Whatever Happened to Codified Economic Substance?

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Our Panel

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Whatever happened to the codified economic substance doctrine?

• History of economic substance and “clarification.”
• Government implementation of codified economic substance.
• Developments under pre-clarified economic substance.
• Decisions under codified economic substance.
• Upcoming cases under codified economic substance.
• Government application of codified economic substance.
• Taxpayer response to codified economic substance.
• Was it worth it?
What is the economic substance doctrine?

• Roots in *Gregory v Helvering*.

• *Frank Lyon Co. v. United States*:
  
  • [W]here, as here, there is a genuine multiple-party transaction *with economic substance* which is compelled or encouraged by business or regulatory realities, *is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features* that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

• Two “prongs”: objective economic substance and subjective business purpose.

• Is it a rule of statutory construction, a fact finding rule or a substantive requirement of the tax law? When does it apply?
Transactions to which economic substance doctrine was applied

• Sales and leasebacks: *Hilton v. Commissioner, Rice’s Toyota World, Inc. v Commissioner.*


• Liability assumptions: *Coltec Industries v. United States, The Black & Decker Corp. v United States, WFC Holdings Corp. v. United States.*

• Son-of Boss and other partnership “basis builds”: *American Boat Company, LLC v. United States, Jade Trading, LLC v. United States.*

• Commodity straddles: *Glass v. Commissioner, Sheldon v. Commissioner, Kirchman v. Commissioner.*
The doctrine is “clarified” – what does that mean?

- Section 7701(o) and associated penalty provisions had been on the drawing board since the Clinton administration (see 2001 Budget Proposal).
- They were enacted into law as part of the Health Care and Education Reconciliation Act of 2010 (Obamacare).
- Estimated to raise $4.5 billion between 2010 and 2019.
- Effective for transactions entered into after March 30, 2010.
- Section 7701(o) provided clarification (and perhaps required consistency) on a number of points.
- Amendments to sections 6662 and 6664 added a new accuracy-related penalty.
Clarification of economic substance

• 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:
  • The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and
  • The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

• “Economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.
Clarification continued

• Profit potential as meaningful change or substantial purpose:
  • Present value of reasonably expected pre-tax profit form the transaction is substantial in relation to the present value of the expected net tax benefits.
  • Fees and other transaction expenses taken into account as expenses in determining pre-tax profit.
  • Treasury shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit “in appropriate cases.”

• State and local tax benefits and financial accounting benefits are not meaningful changes or substantial purposes if related to / resulting from the federal tax benefit.

• “The determination of whether the economic substance doctrine is relevant ... shall be made in the same manner as if this subsection had never been enacted.”

• “Transaction” includes a series of transactions.
Clarification: Penalty changes

• Section 6662(b)(6) added a new instance for application of the 20% accuracy-related penalty: “any disallowance of claimed tax benefits by reason of a transaction lacking economic substance … or failing to meet the requirements of any similar rule of law.”

• Section 6662(i) increased the penalty to 40% for any “nondisclosed economic substance transaction,” requiring relevant facts affecting the tax treatment to be adequately disclosed on the return or an attached statement.

• Section 6664 and 6676 amended to eliminate reasonable cause / good faith defense to penalties.
Government implementation of clarification

• Notice 2010-62 (September 13, 2010):
  • Use of “conjunctive” economic substance; IRS will challenge taxpayers who rely on either objective economic substance or subjective business purpose, but not both.
  • “Relevance” expected to continue to develop; IRS will not issue general administrative guidance on transactions to which doctrine is relevant.
  • IRS to use existing case law and guidance on calculating pre-tax profit.
  • IRS and Treasury will issue regulations on when foreign taxes are treated as expenses, but this should not restrict courts in the interim.
  • Describes what the IRS will consider adequate disclosure for section 6662(i).
Government implementation continued

• September 14, 2010: guidance that any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.

• July 15, 2011: outline of four-step procedure that examination is expected to follow when seeking approval of DFO to apply the doctrine.

• April 3, 2012: instructions to Counsel for coordination with examinations, issuance of statutory notice, and in litigation.

