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TAX LITIGATION ISSUES

Expert Analysis

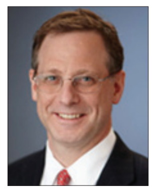
Redefined Role of Profit In Economic Substance Doctrine

Learned Hand famously opined that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[1] There is, however, a line between legitimate tax avoidance and illegal tax evasion and, in drawing that line, the IRS has long challenged attempts by taxpayers to reduce their tax liability by executing transactions that lack economic substance. Under the economic substance doctrine, courts preclude taxpayers from claiming benefits arising from certain transactions that satisfy the technical requirements of the Internal Revenue Code, but create consequences that are contrary to the purpose of the tax laws.[2]

The breadth and flexibility of this doctrine is demonstrated by the wide range of contexts in which the government has used it to nullify benefits claimed by a taxpayer, including schemes to avoid the tax consequences of winning the lottery, sale-leaseback transactions meant to shift energy tax credits from one taxpayer to another, and deductions arising from interest incurred on loans used to finance employee life insurance policies owned by corporations. The doctrine has also been used to support tax shelter prosecutions involving the country's most prominent accounting firms.[3]

A transaction's potential profitability is critical to the application of the economic substance doctrine, and many courts have held that transactions lack economic substance only if they carry no reasonable possibility of generating a profit. A recent decision by the U.S. Court of Appeals for the Ninth Circuit, however, suggests that courts are changing the way they view potential profitability in applying the economic substance doctrine. Thus, it may no longer be sufficient that a transaction has the potential to generate a profit. Rather, courts are beginning to focus on the proportionality between a transaction's potential profitability and its tax benefits. This approach, which leads to greater skepticism of transactions where the tax benefits are orders of magnitude greater than the expected profits, may result in the rejection of transactions that would previously pass muster.

By **Jeremy H. Temkin**



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Potential Profitability

The economic substance doctrine looks behind the form of a transaction to determine whether it is connected to economic realities beyond the creation of tax benefits, and if no underlying economic reality exists, a court will not permit the taxpayer to claim benefits from the transaction. Courts have broken down this substance over form analysis into two components: an objective analysis and a subjective analysis. The objective analysis considers whether a transaction has economic benefits to the taxpayer other than the creation of a tax loss, while the subjective analysis considers whether the taxpayer had some non-tax business purpose for entering into the transaction.[4]

Historically, circuit courts have disagreed about whether a transaction must satisfy both the objective and the subjective prongs of the economic substance doctrine to enable the taxpayer to take advantage of the tax benefits created through a transaction, or whether satisfying either test is sufficient by itself. In 2010, however, Congress codified the doctrine, providing that a transaction must pass both the objective and subjective analysis.[5]

In defining the objective prong of the economic substance doctrine, courts have used the concept of potential profitability with most circuits stating that a transaction satisfies the objective prong if a reasonable possibility of profit exists.[6] In fact, the U.S. Court of Appeals for the Second Circuit has approved jury instructions stating that, in order to prove that a transaction lacks economic substance, the government must prove that it had no reasonable possibility of generating a profit.[7] Courts have analyzed potential profitability by considering both a transaction's expected rate of return as well as the percentage chance that a transaction will yield any profit, which often requires the presentation of expert testimony analyzing the transaction at issue.

Although potential profitability features more prominently in the objective analysis, it is also relevant to the subjective analysis. Many courts have concluded that if a transaction is motivated by potential profit, it has been entered into with an appropriate business purpose and therefore satisfies the subjective test. If, however, it appears that a transaction has been entered into with an indifference to its ability to generate profits, courts have found a proper business purpose lacking.[8]

A recent decision suggests that courts are changing the way they view potential profitability in applying the economic substance doctrine.

A Changed Focus

Analyzing potential profitability as a sine qua non of economic substance has been criticized. In an influential article, one leading practitioner argued that even profitable transactions could lack economic substance, and that the relationship between profitability and economic substance was at best a correlation.[9] This practitioner explained that "where a tax-motivated transaction takes the form of an investment, the taxpayer can always contribute enough net equity to assure that there will be significant net profit (even after taking transaction costs into account)," and that courts should therefore be skeptical where insubstantial economic transactions generate significant tax benefits but yield rates of return less than interest-bearing bank accounts.

