Substance, Form and Ambiguity: Will the IRS Challenge Your Transaction by Asserting the Economic Substance Doctrine?

2014—Issue 6—It remains hard to say whether the IRS will challenge your transaction by asserting the economic substance doctrine, because the IRS said in December it won’t be issuing anticipated further guidance or an angel list. Therefore, make sure to structure your deals carefully, documenting their business purposes.

The economic substance doctrine, unlike many other principles of tax law, was developed by courts as a common law principle. For years, the doctrine was argued by the IRS and enforced by the courts, although it appeared nowhere in the Internal Revenue Code. In 2010, however, the economic substance doctrine was finally codified by the Health Care and Education Reconciliation Act. Unfortunately, the new code sections by design neglected to provide when the economic substance doctrine would apply. Thus, although there is now a definition of the economic substance doctrine, there remains substantial uncertainty as to when a transaction will be subjected to it. In mid–December, Daniel Rosen, special trial attorney with the IRS’s Large Business and International Division (LB&I), announced that it “has no intention to issue guidance on when the economic substance doctrine will apply.” Additionally, he provided that the IRS would not be issuing an “angel list” of transactions deemed to meet economic substance requirements since the IRS does not want a bright-line test. He further noted that the IRS would like to see a body of case law develop around the economic substance doctrine.

All of this comes as no real surprise to those who have followed this and related issues over the past few years. The IRS has been aggressive in its application of economic substance concepts both to transactions that strike practitioners as obviously questionable and to those that historically were considered safe. The IRS has won a series of recent court decisions that support its view.

By way of example, in 2013 several economic substance cases were litigated, including Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15 (2013); Salem Financial Inc. v. United States, No. 10–192T (Ct. Fed. Cl. Sept. 20, 2013); and Santander Holdings USA Inc. v. United States, 2013 WL 5651414 (D. Mass.). These cases all involved structured trust advantaged repackaged securities (STARS) transactions, and the results were mixed, with BNY Mellon and Salem Financial coming down in favor of the government, and Santander Holdings being decided in favor of the taxpayer. Although the cases reached different results, the facts in each case were substantially the same. In each case, a U.S. bank entered into a transaction with Barclays, a British bank, whereby Barclays received substantial benefits under U.K. tax laws. Barclays, in turn, was able to lend funds to the U.S. bank at a lower cost than would otherwise be available. Additionally, the U.S. banks were able to take valuable deductions and foreign tax credits that would not otherwise have been available.

The inconsistent results in the three cases arose as a result of differing application of the economic substance doctrine. The courts agreed that the relevant component of a transaction with multiple steps to be considered when analyzing for economic substance is the portion of the transaction that produces the disputed tax benefit. However, in both BNY Mellon and Salem Financial, the courts decided that the trust arrangement that provided the tax benefit to Barclays and the reduced rate loan from Barclays to the U.S. bank were unrelated and therefore applied the economic substance test only to the trust arrangement. In both cases, the court then determined that the trust arrangement lacked economic substance and the transactions were instead an “elaborate series of prearranged steps designed as a subterfuge for generating, monetizing, and transferring the value of foreign tax credits.” (Bank of New York Mellon, 140 T.C. 15 (2013)). Conversely, the court in Santander Holdings took into account the entirety of the STARS transaction when testing for economic substance. Because Santander (formerly BB&T) had a reasonable opportunity to profit from the transaction as a whole, the transaction met the economic substance test.
These differing holdings are likely to mean continued confusion on the proper application of the economic substance doctrine both broadly and to STARS transactions specifically. These cases support the position that in order to meet the economic substance test, the courts continue to believe that transactions with a demonstrable non-tax profit motive will be better positioned. BNY Mellon has expressed its intent to appeal the decision in its case, so perhaps there is taxpayer guidance on the horizon.

On January 13, 2014, the government scored two more victories in Kerman (cert. denied, S.Ct. 13–387) and United States v. Nevada Partners Fund (cert. granted, S. Ct. 13–343). In Kerman, the Supreme Court declined to review a Sixth Circuit Case affirming the Tax Court decision that a taxpayer who entered a custom adjustable rate debt structure (CARDS) transaction was not entitled to a loss deduction because of lack of economic substance. Similarly, in Nevada Partners Fund, the Supreme Court vacated the Court of Appeals decision that held that a valuation misstatement penalty did not apply in a situation where an entire transaction was disregarded for lack of economic substance.

