The Service Continues to Challenge Taxpayer Transactions Based on the Economic Substance Doctrine

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Valuation analysts and other financial advisers are often called on to perform economic substance analyses in federal income tax challenges. In these cases, the Internal Revenue Service challenges a tax deduction or loss related to a taxpayer transaction by applying the so-called economic substance doctrine. Codified in Internal Revenue Code Section 7701 and repeatedly accepted by the courts, this doctrine allows the Service to disallow a taxpayer transaction if the taxpayer (or the taxpayer's expert witness) cannot prove that (1) the taxpayer expected to earn a profit (absent any income tax consideration on the transaction and (2) the taxpayer had a reasonable business purpose for entering the transaction (other than the reduction of income tax expense). Recently, the Service issued expanded administrative and procedural guidance regarding its application of the economic substance doctrine. This discussion summarizes the guidance provided in Notice 2014-58.

Introduction

A basic principle of the federal tax law is that a taxpayer is entitled to structure its business transactions in a manner that produces the least amount of tax. However, taxpayer business transactions must have "economic substance." The so-called economic substance doctrine is codified in Internal Revenue Code Section 7701(o) and the related Section 6662 tax penalty provisions.

Simply stated, a taxpayer transaction is considered to have economic substance if it has (1) a reasonable possibility of the taxpayer earning a profit and (2) an independent business purpose other than the taxpayer's saving of income taxes. The Internal Revenue Service ("the Service") continues to be diligent in examining—and disallowing—taxpayer transactions that it considers to lack economic substance or to be a sham.

Accordingly, in federal income tax disputes, valuation analysts, economists, forensic accountants, and other financial advisers (collectively, "analysts"), are often called on to analyze—and opine on—whether taxpayer transactions either have or lack economic substance.

These economic substance analyses typically focus on two economic questions:

1. Does the taxpayer have a reasonable expectation of earning a positive economic benefit from the subject transaction?
2. Is there a reasonable business purpose for the taxpayer entering into the subject transaction—other than the reduction of federal income taxes?

The Service has generally prevailed in many of its judicial decisions regarding economic substance challenges to taxpayer transactions. In these challenges, the Service typically alleges that the taxpayer entered into the suspect transaction solely for the purpose of generating tax deductions or capital losses.

In other words, the Service claims that the only expected economic benefit from the suspect transaction is the reduction of taxable income—and income taxes. When litigated, these economic substance cases often become a battle of the accounting, economics, or valuation experts.

And, in 2010, the Service obtained an additional tool in its challenge of taxpayer transactions when the U.S. Congress codified the so-called economic substance doctrine in the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) (hereinafter “the 2010 Act”).

Late last year, the Service issued a notice that provides taxpayers and their legal and other tax advisers with updated guidance with regard to its interpretation of the economic substance doctrine.

Notice 2014-58 expands on the prior administrative and procedural guidance available from Notice 2010-62. The 2014 notice provides guidance on the definition of the term “transaction” in the application of the Section 7701(o) economic substance doctrine. Notice 2014-58 also provides updated guidance on the meaning of the term “similar rule of law” under the Section 6662(b)(6) accuracy-related penalty.

The 2014 notice is effective retroactively—for taxpayer transactions entered into after March 30, 2010.

Economists, forensic accountants, and valuation analysts who perform economic substance transactional analyses for federal income tax purposes should be familiar with this updated administrative and procedural guidance. In addition, taxpayers that are involved in economic substance disputes with the Service—and their legal and other tax advisers—should also be familiar with this updated guidance.

The Economic Substance Doctrine

As mentioned above, Congress codified the economic substance doctrine as part of the 2010 Act. The 2010 Act added Section 7701(o) to the Internal Revenue Code.

Section 7701(o) states that a taxpayer transaction is considered to have economic substance if it meets a two-part test:

1. The transaction must change in a meaningful way, apart from any federal income tax effects, a taxpayer’s economic position.
2. The taxpayer must have a substantial purpose, apart from any federal income tax effects, for entering into the transaction.