Consistent with this criticism, circuit courts hearing appeals from the U.S. Tax Court have begun abandoning their focus on potential profit alone, and instead have compared potential profits to tax benefits, a trend exemplified by the Ninth Circuit's recent decision in *Reddam v. CIR*.[10] In *Reddam*, the taxpayer John Paul Reddam participated in KPMG's Offshore Portfolio Investment Strategy (OPIS) to mitigate the tax consequences of his sale of a multimillion-dollar business. Through the OPIS program, KPMG used a complex series of transactions with Deutsche Bank and a Cayman Islands investment vehicle to create a $50 million tax loss. The IRS disallowed the deduction, and the Tax Court affirmed, reasoning that the OPIS transaction lacked economic substance and could therefore be disregarded for tax purposes.

On appeal, Reddam emphasized the potential profitability of his OPIS transaction, presenting expert testimony that the transaction would be profitable roughly 25 percent of the time, and would yield a 50-100 percent return in a three-month period roughly 5 percent of the time. These potential profits, according to Reddam, showed that the transaction had actual economic consequences, and should not be disregarded under the economic substance doctrine.

The Ninth Circuit rejected Reddam's arguments, and in doing so, explicitly abandoned the notion that potential profitability necessarily gives a transaction economic substance. Instead, the Ninth Circuit held that small potential profits cannot give a transaction economic substance when the profits are "dwarfed" by the tax loss generated. The court then compared the "small percentage chance" that the OPIS transaction would produce a significant profit to the $42 million tax loss it was guaranteed to generate, and concluded that in light of this disparity, the possible profits generated by the OPIS transaction did not give it economic substance. Thus, the Ninth Circuit replaced an analysis that focuses on the existence of profit potential with an analysis that compares the magnitude of the possible profits to the magnitude of tax losses generated.[11]

Significantly, the Ninth Circuit's decision in *Reddam* parallels a provision in the codification of the economic substance doctrine, which provides that a transaction's potential profitability can only be considered 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."[12] The government relied on this provision in *Reddam*, urging the Ninth Circuit to apply this proportionality principle even though it conceded that the statute was inapplicable to the OPIS transaction, which took place before the statute's effective date. Although the Ninth Circuit did not cite the codification in its opinion, the clear parallels between its holding and the statutory rule suggest that *Reddam* provides a glimpse of how courts will apply the new statute.

Consequences

In light of *Reddam*, practitioners defending transactions in the face of arguments that they lacked economic substance need to anticipate that courts will no longer be persuaded solely by evidence that a transaction did result, or could have resulted, in a possible profit. *Reddam* suggests two strategies for mitigating this risk.

First, rather than focusing narrowly on profits, practitioners should analyze the totality of the circumstances to explain all of the potential non-tax benefits a transaction carried. The Ninth Circuit in *Reddam* declined "to apply a one-size-fits-all test," and explained that it analyzed potential profits and tax benefits as "part of a pragmatic total inquiry" focused on the overall reasonableness of the transaction.[13] Applying this broad approach, the Ninth Circuit in *Reddam* found that the disparity between the potential profits and tax benefits suggested a lack of economic substance because the OPIS transaction was an unreasonable investment despite its potential to produce some profit. Where a tax-advantaged investment is being scrutinized for economic substance, practitioners need to be able to articulate the non-tax benefits a reasonable investor would hope to achieve through the transaction under scrutiny as opposed to simply depositing her money in the bank.[14]

The Ninth Circuit in 'Reddam' replaced an analysis that focuses on the existence of profit potential with an analysis that compares the magnitude of the possible profits to the magnitude of tax losses generated.

Second, in *Reddam*, the court relied heavily on its observation that regardless of how Reddam's investment performed, it was guaranteed to create a tax loss of $42 million, and appeared baffled as to how this tax consequence could be reasonable in light of the expected profits and amounts invested. Thus, practitioners should be prepared to explain why the tax consequences of a transaction make sense in light of the purpose of the tax laws.[15] After all, the fundamental policy underlying the economic substance doctrine is that taxpayers should not be able to abuse formalities to claim benefits that are contrary to the spirit of the tax code.

