

Fall 2013

OMG! ESD Codified!: The Overreaction to Codification of the Economic Substance Doctrine

Monica D. Armstrong

Follow this and additional works at: <http://commons.law.famu.edu/famulawreview>

 Part of the [Business Organizations Law Commons](#), [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Monica D. Armstrong, *OMG! ESD Codified!: The Overreaction to Codification of the Economic Substance Doctrine*, 9 Fla. A&M U. L. Rev. (2013).

Available at: <http://commons.law.famu.edu/famulawreview/vol9/iss1/6>

This Article is brought to you for free and open access by Scholarly Commons @ FAMU Law. It has been accepted for inclusion in Florida A & M University Law Review by an authorized editor of Scholarly Commons @ FAMU Law. For more information, please contact linda.barrette@famuedu.

OMG! ESD CODIFIED!: THE OVERREACTION TO CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

*Monica D. Armstrong**

I. INTRODUCTION

A Cautionary Tale

The year was 1928. Mrs. G, the sole shareholder of Y Corporation (Y), desired a certain piece of property owned by Y. The most efficient way to obtain the property was a direct transfer from Y to Mrs. G. However, Mrs. G's tax advisor warned her that a direct distribution of the property from Y would result in a significant tax liability. This proved to be a conundrum for Mrs. G. She told her advisor, in no uncertain terms, that she wanted the property but did not want to pay an exorbitant tax.

The tax advisor explained to Mrs. G that in order to achieve her objectives she must direct Y to form a new corporation. Y would then transfer the desired property to the new corporation and the new corporation would transfer all of its shares to Mrs. G. (making Mrs. G the sole shareholder of both corporations). Immediately after the exchange of the property and the shares—which would take no more than four days—the new corporation would liquidate and distribute to Mrs. G the desired property. By conducting the transaction in this roundabout way Mrs. G could get her desired property and, more importantly, a lower tax liability.

Mrs. G's skepticism caused her to ask the obvious question: "Is this legal?" The advisor responded with enthusiasm and conviction, "Of course it's legal. It's authorized by the Internal Revenue Code!"¹

* Associate Professor of Law, Mercer University School of Law. I would like to thank Professor Anthony Baldwin, Mercer University School of Law and Professor Gail Richmond, Shepard Broad Law Center, Nova Southeastern University for their very helpful comments and suggestions.

1. For those who are familiar with the case of *Gregory v. Helvering*, 293 U.S. 465 (1935), you may have noticed that I changed the scenario ever so slightly.

The Economic Substance Doctrine

Throughout the years, the Internal Revenue Service (IRS) and the courts have employed a number of judicial doctrines to prevent taxpayers from manipulating the tax code and relying on a literal interpretation of the tax provisions to obtain tax benefits unintended by the statute. The economic substance doctrine is one such doctrine.² The economic substance doctrine is one that disallows claimed tax benefits³ if the transaction related to the said benefit does not change the taxpayer's financial position and/or lacks a business purpose.⁴ This doctrine shall apply despite the fact that the transaction may meet all requirements of the Code provision under which the taxpayer is claiming the tax benefit.⁵

After many attempts,⁶ on March 25, 2010, Congress passed a bill codifying the economic substance doctrine. The bill was enacted into law as part of the Health Care and Education Affordability Reconciliation Act of 2010⁷ that was signed by President Barack Obama on

2. Other similar judicial doctrines include the business purpose doctrine; the step-transaction doctrine; sham transaction; and substance over form. For a full discussion of these doctrines see Joseph Bankman, *The Economic Substance Doctrine*, 74 CAL. L. REV. 5 (2000).

3. *E.g.*, tax deductions, tax credits, net operating loss carryovers, etc.

4. I purposely use "and/or" because some courts disallowed the transaction when just one of the two factors were not met, while other courts disallowed the transaction only when the taxpayer failed to meet both factors. This split in authority is one of the purposes behind codification—to provide a uniform rule.

5. *See* Coltec Industries, Inc. v. United States, 454 F.3d 1340, 1354 (Fed. Cir. 2006) ("[T]he economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance."), *cert. denied*, 549 U.S. 1206 (2007).

6. This was ten years in the making. Codification of the economic substance doctrine was first introduced in 1999 by Rep. Lloyd Doggett (D-TX) in "The Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255 106th Cong.; it was reintroduced almost every year until it finally became law in 2010. *See* Abusive Tax Shelter Shutdown Act of 2001, H.R. 2520, 107th Cong. (2001); The Tax Haven and Abusive Tax Shelter Act of 2002, S. 2339, 107th Cong. (2002); American Jobs Creation Act of 2004, H.R. 4520; Highway Reauthorization and Excise Simplification Act of 2005, P.L. 109-82; 2007: Food and Energy Act of 2007, H.R. 2419, 110th Congress; The Heartland, Habitat, Harvest, & Horticulture Act of 2007, S. 2242; 2007: Tax Reduction and Reform Act of 2007, H.R. 3970. "The codification of the economic substance doctrine had been stoutly resisted by the [Bush] Administration out of concern that the proposal would reduce the courts' ability to use the economic substance doctrine to address taxpayer abuses." Richard M. Lipton, *'Codification' of the Economic Substance Doctrine—Much Ado About Nothing*, ALI-ABA Course of Study Materials, Creative Tax Planning for Real Estate Transactions, Volume 1, November 2010.

7. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

March 30, 2010. Specifically, Section 1409⁸ codified the economic substance doctrine by adding Section 7701(o) to the Code. Among other things, Section 7701(o) provides a two-part conjunctive test to determine whether a transaction has economic substance.

Section 7701(o) provides:

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 a transaction.

Unlike the judicial definition where some courts found a transaction to have economic substance when there existed a business purpose *or* a change in the taxpayer's economic position, Section 7701(o) requires both—a change in the taxpayer's economic position *and* business purpose—in order for a transaction to have economic substance. Thus, all courts must determine: (1) whether the transaction entered into by the taxpayer changed his economic position “in a meaningful way” without tax considerations *and* (2) whether the taxpayer had a substantial non-tax purpose in entering into the transaction. If the answer to both inquiries is yes, the transaction will be respected and the taxpayer shall be entitled to the claimed tax benefit. On the other hand, if the transaction fails one of the prongs, it fails the economic substance test and the claimed tax benefit will be disallowed.

Failing the economic substance test under Section 7701(o) will result in more than the denial of a claimed tax benefit. The taxpayer whose transaction fails the two-prong conjunctive test will also be subject to a tax penalty.⁹ The amount of the penalty is 20% of the tax underpayment, i.e., the amount the taxpayer saved as a result of the claimed tax benefit.¹⁰ The penalty increases to 40% for transactions that are not disclosed on the taxpayer's tax return.¹¹ To add insult to injury—at least in the eyes of the taxpayer—the penalty is not subject

8. *Id.*

9. 26 U.S.C. § 6662(b)(6). The penalty applies to “[a]ny 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(b)(6) is a new Code provision added under the same Act as section 7701(o). P.L. 111-147.

10. 26 U.S.C. § 6662(a). The underpayment penalty will also apply to “any disallowance of claimed tax benefits by reason of a transaction lacking economic substance” (within the meaning of section 7701(o)). 26 U.S.C. § 6662(b)(6).

11. 26 U.S.C. § 6662(i)(1).

to the reasonable cause exception.¹² In other words, a transaction failing the economic substance test results in a strict liability penalty.

Congress' objectives in codifying the economic substance doctrine were to provide a uniform test for economic substance¹³ and also to raise revenue.¹⁴ A third objective, while not explicitly stated in the recently enacted legislation, aimed to curb tax motivated transactions.¹⁵ Despite these positive objectives, certain groups engaged in letter writing campaigns to the Treasury and the IRS in an uproar over codification.¹⁶ These groups argue that Section 7701(o) is vague as to the types of transactions that are subject to the economic substance test; they assert that such vagueness will result in taxpayer uncertainty,¹⁷ thereby creating a chilling effect on future business

12. 26 U.S.C. § 6664(c)(1) allows the taxpayer to escape a tax penalty if he can show reasonable cause for the underpayment and that he acted in good faith. However, section 6664(c)(1) does not apply to transactions lacking economic substance. See 26 U.S.C. § 6664(c)(2).

13. Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Two: Business Tax Provisions* (JCS-3-09), September 2009 ("There is a lack of uniformity regarding the proper tests to use when applying the economic substance doctrine."); Alison Bennett, *Tax Shelters Economic Substance Doctrine to be Prominent Issue for IRS, Courts, Congress*, 10 DTR S-18 (2010) (quoting IRS Chief Counsel William Wilkins, "It clears up some different approaches in the circuits and clarifies some of the standards.").

14. Section 7701(o) was estimated to bring in \$657 million in revenue in the year of enactment, 2010; 3.527 billion by 2014; and 8.120 billion by 2020. See Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009*, (JCX-28-09), June 11, 2009. Earlier estimates predicted revenues of \$17 billion by 2020. See Jeremiah Coder, *The Journey to Codify Economic Substance is Over, But Will It Be Worth It*, 2010 TAX NOTES TODAY 61-1.

