

TAX LITIGATION ISSUES

Expert Analysis

Greater Clarity for the Economic Substance Doctrine

The federal government's long-standing fight against transactions it perceives to be abusive tax shelters is well-chronicled.¹ Because tax shelters are often carefully designed to satisfy the technical provisions of the Internal Revenue Code, the government frequently resorts to common law doctrines to attack the validity of specific transactions. Among the tools in the government's arsenal is the economic substance doctrine, which one court has described as a "judicial effort to enforce the statutory purpose of the tax code.... [intended] to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit."²

On March 30, 2010, after years of failed efforts, a provision codifying the economic substance doctrine was included in the Health Care and Education Reconciliation Act of 2010. While its full impact will not be felt for years, this long-anticipated move will likely affect tax shelter litigation for years to come.

Judicial Application

The economic substance doctrine permits courts to disregard the tax consequences of transactions that it finds lacking in "economic substance." In *Frank Lyon Co. v. United States*, the Supreme Court defined a transaction with economic substance as one "which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." The Court went on to hold that, when these factors are present, the government "should honor" the intent of the taxpayers.³

When the Internal Revenue Service disputes the tax treatment sought by a taxpayer on grounds that the transaction lacked economic substance, a reviewing court will evaluate both the transaction's objective economic effect and the taxpayer's subjective business purpose in engaging in the transaction. The objective analysis requires the court to determine whether the transaction "is wholly lacking in economic reality, such that no realistic financial benefit inures to the taxpayer beyond the tax features, or that no reasonable possibility of profit is present." The subjective analysis asks whether the taxpayer had a non-tax business purpose for engaging in the

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transaction.⁴

Over the years courts have divided, principally in two camps, over how to apply the common law economic substance doctrine. Some courts have required that a transaction have both an economic reality (such as a potential for profit or other financial benefit) and a non-tax business purpose. This application of the doctrine, called the "conjunctive test," sets a higher bar for taxpayers, requiring them to satisfy both the objective and subjective prongs in order to obtain the claimed tax benefits. Other courts have applied a more

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lenient "disjunctive" test, holding that a transaction would be respected for tax purposes if the taxpayer can show it had either an economic reality or a non-tax business purpose.⁵ Regardless of which test was applied, the economic substance doctrine was frequently (although not uniformly) applied to reject deductions claimed by taxpayers.⁶

Codification of the Doctrine

In light of the inconsistent applications of the economic substance doctrine, in 1999, the Treasury Department and the Joint Committee on Taxation suggested that codification might advance the government's fight against tax shelters.⁷ Starting that year, and almost every year thereafter, various legislative proposals were introduced in Congress in an effort to incorporate the economic substance doctrine into the Internal Revenue Code. Driven primarily by Senators Max Baucus and Charles Grassley, the current Chairman and Ranking Member of the Senate Finance Committee, supporters of the legislation argued that codification of the doctrine would restore faith in a tax system "rampant with" corporate tax shelter abuses.⁸

These proposals, however, met with resistance from government officials, taxpayer organizations, and practitioners. Taxpayer organizations and practitioners argued that codification of the doctrine would "introduc[e] statutory complexity and traps for small business and a broad cross section of taxpayers" and would "deprive the tax system of the flexibility needed to keep pace

with the changing economic environment,"⁹ while the Treasury Department was concerned that a statute might hurt enforcement actions "as it could possibly constrain the court's ability to apply the economic substance doctrine to situations that are not specifically addressed by the statute."¹⁰

Some Treasury officials believed the doctrine could only be properly applied in a courtroom that permitted flexible consideration of facts and circumstances unique to every situation.¹¹ Thus, in 2005, then IRS Chief Counsel Donald L. Korb asserted that the Service already had sufficient resources to combat tax shelters and that the doctrine was not meant to be a "general anti-abuse rule to be trotted out by the IRS every time it confronts a tax shelter transaction it simply doesn't like."¹²

Earlier this year, as part of the health care reform debate, Congress finally codified the economic substance doctrine.¹³ Although the legislation as passed was slightly modified from earlier versions,¹⁴ it is unclear what caused the key to turn after more than a decade of almost uniform opposition.¹⁵

The new provisions, set forth in §7701(o) of the Internal Revenue Code, are applicable to all transactions entered into after March 30, 2010, except that transactions entered into by individuals are only subject to the statute if they were made "in connection with a trade or business or an activity engaged in for the production of income."¹⁶

The statute provides that, "in the case of any transaction to which the economic substance doctrine is relevant," courts are to apply a conjunctive test: a transaction should 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."

