finally issued guidance for its examiners on when to use the "economic substance doctrine," designed to penalize transactions that are structured solely for tax purposes. Congress enacted legislation incorporating the doctrine into the federal tax code – and arming it with a stiff, nonwaivable penalty – more than a year ago. The new guidance serves to alleviate many of the worst fears associated with the doctrine. However, considerable uncertainty remains, so taxpayers planning tax-sensitive transactions should remain on guard.

Background

Before its codification in March 2010, the economic substance doctrine had developed as case law over many years. Courts considered and frequently rejected taxpayers' attempts to realize tax benefits through complex transactions, where the elements producing those benefits had no independent economic significance. Rather than clarifying the doctrine, the new statute sharpened its teeth, mandating substantial penalties on taxpayers engaging in transactions deemed improper. Congress estimated that the penalties will generate an extra $4.7 billion of tax revenue over ten years: presumably, a combination of anticipated penalty dollars from those taxpayers unlucky enough to lose their cases and a chilling effect on others.

The Doctrine

In transactions where courts find the economic substance doctrine "relevant," a two-pronged test applies. To pass muster, a transaction must (1) meaningfully change the taxpayer's economic position, *and* (2) have a substantial business purpose. If a transaction does not meet both elements of the test, the taxpayer is subject to a nonwaivable penalty: 40% of any tax underpayment resulting from the transaction (or 20%, if the transaction is adequately disclosed by the taxpayer). Once imposed, there is nothing that a taxpayer can do to appeal or reduce the penalty.

Finally, Some Guidance

Especially in light of the harsh penalty, the economic substance doctrine has remained frustratingly ambiguous. Congress has provided no bright-line rules specifying the types of transactions to which the statute applies, leaving taxpayers and their advisors to scrutinize a long, confusing, and sometimes inconsistent body of case law. Consequently, it came as a great relief when, on July 15, 2011, the IRS issued a directive to its examiners and managers, setting forth a basic framework for applying the doctrine.

Although the guidance does not include an "angel list" of specific transactions to which the doctrine will not apply, it does list four common taxpayer choices that likely should not be subject to the doctrine:

- Whether to capitalize a business with debt or equity;
- Whether to use a U.S. corporation or a foreign corporation in making an offshore investment;
- Transactions constituting a corporate organization or reorganization (presumably including the decision whether to structure a merger as a "forward" transaction in which the acquiring company or its subsidiary survives, or a "reverse" transaction in which the target survives – although the guidance does not so specify);

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- Whether to use a related party entity in a transaction (if the parties apply an arm's length standard and otherwise satisfy applicable tax rules).

The guidance also directs examiners to apply a series of factors indicating whether the doctrine is "appropriate." Those factors include:

- Whether the transaction is promoted, developed, or administered by tax advisors;
- Whether the transaction is "highly structured";
- Whether the transaction contains unnecessary steps;
- Whether the transaction generates tax incentives that (in form and substance) are consistent with Congress' intent;
- Whether the transaction is at arm's length with unrelated third parties;
- Whether the transaction creates a "meaningful economic change" on a pretax, present-value basis (the guidance speaks of both "meaningful" profit potential and "significant" risk of loss);
- Whether the transaction "artificially limits" the taxpayer's potential gain or loss (e.g., through holding of offsetting positions);
- Whether tax items are manipulated (e.g., through loss acceleration, duplicated deduction, generation of a deduction that is not matched by economic expense or loss, artificial basis creation or increase, or separation of income from a related deduction – either between different taxpayers or in different years);
- Whether the transaction involves a tax-indifferent counterparty;
- Whether the transaction has a "credible" nontax business purpose; and
- Whether the transaction is outside the taxpayer's ordinary business operations.