15. See, e.g., Tax Haven & Abusive Shelter Reform Act of 2002, 148 Cong. Rec. S2339 (One of the objectives was to end "meaningless and abusive tax transactions" by, among other things, codifying the economic substance doctrine); Jumpstart Our Business Strength Act (JOBS) (The Committee Report provided as one of the reasons for codification was because it was "concerned that many taxpayers [were] engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions").

16. See *PWC Seeks Quick Action From Treasury, IRS to Mitigate Uncertainty Created by Economic Substance Codification*, 2010 TAX NOTES TODAY 79-117 (April 22, 2010) [hereinafter PWC]; see also 2011 TAX NOTES TODAY 86-19: *Practitioners Want More Specifics on Codified Economic Substance Doctrine*, May 2, 2011 (Doc. 2011-9441).

17. See, e.g., PWC, *supra* note 16 ("The new law raises a number of issues with respect to the economic substance doctrine, simultaneously increasing taxpayer uncertainty around when and how the doctrine is to be applied."); Allison Bennett, *Codification Would Create More Problems Than it Solves, Says Korb*, 118 TAX NOTES TODAY 777 (Feb. 18, 2008) (quoting Former IRS Chief Counsel Donald Korb, "What we are going to have is less aggressive taxpayers not going forward with transactions maybe they otherwise should [go forward with], while the more aggressive who understand how the system works may just plow right ahead.").

transactions¹⁸ due to fear of the strict liability tax penalty that will be imposed if they fail the test. Therefore, those opposed have urged the Treasury and IRS to (1) provide guidance (an angel list) on the types of transaction that are subject to the economic substance doctrine; (2) define certain terms within the statute, such as “meaningful change in the taxpayer’s economic position” and “substantial nontax purpose,” and (3) reconsider the strict liability tax penalty.¹⁹

The purpose of this article is to counter the numerous articles that have unfairly represented Section 7701(o) as a doomsday statute for taxpayers and business transactions. This article shall respond to the critics through an analysis of Section 7701(o), focusing on its particular words, phrases, and terms of art with which the critics take issue. In addition, it addresses the fears that opponents of codification have expressed that the newly added statute will affect many legitimate transactions that may fall victim to the strict liability tax penalty. To be clear, this is not an article touting the wonders of codification of the economic substance doctrine. As with anything, there is always room for improvement. This article is designed to show that the negative way in which Section 7701(o) has been portrayed is unfounded and exaggerated.

Part II of this article begins with an in-depth discussion of the development of the economic substance doctrine by the United States Supreme Court. Part III provides a brief discussion of the problem in applying the economic substance test among the different circuits. Said problem became one of the objectives for codification—to provide consistency and certainty in the application of the economic substance doctrine. Part IV, the heart of the article, addresses the concerns critics have with respect to section 7701(o).

II. HISTORY AND DEVELOPMENT OF THE ECONOMIC SUBSTANCE DOCTRINE

Three U.S. Supreme Court cases have been credited with the creation and shaping of today’s economic substance doctrine: (1) *Gregory v. Helvering*,²⁰ (2) *Knetsch v. United States*,²¹ and (3) *Frank Lyon*

18. See *PWC*, *supra* note 16.

19. See *id.* (“Due to the severity of the penalty and the inapplicability of the reasonable cause defense, it is absolutely critical that taxpayers be provided with a process for establishing certainty with respect to a transaction prior to engaging in the transaction. [T]axpayers should be entitled to a pre-transaction ruling process . . .”).

20. 293 U.S. 465 (1935).

21. 364 U.S. 361 (1960).

Co. v. United States.²² All three cases stand for the broad principle that mere compliance with the tax provision will not automatically entitle a taxpayer to the tax benefits in which he seeks. In addition, they represent the components of today's economic substance test now found in Section 7701(o). Specifically, *Gregory* is linked to the requirement that the transaction must serve a business purpose,²³ while *Knetsch* is associated with the requirement that the transaction "meaningfully change the taxpayer's economic position." *Frank Lyon* extracted those two principles and articulated the first test for economic substance.

A. *Gregory v. Helvering*

Many credit *Gregory* as the birth of today's economic substance doctrine.²⁴ There are, however, a few who disagree.²⁵ Whether *Gregory* is the source of today's economic substance doctrine or not, it cannot be disputed that the facts of the case present a perfect example of the purpose of the doctrine.

Mrs. Gregory was the sole shareholder of United Mortgage Corporation (UMC), which held 1000 shares of stock as one of its assets in Monitor Securities Corporation (Monitor).²⁶ Mrs. Gregory wanted the cash value of those shares and could have easily accomplished such with UMC selling the Monitor shares to a third party and distributing

22. 435 U.S. 561 (1978).

23. *But see* Leandra Lederman, *(W)hither Economic Substance*, 95 Iowa L. Rev. 389, 391 ("[T]he business purpose requirement dates to the landmark case of [*Gregory*], but in that case, the U.S. Supreme Court and the Second Circuit merely interpreted the governing statute as implicitly requiring a business purpose. . . . Over the years, the business purpose requirement has been distorted, resulted in analyses that make little sense."); Jerome B. Libin, *Congress Should Address Tax Avoidance Head-on: The Internal Revenue Code Needs a GAAR*, 30 Va. Tax Rev. 339, 343 ("[T]he requirement of 'business purpose' enunciated in *Gregory* was not intended as some sort of new, free-form judicial doctrine . . .").

24. "The origins of the economic substance doctrine can be traced back to the Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935)." *Palm Canyon X Investments, LLC v. C.I.R.*, 98 T.C.M. (CCH) 574 (T.C. 2009); *see also* *Lerman v. Comm'r*, 939 F.2d 44, 52 ("Per *Gregory v Helvering*, it is settled federal law that for transactions to be recognized for tax purposes they must have economic substance"); "ACM, p. 246 ("We begin our economic analysis with *Gregory v. Helvering* . . ."); *Kirchman v. Comm'r*, 862 F.2d 1486, 1490 ("The sham transaction doctrine emerged from the Supreme Court decision in *Gregory v. Helvering*"); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law 235 (Winter 1999), ("The economic substance doctrine was, if not formulated, then at least popularized by Learned Hand in the Second Circuit's 1934 decision of *Gregory v. Helvering*").

25. "Nowhere in the court's opinion, the facts of the case, or anywhere else is there any suggestion that the transaction devised by Mrs. Gregory and her tax advisors failed because it lacked economic substance." 30 VA. TAX REV. 339. *See also* Leandra Lederman, *(W)hither Economic Substance*, 95 IOWA L. REV. 389.

26. *Gregory*, 293 U.S. at 467.

the cash back to Mrs. Gregory. However, that plan would have resulted in tax consequences to both UMC and Mrs. Gregory.²⁷ If instead UMC distributed the stock directly to Mrs. Gregory, the corporate level tax would be eliminated²⁸; however, the distribution would still result in a taxable dividend to Mrs. Gregory in the amount of \$133,333.33.²⁹ Wishing to avoid a taxable dividend, but still desiring the cash proceeds from the sale of the stock, Mrs. Gregory (no doubt with the aid of tax advisors) devised a plan that would allow her to meet those objectives.

B. Tax Plan (or Tax Scheme) and Resulting Tax Consequences Under the Code

On September 18, 1928, UMC created Averill Corporation (Averill) and two days later, UMC transferred the Monitor shares to Averill. In return for the Monitor shares, Averill transferred all of its own shares of stock to Mrs. Gregory, thereby making her its sole shareholder.³⁰ The formation of Averill Corporation was a corporate reorganization³¹ and since Mrs. Gregory received the Averill shares through a corporate reorganization, she would not have a taxable gain.³² However, the tax laws required Mrs. Gregory to allocate part of her cost basis in the UMC stock to the Averill stock.³³ This resulted in a basis in the Averill stock of \$57,325.45.³⁴ On September 22, 1928, four-day old Averill liquidated and distributed the Monitor stock, valued at \$133,333.33, to Mrs. Gregory. Mrs. Gregory treated the receipt of the Monitor stock as a sale or exchange. Offsetting the \$133,333.33

27. The corporation would be subject to an income on the gain from the sale of the stock and Mrs. Gregory would be subject to a dividends tax.

28. See *General Utilities v. Helvering*, 296 U.S. 200 (1935). In 1928, when the transaction occurred, the tax law at the time allowed corporations to distribute appreciated property (including stock) to their shareholders without incurring a tax. This generous tax law was repealed with the enactment of I.R.C. § 311(b) in 1986.

29. *Gregory v. Helvering*, 27 B.T.A. 223, 224 (1932).

30. *Id.*

31. Under section 112(i) of the Revenue Act of 1928. Pursuant to Section 112(i)(1), reorganization includes a transfer of assets by one corporation to another corporation and after the transfer, the stockholders control both the transferor corporation and the transferee corporation.

32. Pursuant to section 112(g) of the 1928 Revenue Act. Section 112(g) provides that no gain shall be recognized by a shareholder who receives stock pursuant to a corporate reorganization.