The term “economic substance” is defined in Section 7701(o)(5)(A) as the common law doctrine that disallows income tax benefits under Internal Revenue Code subtitle A, if the transaction that produces those income tax benefits lacks either:

1. economic substance or
2. a business purpose.

Definition of the Term “Transaction”

Notice 2014-58 applies an aggregation definition to the term “transaction.” That is, according to the 2014 notice, a transaction “generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of those steps that are carried out as part of a plan.”

Therefore, when a taxpayer transaction that generates an income tax benefit involves a series of interconnected steps with a common objective, then the transaction is considered to include all of the steps in the aggregate. Under this 2014 notice

interpretation, each interconnected step should be considered when analyzing whether the taxpayer transaction as a whole lacks economic substance.

However, when a taxpayer transaction includes a series of steps, including a tax-motivated step that is not necessary to achieve a nontax objective, Notice 2014-58 indicates that the Service may apply a disaggregation approach.

This disaggregation approach determines whether any of the individual tax-motivated steps is considered a separate transaction that is subject to the economic substance doctrine. Accordingly, under the 2014 notice provisions, the Service is free to either aggregate or disaggregate the interconnected steps of an overall taxpayer transaction.

And, the Service may aggregate or disaggregate a transaction's interconnected steps when assessing the application of the economic substance doctrine on a case-by-case basis.

This Notice 2014-58 definition of transaction is consistent with the legislative history of the term "transaction" in Section 7701(o)(b)(6). That legislative history was provided in the House report on the 2010 Act. The 2014 notice specifically refers to that House report.

That House report explains that the legislative provision "does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction" when applying the economic substance doctrine.[1]

Definition of the Term "Similar Rule of Law"

Sections 6662(b)(6) and 6662(i) together impose a per se 40 percent penalty for taxpayer transactions that fail the economic substance doctrine or a "similar rule of law."

Notice 2014-58 provides an explanation that "a similar rule of law" is a rule or doctrine that applies the same factors or analysis as required under Section 7701(o). The 2014 notice explanation indicates that the "similar rule of law" provision applies even if the doctrine is called something different.

Notice 2014-58 provides the example of the "sham transaction doctrine." Specifically, the 2014 notice defines "similar rule of law" to mean a rule or doctrine that disallows the income tax benefits under Internal Revenue Code subtitle A related to a taxpayer transaction because:

1. the transaction does not change a taxpayer's economic position in a meaningful way (apart from federal income tax effects) or
2. the taxpayer did not have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

Notice 2014-58 also explained that the Service will not apply a Section 6662(b)(6) penalty unless the Service also raises Section 7701(o) to support its underlying income adjustments.

Even with this updated administrative guidance, it remains to be seen exactly how or when the Service will assert the codified economic substance doctrine. The guidance in LB&I-4-0711-015 provides for a specific set of factors for the Service examiners and their managers in the Large Business & International (LB&I) division to consider and procedures for the LB&I division to follow when seeking approval through the Service's chain of command to apply the Section 6662(o)(6) penalty.

Taxpayers and their advisers should hope that the Service's decision to apply the Section 6662 tax penalty will not be taken lightly.

Summary of Recent Judicial Decisions

As mentioned in the introduction, the Service has historically experienced a fair amount of success when it applies the economic substance doctrine to challenge suspect taxpayer transactions in the courts. The last year or two continued this trend of judicial success related to the Service's use of the economic substance challenge.

The following discussion summarizes several recent judicial decisions (all pre-2014 notice) in which the Service challenged taxpayer transactions under the economic substance doctrine.

Kenna Trading, LLC

In 2014, in *Kenna Trading, LLC*,[2] certain Brazilian retailers contributed distressed consumer accounts receivable to a limited liability company (LLC). The LLC claimed a carryover tax basis in the receivables under Section 723.

Later, the LLC contributed some of the accounts receivable to trading companies and then contributed the LLC's interest in each trading company to a holding company.

