

The Economic Substance Doctrine

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Topics

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 - When Will ESD Apply?
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[Note: Case citations that do not appear in slides can be found in Appendix.]

H.R. 4872

- Section 7701(o) Clarification of Economic Substance Doctrine-
- `(1) APPLICATION OF DOCTRINE- 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.
- `(2) **SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL-**
- `(A) IN GENERAL- The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction **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.
- `(B) TREATMENT OF FEES AND FOREIGN TAXES- Fees and other transaction expenses **shall be** taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in **appropriate cases**.
- `(3) STATE AND LOCAL TAX BENEFITS- For purposes of paragraph (1), any State or local income tax effect which is **related to** a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.
- `(4) FINANCIAL ACCOUNTING BENEFITS- For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a **reduction** of Federal income tax.
- `(5) DEFINITIONS AND SPECIAL RULES- For purposes of this subsection--
- `(A) ECONOMIC SUBSTANCE DOCTRINE- **The term `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.**
- `(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS- In the case of an individual, paragraph (1) shall apply only to transactions entered into **in connection with a trade or business or an activity engaged in for the production of income**.
- `(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED- The determination of whether the economic substance doctrine is **relevant** to a transaction shall be made in the same manner as if this subsection had never been enacted.
- `(D) TRANSACTION- The term `transaction' **includes a series of transactions.**'.

H.R. 4872

- Section 6662(b)(6) [20% accuracy related penalty] Any 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(i) Increase in Penalty in Case of Nondisclosed Noneconomic Substance Transactions-
- `(1) IN GENERAL- In the case of any portion of an underpayment which is **attributable to** one or more **nondisclosed** noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting `40 percent' for `20 percent'.
- `(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS- For purposes of this subsection, the term `nondisclosed noneconomic substance transaction' means any portion of a transaction described in subsection (b)(6) with respect to which the **relevant facts affecting the tax treatment** are not adequately disclosed in the return nor in a statement attached to the return.
- `(3) SPECIAL RULE FOR AMENDED RETURNS- In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is 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 as is specified by the Secretary.'
- Section 6676(c) [erroneous claim for refund penalty] Noneconomic Substance Transactions Treated as Lacking Reasonable Basis- For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.'
- [Coordination of Penalties: (1) if 40% penalty applies, section 6662A reportable transaction penalty cannot apply; (2) fraud penalty trumps ESD penalties; (3) no reasonable cause exception can apply.]
- (e) Effective Date- (1) IN GENERAL- Except as otherwise provided in this subsection, the amendments made by this section shall apply to **transactions entered into after** the date of the enactment of this Act.

Codification: General Information

- The Act does not codify the ESD but rather codifies a precondition to taxpayer's escaping the ESD, and imposes penalties, which seem to be the most important feature of the enactment.
- The core issue of when the ESD is "relevant" to a tax benefit from a transaction is left undefined.
- The codification ultimately resulted from a combination of influences: (1) it carried a \$4.5B revenue estimate (over 10 years) and so was used to bring down the cost of the health care bill, of which it was a part; (2) initially at least, taxpayer groups wanted more certainty about the test, which the provision supplies to some extent; (3) politically it was viewed as part of cracking down on abusive taxpayers; and (4) it had been somewhat of a political football, first in favor during the last days of the Clinton administration, then out of favor during the Bush administration, then Senator Obama co-sponsored one of the earlier bills in 2007, then it passed during the Obama administration, after having been included in the President's 2010 Budget proposal.
- The most thorough official review of the ESD and codification proposals is in JCS-3-09 (Sept. 2009) Description of Revenue Provisions in 2010 Budget, Part Two, pp. 34-72 ("JCT 9/09").
- The JCT explanation was continuously refashioned as various bills were introduced, ultimately resulting in JCX-18-10 (3/21/2010), with the final bill.
- This provision was removed from the bill, but remains in the JCT explanation in substance: OTHER COMMON LAW DOCTRINES NOT AFFECTED- Except as specifically provided in this subsection, the provisions of this subsection shall not be construed as altering or supplanting any other rule of law, and the requirements of this subsection shall be construed as being in addition to any such other rule of law.

