

Economic Substance Doctrine: The Curious Case of Codification

By Bruce Givner and Ken Barish

Bruce Givner and Ken Barish examine codification of the economic substance doctrine.

Hidden away in the health care legislation is a little gem, more cubic zirconium than diamond. Codification has long been discussed, often introduced into other bills and widely decried.¹ Now it's here. How the playing field has changed will be the subject of much discourse, and we add our two cents.

Ancient History

Case Law

The common law economic substance doctrine (ESD) is rooted in three Supreme Court cases that have been cited so many times they are like old friends.

- **Gregory v. Helvering.**² A reorganization was “a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.”³
- **K.F. Knetsch.**⁴ “For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly ‘lent’ back was in reality only the rebate of a substantial part of the so-called ‘interest’ payments. There may well be single-premium annuity arrangements with nontax substance which create an ‘indebtedness’ for the purposes of ... Code. But this one is a sham.”⁵
- **Frank Lyon Co.**⁶ There must be 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.”⁷

From these and other cases have sprouted the related common law doctrines that the IRS and courts have applied to disallow tax benefits from allegedly tax motivated transactions:

- Substance over form
- Sham transaction
- Step transaction
- Business purpose⁸

The rationale behind the *Gregory* and *Knetsch* line of cases is that courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose other than tax savings.⁹ The economic substance doctrine is “a composite of the ‘business purpose,’ ‘substance over form,’ and ‘sham transaction’ doctrine.”¹⁰

The various circuit courts have taken three different approaches in determining whether particular transactions come within the ESD. The Joint Committee on Taxation Report to H.R. 4872¹¹ does an excellent job of summarizing the “lack of uniformity regarding the proper application of the economic substance doctrine”:¹²

Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (*i.e.*, the objective component) and business purpose (*i.e.*, the subjective component) in order for the transaction to survive judicial scrutiny. A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction. A third approach regards economic substance and business purpose as “simply more

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precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits.

Prior Failed Legislation

Congress has tried several times in recent years to “codify” or “clarify” the ESD. Some of those attempts include the (1) Jobs and Growth Reconciliation Tax Act of 2003;¹³ (2) proposed Care Act of 2003 (S. 476); (3) American Jobs Creation Act of 2004;¹⁴ (4) proposed Highway Reauthorization and Excise Tax Simplification Act of 2005 (H.R. 3); (5) proposed Tax Shelter and Tax Haven Reform Act of 2005 (S. 1565); (6) proposed Heartland, Habitat, Harvest and Horticulture Act of 2007 (“4H Act”) (S. 2242); and (vii) proposed Tax Reduction and Reform Act of 2007 (“TRRA 2007”) (H.R. 3970).

The revenue estimate for codification of the ESD was \$10 billion over 10 years in the 4H Act. However, three weeks later, in TRRA 2007, it was only \$3.59 billion. What changed? Then IRS Chief Counsel Donald Korb, speaking on October 31, 2007, at the UCLA Tax Controversy Institute, speculated that the dramatic reduction was out of belated recognition of the IRS’s victories using the ESD in the Appeals courts in 2006.¹⁵

New Code Sec. 7701(o)

Codification of the ESD was included as Act Sec. 1409 of both H.R. 3590, Patient Protection and Affordable Care Act of 2010, in Subtitle E “Revenues,” and H.R. 4872, The Health Care & Education Affordability Reconciliation Act of 2010.

H.R. 3590 was signed into law by the President on March 23, 2010. H.R. 4872 was passed by the Senate and the House on March 25, 2010, and was signed into law by the President on March 30, 2010.¹⁶ The date of signing is critical since the effective date for all of the provisions references the “date of the enactment of this Act.”

What the New Law Provides

Act Sec. 1409 is divided into four subsections: subsection (a) adds the new definition in Code Sec. 7701(o); subsection (b) adds new penalty provisions in Code Secs. 6662 and 6662A; and subsections (c) and (d) remove the reasonableness exceptions for transactions that lack economic substance.