33. Section 113(a)(9) the Revenue Act of 1928. UMC purchased a total of 5000 shares on two separate occasions, October 1, 1920 and December 16, 1921 for a total cost of \$250,000. 27 B.T.A. at 224.

34. *Id.*

value of the Monitor stock against the \$57,325.45 basis in her Averill stock, Mrs. Gregory would report a capital gain of \$76,007.88.³⁵ The transaction allowed Mrs. Gregory to save \$10,678.16 in income taxes.³⁶

The Commissioner of Internal Revenue (Commissioner) rejected Mrs. Gregory's treatment of the transaction, determining that the transaction lacked substance and was entered into solely for tax avoidance purposes.³⁷ Consequently, the Commissioner disregarded the reorganization and taxed the distribution of the Monitor stock as a dividend.³⁸

C. Courts' Decisions

The Board of Tax Appeals sided with Mrs. Gregory's tax treatment of the transaction stating:

[A] statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration. The general legislative plan apparently was to recognize the corporate entity and, in view of such recognition, to specify when the gains or losses would be recognized and upon what basis they should be measured. We may not destroy the effectiveness of this statutory plan by denying recognition to the corporation and thus preventing consideration of its transaction.³⁹

The Board reasoned that since Mrs. Gregory complied with the applicable code provisions—regardless of how she went about it—her treatment of the receipt of the Monitor stock as a sale or exchange was proper. As a result, the Board held, such sale resulted in a capital gain of \$76,007.88.⁴⁰

On appeal the Second Circuit, while sanctioning a taxpayer's attempt to avoid or reduce taxes as permitted under the law, disagreed with the Board's literal interpretation of the reorganization tax provision. Judge Learned Hand, the author of the opinion, admonished:

[I]t does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board

35. *Id.*

36. *Id.*

37. *Id.* at 225. As the Second Circuit aptly put it, the Commissioner's position on Mrs. Gregory's transaction was "merely the declaration of a dividend by the United Mortgage Corporation consisting of the Monitor shares in specie, on which the taxpayer must pay a surtax calculated at their full value." *Helvering v. Gregory*, 69 F.2d 809, 822 (2d Cir. 1934).

38. *Id.* at 224.

39. *Id.* at 225-226.

40. *Id.* at 226.

has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the section is plain enough; men engaged in enterprises – industrial, commercial, financial, or any other — might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as “realizing” any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders’ taxes is not one of the transactions contemplated as corporate “reorganizations.”⁴¹

Thus, instead of a textualist approach, the Second Circuit adopted a purposive interpretation finding the intention of the reorganization tax provision relied on by Mrs. Gregory was not for the reduction of taxes, the sole reason for Mrs. Gregory’s transaction. The Court of Appeals found that the reduction or avoidance of taxes did not fall within the purview of the reorganization tax provisions.

The Supreme Court affirmed the Second Circuit, specifically finding that Mrs. Gregory’s transaction was in pursuance of a plan to reduce her taxes which “[had] *no business or corporate purpose*,” which it determined to be a prerequisite for corporate reorganizations.⁴² It held for the Government, for to hold otherwise, it explained, would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.⁴³

D. *Knetsch v. United States*

In 1953, 60-year old Knetsch purchased ten 30-year annuity savings bonds (bonds) for \$4,004,000 from Sam Houston Life Insurance Company (Sam Houston).⁴⁴ To finance the purchase, borrowed \$4 mil-

41. *Helvering v. Gregory*, 69 F.2d 809, 810-11.

42. 293 U.S. at 469-70 (The Court saw the transaction as “a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the 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. . . . [The] corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death”) (emphasis added).

43. *Id.* at 470.

44. *Knetsch*, 364 U.S. at 363.

lion dollars from Sam Houston and contributed \$4,000 of his own money.⁴⁵ At maturity, the value of the annuity would be \$8,388,000 entitling Mr. Knetsch to a monthly payment of \$90,171 for life.⁴⁶ While the contract obligated Knetsch to prepay the interest, it allowed him to borrow against the net value of the bonds and use the borrowed funds to prepay the interest on the original loan.⁴⁷ Taking advantage of the generous terms, Knetsch borrowed \$99,000 of the bonds' net value of \$100,000 in the first year of the contract and prepaid the interest on the original \$4 million loan and the second (\$99,000) loan. In total, Knetsch paid Sam Houston \$143,465 in purported interest payments whereby he claimed an interest deduction⁴⁸ in that same amount on his 1953 Federal income tax return.⁴⁹

In 1954, Knetsch borrowed all but \$1,000 of the net value of the bonds, \$104,000, to prepay the interest on his now \$4,099,000 indebtedness and brand new \$104,000 obligation. Knetsch paid a total of \$147,105 to the insurance company and, as in 1953, claimed an interest deduction of \$147,105 on his 1954 income tax return.⁵⁰ Knetsch continued borrowing against the bonds' value for another two years, after which he terminated the contract.⁵¹ If Knetsch had continued to borrow all but \$1,000 of the cash value of the bonds until maturity the bonds would have been worth only \$1,000 and Knetsch, who would have been ninety at the time, would be entitled to a mere \$43 a month.⁵²

The large interest deductions perhaps are what initially caught the eye of the Commissioner. Viewing the transaction as economic shams, he disallowed the deductions. Both the District Court and Ninth Circuit Court of Appeals sustained the Commissioner's determination.⁵³ The Supreme Court, after analyzing the transaction,⁵⁴ determined it to be a sham, which "did not appreciably affect

45. *Id.*

46. *Id.* at 364.

47. *Id.* at 362.

48. *Id.* (pursuant to I.R.C. § 23(b) (1939)).

49. *Id.*

50. *Id.* at 362 (the code provision allowing the deduction was pursuant to § 163(a) of the Internal Revenue Code of 1954).

51. *Id.* at 362-64 (Knetsch continued to borrow against the cash surrender value for two more years and taking interest deductions on the prepaid interest. He terminated the contract in 1956).

52. *Id.* at 364.

53. *See* Knetsch v. United States, 58-2 U.S. Tax Cas. (CCH) P9935 (S.D. Cal. 1958) ("While in form the payments to [the insurance company] were compensation for the use or forbearance of money, they were not in substance a payment of interest, the transaction was a sham;"); 272 F.2d 200 (9th Cir. 1959).

[Knetsch's] beneficial interest, except to reduce his tax,"⁵⁵ i.e., it did not meaningfully change his economic position.

E. Frank Lyon Co. v. United States

Worthen Bank & Trust Company (Worthen) planned to construct an office building which would cost approximately \$9 million. Worthen wanted to finance the project by offering \$4 million in debentures of one of its subsidiaries and borrowing the remaining \$5 million from a local bank. However, Worthen could not use either financial device. First, state banking laws in Arkansas prohibited Worthen, a state-owned bank, from paying interest on the debentures at the rate that would attract investors. Second, the Federal Reserve would not authorize Worthen to borrow \$5 million from a bank due to insufficient capital stock and surplus.⁵⁶

Enter taxpayer Frank Lyon, Inc. (Frank Lyon) to solve Worthen's problem. Frank Lyon agreed to purchase the building for \$7,640,000, using \$500,000 of its own money and borrowing the remaining amount (\$7,140,000) from New York Life Insurance Company.⁵⁷ After purchasing the building, Frank Lyon leased it back to Worthen for 25 years. Worthen had the option to purchase the building when the lease term ended for an amount equal to what Lyon had already paid for the property and the assumption of the mortgage balance.⁵⁸ As lessee Worthen would: (1) make lease payments totaling the exact amount of Lyon's amortized mortgage payments; (2) pay all building expenses; (3) be entitled to receive all insurance proceeds exceeding the mortgage balance in the event the building was damaged or destroyed; and (4) be entitled to the \$500,000 paid by the Frank

54. Knetsch, 364 US at 365-66. ("When we examine 'what was done' here, we see that Knetsch paid the insurance company \$ 294,570 during the two taxable years involved and received \$ 203,000 back in the form of 'loans.' What did Knetsch get for the out-of-pocket difference of \$ 91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of \$ 8,388,000, which would produce monthly annuity payments of \$ 90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of \$ 1,000. Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax . . .") (citing *Gilbert v. Commissioner*, 248 F.2d 399, 411 (dissenting opinion)).

55. *Id.* at 366.

56. *Frank Lyon*, 435 U.S. at 563-64.

57. *Id.* at 564-66.

58. *Id.* at 566-67.