Codification

JCT 9/09 Description:

- “. . . several doctrines [including ESD] .. can be applied to deny tax benefits of a tax motivated transaction, *notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision.*” (p. 34) (emphasis added)
- “. . . if the tax benefits are clearly consistent with all applicable provisions of the code *and the purposes of such provisions*, it is not intended that such benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision.” (p. 44) (emphasis added) [But JCX-18-10, fn. 344, dropped “clearly.”]
- Notes S. 2242 proposal leaves to court to determine applicability of doctrine. (p. 43); JCX-18-10 carries this forward.
- At p. 37 seems to dismiss separation of powers argument against ESD and points to heavy burden on taxpayer who appears to act with purpose of tax avoidance.

Codification

- A fair statement of the codification based on contents of H.R. 4872 and the JCT explanations is as follows:
 - A taxpayer whose facts (as properly determined under all available methods for disregarding fraud, integrating step transactions, identifying the existence of debt and insurance, etc.) otherwise satisfy the legal requirements (as properly interpreted as a matter of law) for a tax benefit, shall be denied that tax benefit, if in the opinion of the IRS:
 - (1) the benefited taxpayer was motivated to arrange the transaction by a purpose to obtain that tax benefit,
 - (2) the benefit was not within the “purposes” Congress had in mind in writing the pertinent statute, and
 - (3) the taxpayer fails to prove satisfaction of the statutory economic substance test once the Service asserts application of the ESD.

Codification

The JCT 9/09 Description stated the goals of codification as follows:

- provide partial certainty by resolving the lack of uniformity in different judicial version of the tests;
- possibly lead to more IRS success in asserting ESD by overruling courts that allow proof of one “prong” of test to satisfy;
- increase level of profit and business purpose required relative to some tests stated by courts;
- not change the “existing judicial framework” under which applicability of ESD is determined;
- no intent to modify the application or development of other interpretive rules or prevent Service from proceeding on multiple grounds;
- change taxpayers’ cost-benefit analysis and deter some aggressive taxpayer behavior;
- not to displace the common law ESD in cases to which the statute is inapplicable (such as individual non business/investment activities).

Specifics of Sec. 7701(o)/ Current Operation of ESD

When Will the ESD Apply in Practice?

- When IRS asserts it applies.
 - “..if economic substance as such is not explicitly stated as one of the grounds for disallowance of tax benefits, the application of the companion penalty provisions may be in doubt.” JCS 9/09 at p. 47.
 - Presumably IRS agent must believe that taxpayer likely qualifies for the tax benefit as reported in the return under the law and facts as normally determined, but Congress did not intend to so benefit that taxpayer.
 - Therefore, at the outset of the dispute there will arise important issues of:
 - (1) statutory construction (which always includes consideration of congress’ intent and purposes);
 - (2) applicability of any safe harbors;
 - (3) whether in practice auditors can short circuit the threshold question of relevance of the ESD to the case by simply finding the two prong test to have been failed by the taxpayer;
 - (4) the scope of the excluded personal transactions;
 - (5) audit procedure and burden of proof on the ESD relevance question.

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Statutory intent:

- JCT 9/09 quotes Senate Report for principle that ESD will not apply when “the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions.” (p. 45)
- JCX-18-10 n. 344 downgraded this statement to “consistent with” the Congressional purposes or plan that Congress designed the benefits to effectuate.
 - Gave examples of secs. 42, 45, 45D, 47 and 48 credits that are allowable if the transactions occurred in form and substance. Did not cite, but similar to Rev. Rul. 79-300 (sec. 183 n/a to low income housing pship even though cannot make any money, but depends on tax benefit of losses)
 - Therefore IRS auditor will weigh when benefits are not consistent with purposes of Code provisions; presumably auditor will have already determined that the benefits are consistent with the terms of the provisions themselves.
 - In effect codification will backhandedly define ESD as applying to tax benefits that IRS perceives to be inconsistent with purposes of the particular Code provision the taxpayer relies on for the tax benefits.
 - To what extent do words Congress writes into the Code reflect its “intent” and “purpose”?
 - Will/should assertion of ESD be limited to listed transactions?; authorization up the chain at IRS?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Statutory intent:

- Will/does IRS view all tax benefits that it conceives to have been “unintended” by Congress to be outside the purposes of Congress and thus subject to the ESD, justifying deficiency and penalty assessment?
- How does IRS agent determine the Code purposes?
 - Rev. Proc. 64-22, 1964-1 C.B. 689: “It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is “protecting the revenue.” The revenue is properly protected only when we ascertain and apply the true meaning of the statute.”
 - “The proper method for conveying the positions of the Office and the policies of the Service is through published guidance. In contrast, litigation should be used as an enforcement tool to advance and defend established positions, not as a vehicle for making policy.” I.R.M. 31.1.1.1.3(1).

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Statutory intent:

Apply the ESD to landmark cases:

- *Cottage Savings*: Overall transaction of mortgage pool interest swaps had no possible economic profit and no business purpose; motivated entirely by desire for tax benefit of loss recognition, and losses were not booked for accounting purposes. [may be an allowed “longstanding choice” discussed below]
- *Esmark, Inc. v. CIR*, 90 T.C. 171, aff’d, 886 F.2d 1318 (7th Cir. 1989): overall transaction had business purpose and economic effect, but arguably not the steps by which Mobil purchased Esmark stock from public, followed by stock’s redemption for stock of Vickers subsidiary of Esmark; not economically different from sale of Vickers by Esmark.
- *Chamberlin v. CIR*, 207 F.2d 462 (6th Cir. 1953): No business purpose to distribute preferred pro rata on common, with plan for preferred to be bought by friendly insurance company. Ruled for taxpayer; congress had to change law (sec. 306).
- *Cumberland Public Service*: Same overall business purpose as in Gregory v. Helvering, but no business purpose for step of distributing assets before their sale, allegedly by shareholders; no economic impact of steps on either corporation or shareholders other than tax reduction.

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Statutory intent:

Apply the ESD to landmark cases:

- *Frank Lyon*: No business purpose for Lyon's seller/lessee (the bank) not to have borrowed the money and built its own building; alleged lease economically similar to that result; no economic savings but tax savings.
- *Gitlitz*: taxpayer allowed to deduct presumably real losses on account of phantom income providing basis; is this protected from ESD simply because taxpayer and S corp. did not engage in any "transaction" that they could control in the year at issue? Should the timing of the discharge of indebtedness of the S corp in that year have been questioned?

Specifics of Sec. 7701(o)/Current Operation of ESD

When will ESD apply: Safe Harbors: “longstanding administrative choices”

According to JCS 9/09 and JCX-18-10 these safe harbors exist. They are categorized as a possibly second category of cases to which ESD is not relevant: **“certain basic business transactions that under longstanding judicial and administrative practice** are respected [and the ESD will not be applied to them] merely because the choice **between meaningful economic alternatives** is largely or entirely based on comparative tax advantages.” The four non exclusive examples are:

- (1) capitalizing a “business enterprise” with debt or equity;
 - The use of debt is the biggest “tax shelter” there is, due to the interest deduction; why is it excluded? What does this say about perceived congressional view of debt? Will this be useful in future debt/equity disputes? Does it matter that the creditor is related (not according to later safe harbor).
 - Debt also is a principal ingredient of most transactions the IRS views as “tax shelters,” for examples: Knetsch; Rice’s Toyota; ACM, but these were not literally debt v. equity cases. Note, safe harbor protects only choice of capitalizing an entity, not debt as used in the cited cases.
 - What is a “business enterprise”? Is it limited to entities; does it include sole proprietorship; what if the undertaking being financed is an investment and not a business?
 - Does this exclusion add to the implication that the ESD otherwise can apply to steps in a larger transaction (like running a business in a corporation) that passes the 2 prong test?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Safe Harbors Cont'd