The new law further provides that "[t]he 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."¹⁷ Commentators opine that this provision reflects "congressional intent that the codification of the [] doctrine should not result in its application in circumstances in which courts have historically not applied the doctrine."¹⁸ Indeed, the Joint Committee on Taxation specifically notes that "[t]he 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."¹⁹

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The statute also clarifies the extent to which courts should consider a transaction's pre-tax profit potential. Section 7701(o)(2) requires taxpayers relying on the potential for profit to satisfy the statutory economic substance doctrine to demonstrate that "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." Moreover, the statute makes clear that fees and other transaction expenses, including foreign taxes, are to be taken into account as expenses in determining a transaction's pre-tax profit.²⁰

Where tax benefits claimed by a taxpayer are disallowed under the economic substance doctrine, the new law subjects the taxpayer to a "no fault" 20 percent penalty. This penalty is increased to 40 percent if the taxpayer did not adequately disclose the relevant facts regarding the transaction on the tax return (or an amended return filed before the IRS informs the taxpayer that it will be auditing the return).²¹

The American Bar Association's Section on Taxation has criticized this increased penalty as overly harsh given the subjective nature of the analysis.²² Further, taxpayers will be subject to these penalties notwithstanding any opinion letter issued by a tax professional in connection with the transaction: the statute removes transactions lacking economic substance from the provision that no penalty shall be imposed "if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith."²³ In what will likely provide little comfort to taxpayers, the statute provides that the 20 and 40 percent penalties will not be applied if the 75 percent civil fraud penalty is imposed.

Impact on Criminal Cases

In recent years, the government has invoked the criminal laws to attack tax shelters and has pursued tax evasion charges against lawyers, accountants and tax shelter promoters. In order to convict a defendant of tax evasion, the government must prove that the taxpayer owed additional taxes, which turns on whether the taxpayer was entitled to the tax benefits derived from the transaction. If the tax shelter at issue met the requirements of the tax code and satisfied the common law economic substance doctrine, the taxpayer was entitled to the claimed benefits and the defendant cannot be liable for tax evasion. Thus the economic substance doctrine has come into play in criminal tax cases.

For example, in *United States v. Pfaff*, three individuals were charged with tax evasion in connection with their roles marketing tax shelters. Instructing the jury, Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York described the economic substance doctrine in the context of the government's contention that the taxpayers who invested in the shelters owed more federal income tax than they had reported because they were not entitled to deductions attributable to a tax shelter. Specifically, Judge Kaplan explained that the government was obligated to establish a lack of economic substance, which required that it prove beyond a reasonable doubt both "that the relevant taxpayer had no business purpose for engaging in the transaction apart from creating the tax deduction," and "that there was no reasonable

possibility that the transaction would result in a profit."²⁴ Virtually identical instructions have been given in at least one other criminal case in the Southern District of New York.²⁵

This instruction is consistent with the fact that, in jurisdictions applying the disjunctive test, a deduction generated through a tax shelter is valid if either the objective or the subjective prong of the economic substance test is satisfied. In a case where the defendant is facing criminal sanctions for advising a client with respect to a transaction, requiring the government to disprove both the objective and subjective aspects of the economic substance test is appropriate. While the economic substance statute is inapplicable to the transactions at issue in *Pfaff* and similar prosecutions, which pre-date the statute's effective date, the codification of the economic substance doctrine does not undermine the need for a heightened test in criminal cases.

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Indeed, one commentator has noted the difficulty of having lay jurors applying the economic substance doctrine in criminal cases. First, unlike a civil tax trial where a judge usually makes findings of fact and applies the law in a lengthy opinion, "untrained" jurors typically do not engage in a detailed analysis to support their conclusion that a transaction does or does not have economic substance.

Second, the commentator opines that the "subjective" prong of the test, which focuses on the intent of the taxpayer who invested in a shelter designed or marketed by the defendant, is made objective in those cases in which the taxpayer doesn't testify. "[A]t best at least for the absent, nontestifying taxpayers in the courts of conviction, all the [g]overnment may have proved beyond a reasonable doubt was that it may have been unreasonable for them to have a profit or business motive, but that is not the same as prov[ing] beyond a reasonable doubt that they did not have the motive."²⁶ Nothing in the statutory iteration of the economic substance doctrine obviates these overarching concerns, which permeate what remains an exceedingly complex area of the law.

Conclusion

With the passage of a law codifying the economic substance doctrine, some long-standing disagreements among the federal courts regarding the test for whether a transaction has economic substance have been resolved. It remains to be seen whether concerns expressed over the past 11 years by opponents to the codification will manifest themselves. While the statute's full impact may not be felt for a while, it is sure to be closely watched.

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1. See John J. Tighe, Jr. and Jeremy H. Temkin, "Tax Shelters and Economic Substance Doctrine Hotly Litigated," NYLJ (Jan. 20, 2005); John J. Tighe, Jr. and Jeremy H. Temkin, "Tax Shelter Enforcement Efforts," NYLJ (March 18, 2004); John J. Tighe, Jr. and Jeremy H. Temkin, "IRS Attacks Abusive Tax Shelters," NYLJ (Sept. 20, 2001).

2. *Coltec Industries Inc. v. United States*, 454 F.3d 1340 (Fed. Cir.

2006), cert. denied, 549 U.S. 1206 (2007).