• Notice 2014-58: guidance on “transaction” (aggregation and disaggregation) and “similar rule of law” (sham transaction, yes; substance over form and step transaction, no).
Recent developments in “common law”

- STARS cases.
- CARDS cases.
- *Tucker* – “customized” foreign exchange transactions providing some profit potential.
- *Summa Holdings* and *Benenson* Appeals Court decisions and *Mazzei* Tax Court decision.
- *Illinois Tool Works*. 
STARS transactions

• Complex transactions in which US bank would expose some of its assets to UK taxation, generating UK tax benefits for Barclays, which would share the benefit through low cost financing for US bank.

• Necessary for US bank to take foreign tax credit for UK taxes in order to obtain overall cheap financing.

• *Salem Financial, Bank of New York Mellon, Santander Holdings* all disallowed use of foreign tax credits.

• Economic substance doctrine “relevant” to these transactions.

• Foreign taxes treated as expense to determine pre-tax profitability.

• Transaction “disaggregated” to find transaction without economic substance.
CARDS transactions

• Increased basis in assets by claiming partnership liable for full amount of joint and several liability on foreign currency borrowing.

• *Baxter* (Fourth Circuit), *Curtis Investment Company LLC* (11th Circuit): separate appeals of single Tax Court decision, affirmed in each case.

• No question of whether doctrine was relevant; disaggregation upheld.

• Fourth Circuit (disjunctive analysis) found both lack of objective economic substance and no subjective non-tax business purpose.
“Customized solution” for lawyer / CPA who became CEO of Waddell & Reed and then recognized $40+ million from stock option exercise in 2000.

The structure involved setting up a CFC that entered into a digital FX option spread, recognizing the gain leg, checking the box on the CFC before 30 days ran out, and then recognizing the loss leg. Election under 367 temporary regulations allowed taxpayer to avoid recognizing gain.

Fifth Circuit held that economic substance doctrine applied (was relevant) and that digital FX option had no reasonable opportunity of profit (no objective economic substance).

Commissioner did not challenge taxpayer’s win on reasonable cause / good faith defense on appeal.
Summa Holdings, Inc and related cases

• *Summa Holdings, Inc.* considered a structure in which Roth IRAs owned DISCs. Taxpayers used DISC pricing rules to transfer substantial value into DISCs and hence IRAs.

• IRS challenged on substance-over-form principles, claiming that distributions from DISCs to Roth IRAs were in substance distributions made to company shareholders, followed by (excess) contributions to Roth IRAs.

• Tax Court agreed with IRS, but Sixth Circuit reversed: attempt to recharacterize the flows a stretch, and in any case, the only purpose of the Roth IRA and DISC provisions was tax minimization.

• Indications as to “relevance” of economic substance?
Summa Holdings, Inc.

James Benenson, Jr.
Trust for sons
Summa Holdings, Inc.

Son 1
Son 2
Roth IRA
Roth IRA

Tax
Dividend
DISC commission payments

JC Export (a DISC)
JC Holdings
Cases after *Summa Holdings*

- *Celia Mazzei v Commissioner*: Tax Court case considered Roth IRA – FSC structure; despite similarities to *Summa Holdings*, Tax Court again affirmed IRS recharacterization of distributions as made to shareholders, followed by (excess) contributions to Roth IRAs on substance-over-form principles.

- Decision reviewed by full court; dissent by four judges.

- After *Celia Mazzei*, the *Summa Holdings* decision was followed in First and Second Circuits (*Benenson*, dealing with shareholders of Summa Holdings).
Celia Mazzei, et al.

Mazzei Injector Corp. → FSC managed by Western Growers Assn → Roth IRA

(Treated as separate FSCs)

Tax on only a portion of FSC income

Angelo Mazzei → Roth IRA
Mary Mazzei → Roth IRA
Celia Mazzei → Roth IRA
Illinois Tool Works

• Parent owned chain of foreign corporations; upper tier foreign subsidiary had cleared out its earnings and profits with earlier distributions to parent.

• Lower tier subsidiaries lent money to upper tier foreign subsidiary, which then paid a return-of-capital distribution to parent.

• IRS recharacterized the loans as distributions.

• In Tax Court, taxpayer met the well-established criteria for shareholder loans rather than distributions.