- (2) U.S. person's choice to operate a foreign business in a domestic (i.e. branch) or foreign corporation (but fn. indicates questions can arise about whether the corporation is acting as agent for its shareholders).
 - Once again, this safe harbor shows the ESD dodging the 2d biggest "tax shelter": the ability to defer income offshore. Does this mean that the "reality" of foreign corporations will be unquestioned? JCX-18-10 fn. 347 indicates Bollinger agent exception.
- (3) entering into a corporate reorganization (which has its own business purpose requirement), or organization.
 - How does this square with IRS position when it cites Caruth, 688 F. Supp. 1189, for "business purpose" requirement for sec. 351?
 - How about Mrs. Gregory?
 - JCX-18-10 justifies this safe harbor by fact that Chief Counsel will not give comfort rulings on these transactions?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Safe Harbors Cont'd

- (4) utilizing a related party in a transaction, so long as arm's length/section 482 standards and "other applicable concepts" (which the footnote indicates refers to the Moline Properties – National Carbide – Bollinger standards for respecting corporations and use of corporations as agents by their shareholders) are followed.
 - Why are not all related party transactions particularly suspect?
 - Doesn't sec. 482 rule for intangibles assume that arm's length prices cannot be trusted between related parties?
 - Is a related party partnership safer to use than a related party corporation?
 - Does ESD defer totally to sec. 482?
 - How about Gregory, Higgins v. Smith, McWilliams?
 - Cf. Reg. 1.881-3(a)(4) (being related is primary way to trigger conduit financing regs)
 - JCX-18-10 fn. 349 contrasts Moline/National Carbide/Bollinger/Aiken Ind./sec. 7701(l) conduit regs.

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Default Possibility # 1 - Any time two prong test failed?

- Example: IRS auditor concludes transaction (a) resulted in favorable tax reporting; (b) did not have business purpose; (c) was not expected to make much money.
 - Isn't that likely to be the end of the auditor's analysis?
 - Isn't the "relevance" issue likely to be skipped or assumed?
 - Once the deficiency is set up, what realistic opportunity will taxpayer have to prove satisfaction of law as written and prove facts as occurred, or to contest ESD relevance short of court?
 - JCS 9/09 and 2007 S. Rep. say flunking 2 prong test not dispositive, but isn't it likely to work out that way in practice?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Any time two prong test failed?

- In fact, courts do not necessarily determine that the taxpayer's facts satisfy the law as written before applying the ESD, nor do they spend much time analyzing the relevance of the ESD.
 - Country Pine Finance LLC v. Commissioner, T.C. Memo. 2009-251 (CARDS case; analysis portion of opinion only involved application of ESD, citing Am. Elec. Power)
 - Am. Elec. Power Co. v. United States, 326 F.3d 737, 741 (6th Cir. 2003) (rejected trial court “sham in fact” finding, while applying 6th Cir. version ESD).
 - Two recent BLISS cases analyze and decide only ESD: Palm Canyon, T.C. Memo 2009-228; New Phoenix Sunrise Corp., 132 T.C. No. 9 (2009).

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply: Default Possibility # 2 - Any time “relevance” is found?

- Assuming the IRS agent will not tend to assert the ESD unless the agent perceives a tax motivated transaction (which is not hard to perceive), is it likely as a practical matter that the dispute may be over once the “relevance” issue is resolved by the agent/LMSB?
 - IRS Chief Counsel cannot advise agent on the factual analysis specifically.
 - Chief Counsel, or LMSB, or agent, or Appeals determination of relevance will be determinative absent litigation?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply? Non business/income exclusion

