CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

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ABSTRACT

The Health Care and Education Reconciliation Act of 2010 (Public Law No. 111-152) contains numerous tax provisions. One of these provisions (Act Section 1409) contains the codification of the Economic Substance Doctrine. This doctrine has been used since the *Gregory* case in 1935 (*Gregory v. Helvering*) to deny tax benefits when it is determined that no "economic substance" exists in a particular transaction apart from federal tax considerations. However, there has been some definitional split among the circuits as to exactly what constitutes economic substance.

This article will give the history of the economic substance doctrine, the reasons for the codification, and reach a conclusion as to whether or not codification was necessary. The article will explain the economic substance rule, explain the provisions of the new law (including how it expands the doctrine), and conclude with a critique of the law.

Common Law Doctrines in the Tax Law

As a former colony of the United Kingdom, the United States uses a common law system. A feature of the common law is that judges refer to earlier cases, or precedents, in deciding cases that come before them. Sometimes, the dispute in a case involves a new matter and there is no existing precedent. When this happens, the case is known as a case of first impression. The decision in a case of first impression creates a new precedent. The trial court decision might be overturned on appeal. If the trial court's decision is supported on appeal, or if other trial courts adopt the same or similar rules, the original decision becomes the foundation for a common law rule. These common law rules are also referred to as common law doctrines. Although courts generally follow precedent, common law doctrines are flexible. The courts may adapt doctrines to new or changing circumstances.

Another important feature of the United States legal system is the clear hierarchy of laws. The United States Constitution is the highest law of the land. Next in authority are the statutes passed by Congress and signed into law. Common law doctrines evolve through the judicial system and are lower in the hierarchy than statutes. This means that Congress may overturn or modify common law doctrines through the legislative process.

The tax law, more than most areas of the federal law, is statutory. Most tax rules are contained in the Internal Revenue Code.[1] There are, however, a few important common law doctrines used in the tax law. Many of these date back to the 1930s. Several of the common law doctrines share more than a passing resemblance to each other, both in their nature and in the way that the Treasury Department uses them to disallow positions taken by aggressive taxpayers. These include the step transaction doctrine, the substance over form doctrine, the sham transaction doctrine, the business purpose doctrine, and the economic substance doctrine (Bankman, 2000).

The Health Care and Education Reconciliation Act of 2010 (Public Law No. 111-152) (hereinafter the "Reconciliation Act") contains numerous tax provisions. One of these provisions (Act Section 1409) contains the codification of the Economic Substance Doctrine. This provision is codified as Internal Revenue Code (IRC) §7701(o).

In this article, the authors will give the history of the economic substance doctrine, explain the common law doctrine as it existed prior to the passage of the Reconciliation Act, list the stated reasons for the codification, and reach a conclusion as to whether codification was necessary. The article will also explain the provisions of the new law (including how it expands the doctrine) and critique the law.

History and Definition of Economic Substance

Gregory v. Helvering, 293 U.S. 465 (1935) was a landmark decision by the Supreme Court that is often cited as the source of several important legal doctrines: the business purpose doctrine, the doctrine of substance over form, the step transaction doctrine and the economic substance doctrine. *Gregory* was the first case of its kind to come before the courts on the issue of whether there was a tax-free corporate reorganization where there was no intent to carry on business, only to avoid taxes (Quinn and Flesher 2002). As mentioned above, many of the common law doctrines in the tax law share features and are used by the Treasury for similar purposes. The business purpose doctrine states that when a transaction has no substantial business purpose other than tax savings, the transaction will not be allowed for tax purposes. The doctrine of substance over form means that regardless of the form of the transaction, its economic substance will determine its tax treatment. The step transaction doctrine states that the taxation of a complex transaction should be determined by reference to the beginning and ending points rather than at each intermediate step along the way. The economic substance doctrine will be explored in the following paragraphs.

In 1928, Mrs. Gregory owned all the stock of the United Mortgage Company (United) and United owned 1,000 shares of another company, Monitor Securities Corporation (Monitor). Monitor's stock had appreciated in value and Mrs. Gregory wanted to sell the stock but also wanted to minimize any tax liability on the profit. Specifically, she wanted to avoid any double taxation. If United sold the stock, any gain would be taxed at United's ordinary income tax rate

and any distribution of the proceeds to Mrs. Gregory would be in the form of a taxable dividend to Mrs. Gregory.