The LLC claimed a cost of goods sold deduction for each holding company equal to the tax basis of the contributed accounts receivable. The LLC then sold an interest in each holding company to an investor. The trading companies claimed bad debt deductions related to the accounts receivable.

The next year, the LLC contributed more of the Brazilian accounts receivable to main trusts. Each main trust then assigned the accounts receivable to a newly created subtrust. Other investors contributed cash to the main trust, in exchange for a beneficial interest in the subtrust. The subtrusts then claimed bad debt deductions for the accounts receivable.

Claiming that the subtrusts were grantor trusts, for federal income tax purposes, the investors claimed deductions on their income tax returns. The Service disallowed these bad debt deductions under the economic substance doctrine.

In addition, the Service levied (1) the Section 6662(h) gross valuation misstatement penalties, (2) the Section 6662(a) accuracy-related penalties related to the amount of the LLC's underpayments of tax, and (3) a Section 6662A listed transaction understatement penalty.

The Tax Court received expert testimony from both sides in the case. In its decision in *Kenna Trading, LLC*, the Tax Court held that the Brazilian retailers did not intend to enter into a partnership for federal income tax purposes. In addition, the Tax Court concluded that the LLC had a cost basis in the accounts receivable, not a carryover tax basis.

Also, the Tax Court found that the entire taxpayer transaction lacked economic substance. Lastly, because the LLC had understated its income as the Service proved, the Tax Court concluded that the LLC was subject to all three tax penalties.

Humboldt Shelby Holding Corp.

Humboldt Shelby Holding Corp.[3] provides another recent economic substance judicial decision. In *Humboldt Shelby Holding Corp.*, the taxpayer, a holding company, bought two corporations that had recently realized large capital gains.

To avoid paying taxes on the gains it inherited, the taxpayer executed a common tax-avoidance scheme to generate capital losses. Under the scheme, the taxpayer contributed offsetting short-term options to two LLCs that it had formed. The taxpayer increased its tax basis in the recently formed LLCs by the cost of the purchased options. However, the taxpayer did not reduce tax its basis by the cost of the sold options.

This accounting treatment allowed Humboldt Shelby Holding Corp. to increase its tax basis in the partnerships by approximately $75 million—while spending only $320,000.

After the options expired, the taxpayer resigned from the LLCs and received stock with a very low fair market value—and a very high tax basis. The taxpayer then sold the stock and recognized capital losses of almost $75 million. These capital losses completely offset the gains that the Humboldt Shelby Holding Corp. had inherited from the two corporations.

The Service issued a deficiency notice disallowing the taxpayer's claimed deductions from the stock sales under the economic substance doctrine. In addition, the Service assessed the accuracy-related penalty under Section 6662.

Again, the Tax Court received expert testimony from both sides in the case. In *Humboldt Shelby Holding Corp.*, the Tax Court concluded that the taxpayer improperly deducted capital losses on stock with a basis that was artificially inflated in a transaction that lacked economic substance. In addition, the Tax Court concluded that Humboldt Shelby Holding Corp. was liable for the Section 6662 accuracy-related penalty.

Summary and Conclusion

Both at the examination level and in the courts, the Service continues to challenge suspect taxpayer transactions based on the so-called economic substance doctrine. And, at least at the judicial level, the Service continues to win many of these taxpayer transaction challenges. The Service seems to be successful in these challenges when the taxpayer's expert witness cannot convince the court regarding both questions to the economic substance test.

Notice 2014-58 provides Service-friendly administrative and procedural guidance with respect to the application of the economic substance doctrine. However, at least this 2014 notice provides expanded guidance that taxpayers (and their legal and other tax advisers) can consider in their tax planning related to proposed transactions. Valuation analysts, forensic accountants, and economists who provide so-called economic substance analyses should be familiar with this most recent guidance provided by the Service.

Notes:

1. See House Report No. 111-443, 111th Cong., 2d Session 296.
2. Kenna Trading, LLC v. C.I.R., 143 T.C. No. 18 (2014).
3. Humboldt Shelby Holding Corp. v. C.I.R., T.C. Memo. 2014-47 (March 18, 2014).

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