• After traditional finding, Tax Court dealt with whether economic substance doctrine would recharacterize; it found that the loans had both objective economic substance and subjective non-tax business purpose.

• Why didn’t the court hold that the doctrine was not relevant here?
Post-effective date cases

- Section 7701(o) and the amended penalty sections apply to transactions entered into after March 30, 2010.
- One decision applies section 7701(o) to a post-March 30, 2010 transaction.
- Several cases mention the economic substance accuracy-related penalty, but it has not applied yet.
Question to be decided was whether a given mix of alternative fuel and diesel qualified for a credit under Code section 6426(e).

That subsection gives a credit of 50¢ per gallon of alternative fuel used by the taxpayer in producing any alternative fuel mixture “for sale.”

The taxpayer claimed the credit where it paid users a per gallon “handling fee” to take its alternative fuel mixture and the users paid a fixed amount, regardless of number of gallons delivered.

Court of Federal Claims determined that the “small sales price” lacked economic substance because it was used only to garner the tax credits.

Was section 7701(o) necessary for this result?
Cases citing penalty provisions

- *United States v. Owensboro Dermatology Assoc., PSC.*: section 6662(b)(6) penalty asserted in related Tax Court cases; District Court of Kentucky denied government motion to compel production of attorney-client emails.

- Tax Court cases involve captive insurance companies; Commissioner asserted, among other things, that the transactions lacked economic substance.

- Taxpayers asserted that they relied on the advice of their lawyers (reasonable cause defense); government argues this waives attorney-client privilege.

- Apparently, the reasonable cause defense was to the alternative 6662(h) (gross misstatement of value) penalty.
Cases citing penalty provisions

• *Estate of Howard Barnhorst, II v Commissioner*: 6662(b)(6) and 6662(i) penalty asserted, but conceded by Commissioner before trial.

• *Estate of Barnhorst* involved whether a payment under a disability policy was excludable under Code section 105. The policy was purchased first in 1999; the claim was made in March 2010.

• IRS asserted the economic substance penalty in the Notice of Deficiency.

• In answer to Tax Court petition, Commissioner switched to ordinary 20% accuracy related penalty.

• Obvious effective date concerns (what is the “transaction” here?), but how did the Notice of Deficiency get past Chief Counsel review?
What has IRS experience been?

• How often does Examination contact Associate Chief Counsel (Procedure and Administration) concerning 7701(o) or economic substance penalties?

• How is four-step process working?
  • 90-day letters asserting economic substance for post-March 30, 2010 transactions.
  • Docketed cases involving economic substance.

• Is relevance of economic substance doctrine a consideration?

• What is the breakdown in application: individuals, small businesses, public corporations?
One recent discussion of economic substance

• AM 2018-002 (February 28, 2018). Concerned the treatment of refined coal credit transactions and the eligibility of participants therein to claim the section 45 tax credit.

• Analyzed outside equity participants in refined coal credit transactions under a bona fide partner analysis, a prohibited sale of tax credits analysis, or an economic substance analysis.

• Application of economic substance under 7701(o) ("relevance") same as under pre-codification.

• “[T]he economic substance doctrine should not be applied to disallow the refined coal credit if the taxpayer is, in form and substance, undertaking the type of activity that the refined coal credit was intended to encourage.”

• “[A]n investor must have an entrepreneurial interest in the underlying activity giving rise to the credit.”

• Why even discuss economic substance doctrine in this instance?
How should banks deal with codified economic substance?

• Has it been raised in examinations?
• How to handle economic substance questions in examination.
• How to analyze current transactions:
  • Specific borrowings and investments.
  • Marketed structures.
• Opinion practice: is there less value to an opinion?
Cases discussed

- *Salem Financial, Inc. v United States*, 786 F.3d 932 (Fed Cir 2015).
- *Santander Holdings USA, Inc. v United States*, 844 F.3d 15 (1st Cir 2016).
- *Tucker v Commissioner*, [Cite] (5th Cir 2018).
- *Benenson v Commissioner*, 887 F.3d 511 (1st Cir 2018).
- *Estate of Howard J. Barnhorst, II v Commissioner*, TC Memo 2016-177.