To reduce the taxes on the sale of the stock, the following plan was carried out. Mrs. Gregory incorporated a new company called the Averill Corporation (Averill). United transferred all the Monitor stock to Averill and Averill distributed the Averill stock to Mrs. Gregory. Three days later, Mrs. Gregory dissolved Averill and the Monitor stock was distributed to Mrs. Gregory as a liquidating dividend. Mrs. Gregory then sold the Monitor stock and reported the transaction on her individual tax return. She took a basis in the Monitor stock equal to the proportion of the original cost of her United shares that the Monitor stock held relative to the total assets of United. She reported a gain equal to the proceeds from the sale less the basis she attributed to the Monitor stock.

Upon audit, the Commissioner of the IRS assessed a deficiency on the grounds that no true reorganization took place. Mrs. Gregory appealed the decision to the Board of Tax Appeals, which held for Mrs. Gregory. The Commissioner then petitioned the Second Circuit U.S. Court of Appeals.

The Second Circuit Court of Appeals heard *Helvering v Gregory,* 69 F.2d 809 (1934). In an opinion written by Judge Learned Hand, the Appeals Court rejected the lower court's opinion in favor of Mrs. Gregory. Although Mrs. Gregory followed the letter of the law, the transaction did not follow the 'spirit of the law'. Although the transactions took the form of a corporate reorganization, in substance, the transactions were really a transfer of property to Mrs. Gregory. There was no business purpose for the transactions other that tax savings.

Mrs. Gregory then appealed the decision to the U.S. Supreme Court. In *Gregory v. Helvering* 293 U.S. 465 (1935), the Court found that the transactions were a true corporate reorganization, stating that " the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." The Court held that the transaction was outside the plain intent of the statute.

In essence, the economic substance doctrine means that a transaction with no economic substance will not be recognized for tax purposes. No matter how closely a transaction is structured to follow the letter of the law, if it lacks economic substance, it will be disallowed.

The Tax Shelter Cases and a Definitional Split among the Circuit Court of Appeals

The IRS has used the economic substance doctrine for decades in its fight against tax abuse. A series of tax shelter cases were tried in the 1980s and 1990s. The common feature in these cases was an attempt by the Treasury Department to deny tax benefits to taxpayers who implemented increasingly complicated tax stratagems that complied with the technical letter of the law, but did not change the economic position of the taxpayer in a significant way. The courts were in general agreement as to the applicability of the economic substance doctrine, but were not in agreement as to how it should be applied. The highest courts to review these cases were the Circuit Courts of Appeals; the United States Supreme Court did not revisit the economic substance doctrine to resolve the split among the circuits.

Several courts adopted a "two-pronged" test. One group of courts required the taxpayer to meet both parts of the test. The first part of the test is that the taxpayer must prove that the transaction in question has any economic substance beyond producing tax savings (*Pasternak* 1993). Several courts used the sham transaction doctrine to evaluate this prong of the test, and this test was viewed by the courts as an objective standard.[2] The second prong requires the taxpayer to show a profit motive behind the transaction *(Pasternak* p898). This second prong allows the court to consider subjective factors, as the taxpayer's motive and intent may not be something that can be reduced to a single number.

Other courts used a two pronged test, but did not require the taxpayer to meet both prongs. A taxpayer who met one test could sustain the desired tax benefits. For example, in *Rice's Toyota World*, *Inc. v. Commissioner of Internal Revenue*, 752 F.2d 89 (4th Cir., 1985), the taxpayer entered into a transaction that was clearly motivated by tax savings. However, the court held that some parts of the transaction had economic substance. The tax benefits related to these parts of the transaction were allowed.

Another group of courts held that the economic substance test was a single test focused on whether there were economic benefits beyond tax savings (*E.G. James v. Commissioner,* 899 F.2d 905, 908-09 (10th Cir. 1990)).

In recent years, the Treasury Department has won several significant cases. *Coltec Industries, Inc. v. U.S.* 454 F.3d 1340 (Fed. Cir., 2006) is an example of one of these cases. This case has a strong focus on the objective test. The taxpayer activated a formerly inactive subsidiary and contributed high basis assets and contingent liabilities to the subsidiary in exchange for newly issued stock. It took a basis in the subsidiary stock equal to its basis in the assets, but made no downward adjustment for the contingent liabilities. The taxpayer then sold the subsidiary for a nominal price, and recorded a significant capital loss. Normally, a corporate taxpayer does not desire capital losses, but, in this case, the taxpayer had significant capital gains to offset against the loss.

In *Coltec Industries v. U.S.,* 94 AFTR 2d 2004-6708 (Ct. Fdl. Cl., 2004), the trial court found that either the economic purpose doctrine was unconstitutional, or, alternatively, there was a legitimate business purpose involved in managing the contingent liabilities. Upon appeal, the taxpayer lost because they could not meet the objective standard. There was no economic basis for the idea that a corporation could insulate itself from liabilities for past acts by transferring those contingent liabilities to a subsidiary.