In a context largely unrelated to STARS or CARDS transactions, May 2013 brought us the final word on Historic Boardwalk Hall v. Commissioner, 694 F.3d 425 (3rd Cir. 2012) cert. denied 2013 WL 249846, which was another instance where the IRS and the court applied common law economic substance principles to attack a transaction that was not a tax shelter. When the U.S. Supreme Court denied cert., taxpayers were left with a Third Circuit decision siding with the IRS and requiring taxpayers to consider an economic substance type analysis in the context of tax credit transactions that many taxpayers did not historically view as subject to this level of scrutiny. Unlike the more general economic substance cases described above, the IRS issued Rev. Proc. 2014–12, which provides a safe harbor regime in 2014 related to allocation of historic rehabilitation credits. This safe harbor was, among other things, a response to feedback from the business community about the uncertainty of credit allocation and its impact on the market.

However, as discussed in a previous issue of Tax Advisor Weekly, the safe harbor in Rev. Proc. 2014–12 is not necessarily taxpayer favorable and in fact requires an analysis of the economic value of an investment in the partnership entirely without regard to the value of the tax credits. Given the impact the valuation requirements in the safe harbor could have on the market for the credits and the pricing, it seems clear the government has become emboldened by its recent success in asserting the economic substance doctrine. This raises questions about whether the IRS will begin to interpret narrowly other seemingly taxpayer-favorable provisions of the Internal Revenue Code. Furthermore, this revenue procedure shows that taxpayers may want to be careful what they wish for when asking for bright-line guidance.

In light of the current emphasis on the application of the economic substance doctrine, the following is a summary of the technical aspects of the law that may be helpful. Taxpayers would be wise to consider these rules when structuring most of their transactions.

**Economic Substance Background**

Economic substance is a common law doctrine that courts have developed and applied to deny the tax benefits of a transaction that complies with the literal requirements of the tax code but lacks any practical economic significance apart from the tax benefits achieved. Courts generally agreed on the prongs of the economic substance test, which were that a tax-beneficial transaction (a) changed a taxpayer’s economic position and (b) had an underlying business purpose. But courts disagreed whether a taxpayer had to satisfy both prongs (the conjunctive test) or only one prong (the disjunctive test). Thus, for many years there was a great deal of uncertainty about both when the economic substance doctrine would be applied and, when applied, what form it would take.

In 2010 the Health Care and Education Reconciliation Act codified the economic substance doctrine. This Act, which added new IRC section 7701(o)(1), imposes a conjunctive test requiring taxpayers to demonstrate both an objective element regarding the effect of the transaction on the taxpayer’s economic position and a subjective element inquiring into the taxpayer’s motives for entering into the transaction. Therefore, many commentators believe that the Act effectively superseded the disjunctive test used by some courts. Section 7701(o)(1) reads:

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 transaction.
The term “economic substance doctrine” is defined under Code section 7701(o)(5)(A) to mean “the common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”

The Act also added section 6662(b)(6), which imposes a 20 percent strict liability penalty for the underpayment of tax attributable to any disallowance of a claimed tax benefit because of a transaction lacking economic substance or failing to meet any similar rule of law. The penalty is increased to 40 percent where the relevant facts are not adequately disclosed in the return or in a statement attached to the return (IRC section 6662(i)(1)).

Applicability and Relevance of the Economic Substance Doctrine
Fortunately, however, the economic substance doctrine does not apply to all transactions. Under section 7701(o)(5)(A), the determination of whether a transaction is subject to the economic substance doctrine is made “in the same manner as if section 7701(o) had never been enacted.” The IRS later elaborated in Notice 2010–62 that “if authorities prior to the enactment of section 7701(o) provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.”

In other words, the provision “does not change the present law standards in determining when to utilize an economic substance analysis” according to the Joint Committee on Taxation (JCX–18–10 (March 2010)). The JCT further noted that if “the realization of the tax benefits of a transaction is consistent with the Congressional purpose of plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.” It is worth noting that the result in Historic Boardwalk seems to run counter to this idea.