- Not to individual's transactions unless business or for production of income
- Actually, 7701(o)(5)(B) does not protect the individual non income transaction from the ESD but only from being limited by the 7701(o)(1) two prong test
 - So ESD can still apply.
- Presumably means gross income expectation can subject individual to the test (as in sec. 212)
 - So 212, 183 hobby loss rule, and ESD can all apply to activity expected to produce gross income
 - But sec. 183 much easier for taxpayer to prove out of than ESD (need not even have reasonable expectation of profit)
- So ESD two prong test not apply to transactions designed to reduce taxes like:
 - estate planning?
 - Charitable contributions?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply? Procedure:

- Must and when must IRS assert ESD by name?
 - Is litigation too late? Is appeals too late?
 - Is RAR expected to be the proper place for assertion of ESD?
- What legal consequences hinge on timely assertion?
 - Applicability vel non.
 - statutory penalties: 40% penalty can apply only if 20% ESD penalty could apply; even if 20% penalty would also apply due to substantial understatement, the ESD ground must be properly asserted and relied upon for the 40% penalty to apply.
 - Burden of proof? Shifts to IRS in Tax Court if ESD raised after petition filed. TCR 142(a).
- In what venue(s) will Taxpayer be able to dispute applicability/relevance of ESD?
 - Most taxpayers likely will be forced into Tax Court to avoid paying heavy penalties first.
- Isn't the threshold decision made by the agent to assert the ESD likely to go unchanged absent litigation?

Specifics of Sec. 7701(o)/ Current Operation of ESD

When will ESD apply? Procedure:

- As to the “consistent with” purposes of the code, this is a legal issue, not a factual issue.
 - The Service is asserting a rule contrary to statute and regulations law and so should have some sort of burden to justify that.
 - But *Chevron* deference likely will accord some weight to the Service’s view.
 - What role will *Chevron* deference play in the ESD?
 - Even if taxpayer has normal burden of proof as to the two prong test if ESD is asserted, the taxpayer should not be tasked with any burden to counter the Service’s assertion of the generally applicability of the ESD, but rather the court should carry out its duty to determine the true meaning of the law.

Specifics of Sec. 7701(o)/ Current Operation of ESD

Scope of the Transaction

- Does the overall transaction as well as each step have to meet the test?
- Should apply to overall transaction only, to be consistent with the fundamental right, recognized by the Supreme Court in *Gregory v. Helvering*, of taxpayers to arrange their affairs so as to reduce their tax liability = selecting the steps to the end result.
- But sec. 7701(o)(5)(D) is ambiguous:
 - Defines transaction as including series of transactions
 - JCX-18-10 states no intend to limit “... the court’s ability to aggregate, *disaggregate*, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to *bifurcate a transaction* in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”
 - How about the IRS agent’s ability?
- JCX-18-10 seems to lean toward applying ESD to isolated step; cites *Coltec* for its application of ESD to the particular step that produced the high basis. (fn. 352)
- Also, the four longstanding safe harbors are all usually steps in larger transactions.
- In contrast, *Shell Petroleum*: refused “slicing and dicing.”
- Cf. Notice 98-5 (foreign tax credit “shelters” proposed regulation): “...portions of a single transaction or investment may be treated as separate arrangements. ...For example, ... if a controlled foreign corporation, as part of its business, enters into a buy-sell transaction involving a debt instrument, that buy-sell transaction could be treated as a separate arrangement.
- Conclusion: IRS likely will go narrow on defining the transaction in order to limit profit associated with it and bring its purpose into question.

Specifics of Sec. 7701(o)/ Current Operation of ESD

The Two Prong Test: Economic Position Change

- Statute does not require net profit potential but rather “meaningful change to taxpayer’s economic position,” which it calls “economic substance”.
 - Note: sec. 7701(o) uses term “economic substance” in two ways, both of which are different from usual meaning: as (1) a shorthand name for the two prong ESD test in 7701(o)(1), and (2) in 7701(o)(5)(A) as a shorthand name for the economic position change prong of the ESD test.
 - Neither of the usages is the same as the common law fact finding method of basing the characterization of facts on economic substance (for example, the corporate tax law has long known that when the corporation paid the shareholders taxes it paid a dividend: that is economic substance fact finding)
 - **THEREFORE, BEWARE OF CONFUSING NORMAL FACT FINDING BASED ON ECONOMIC SUBSTANCE WITH THESE TWO USAGES IN SECTION 7701(o).**
- Who is “the taxpayer”? What if the change to the economic position is not that of the taxpayer that engaged in the questioned transaction but rather a partner, or a partner’s partnership, or an affiliated corporation (whether or not the corporations file consolidated returns), or a relative where the “income producing” threshold is passed, or a counterparty?