The Treasury Department has argued for codification of the economic substance doctrine for years. In 1999, testifying before the House Ways and Means Committee, Jonathan Talisman, Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury, stated that the Treasury Department was concerned about the proliferation of corporate tax shelters. Talisman testified that a common characteristic of tax shelters is the lack of economic substance and that the Treasury believes that a codification of the economic substance doctrine is necessary to curb the growth of abusive tax shelters. Talisman testified that "The centerpiece of the substantive law proposal is the codification of the economic substance doctrine first found in seminal case law such as *Gregory* . . . ." (Talisman, 1999).

The Codification

Newly adopted Section 7701(o)(1) requires a conjunctive test for determining if a transaction has economic substance. A transaction will be considered as having economic substance only if it both changes in a meaningful way (apart from federal taxes) the taxpayer's economic position ***and*** the taxpayer has a substantial purpose for entering the transaction (other than federal income taxes purposes). This is the two prong test where the taxpayer must meet both tests to be successful.

Section 7701(o)(2) delineates a special rule if the taxpayer relies on profit potential of a transaction to meet either or both of the tests of Section 7701(o)(1). Such requirements are considered to be met only if the present value of the reasonably expected pre-tax profit from transaction is substantial in relationship to the present value of expected tax benefits. Gross income alone cannot meet the standard.

Paragraph 4 of the Section states that financial accounting benefits of the transaction are not to be considered as meeting the Section 7701(o)(1) dual prong tests if such benefits are solely based on reductions in federal income tax. In addition, fees and foreign taxes will be treated as expenses further lowering pre-tax profit according to paragraph (2)(B). The effect will be to make it harder to meet the pre-tax profit test. Therefore, the reduction of these taxes may not be used as a reason to enter the transaction.

A financial accounting benefit cannot be considered to achieve a paragraph (1)(B) benefit if the benefit is due only to the reduction of federal income taxes. Therefore, a higher net income due only to lower federal income taxes from the transaction does not pass the conjunctive test.

These rules apply to transactions entered into after the enactment date of March 31, 2010.

The law does allow an exception for personal transactions of individuals in paragraph (5)(B). Individuals will only be subject to the economic substance doctrine for transactions entered into for an activity engaged in for the production of income or connected to a trade or business.

According to paragraph (5)(C), the codification does not affect whether the economic substance doctrine is relevant to a particular transaction. The codification is only relevant to transactions that would have fallen under the rules prior to the Act. This will continue to be determined in the same way as if the act had not been enacted. In paragraph (5)(D), the term "transaction" is defined as referring to a single transaction or a series of transactions.

Another provision of the Act modifies IRC Section 6662 increasing the penalty for nondisclosed noneconomic substance transactions. Any portion of the underpayment of tax which is related to a nondisclosed noneconomic substance transaction shall be subject to a 40 percent penalty instead of 20 percent penalty. This would include transactions described in 6662(b)(6) where relevant facts had been omitted on the tax return and attached statements.

The Act disallows the use of a reasonable cause exceptions allowed under section 6664(c) for transactions that fall under the economic substance doctrine**.** Special rules were enacted for amended returns. "In no event shall any amendment or supplement to a return be taken into account for the purpose of this subsection if the amendment or supplement was filed after the

earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date specified by the Secretary (IRC Section 6662 (i)(3).

Conclusion

Codification of the economic substance doctrine has been promoted as a weapon against aggressive tax shelters and as a source of revenue for the government. One stated advantage of codification is the elimination of uncertainty in the application of the doctrine to taxpayer activities. Although the Treasury was a strong supporter of codification, codification was not without its critics. The AICPA wrote a letter in 2007 arguing against the codification of the economic substance doctrine. The main points in this letter were that the codification would introduce statutory complexity, traps for unwary taxpayers, and would deprive the tax law of needed flexibility. The Institute went on to say that fixed rules could be easily avoided by aggressive taxpayers.

As mentioned above, common law doctrines allow flexibility in the law as times and circumstances change. The economic substance doctrine has functioned in this manner as part of the tax law for 75 years. Although §7701(o)(5)(C) retains the common law rules for determining the application of the doctrine, codification removes much of the flexibility that previously existed in the law.

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IRC §7701(o)(5)(C).

IRC §7701(o)(5)(D).

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[1] Title 26 of the United States Code. All section references in this document are to the Internal Revenue Code of 1986 as amended.
[2] *Id. See also, Casebeer v. Commissioner of Internal Revenue*, 909 F.2d 1360, 1363 (9th Cir. 1990).