Lyon.⁵⁹ Even though Worthen bore the burdens and benefits of ownership, Lyon, being the legal owner of the property, claimed depreciation and interest deductions totaling \$497,219.18.⁶⁰ The Commissioner disallowed the deductions re-characterizing the sale-and-leaseback transaction as a financing arrangement whereby Worthen borrowed \$500,000 from Lyon and Lyon acted as an agent for the mortgage payments from Worthen to New York Life.⁶¹

The District Court considered the facts and found that the two parties, Lyon and Worthen, intended to create a sale-and-leaseback and did in fact create a sale-and-leaseback. Therefore, it rejected the Commissioner's characterization of the transaction as a financing arrangement holding that the deductions were allowable.⁶² However, the Eighth Circuit Court of Appeals accepted the Commissioner's view of the arrangement and reversed the District Court's decision, stating:

In sum, the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. . . . The vice of the present lease is that all of [its] features have been employed in the same transaction with the cumulative effect of depriving [Lyon] of any significant ownership interest.⁶³

The Supreme Court reversed the Eighth Circuit, finding the transaction to be a true sale-and-leaseback and articulated the following rule:

Where . . . there is a genuine multiple-party transaction with economic substance which is compelled 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 Government should honor the allocation of rights and duties effectuated by the parties so long as the lessor retains sufficient and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.⁶⁴

Thus, the sale-and-leaseback transaction was to be respected because it: (1) had economic substance and (2) "business realities . . . imbued with tax-independent considerations," i.e. a non-tax business purpose. This rule, which featured aspects of *Gregory* and *Knetsch* be-

59. *Id.*

60. *Id.* at 568.

61. *Id.* at 568-69.

62. *Frank Lyon Co. v. United States*, 75-2 U.S. Tax Cas. (CCH) P9545 (E.D. Ark 1975).

63. *Frank Lyon Co. v. United States*, 536 F.2d 746, 754 (8th Cir. 1976).

64. *Frank Lyon Co.*, 435 U.S. at 583-84 (1978). See Bernard Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 Cornell L. Rev. 1075 (1981).

came known as the economic substance test. However, this five-part test was subsequently interpreted by the lower courts to create a two-part test for determining whether a transaction lacks economic substance. However, as will be explained below, the application of the economic substance test was not consistent among the circuits.

III. THE DIFFERENT CONSTRUCTIONS OF *FRANK LYON'S* ECONOMIC SUBSTANCE TEST

*Rice's Toyota World v. Commissioner*⁶⁵ was one of the first cases to apply the economic substance test articulated in *Frank Lyon*.⁶⁶ The Tax Court construed *Frank Lyon* as a two-part disjunctive test and held the taxpayer's transaction lacked economic substance because the transaction had neither a business purpose nor a reasonable possibility of a profit.⁶⁷ In other words, if the transaction had either a business purpose *or* a reasonable possibility of profit, the taxpayer would have prevailed. The Fourth Circuit affirmed the Tax Court's opinion and also adopted its two-part disjunctive test.⁶⁸ The Eighth Circuit also followed the Tax Court's narrow interpretation of *Frank Lyon's* test for economic substance test.⁶⁹

As is often the case, there was another school of thought with some of the other circuits on how to apply the economic substance test enunciated in *Frank Lyon*. Those Circuits construed *Frank Lyon, Inc.* as mandating a multi-part conjunctive test for economic substance. Thus, the tax benefit would be allowable only if the transaction had a

65. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983).

66. Earlier cases applying *Frank Lyon* include *Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982); *Belz Investment Co. v. Commissioner*, 72 T.C. 1209 (1979).

67. *Rice's Toyota*, 81 T.C. at 209.

68. See *Rice's Toyota*, 752 F.2d 89, 91-2 (4th Cir. 1985) ("The tax court read *Frank Lyon Co. v. United States* to mandate a two-pronged inquiry to determine whether a transaction is, for tax purposes, a sham. To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists. We agree that such a test properly gives effect to the mandate of the Court in *Frank Lyon*.").

69. *IES Industries v. United States*, 253 F.3d 350, 353 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes, the Eighth Circuit has applied a two-part test set forth in *Rice's Toyota World, Inc. v. Commissioner*, which the Fourth Circuit ostensibly found in the Supreme Court's opinion in *Frank Lyon Co.* Applying that test, a transaction will be characterized as a sham if 'it is not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test).").

business purpose *and* economic substance.⁷⁰ The remaining circuits, while acknowledging *Frank Lyon* created a two-prong economic substance test, insisted that the Court never intended the test to be a “rigid two-step analysis.” Rather, business purpose and economic substance were to be treated as factors, along with other considerations, when scrutinizing the substance of transaction.⁷¹

The various tests applied by the courts resulted in (1) uncertainty to the taxpayers (and by implication to the government and courts); (2) costly litigation; and (3) more frustration for the Internal Revenue Service in handling cases and the government in trying cases, or so certain members of Congress believed. A uniform test for economic substance, of course, would do the exact opposite—bring about certainty to all parties involved; result in less litigation and more settlements; and reduce the Revenue Agents’ workload. Thus in March 2010, Congress codified the economic substance test adopting a two-part conjunctive test for economic substance.

IV. RESPONDING TO THE CRITICS’ OVERREACTION TO SECTION 7701(O)

As discussed in Part III, the courts were inconsistent in applying the economic substance doctrine. Did codifying and adopting a two-prong conjunctive test for economic substance cause harm to the economic substance doctrine as the critics claim? Addressing that question requires a breakdown of section 7701(o).

Section 7701(o) begins with the following statement: “In the case of any transaction to which the economic substance doctrine is

70. See, e.g., *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009) (“[I]f a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations”); *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction”); *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001) (“A transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose.”).

71. See, e.g., *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990) (“[T]his circuit [has] found that the Court’s holding in *Frank Lyon* was not intended to outline a rigid two-step analysis. . . Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of [the] court’s traditional sham analysis.”); *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1990) (“The better approach, in our view, holds that ‘the consideration of business purpose and economic substance are simply more precise factors to consider in the [determination of] whether the transaction had any practical economic effects other than the creation of income tax losses.’”) See also *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988); *American Electric Power Co., Inc. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003).

relevant.”⁷² So the obvious question is: What kind of transactions will cause the economic substance doctrine to be relevant? Section 7701(o)(5)(C) provides: “[T]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if section 7701(o) had never been enacted.” However, that Code section goes no further than that statement. It does not provide examples of transactions subject to the economic substance or point to another Code provision or Treasury Regulation. In addition, the Service announced that it would not provide a list of transactions to which the economic substance doctrine is relevant or irrelevant.⁷³ Nor will it issue private letter rulings or determination letters concerning the relevancy of the economic substance doctrine to a particular transaction.⁷⁴ Moreover, there is no legislative history to section 7701(o) that may provide some insight as to what transactions are subject to section 7701(o).⁷⁵

While critics of codification viewed the scant guidance as an egregious flaw in section 7701,⁷⁶ it should be viewed as a deliberate omission having no negative impact. As I will explain below, taxpayers are not in the dark with respect to determining the type of transactions that will invite an economic substance inquiry.

A. Transactions Subject to § 7701

“The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if

72. I.R.C. §7701(o) (Emphasis added.) (An earlier provision provided that a codified economic substance doctrine would be applicable only where “a court determines that the economic substance doctrine is relevant.”) See Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018, 111th Cong. §411 (2009)).

73. See I.R.S. Notice 2010-62, 2010-40 IRB 411.

74. *Id.*; see also *IRS Issues Interim Guidance on Economic Substance*, Doc. 2010-20020, 2010 TAX NOTES TODAY 177-14.

75. There exists a Joint Committee on Taxation (JCT) Report that provides some guidance, however JCT Reports are not legislative history. See *Hutchinson v. Commissioner*, 765 F.2d 665, 669 (7th Cir. 1985).

76. “Major flaw in codification is not clarifying the transaction,” NYBSA, *Economic Substance Codification*, Tax Notes, June 23, 2003; “I have never seen such a vague word used at the fulcrum of a statute. If the term is broadly construed, there is an endless number of transactions subject to the doctrine, which is why the government needs to hew to a narrower definition of relevance. Otherwise, every big tax case will have an economic component.” Jeremiah Coder, *Determining Relevance of Economic Substance Doctrine is Not Hard*, *Alexander Says*, 2010 TAX NOTES TODAY 107-2 (quoting statement of David P. Hariton of Sullivan & Cromwell, LLP); “[T]he existing ambiguity in the statute suggests a broad reading of when the doctrine is applicable, that broadness ‘just can’t be where this has gone.’” (quoting statement of Karen Gilbreath Sowell of Ernst & Young LLP).

section 7701(o) had never been enacted.”⁷⁷ Section 7701(o)(5)(C) is not vague at all, it merely directs us back to case law. As the IRS Associate Chief Counsel, William Alexander stated: “The language of section 7701(o) has a ‘helpful hint’ referencing the common law doctrine, so practitioners should go back to old authorities. By using the terms ‘relevant’ and ‘common law’ in the statute, it is apparent that Congress made some effort to reference existing law.”⁷⁸

Research will reveal that the Service has only asserted the economic substance doctrine on transactions that the Service considered abusive or tax-motivated. Conveniently, those transactions are included in a non-exhaustive list that the Service has deemed abusive or tax Research will also reveal that the types of transactions where the Service has asserted the economic substance doctrine possess certain characteristics. Those characteristics include transactions that: (1) are promoted or developed by tax departments or promoters; (2) have no significant risk of loss; (3) are pre-packaged; (4) are outside the taxpayer’s ordinary course of business; (5) use various entities including partnerships, LLC’s, and trusts; (6) involve tax indifferent partners; and (8) have no meaningful potential for profit; (9) are not at arm’s length with unrelated third parties; (10) are highly structured; and (11) use unnecessary steps.⁷⁹

A taxpayer whose transaction does not contain the characteristics listed above should feel confident that he will not have to defend his business decisions. In other words, he can rely on the implication made under section 7701(o)(5)(C)—if the IRS did not consider the economic substance doctrine relevant to run-of-the-mill transactions prior to codification, then the economic substance doctrine will not be relevant to those same transactions as a result of codification.