The New Definition

Reliance on Case Law

Congress defines the ESD with reference to the case law: “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.”¹⁷

As a wise and noted author wrote a year before the law was enacted:

Taxpayers should be wary of codification of the “economic substance doctrine,” but not for the usual reasons. Its main problem is that it assumes a doctrine exists that the Supreme Court has never mandated, without taking on the heavy lifting of actually stating what the doctrine is.¹⁸

Conjunctive Test

New Code Sec. 7701(o) adopts the conjunctive or “two-prong” test first articulated in *Rice’s Toyota World, Inc.*¹⁹ It provides that a transaction shall be treated as having economic substance only if:

(A) the transaction changes in a meaningful way (apart from Federal income tax effects²⁰) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose²¹ (apart from Federal income tax effects) for entering into such transaction.²² [Emphasis added.]

In other words, “there must be an inquiry regarding the *objective* effects of the transaction on the taxpayer’s economic position and an inquiry regarding the taxpayer’s *subjective* motives for engaging in the transaction.”²³ So there is no longer a question of which court’s test to apply.

Applicability

Consistent with the definition’s deference to the courts, the new statute directs that generally “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.”²⁴ It specifically authorizes the courts to bifurcate a transaction in which independent activities with nontax objectives are combined with an unrelated item having only tax-avoidance objectives to disallow those tax-motivated benefits.²⁵ However, for individuals it “only [applies] to transactions en-

tered into in connection with a trade or business or an activity engaged in for the production of income.”²⁶

Profit Potential

Assume that the taxpayer wishes to use a transaction’s profit potential to satisfy either of the two prongs of the ESD test (that there is a meaningful change in economic position or that there is a non–federal income tax purpose). The taxpayer must establish that the present value of the reasonably expected pre-tax profit is “substantial” in comparison to the present value of the expected net tax benefit, in each case resulting from the transaction (were it to be respected).²⁷ In determining pre-tax profits, fees and other transaction costs will be taken into account as expenses.²⁸

New Penalty Provisions

Strict Liability

Existing Code Sec. 6662 is entitled “Imposition of accuracy-related penalty on underpayments.” Subsection (a) imposes a 20-percent penalty on any portion of an underpayment to which the section applies. Subsection (b) spells out the situations in which the penalty applies which include (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income tax; (3) any substantial valuation misstatement under chapter 1; (4) any substantial overstatement of pension liabilities; (5) any substantial estate or gift tax valuation understatement; and now new paragraph (6):²⁹

[D]isallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of Code Sec. 7701(o)) or failing to meet the requirements of any similar rule of law.³⁰

Failure to Disclose

Existing Code Sec. 6662(h) provides for an “Increase in [the] penalty in [the] case of gross valuation misstatements” from 20 to 40 percent. The HIRE Act adds a new subsection (i), which similarly increases the penalty to 40 percent for a “nondisclosed noneconomic substance transaction.” It defines an “NNEST”³¹ as “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.”³²

The HIRE Act also provides a conforming amendment to the reportable transaction accuracy-related

penalty of Code Sec. 6662A to prevent the application of both that penalty and the new NNEST penalty to the same transaction.³³

Removal of Reasonableness Exceptions

The “reasonableness” of a taxpayer’s action is the basis for avoiding various penalties. The HIRE Act eliminates “reasonableness” as an excuse when a taxpayer engages in a transaction that lacks economic substance.

Code Sec. 6664 is entitled “Definitions and special rules.” However, it is better known for subsection (c), entitled “Reasonable cause exception for underpayments.” That important exception to the application of the accuracy-related penalty of Code Sec. 6662 is available for “any portion of an underpayment if it is shown that there was a reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion.” (Emphasis added.) New Code Sec. 6664(c)(2) make the reasonable cause–good faith exception unavailable for a transaction lacking economic substance.

There is a special reasonable cause–good faith exception to the Code Sec. 6662A accuracy penalty for reportable transactions. It is only available if:

(A) the “relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations”; (B) “there is or was substantial authority;” and (C) “the taxpayer reasonably believed that such treatment was more likely than not” proper.

New Code Sec. 6662(d)(2) makes the special reasonable cause–good faith exception unavailable for a reportable transaction lacking economic substance.

Code Sec. 6676, entitled “Erroneous claim for refund or credit,” provides a 20-percent penalty on the amount of an excessive credit or refund. However, there is an exception if the claim has a “reasonable basis.” New Code Sec. 6676(c) makes the reasonable basis exception unavailable for a transaction lacking economic substance.