Finally, it should be noted that the proportionality rule applied in *Reddam* will likely be inapplicable in criminal tax evasion cases, where the government must prove that the taxpayer violated a known legal duty.[16] Courts have recognized that a defendant cannot possess the requisite intent to violate vague or highly debatable laws, and at present, it is unclear when a disparity between potential profits and tax benefits will cause a transaction to be disregarded under the economic substance doctrine.[17] Therefore, if a defendant can show a reasonable chance to profit from a transaction challenged under the economic substance doctrine, the government should not be able to rely on a disparity between potential profits and tax benefits to establish that the defendant participated in the challenged transaction with criminal intent.

Conclusion

The role of profitability in the economic substance doctrine will continue to evolve, particularly when courts begin applying the codified version of the doctrine. It remains to be seen what significance courts will attach to potential profitability where, unlike *Reddam*, a transaction yields tax benefits well in excess of profits but there are strong arguments justifying the transaction nonetheless. Thus, a taxpayer could be more successful in defending his tax benefits if, for example, a transaction high in tax benefits but low in profit were a hedge against another investment, or if it transferred tax benefits from some taxpayers to others.[18] Given the expansive range of contexts in which the doctrine can be applied, practitioners need to be mindful of the need to develop the factual record supporting their clients' claim that, notwithstanding substantial tax benefits, challenged transactions did, in fact, have economic substance.

1. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d. Cir. 1934).
2. *Horn v. C.I.R.*, 968 F.2d 1229, 1236 (D.C. Cir. 1992).
3. *Goldstein v. C.I.R.*, 364 F.2d 734 (2d. Cir. 1966) (lottery winnings); *Sacks v. C.I.R.*, 69 F.3d 982, 987 (9th Cir. 1995) (energy tax credit shifting); *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006) (corporate-owned life insurance); *United States v. Daugerdas*, 867 F.Supp.2d 445 (S.D.N.Y. 2012) (tax shelter).
4. *Sacks*, 69 F.3d at 987-88.
5. 26 U.S.C. §7701(o); see also Jeremy H. Temkin, "Greater Clarity for the Economic Substance Doctrine," NYLJ (July 8, 2010).
6. *United States v. Coplan*, 703 F.3d 46, 90 n.40, 92 (2d. Cir. 2012); *In re CM Holdings*, 301 F.3d 96, 103 (3d. Cir. 2002); *Rice's Toyota World v. Comm'r*, 752 F.2d 89 (4th Cir. 1985); *Southgate Master Fund, LLC ex rel. Montgomery Capital Advisors, LLC v. United States*, 659 F.3d 466, 482 n.49 (5th Cir. 2011); *Smith v. C.I.R.*, 937 F.2d 1089, 1098-99 (6th Cir. 1991); *IES Indus. v. United States*, 253 F.3d 350, 354 (8th Cir. 2001); *Bohrer v. C.I.R.*, 945 F.2d 344, 348 (10th Cir. 1991); *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1376-77 (Fed. Cir. 2010).
7. *Coplan*, 703 F.3d at 90 n.40, 92.
8. *Dow Chem. Co.*, 435 F.3d at 599; *Sala v. United States*, 613 F.3d 1249, 1253 (10th Cir. 2010).
9. David P. Hariton, "Sorting Out the Tangle of Economic Substance," 52 Tax Law. 235 (1999) (hereafter "Hariton").
10. *Reddam v. C.I.R.*, 755 F.3d 1051 (9th Cir. 2014). The Eighth and Tenth circuits have applied a similar proportionality analysis. See *Sala*, 613 F.3d at 1254; *WFC Holdings Corp. v. U.S.*, 728 F.3d 736, 746 (8th Cir. 2013).
11. *Reddam*, 755 F.3d at 1061-62.
12. 26 U.S.C. §7701(o)(2)(A).
13. *Reddam*, 755 F.3d at 1060-61.
14. Hariton at 249.
15. Hariton at 270.
16. *Cheek v. United States*, 498 U.S. 192, 200 (1991).
17. See, e.g., *United States v. Pirro*, 212 F.3d 86, 91 (2d. Cir. 2000).
18. See *Sacks*, 69 F.3d at 988 (transfer as opposed to spurious creation of tax benefits weighs in taxpayer's favor).