B. Specific Transactions Not Subject To § 7701

In spite of the Service’s position that it will not provide an angel list of transactions subject to § 7701, Notice 2010-62 does provide the taxpayer with a little guidance regarding transactions that will not be subject to the economic substance test. The Notice provides that the economic substance doctrine will not apply if authorities, prior to enactment of section 7701(o), provided that the economic substance doctrine was not relevant.⁸⁰ Those transactions include (1) like-kind

77. I.R.C. § 7701(o)(5)(C).

78. *Id.*

79. See CARE Act, § 701 (draft language at section 7701(n)(3)(B)).

80. I.R.S. Notice 2010-62, 2010-2C.B. 411.

exchanges under section 1031; (2) involuntary conversions under section 1033; (3) corporate formations under section 351; (4) choosing between debt or equity to capitalize a business entity; (5) the choice between a domestic or foreign corporation for a foreign investment; (6) structuring of a corporate reorganization; and (7) use of a related entity in a transaction.⁸¹ In addition, cases factually similar to *Cottage Savings*⁸² would be safe as well.

C. *Is IRS Guidance Regarding What Transactions Are Subject to § 7701(o) Really Necessary?*

Despite what I believe to be adequate guidance concerning those transactions, “To which the economic substance doctrine is relevant,” there are many critics who will not be persuaded by my arguments. Assuming *arguendo* that taxpayers are not clear as to what transactions are subject to the economic substance doctrine and, as the critics fear, all transactions could potentially be subject to section 7701(o)—other than those specifically excluded, I respond: So what?

Perhaps, it is a good idea to force businesses to consider the purpose of their transaction prior to entering into it if they desire the tax benefit. At least one court believed that *Gregory* implied economic substance as a prerequisite.⁸³ Requiring all transactions to pass the economic test would be no different than requiring all businesses to substantiate their expenses. It would be a requirement that most transactions will meet since the majority of taxpayers truly have non-tax reasons for entering into a transaction. These run-of-the-mill transactions will not even be given a second glance by the tax auditors—at least with respect to the economic substance doctrine. The

81. See J. Comm. Staff Description of Bus. Tax Revenue Provisions, Budget Proposal, (JCS-3-09 Sept. 2009). See also S. Rep. 110-206, 92-93; Technical Explanation of the Revenue Provisions Contained in H.R. 3962, The “Affordable Health Care for America Act,” as amended at 90-91 (JCX-47-9 Nov. 5, 2009).

82. In the Supreme Court case of *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991), the taxpayer (a bank) exchanged mortgage portfolios, practically identical in nature, and realized a loss from the transaction. The transaction was entered into for the sole purpose of obtaining a deduction. The transaction had no business purpose and lacked any profit potential. Nonetheless, the Supreme Court sustained the taxpayer’s deduction finding that Congress’ intent under section 1001, and the accompanying regulations, included accelerating losses in the way the taxpayer had done. The taxpayer in *Cottage Savings*, realized an actual loss, unlike the artificial losses created in other transactions that involved sales and exchanges of property.

83. See *Lerman v. Comm’r*, 939 F.2d 44, 52 (3d Cir. 1991) (“Per *Gregory v. Helvering*. . . it is settled federal tax law that for transactions to be recognized for tax purposes they must have economic substance. Therefore, economic substance is a prerequisite to the application of any Code provisions allowing deductions.”).

Service does not have the time, interest, or money to scrutinize every business transaction. To make it a requirement for every transaction to pass the economic substance test does not mean every transaction will be subject to an inquiry by the Service.

There would only be a minority of taxpayers who would need to be concerned that their transactions will raise the eyebrows of the IRS auditors; those are taxpayers whose transactions contain the characteristics mentioned earlier.⁸⁴ However, even with those transactions, it is important to remember that just because the economic substance doctrine is relevant to the transaction it does not necessarily mean it will fail the test. Put another way, a transaction in which the economic substance doctrine is relevant, does not necessarily mean it is a tax-motivated transaction. Consider Frank Lyon, it dealt with a transaction that the Service thought was suspicious because of the unusual way the taxpayer structured its transaction.⁸⁵ The Court found legitimate reasons the taxpayer structured the transaction the way it did and found the transaction to have economic substance.⁸⁶ Thus, taxpayers with this issue should understand that their transactions will be scrutinized; therefore, they need to be prepared to defend their position.

1. First Prong – Meaningful Change in a Taxpayer’s Economic Position

Upon a determination by the courts that the transaction is one in which the economic substance doctrine is relevant, they will be put to the task of applying the two-prong conjunctive economic substance test. The first prong provides that the transaction must change the taxpayer’s economic position in a meaningful way apart from federal income tax considerations.⁸⁷ Critics of codification of the economic substance doctrine expressed dissatisfaction that neither the statute nor the legislative history defined the term “meaningful.”⁸⁸

While the critics are correct, they ignore the fact that the term “meaningful” does not become an issue unless the transaction actually changes the taxpayer’s economic position. In most economic substance

84. See CARE Act, § 701 (draft language at section 7701(n)(3)(B)).

85. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

86. *Id.*

87. I.R.C. § 7701(o)(1)(A).

88. “There is scant legislative history explaining how the terms ‘meaningful change,’ and ‘economic position’ are to be interpreted and applied.” ABA Members Seek More Guidance on Codification of the Economic Substance Doctrine, 2011 TAX NOTES TODAY 12-13.

doctrine cases, the taxpayer's economic position has not changed at all. Thus, the analysis should begin, and in most cases will end with whether the transaction changed the taxpayer's economic position.

How a transaction changes a taxpayer's economic position can be explained in the example below:

A gives B a government security in exchange for \$1million. (In essence, B is loaning A \$1 million and B receives the government security as collateral.) A agrees to repurchase the government security for \$1 million plus interest on a specified date that is prior to the date the government security matures. The amount of interest A will be required to pay will be based on the going interest rate at the time of repayment. Thus, the interest rate is not known at the time of the transaction. If at the time A repurchases the government security, i.e. repays the loan, A's government securities are worth \$900,000 and A pays \$200,000 in interest (high interest rate at 20%) A has lost \$300,000 (A paid \$1,200,000 and received back \$900,000).

On the other hand, if the value of the government securities is worth \$1.3 million and A pays back \$1 million principal plus \$100,000 in interest (assuming a low interest rate of 10%), then A gains \$200,000 (\$1,300,000 received less \$1,100,000 paid).⁸⁹

In both instances, notwithstanding income tax considerations, the taxpayer's economic position has changed, negatively in the first scenario and positively in the second. Since the above scenarios result in a true economic change to the taxpayer's financial position, the interest that the taxpayer paid on the deemed loan would entitle A to a tax deduction.⁹⁰ In other words, the transaction would be respected as having economic substance, meaning the interest deduction would be allowed.

However, one does not typically see the type of transaction in the above examples in tax motivated transactions. In a tax motivated transaction, where the government has invoked the economic substance doctrine, the taxpayer's financial position has not changed at all and if so, only negligibly. Thus, the court never arrives at determining whether the change in economic position was "meaningful", thereby rendering such term meaningless. The following cases demonstrate this position.

89. The example is based on the facts in *United States v. Wexler*, 31 F.3d 117 (3d Cir. 1994) The transaction is a "Repo" which the sale of government securities by a securities dealer to another which will be repurchased at a later time.

90. Pursuant to I.R.C. § 163(a).

*a. ACM Partnership v. Commissioner*⁹¹

In ACM, the taxpayer purchased \$175 million worth of Citicorp notes for \$175 million cash. Twenty-four days later ACM sold the Citicorp notes and received \$140 million in cash and LIBOR (London Interbank Offered Rate) notes worth \$35 million. Even the most math-challenged person could figure out that ACM earned absolutely nothing from the transaction.⁹² However, by manipulating the contingent installment sales and ratable basis recovery rules under § 453,⁹³ the taxpayer claimed a \$32 million capital loss from the transaction and offset it against capital gains in a related entity.⁹⁴ The loss, not surprisingly, was disallowed by the Commissioner. Both the Tax Court⁹⁵ and the Third Circuit Court of Appeals upheld the Commissioner's determination. While the Court of Appeals acknowledged ACM's receipt of interest payments from the Citicorp notes, it found that they did "not have a material effect on ACM's financial position because the notes paid interest at a rate that varied only nominally from the rate that ACM's \$175 million was already earning in deposit accounts before the notes were acquired."⁹⁶ In other words, the court found that the transactions with respect to the Citicorp notes left ACM in the same position it had occupied before engaging in the offsetting acquisition and disposition of those notes.⁹⁷

*b. Lerman v. Commissioner*⁹⁸ (*Disposition of property resulting in an actual loss*)

While ACM involved a disposition of property, which produced a paper loss, Lerman involved dispositions of property that resulted in actual losses. In Lerman, the taxpayer engaged in option-straddle transactions.⁹⁹ Essentially, the taxpayer engaged in related transactions spanning two years. In the first year, the taxpayer realized a loss

91. ACM P'ship, 157 F.3d at 231 (disposition of property resulting in a paper loss).

92. "The court noted that ACM sold the Citicorp notes 'for consideration equal to [their] purchase price' and thus did not realize any gain or loss in the notes' principal value." ACM P'ship, 157 F.3d at 249 (citing 73 T.C.M. at 2215 n. 19).