3. 435 U.S. 561, 583-84 (1978). In *Frank Lyon Co.*, the Court found that the sale-and-leaseback transaction pursuant to which the taxpayer took title to a building under construction by bank and simultaneously leased the building back to bank for long-term use as its headquarters and principal banking facility was not a sham and thus taxpayer was entitled to claimed deductions in connection with its obligations under agreement.

4. See *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636 (2008) (articulating objective and subjective tests).

5. Martin J. McMahon, Jr., "Living With (and Dying By) the Codified Economic Substance Doctrine," University of Florida Levin College of Law Research Paper (June 11, 2010).

6. Id. at 9 n. 34 (citing *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008); *Coltec Industries Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 549 U.S. 1206 (2007); *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007); *American Electric Power Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003); *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282 (2d Cir. 2003); *In re CM Holdings Inc.*, 301 F.3d 96 (3rd Cir. 2002); *Winn-Dixie Stores Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001)). Although less frequent, taxpayers also have been able to satisfy the economic substance test and avoid disallowance of their claimed deductions. See, e.g., *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), rev'g 113 T.C. 214 (1999); *IES Indus. Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *Shell Petroleum Inc. v. United States*, 102 A.F.T.R.2d 2008-5085 (S.D. Tex. 2008).

7. U.S. Dept. of the Treasury, "The Problem of Corporate Tax Shelters: Discussion Analysis, and Legislative Problems" (1999); Joint Committee on Taxation, "Study of Present Law Penalty and Interest Provisions, as Required by section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998" (JCS-3-99) (July 22, 1999).

8. M. Jackel, "For Better or for Worse: Codification of Economic Substance," Tax Notes (May 24, 2004) at p. 1069 n. 5.

9. American Institute of Certified Public Accountants Letter to Senate Permanent Investigations Subcommittee, "AICPA Commends Senate Investigations Panel Report on Tax Shelters," 2005 TNT 90-35 (May 4, 2005).

10. A&M Tax Advisor Weekly, "What Purpose Is This Business? A View of the Business Purpose and Economic Substance Doctrines" (March 8, 2006).

11. See "Officials Gauge Government Success in War on Abusive Shelters" 2005 TNT 29-2 (Feb. 11, 2005) (citing Treasury Department Assistant Secretary Eric Solomon).

12. Donald L. Korb, Chief Counsel for the Internal Revenue Service, Remarks at the 2005 University of Southern California Tax Institute, "The Economic Substance Doctrine in the Current Tax Shelter Environment," Los Angeles, California (Jan. 25, 2005).

13. The Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152 (March 30, 2010).

14. At least two versions of the proposed doctrine included language that the transaction be a "reasonable means" of accomplishing the taxpayer's subjective non-tax intent. See Proposed IRC §7701(p)(1)(B)(i) as set forth in Report of the Senate Committee on Finance accompanying Telephone Excise Tax Repeat and Taxpayer Protection and Assistance Act of 2006 (S. 1321) (Sept. 15, 2006), S. Rep. No. 109-336, 109th Cong., 2d Sess. 138. In addition, earlier versions included stronger language providing that the fact that a transaction had a potential for profit was not enough to satisfy the economic substance requirement unless the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return. See Proposed IRC §7701(p)(B)(ii). Neither of these provisions is included in the adopted legislation.

15. The Joint Committee on Taxation estimates that a codified economic substance doctrine and its applied penalties would generate approximately \$4.5 billion in revenue for fiscal years 2010-2019. Joint Committee on Taxation, "Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872," JCX-17-10 (March 20, 2010). Given concerns about the fiscal impact of health care reform, one explanation for Congress' successful action is that the additional revenues were necessary to improve the Congressional Budget Office's "score" of the law as a whole.

16. 26 U.S.C. §7701(o)(5)(B).

17. 26 U.S.C. §7701(o)(1) and (5)(C).

18. McMahon, Jr., "Living With (and Dying By) the Codified Economic Substance Doctrine" at p. 12.

19. Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,' as Amended, in Combination with the 'Patient Protection and Affordable Care Act,'" (JCX-18-10) at p. 152 (March 21, 2010).

20. 26 U.S.C. §7701(o)(2)(B).

21. 26 U.S.C. §6662.

22. American Bar Association Section of Taxation, Supplemental Comments on the Proposed Codification of the Economic Substance Doctrine at pp. 9-10 (April 12, 2007) (stating that "[g]ood faith, well-advised and carefully considered judgments on these questions, even if ultimately incorrect, do not warrant a strict-liability penalty...[of such] magnitude").

23. 26 U.S.C. §6664(c).

24. *United States v. Pfaff*, 05 Cr. 888 (LAK) (S.D.N.Y. Dec. 11, 2008) at pp. 5225-5232.

25. See *United States v. Coplan*, 07 Cr. 453 (SHS). The author represented one of the defendants in *Coplan*.

26. Jack Townsend, "The KPMG Enabler Convictions—The Role of the Absent Taxpayers," Federal Tax Crimes Blog (Jan. 26, 2010).