Comparison

Are the strict liability penalty provisions so onerous as to create a situation similar to what we face with Code Sec. 6707A “penalty for failure to include reportable transaction information with return”? The penalties of up to \$100,000 for a “natural person”

and \$200,000 in any other case are so harsh that the IRS hesitated to add new “listed” transactions.³⁴ Congress is grappling with making the Code Sec. 6707A penalties more commensurate with the tax benefits derived from the transactions. Will this also be necessary for the ESD penalty provisions? Time will tell on this and the other problems and ambiguities of the ESD codification.

Problems and Thoughts

There are a number of ambiguities in the new ESD Code sections and there is little guidance for practitioners.

When Is ESD to Be Invoked?

New Code Sec. 7701(o)(5)(C) provides that the determination of when the ESD is relevant shall be made as if the new section had not been enacted. The statute, however, gives no guidance as to as to the nature of the “transaction” to which the provision is to apply.

The issue raised is whether more transactions will be viewed through the Code Sec. 7701(o) prism. Due to the harsh penalties, taxpayers and their advisors will now be pressured to consider whether an ordinary commercial or investment transaction might fall within the scope of the ESD as applied by an aggressive IRS agent. Is this a good development for our business environment? As the Tax Executives’ Institute told its members in its March–April 2008 newsletter:

[S]tatutorily “clarifying” the economic substance doctrine would do nothing to curb illegitimate transactions because there are no illegitimate transactions currently beyond the judicial doctrine’s reach. In other words, since the judicial doctrine requires judges to apply their best judgment to the facts and circumstances, there is no need for statutory embellishment.³⁵

The Committee Report provides a nonexclusive list of transactions that would not be impacted by the new law: capitalizing a business with debt or equity, using a domestic or foreign entity to make a foreign investment, using a single or multiple steps in a corporate organization or reorganization, entering into a related-party transaction and leasing. The Committee Report also provides that tax benefits arising from a transaction would be allowed if they are consistent

with the Congressional purpose, e.g., investments generating the Code Sec. 42 low-income housing credit and Code Sec. 48 energy credit.

Undefined Terms

The statute has left to the courts what is meant by “changing in a meaningful way ... the taxpayer’s economic position.” Similarly, the statute does not provide any guidance as to when a transaction has met the threshold of having a “substantial purpose” other than federal income tax effects. The Code’s answer is one of looking at the proportionality of the present value of expected pre-tax profit to the present value of the expected net tax benefit resulting from the transaction. The question remains, nevertheless, what is the minimum return that will be needed to get to a transaction over the ESD hurdle?

The provision is said to raise approximately \$4.5 billion in revenue. The question is whether such a revenue raise is anticipated to be a result of the broadening of the transactions that will be disregarded through use of Code Sec. 7701(o), or whether the strict liability penalties are the basis for this proposed increase in revenue.

State Law

New Code Sec. 7701(o)(3) lumps state and local tax effect in with federal income tax effects. What does that mean and why should it be? Assume that a transaction is structured to avoid reassessment for California property tax purposes, and saves \$100,000 per year in California property taxes. The transaction is, however, exempt from attack, e.g., under the step transaction rule, under California law.³⁶ Does that mean that the IRS will impose a 40-percent penalty on the taxpayer every year (since the taxpayer will clearly fail to disclose the transaction on the taxpayer’s relevant federal tax return)?³⁷

The Transaction

New Code Sec. 7701(o)(5)(D) provides that the term “transaction” includes a series of transaction. This confirms existing law. However, with strict liabilities for penalties on a “portion”³⁸ of a transaction that lacks economic substance, the definition of a transaction becomes very important. In *Coltec* the court wrote:

The government does not dispute that the transfer of management activities may have had economic substance. ... The transfer of management activities, however, is not the transaction at issue. Here

... we 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. That transaction is Garrison's assumption of Garlock's asbestos liabilities in exchange for the \$375 million note. ... It is this exchange that provided Garlock with the high basis in the Garrison stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus.³⁹

Other Similar Rules of Law

In General

Assume that the taxpayer is able to demonstrate (1) the transaction changed the taxpayer's economic position, apart from federal income tax effects, in a meaningful way; and (2) the taxpayer had a substantial purpose (apart from federal income tax effects) for entering into the transaction. Might the IRS still seek to strike the transaction down because it violated that step transaction doctrine? Can the taxpayer have a purpose that is "substantial" enough for under Code Sec. 7701 but not *enough* for purposes of some other common law doctrine? Presumably the answer is no. However, the lack of clarity is unfortunate.