93. See ACM P'ship, 157 F.3d at 246; see also, Helvering, *supra* note 28.

94. *Id.* at 243.

95. See 98-2 U.S. Tax Cas. (CCH).

96. ACM P'ship, 157 F.3d at 249. It resulted in just a difference of \$3,500, "a difference which was obliterated by the transaction costs associated with marketing private placement notes to third parties." *Id.*

97. *Id.*

98. Lerman v. Comm'r, 939 F.2d 44 (3d Cir. 1991).

99. *Id.* at 47-48 (for a complete explanation of option straddles).

from the transaction and claimed an ordinary loss deduction¹⁰⁰, which he applied against ordinary income. In the second year, the taxpayer engaged in a related transaction that resulted in a gain, which, not coincidentally, equaled the loss incurred in the Year 1 transaction. Thus, the transactions put the taxpayer in the same financial position he was in prior to entering into them. However, the taxpayer deferred the gain by entering into another related transaction.¹⁰¹ Thus, while the offsetting transaction caused the taxpayer's non-tax economic position to remain unchanged, the tax benefit—taking an ordinary loss from the Year 1 transaction and deferring the offsetting gain—enriched him. In an opinion with no dissent, the Third Circuit Court affirmed the Tax Court, which held that the transactions lacked economic substance thereby denying the taxpayer the loss deduction.¹⁰²

c. *Weller v. Commissioner*¹⁰³ - *Purchase of Annuities
Financed by Debt*

The taxpayer in *Weller* purchased an annuity and pledged it as collateral to borrow funds. *Weller* then used the borrowed funds to prepay interest on future borrowings and to repay the principal on the earlier loans. The taxpayer claimed a deduction on the prepaid interest. The Third Circuit disallowed the interest deduction on the grounds that the transaction did not change the taxpayer's financial position (actually used the words "appreciably change") even though the taxpayer actually made payments satisfying the statutory definition of an "amount paid . . . on indebtedness incurred . . . to purchase a single premium life insurance contract."¹⁰⁴

d. *Gregory v. Helvering* – *Corporate Reorganization*

Let us not forget Mrs. Gregory. Her economic position did not change when she transferred one thousand shares of stock in Monitor to a newly-formed Averill Corporation only to receive the same Monitor shares back four days later when Averill liquidated. The values of the shares remained the same at the time of the transfer and upon liquidation. The Supreme Court disregarded the transaction even though the

100. I.R.C. § 165(c)(2).

101. See Lerman, 939 F.2d at 47-48 (for a detailed explanation of the transactions that the taxpayer entered into).

102. Lerman, 939 F.2d at 56.

103. *Weller v. Comm'r of Internal Revenue*, 31 T.C. 33, *aff'd*, *Weller v. Comm'r of Internal Revenue*, 270 F.2d 294 (3d Cir. 1959).

104. *Weller*, 270 F.2d at 298.

taxpayer had created a “real, valid, corporate entity and carried out a transaction that was within the terms of the statute.”¹⁰⁵

Now, if by some chance the courts find a change in the taxpayer’s economic position, it will be the courts who must decide on whether the change was meaningful. Such a broad term cannot possibly be defined in a statute, as the critics believe. To demand a definition ignores prior case law where the courts have decided such an issue. As in every fact-intensive case, whether the taxpayer’s economic position has changed in a meaningful way will depend on the facts and circumstances. The drafters of section 7701(o) were not remiss by not defining an un-definable term.

It is important to point out that the objective economic prong of section 7701(o) does not require a showing of profit motive or profit objective. The drafters of section 7701(o) should be lauded for not following the line of cases that focused on profit potential to determine whether a transaction had economic substance. Not requiring the taxpayer to show a profit objective respects and protects the integrity of legitimate transactions.

First, it prevents tax motivated transactions which lack economic substance from passing the objective prong of the test merely because it can show profit potential.¹⁰⁶ As the following case demonstrates, profit potential does not necessarily mean it has economic substance.

In *Sala v. Commissioner*,¹⁰⁷ the taxpayer’s wholly owned corporation, Solid Currencies, Inc., created Deerhurst GP partnership and transferred foreign currency options to the partnership. The options that the corporation contributed to the partnership actually had the potential to earn net profits of \$550,000¹⁰⁸ over the course of one year.

105. *Id.* at 296-98.

106. *See, e.g., Keeler v. Comm’r*, 243 F.3d 1212, 1219 (10th Cir. 2001) (“[T]he existence of some potential for profit does not foreclose a finding of no economic substance.”); *Jackson v. Comm’r*, 966 F.2d 598, 601 (10th Cir. 1992) (We have never held that the mere presence of an individual’s profit objective will require us to recognize for tax purposes a transaction which lacks economic substance.) (*citing Cherin v. Comm’r*, 89 T.C. 986, 993 (1987)); *Hariton*, 52 Tax Law 235 (“The fact that a taxpayer derives *substantial* profit from an investment will not prevent a court, however, from concluding that the investment did not significantly alter the taxpayer’s overall economic position.”).

107. *Sala v. Comm’r*, 613 F.3d 1249 (10th Cir. 2010).

108. *Id.* at 1254.

However, before such profits could be realized, after only a few weeks of existence, the partnership liquidated before the end of the year and reported a \$60 million loss on its 2000 return. This \$60 million “loss” was offset against \$60 million of income the taxpayer earned after exercising stock options which resulted in a zero tax liability for the taxpayer and a tax savings of nearly \$24 million.¹⁰⁹

As it turned out, generating profits was not the purpose of the acquisition and subsequent transfer of the options to the partnership. The creation and subsequent transfer of the options to the partnership was for the sole purpose of inflating the taxpayer’s basis in the partnership assets. The liquidation of the partnership before the end of the year was planned and necessary in order to realize the substantial tax loss.¹¹⁰ Despite the potential profit the taxpayer could have realized and in spite of the District Court’s finding that Sala entered into the transaction in order to make a profit, the Tenth Circuit found the transaction failed the economic prong.¹¹¹

Second, an economic substance test that is not based on profit potential recognizes that some legitimate business transactions such as certain leasing transactions, financing agreements, corporate reorganizations, and sale-leasebacks inherently do not produce a pretax profit, but nonetheless have economic substance.¹¹² A profits requirement would mean that these types of transactions would automatically fail the objective prong of the economic substance test.¹¹³ The likely

109. *Id.*

110. *Id.* at 1251. The taxpayer relied on a rule set out in *Helmer v. Comm’r*, 34 T.C.M (CCH)727 (1975), holding that contingent obligations were not liabilities for purposes of determining a partner’s basis in the partnership. As a result, only half of the options that were contributed to the partnership were added to the partnership basis plus an \$8 million cash investment for a total basis of \$69 million. Upon liquidation, Solid received the \$8 million cash plus \$1 million in property. Thus, Solid’s basis in the property was approximately \$61 million. Solid sold the property for under \$1 million resulting in a tax loss of over \$60 million which the taxpayer claimed for the 2000 tax year.

111. *Id.* at 1254.

112. *Sacks v. Comm’r*, 69 F.3d 982, 991 (9th Cir. 1995) (“Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pretax basis.”).

113. Staff of the Joint Comm. on Taxation, *Technical Explanation of H.R. 5095* (The American Competitiveness Act of 2002). 6 JCX-78-02 (July 19, 2002). (“[R]equiring a pre-tax profit test as part of an economic substance analysis could raise concerns with respect to certain customary leveraged lease transactions, financing arrangements in general, and transactions where the tax benefits are both intended by Congress and significant, but the transaction itself is expected to yield little (if any) profit.”); see Martin J. McMahon, *Living With the Codified Economic Substance Doctrine* TAX NOTES TODAY, 2010 TAX NOTES TODAY 158-2 (Aug. 17, 2010) (“The new statutory test recognizes that taxpayers often undertake transactions related to their business that do not in isolation produce an identifiable profit stream.”).

remedy to this problem would be for the Service to create a list of transactions which inherently does not produce a profit be specifically excluded from section 7701(o). Such a task is arduous to say the least since it would require a constant updating of transactions that the Service did not contemplate in the beginning. Thus, the remedy to the problem in requiring a pretax profit test would only create more problems.