After applying those factors, IRS examiners are directed to consider the applicability of other legal rules. If other statutes, regulations, or judicial doctrines support the transaction, examiners are discouraged from using the economic substance doctrine. Similarly, if other legal principles that do not carry a comparable strict liability penalty are more appropriate for evaluating the transaction than the economic substance doctrine, examiners are instructed to apply those other principles in lieu of the economic substance doctrine. Finally, even if an examiner believes that there is a strong argument for applying the economic substance doctrine, the examiner must seek approval from his or her Director of Field Operations, in consultation with the examiner's regional managers.

Defining the Transaction

The guidance is somewhat less helpful in addressing one of the most challenging questions raised by the economic substance doctrine: how to define the "transaction" to be evaluated. The guidance provides that, in general, transactions involving a series of interconnected steps with a common objective are to be viewed as a unit. On the other hand, the guidance notes that one or more steps may be scrutinized separately – for example, where such steps are tax-motivated and bear "only a minor or incidental relationship" to a common transaction. Examiners are required to consult with their managers and local counsel before disaggregating steps in applying the economic substance doctrine.

Despite these indications, it remains difficult to ascertain whether the IRS (and courts) will evaluate each discrete step of a larger deal as a separate "transaction" or if all those steps will be aggregated into a single "transaction" when assessing whether the doctrine applies. In many economic substance cases, that choice can make the difference between blessing and invalidating a transaction.

Countryside Limited Partnership v. Commissioner, a case decided by the U.S. Tax Court in 2008, illustrates that point. Countryside was a partnership that owned a large parcel of appreciated residential property. While Countryside was actively negotiating the sale of that property (which would have triggered substantial taxable gain to Countryside's partners), Countryside entered into a series of transactions designed to liquidate the interests of two of its partners on a tax-free basis:

- Countryside borrowed cash and used the cash to fund a subsidiary holding company, which in turn funded a lower-tier subsidiary.
- The lower-tier subsidiary purchased privately issued notes bearing a lower interest rate than the interest rate owed by Countryside.
- Countryside then distributed the subsidiary holding company's equity to the two outgoing partners in liquidation of their Countryside interests.
- Four months later, Countryside sold the residential property and repaid its debt.
- The lower-tier subsidiary (owned, indirectly, by the liquidating partners) redeemed the notes at the first opportunity, leaving it with cash.

As structured, the series of steps

technically complied with the requirements for the tax-free liquidation of a partnership interest. However, the IRS sought to disregard the form of the transactions, asserting the economic substance doctrine and pointing out that it made no economic sense to borrow at a higher rate and invest at a lower rate. The Tax Court disagreed, focusing on the redemption of the partners' interests as the relevant "transaction" and noting that there was a real exchange of partnership interests for interests in an entity that owned bona fide, third-party notes.

It is far from clear that *Countryside* would be decided the same way today. Now that the economic substance doctrine has been codified as a two-pronged test, a court might give more weight to the parties' tax savings motivation in structuring the series of transactions. Moreover, a court could easily shift its focus, treating the borrowing and reinvestment rather than the redemption as the relevant transaction. Such uncertainty is particularly troubling given the prospect of the nonwaivable penalty.

Plan Ahead

Since the economic substance doctrine now includes the risk of an automatic and potentially substantial penalty, it is more important than ever to ensure that every step of a larger business plan complies with the economic substance doctrine. Each individual transaction within the overall plan, as well as the entire "transaction," should meaningfully change a taxpayer's economic position and have a substantial business purpose. Even though the guidance makes it inadvisable for tax professionals to "drive the bus" by promoting, developing, or administering transactions, it is clear that the best response is more tax planning of the right kind. If the history of the economic substance doctrine sends any clear message, it's that any business transaction that starts with the question "How can we reduce taxes?" is likely to be challenged. Consequently, business planners should coordinate with tax professionals at the earliest stages of a transaction, when the parties can best establish the priority of nontax purposes, develop a disclosure strategy, and assess the level of risk based on evolving case law. Ideally, the tax-favored aspects of the transaction can be integrated seamlessly into the larger business plan from the outset, rather than grafted on later and thus be more likely to be thrust into the harsh statutory spotlight.

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