Penalty

Code Sec. 6662(b)(6) applies the 20-percent penalty to:

... any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of Code Sec. 7701(o)) or failing to meet the requirements of any similar rule of law. [Emphasis added.]

This means that the IRS has a new weapon against transactions that fail the step transaction doctrine, or the sham transaction doctrine or the substance-over-form doctrine, without reference to the ESD. Was this intended?

Penalties As Revenue Raisers

The new law's lack of clarity on every detail except penalties cries out for us to analyze the new law using the format of new law as follows: (1) the new law does not change, in a meaningful way (apart from the chance to raise revenue), the IRS's litigation position; and (2) Congress had no substantial purpose (apart from the chance to raise revenue) for adopting the new law.

Closing Thoughts

Codification of ESD will have a significant chilling effect upon tax practitioners who seek to engage in aggressive tax planning. However, less aggressive practitioners are not out of the ESD shark-infested waters due to the Code's ambiguity. It is unclear what, if any, normal commercial or investment transactions with tax benefits will come under ESD scrutiny. The strict liability penalties are further impetus for practitioners considering ordinary course of business transactions to pay special attention to the ESD.

The enactment of an ambiguous statute with severe penalties will, no doubt, lead to more litigation. The IRS's position of when a transaction fails to have economic substance should not change considerably. However, it remains to be seen how the IRS will use its new weapon. The stakes for practitioners and taxpayers have been heightened.

ENDNOTES

¹ When he was the IRS Chief Counsel, Donald Korb criticized codification of the economic substance doctrine on multiple grounds, including that the enactment of excessive penalties may make it difficult for the IRS to assert and sustain them and that substantial IRS and Chief Counsel resources will have to be devoted to analyzing and justifying application of the penalty. See, e.g., *Economic Substance Codification Could Create Tax Shelter Problem*, Korb Warns, BNA DAILY TAX REP., Feb., 15, 2008, at G-8; *Senate Panel's Economic Substance Bid, Unlikely to Raise Revenue*, BNA DAILY TAX REP., Oct. 11, 2007, at G-8; *Korb Criticizes Economic Substance Bill, Says No Decision Yet on 'Textron' Decision*, BNA DAILY TAX REP., Oct. 15, 2007, at G-8; *Korb Notes Declining Revenue Esti-*

mate for Economic Substance Codification, 2007 TNT 212-6 (Nov. 1, 2006).

² *Gregory v. Helvering*, S Ct, 35-1 USTC ¶9043, 293 US 465 (1935), *aff'g*, CA-2, 69 F2d 809 (1934).

³ The Supreme Court did not provide that all transactions described in the Code require a business purpose. See Cummings, *Codifying The Economic Substance Doctrine*, Alston & Bird, LLP FEDERAL TAX ADVISORY, Apr. 1, 2009.

⁴ *K.F. Knetsch*, S Ct, 60-2 USTC ¶9785, 364 US 361 (1960).

⁵ This case "found as a fact that the taxpayer did not owe a debt, in the ... tax-specific concept that indebtedness is not proved by the form of an instrument." See Cummings, *supra* note 3.

⁶ *Frank Lyon Co.*, S Ct, 78-1 USTC ¶9370, 435 US 561.

⁷ This case "found as a fact that a lease was a lease, without stating any 'rule' but identifying a number of factual considerations relevant to the tax-specific concept of property ownership." See Cummings, *supra* note 3.

⁸ See Keinan, 508 T.M., *The Economic Substance Doctrine*, ¶1.A., entitled "Role of Anti-Abuse Doctrines."

⁹ *CM Holdings, Inc.*, CA-3, 2002-2 USTC ¶50,596, 301 F3d 96, 102.

¹⁰ *Coltec Industries, Inc.*, FedCl, 2004-2 USTC ¶50,402, 62 FedCl 716, 752, *vac'd*, CA-FC, 2006-2 USTC ¶50,389, 454 F3d 1340, *cert. denied*, S Ct, 127 S Ct 1261 (2007).