Third, requiring a profits test would allow taxpayers to take advantage of code provisions which do not require a profit motive. In other words, transactions which lack economic substance would be shielded from the invocation of the economic substance doctrine merely because the code provision specifically holds that a profit motive is not required. Such a rule would allow taxpayers to claim loss deductions, interest expenses, depreciation, or other tax benefits for transactions that have no net effect on their financial positions. Moreover, it would overturn prior case law that has applied the economic substance doctrine even though the code provision in which the taxpayer claimed the tax benefit had no profit motive requirement.¹¹⁴

Finally, not mandating a pretax profit also prevents the problem identified by noted scholar Alvin C. Warren:

The requirement of a pretax profit in [all] cases involves an inherent dilemma because either the tax effect of a transaction turns on the presence of some positive trivial pretax profit, or, if more than a trivial pretax profit is necessary, there is no logical limitation on the amount of such profit required, short of what the market would command in such transactions if no tax benefits were involved. The first branch of the dilemma that the pretax profit need only be positive is arbitrary because a very small economic profit will validate a transaction that may be dominated by tax considerations, whereas a very small economic loss will invalidate the same transaction. But the second branch of the dilemma—requirement of a full market return—is logically incoherent because it ignores the fact that the capital markets will take preferential tax treatment into account in setting relative prices. Finally, any intermediate position—such as

114. See *Dewees v. Comm'r*, 870 F.2d 21, 35 (1st. Cir. 1989) (“[A] taxpayer cannot deduct a “sham transaction” loss, irrespective of his subjective profit motive.”); *Forseth v. Comm'r*, 845 F.2d 746, 48 (7th Cir. 1988) (If a transaction lacks economic substance “then such niceties as whether it was primarily for profit . . . are not involved.”); *Goldstein v. Comm'r*, 364 F.2d 734, 41-42 (2d Cir. 1966) (The language of section 163 did not permit deductions arising from a “transaction that has no substance . . . aside from the taxpayer’s desire to obtain the tax benefit of an interest deduction”); *Kirchman v. Comm'r*, 862 F.2d 1486, 92 (11th Cir. 1989) (“Once a court determines that a transaction is a sham, no further inquiry into intent is necessary.”); *Lerman v. Comm'r*, 939 F.2d 44, 53 (“[E]limination of a profit motive inquiry does not ‘prevent the inquiry into the economic substance of [the taxpayer’s transaction]’”).

requiring a ‘reasonable pretax return’ somewhere between a trivial amount and a full market return—is unsatisfying because choice of the intermediate position is also necessarily arbitrary.¹¹⁵

e. *Section 7701(o)(2)(A) – Where the Taxpayer Chooses to Rely on Profit*

If the taxpayer chooses, he may rely on a profit objective to meet the economic prong of section 7701(o). Section 7701(o)(2)(A) provides that “the potential for profit of a transaction *shall be taken into account* in determining whether [the transaction has economic substance] 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.”¹¹⁶

At first blush, this section seems to promote the very abuses mentioned earlier. However, a closer reading of section 7701(o)(2)(A) shows that it runs in accord with section 7701(o)(1)(A) in that it looks at whether the taxpayer’s economic position has meaningfully changed. Section 7701(o)(2)(A) merely provides guidance, a safe harbor if you may, as to how the taxpayer can show a meaningful economic change to pass the objective prong of section 7701(o).

Despite its title, section 7701(o)(2)(A) is not a profits test per se, in that it is not looking at how much of a profit was possible from the transaction. Instead, this section is using the potential for pretax profits and comparing them to the tax benefits. Thus, if the taxpayer’s potential for pretax profit is substantially greater than the net tax benefits, then the transaction has changed the taxpayer’s economic position in a meaningful way. Put another way, regardless of how much profit has been made from the transaction, if those net profits are less than or not substantially greater than the tax benefits, the taxpayer’s economic position has not meaningfully changed. Thus, a \$5 million pre-tax profit would fail the economics substance test if the tax benefits were \$50 million.

This comparison of pretax profits to tax benefits departs from the line of cases which focused only on the amount of profit potential—or lack thereof—resulting from the transaction itself and did not take

115. Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 (1981).

116. I.R.C. § 7701(o)(2)(A) (emphasis added).

into consideration the tax savings that resulted from the tax benefits.¹¹⁷

f. Brief History of the Pre-Tax Profits Test

While *Gregory* is known for the birthplace of the economic substance doctrine, the Supreme Court had no reason to address the issue of profits. That opportunity came along in *Knetsch* where the Court found that the taxpayer's transaction lacked economic substance because the transaction did not "appreciably affect [his] beneficial interest except to reduce his tax."¹¹⁸ The Second Circuit Court of Appeals upheld the Tax Court's decision in denying an interest deduction in *Goldstein v. Commissioner*¹¹⁹ because the taxpayer "did not have and could not reasonably have had any purpose or intention [in her] transactions to appreciably affect her beneficial interest except to reduce her taxes."¹²⁰

From a profits motive perspective in an economic substance analysis the outcomes in cases like *Knetsch* and *Goldstein* were understandable and expected. But what if the taxpayers in *Knetsch* or *Goldstein* actually made a profit? Would that have changed the outcome? Did the lower courts infer from the Court's opinion in *Knetsch* that as long as the taxpayer made a profit from the transaction it would be respected entitling him to the corresponding tax benefit? The answer to that question would come decades later in the form of a sale-leaseback case, *Rice's Toyota World, Inc. v. Commissioner*.¹²¹

117. Hariton, *supra* note 24, at 48 (As one noted scholar noted: "Many tax practitioners and even scholars, focusing on the mention of profit in cases . . . were until *ACM v. Commissioner*, under the impression that what was required to avoid a disallowance of tax benefits under the economic substance doctrine was a potential for profit from the relevant transactions.").

118. *Knetsch*, 364 U.S. at 366.

119. 364 F.2d 734. The taxpayer claimed an \$81,000 tax deduction because the transaction she entered into failed to produce a profit. The Court of Appeals disallowed the deduction finding that the *only* reason the taxpayer entered into the unprofitable venture was for the interest deduction.

120. *Goldstein v. Comm'r.*, 44 T.C. 284, 300 (1965) (Taxpayer won \$140,000 in a sweepstakes in 1958. Upon the advice of her son, she borrowed \$945,000 from two banks and purchased Treasury Notes worth \$1 million. The loans were subject to a 4% interest rate (\$30,000/year), while the rate of return on the Treasury notes would be no more than 1.5% (roughly 10,500/year) Thus, the transaction projected a \$19,500 loss (and an actual loss of \$25,019). Taxpayer prepaid \$81,396.61 in interest and claimed a deduction in the same amount. As a result of the interest expense deduction, Mrs. Goldstein lowered her tax liability from \$69,600 to \$23,014.04 (total tax savings of roughly \$46,000)).

121. *Rice's Toyota World, Inc.*, 752 F.2d 89 (4th Cir. 1985).

In *Rice's Toyota*, the taxpayer (Rice) entered into a sale-and-leaseback with Finalco, a leasing company. Rice purportedly purchased a used computer from Finalco for \$1,455,227, financing it with a \$250,000 recourse note, payable over 3 years, and two nonrecourse notes totaling \$1,205,227 to be paid over an eight-year period.¹²² At the time of the transaction, the computer was valued at \$1,297,643.¹²³ Rice leased the computer back to Finalco for eight years, who subsequently subleased the computer to another company for five years.¹²⁴ This benefited Rice because Finalco would only become obligated to pay rent on the lease if it received sufficient rent through subleasing the computer.¹²⁵ Rice timely paid off its \$250,000 recourse note at the end of the three-year agreement along with \$30,000 in interest for a total in payments of \$280,000.¹²⁶ At the time of the payoff of the recourse note, Rice recovered \$30,000 of his investment through the rental payments made by Finalco as a result of payments from the sub-lessee. Rice could expect another \$20,000 for the following two years from rent payments made by the sub-lessee to Finalco. However, with respect to the remaining \$230,000 that Rice had actually invested, it could only recover that amount if Finalco was either successful in subleasing the computer to another third party after the initial five-year period expired, or if Rice sold the computer for a substantial sum. Neither was likely to happen since Finalco would be entitled to 30 percent marketing fee for re-leasing the computer¹²⁷ and the value of the computer upon purchase would be less than the amount Rice paid for it.¹²⁸ Rice did not bother to consider this problem. As it was, Rice was solely interested in the accelerated depreciation deductions and interest payments that he would take.¹²⁹ During the years before the trial, Rice claimed depreciation and interest deductions totaling \$1,040,415.93 for a total tax savings of over \$350,000.¹³⁰ The tax savings exceeded the \$230,000 of his unrecovered investment.

122. *Id.* at 91.

123. *Id.* ("Finalco had recently purchased the used computer for \$1,297,643).

124. *Id.*

125. *Id.*

126. *Rice's Toyota*, 752 F.2d at 91.

127. *Id.* at 92.

128. *Id.* at 93 (Rice purchased the computer for \$1,297,643 at a time when the computer was valued at under \$1 million. The Tax Court inferred from this transaction that Rice paid more than the computer was worth because he planned "to abandon the transaction down the road by walking away from the nonrecourse note balance before the transaction ran its stated course").

129. *Id.*

130. See *Rice's Toyota World, Inc.*, 81 T.C. 184, 195 (1983), *aff'd in part, rev'd in part*, *Rice's Toyota*, 752 F.2d 89.