Giving taxpayers hope that additional clear guidance may follow, in July 2011, the IRS published a directive, LB&I–4–0711–015, to instruct examiners on how to determine when it would be appropriate to assert the economic substance doctrine. The directive provided a list of facts and circumstances that tend to show the application of the economic substance doctrine to a transaction is likely not appropriate. If some of the factors apply to the transaction and an examiner continues to believe that the application of the doctrine is appropriate, the examiner should proceed to analyze the transaction using the guidance provided in the directive. The IRS has now clarified that it will not be issuing a formal “angel” list of protected transactions or issuing formal guidance to elaborate on the discussion in the non–binding LB&I directive.

Alvarez & Marsal Taxand Says:
In summary, the IRS considers the issue of economic substance as highly subjective. As a result, it is prime for dispute, and ultimately a high number of cases are likely to remain unresolved at the examination level. Since many economic substance issues involve material items where the taxpayer is unwilling to accept the proposed assessment, particularly in light of the 20 percent and 40 percent penalties, this may often lead either to settlement at appeals or possibly to a higher percentage of litigation, given the IRS’s view that it would like to see the courts provide a body of case law on the subject. When the IRS issued the examination directive in 2011, it appeared the IRS might be willing to issue more bright–line standards; however, these do not appear to be forthcoming. As a result, taxpayers would be well advised to continue to seek specific tax–structuring advice for their transactions, thereby increasing the likelihood that the arrangement will be viewed as having economic substance. Therefore, we also suggest contemporaneous documentation of the business purposes and the related financial analysis, in addition to documentation of how the deal was structured.

Disclaimer
As provided in Treasury Department Circular 230, this publication is not intended or written by Alvarez & Marsal Taxand, LLC, (or any Taxand member firm) to be used, and cannot be used, by a client or any other person or entity for the purpose of avoiding tax penalties that may be imposed on any taxpayer.

The information contained herein is of a general nature and based on authorities that are subject to change. Readers are reminded that they should not consider this publication to be a recommendation to undertake any tax position, nor consider the information contained herein to be complete. Before any item or treatment is reported or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. The information reported in this publication may not continue to apply to a reader’s situation as a result of changing laws and associated authoritative literature, and readers are reminded to consult with their tax or other professional advisors before determining if any information contained herein remains...
applicable to their facts and circumstances.

**About Alvarez & Marsal Taxand**

Alvarez & Marsal Taxand, an affiliate of Alvarez & Marsal (A&M), a leading global professional services firm, is an independent tax group made up of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend A&M’s commitment to offering clients a choice in advisors who are free from audit-based conflicts of interest, and bring an unyielding commitment to delivering responsive client service. A&M Taxand has offices in major metropolitan markets throughout the U.S., and serves the U.K. from its base in London.

Alvarez & Marsal Taxand is a founder of Taxand, the world’s largest independent tax organization, which provides high quality, integrated tax advice worldwide. Taxand professionals, including almost 400 partners and more than 2,000 advisors in 50 countries, grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

To learn more, visit [www.alvarezandmarsal.com](http://www.alvarezandmarsal.com) or [www.taxand.com](http://www.taxand.com)

**Related Issues:**

### Safe Harbor Partnership Rules for Historic Rehab Credits [5]

On January 13, 2014, the Internal Revenue Service will publish Revenue Procedure 2014–12 in Internal Revenue Bulletin 2014–3. Oh, and by the way, Happy New Year to you too. In the Revenue Procedure, the Internal Revenue Service sets forth a safe harbor for partners to share rehabilitation credits generated by a partnership under IRC Section 47.

### Disappearing Partnership Basis: Is Your Partnership Debt Basis at Risk? [6]

Did you know that Treasury and IRS officials appear close to issuing newly proposed Treasury regulations that could significantly impact the way partnership debt is characterized and allocated?
Could the Uncertainty in the Tax Credit Market Help Developers and Possibly the Whole Market? [7]

On August 27, 2012, in Historic Boardwalk Hall LLC v. Comm’r, 694 F.3d 425 (2012), the United States Court of Appeals for the Third Circuit sided with the IRS and denied historic rehabilitation credits for a state authority’s purported partnership with a credit investor, Pitney Bowes Inc...

Source URL:

Links

Authors:
Tyler Horton, thorton@alvarezandmarsal.com, +1 202 688 4218