¹¹ *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as*

ENDNOTES

- Amended, in Combination With the "Patient Protection And Affordable Care Act, JCX-18-10 (Mar. 21, 2010).*
- ¹² Internal footnotes omitted.
- ¹³ Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27).
- ¹⁴ American Jobs Creation Act of 2004 (P.L. 108-357).
- ¹⁵ *Dow Chemical Co.*, CA-6, 70-2 USTC ¶9643, 433 F2d 283; *Coltec Industries, Inc.*, *supra* note 10; and *TIFD III-E, Inc.*, CA-2, 2006-2 USTC ¶ 50,442, 459 F3d 220.
- ¹⁶ Patient Protection and Affordable Care Act of 2010 (P.L. 111-148) as amended by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).
- ¹⁷ Code Sec. 7701(o)(5)(A).
- ¹⁸ See Cummings, *supra* note 3.
- ¹⁹ *Rice's Toyota World, Inc.*, 81 TC 184, Dec. 40,410 (1983), *aff'd in part, rev'd in part and rem'd*, CA-4, 85-1 USTC ¶9123, 752 F2d 89.
- ²⁰ "For purposes of ¶(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." New Code Sec. 7701(o)(3).
- ²¹ "For purposes of ¶(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." New Code Sec. 7701(o)(4).
- ²² New Code Sec. 7701(o)(1).
- ²³ The Joint Committee on Taxation Report to H.R. 4872.
- ²⁴ New Code Sec. 7701(o)(5)(C).
- ²⁵ New Code Sec. 7701(o)(5)(D). See, e.g., *Coltec Industries, Inc.*, *supra* note 10.
- ²⁶ New Code Sec. 7701(o)(5)(B).
- ²⁷ New Code Sec. 7701(o)(2)(A).
- ²⁸ "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 Code Sec. 7701(o)(2)(B).
- ²⁹ There is also a new Code Sec. 7701(o)(7): "any undisclosed foreign financial asset understatement," which was added by Act Sec. 512(a)(1) of the 2010 Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147).
- ³⁰ New Code Sec. 7701(o)(6).
- ³¹ This calls to mind the "NEST" penalty under California Revenue & Taxation Code §19974: "(a) If a taxpayer has a noneconomic substance transaction understatement for any taxable year, there shall be added to the tax an amount equal to 40 percent of the amount of that understatement. ... (b) (1) Subdivision (a) shall be applied by substituting "20 percent" for "40 percent" as to the portion of any noneconomic substance transaction understatement as to which the relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return. ... (c)(2) A "noneconomic substance transaction" includes the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance. A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction."
- ³² New Code Sec. 6662(i)(3) provides a "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." [Emphasis added.]
- ³³ New Code Sec. 6662A(e)(2)(B).
- ³⁴ See, for example, Janet Novack, *Hell Froze Over: This Is Not a Mistake: The IRS Says Tax Shelter Penalties Are Too Tough*, FORBES, June 30, 2008, at 42.
- ³⁵ *TEI urges rejection of economic substance provisions in the Senate farm bill*, at www.entrepreneur.com/tradejournals/article/199912425.html.
- ³⁶ February 29, 2008, "To County Assessors: Revenue and Taxation Code §63.1: Parent-Child and Grandparent-Grandchild Exclusion Questions and Answers," Question and Answer 17. "Question: Parents formed a family limited partnership (LP1) to which they transferred real property, maintaining the same percentage of ownership so that such transfer was excluded under Code Sec. 62(a)(2). Subsequently, the parents gave 49 percent of the LP1 ownership interests to their children and grandchildren. Next, the family dissolves LP1 and transfers the real property proportionally to the parents, children, and grandchildren. Then, the parents give a two percent interest in the real property to their children and file for the parent-child exclusion. The parents, children, and grandchildren now want to form a new family limited partnership (LP2) and transfer the real property to LP2. Will these transfers be subject to the step transaction doctrine? Answer: No. The statement of legislative intent, contained in the uncodified note in Chapter 48 of Statutes of 1987 (the legislation which added §63.1 to the Revenue and Taxation Code), allows the parent-child exclusion for certain step transactions involving legal entities. This statement of intent was amended, effective January 1, 2007, to include transfers involving grandchildren."
- ³⁷ See new Code Sec. 6662(i).
- ³⁸ New Code Sec. 6662(i)(2): "the term 'non-disclosed 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."
- ³⁹ *Coltec Industries, Inc.*, *supra* note 10.