The Commissioner disallowed the deductions. The Tax Court, affirmed by the Fourth Circuit, sustained the Commissioner's determination because there the taxpayer had no "reasonable possibility of profit."¹³¹ The Tax Court applied this "reasonable possibility of profit" standard in subsequent cases and the standard was adopted by many circuits.¹³²

While there have not been many critics of the comparison test under section 7701(o)(2)(A), there are a number of who complain that some of the terms within that section are vague. In particular, critics argue that section 7701(o)(2)(A) does not specifically define "pre-tax profit or "reasonably expected tax benefit." Nor does it provide guidance on how to determine present value or what discount rate should be applied. Moreover, they want to know what that drafters meant by the term "substantial."¹³³

These critics seem to forget that such issues were left to the courts to resolve and should continue to rest with the courts. For example, the issue of what constitutes "substantial" cannot be answered by the statute, but will be based on the facts and circumstances of the particular case. Indeed, when the standard was a reasonable possibility of profit, the courts were not always on one accord in determining

131. *Rice's Toyota*, 752 F.2d at 91.

132. See *Klamath Strategies*, 568 F.3d at 545 ("The proper focus is on whether the loan transactions presented a reasonable possibility of profit."); *Black & Decker*, 436 F.3d 431, 41-42 (4th Cir. 2006) ("Economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."); *IES Industries, Inc. v. U.S.*, 253 F.3d 350, 354 (8th Cir. 2001) ("[The application of the objective economic substance test [involves determining]. . . whether there was a 'reasonable possibility of profit. . . apart from tax benefits.'"); *Hunt v. Comm'r*, 938 F.2d 466, 472 (4th Cir. 1991); *Hines v. United States*, 912 F.2d 736, 739 (4th Cir. 1990) (The transaction "fail[ed] to yield any reasonable expectation of a profit"); *Friedman v. Comm'r*, 869 F.2d 785, 792 (4th Cir. 1989); *Gefen v. Comm'r*, 87 T.C. 1471 (Tax Court acknowledged transaction had "economic substance because the record. . . establish[ed] that the Partnership's transactions offered a reasonable opportunity for economic profit."); *Estate of Thomas v. Comm'r*, 84 T.C. 412, 438 (holding that a transaction has economic substance and will be recognized for tax purposes if the transaction offers a "realistic opportunity for economic profit which would justify the form of the transaction.") (citing *Rice's Toyota v. Comm'r*, 81 T.C. 184, 202-3 and n. 17, *aff'd in part, rev'd in part*, 752 F.2d 89); *James v. Comm'r*, 87 T.C. 905, 924 (The transactions . . . were structured so that no prospect of achieving a non-tax profit from the transactions existed at the time the [transactions were] entered into . . . "); *Bridges v. Comm'r*, 39 T.C. 1064 (1963). For a detailed history, see generally Warren, Jr., *supra* note 119; Yoram Keinan, *The Profit Motive Requirement Under the Economic Substance Doctrine* 21 J. TAX'N INV. 81 (Oct. 2003).

133. See *McMahon*, *supra* note 117 ("There is, however, little authority explaining how to balance tax benefits against pre-tax profits in determining whether a transaction meets the objective prong of the economic substance test.").

what constituted a reasonable profit, ranging from “any” profit¹³⁴ to a “meaningful” profit.¹³⁵

Comparing the potential pretax profits to the tax benefits is certainly a stricter test than the possibility of profits test. However, for the reasons stated in an earlier section concerning the abuses that may arise with a profits test, section 7701(o)(2)(A) is a better standard to test a transaction for economic substance. Incidentally, this standard has already been used in recent court cases.¹³⁶

2. Second Prong: Substantial Business Purpose

The second prong of the economic substance test requires that the taxpayer have a substantial non-tax business purpose for entering into the transaction. This is not a difficult hurdle to overcome, as many taxpayers will testify that they reasonably believed the transaction had profit potential. The low threshold for this prong may explain why opponents have not criticized it compared to the first prong. The only criticism it has received is the statute’s failure to define what constitutes a substantial purpose. My response to this criticism is the same as earlier, what constitutes a “substantial purpose” will be based on facts and circumstances and decided on a case by case basis.

134. See Keinan, *supra* note 132, at n. 10 (citing *Dow Chemical Co. v. U.S.*, 250 F. Supp. 2d 748 (E.D. Mich. 2003); *Boca Investering’s P’ship v. United States.*, 167 F. Supp. 2d 298 (D.D.C. 2001), *rev’d* 314 F.3d (D.C. Cir. 2003); *Rice’s Toyota World*, 81 T.C. at 207 (“As shown by the financial calculations and using even the most optimistic forecasts, the transaction in the case before us could not prove profitable.”), *aff’d in part, rev’d in part*, 752 F.2d 89; *Thomas v. Comm’r*, 84 T.C. 412 (1985).

135. See Keinan, *supra* note 132, at n. 9-10 (“In transactions in which the taxpayer makes a financial investment, courts generally look for a non-*de minimis*, realistic potential for profit to determine whether there is a change in the taxpayer’s economic position. In recent years, various courts indicated that any profit is sufficient, while a few required the profit to be more than nominal.”). Other courts stated there needed to be more than a “peppercorn of economics”.

136. See *Sala*, 613 F.3d at 1254 (“Additionally, while the district court found the long and short options had a potential to earn profits of \$550,000 over the course of one year, the expected tax benefit was nearly \$24 million. That expected tax benefit [\$24 million] dwarf[ed] any potential gain [\$550,000] . . . such that ‘the economic realities of the transaction were insignificant in relation to the tax benefits of the transaction.’”); *Jade Trading, LLC*, 598 F.3d 1372, 1377 (Fed. Cir. 2010) (“[A] disproportionate tax advantage as compared to the amount invested and potential return [] compel a conclusion that the . . . transaction objectively lacked economic substance.”); *K2 Trading Ventures, LLC v. United States*, 101 F.3d Cl. 365, 382 (2011) (“[T]he high ratio of tax benefits to maximum potential profit indicates that the transactions were designed only to produce disproportionate tax benefits.”).

Strict Liability Penalty

What critics of codification dislike more than section 7701(o) is the strict liability tax penalty. In addition to disliking the fact that taxpayers cannot offer up a defense, it is also reviled because it is based on the amount of tax saved (underpayment in tax) as opposed to the amount reported, which in most cases would be a smaller amount.¹³⁷

The purpose of the strict liability penalty is to force taxpayers to think prior to engaging in transactions that reap tax benefits that are too good to be true. Given the fact that such tax motivated transactions have saved corporations millions of dollars in taxes, a strict liability penalty is the best way to halt them.

If section 7701(o) applied to all transactions then the dissatisfaction with the strict liability penalty would be understandable. However, as explained earlier in this article, the economic substance doctrine has always been applied against questionable transactions, i.e. tax shelters. Fighting tax shelters without an accompanying mandatory penalty will always result in a loss for the government. Penalties that can be avoided by showing reasonable cause—which is generally a tax opinion letter from the tax advisor—is not a deterrent.¹³⁸ Imposing a strict liability penalty will certainly curb the aggressive tax shelters. In other words, the strict liability penalty should only result in a chilling effect for tax motivated transactions, not legitimate business transactions.¹³⁹

137. See Alison Baker, *Economic Substance Could be Prominent Issue for IRS, Courts, Congress*, 10 DAILY TAX REP. (BNA) S-18 No. 10 (2010). see also AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM 1 (2009), available at <http://www.aicpa.org/Press/PressReleases/2009/Downloadable Documents/AICPA-report-civil-tax-penalty-reform.pdf> (“overbroad, vaguely defined, and disproportionate penalties, particularly those administered as a part of a system that automatically imposes penalties or that otherwise fails to provide basic due process safeguards, create an atmosphere of arbitrariness and unfairness that is likely to discourage voluntary compliance.”).

138. See Martin J. McMahon, *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 2003 TAX NOTES TODAY 52-35 (Mar. 18, 2003) (“The efforts of the IRS to combat this new wave of tax shelters through a program based on mandatory disclosure of certain transactions, coupled with settlements without penalties for certain voluntary disclosures do not appear to be working overwhelmingly well.”).

139. INTERNAL REVENUE SERVICE, CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE AND RELATED PENALTIES (Sept. 14, 2010) available at <http://www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties>. The Service issued an LB&I Directive, LMSB-20-0910-024 requiring review and approval by the Director of Field Operations of any proposed strict liability penalty as a result of failing the two-prong economic substance test under section 7701(o).

V. CONCLUSION

Section 7701(o) is not inherently flawed as the critics suggest. The decision not to provide further guidance with respect to the application of the economic substance test will not result in taxpayer uncertainty and a halt in normal business practices. If nothing else, it brings about certainty to the taxpayer, as well as to the government and the courts as to how to apply the proper test. Taxpayers engaging in legitimate transactions should feel comfortable continuing with such transactions. The questions that the critics demand from the government such as what constitutes a “meaningful change” and “substantial,” will be answered by the proper authority—the courts.