Specifics of Sec. 7701(o)/ Current Operation of ESD

The Two Prong Test: Economic Position Change

- The taxpayer can elect to try to satisfy the “ES” prong of the ESD by proving substantial net profit potential, and if the taxpayer so chooses its proof must meet the standard defined in section 7701(o)(2).
- Note that 7701(o) literally makes satisfaction of the test as a precondition to escaping the ESD, not a complete escape.
- PV of “Reasonably expected” pre-tax net profit must be substantial in relation to expected net tax benefits
 - So clear that no absolute minimum dollar amount is required
 - JCS-3-09, p. 45, indicates intended to be higher standard than “reasonable possibility,” used in Rice’s Toyota;
 - Note: “reasonable possibility” is too high a standard for sec. 183, which requires only “objective to make a profit”
 - Present value (how? Taxpayer’s normal internal method?)
 - Substantial relative to net federal tax benefits: is 1 out of 3 substantial?
 - Reg. sec. 1.170A-9(f) defines substantial as 1/3.
 - How do you prove an actual economic change (which the test literally requires) by proving only the potential for profit, if no profit is actually realized?

Specifics of Sec. 7701(o)/ Current Operation of ESD

The Two Prong Test: Economic Position Change

- Section 7701(o)(2)(B): Fees and transaction expenses must be counted in determining net pre tax profit.
- Directs Secretary to issue regulations to treat foreign taxes same way in “appropriate cases.”
- Bill changed dramatically on the foreign tax issue in final days, from “shall be” treated as expenses, to no reference, to direction to treat in appropriate cases.
- JCT explan. indicates belief that foreign taxes should be treated as expenses.
- Cf. Notice 98-5: proposed to deny foreign tax credits to transactions that were not entered into for profit and to deduct foreign taxes as an expense in that analysis; withdrawn by Notice 2004-19.
- Contra Compaq and IES, which applied ESD to pre-foreign tax profits.
 - Theory is that US taxes are not counted, and so neither should foreign taxes that are creditable.

Specifics of Sec. 7701(o)/ Current Operation of ESD

The Two Prong Test: Economic Position Change

- The bill leaves open the possibility of other ways of proving economic position change.
 - Up to taxpayer to choose to attempt another type of proof.
 - Examples given in JCS-3-09, but not final explanation: financial transactions and reorganizations may not have quantifiable profit aims.
 - But reorganizations are supposed to be in a safe harbor?
 - What about “financial transactions”? Wouldn’t this normally refer to straddles, hedges, notional principal contracts?

Specifics of sec. 7701(o)/Current Operation of ESD

Two Prong Test: The Subjective Prong:

- Substantial non federal tax purpose:
 - What was original purpose of this prong in the caselaw? (likely to protect transactions such as incorporation that could not logically be related to profit motive?) Has this purpose been lost?
 - JCT viewed this as the “dominant issue” and an “absolute requirement.” JCT 9/09
 - Can also be satisfied by same substantial profit potential that can apply to “ES” prong. Likelihood that two prongs will collapse into one?
 - How much non tax purpose: substantial?
 - Compare: Reg. section 1.701-2(a)(1), the partnership anti-abuse rule, requires a transaction be entered into for a substantial business purpose.

Specifics of sec. 7701(o)/Current Operation of ESD

Two Prong Test: The Subjective Prong:

- Cf. Reg. section 1.355-2(b)(1), which in effect requires a substantial business purpose for a spin-off: a “substantial part” business purpose is thought not to require either a primary or more than 50% purpose; 1/3 purpose seems sufficient.
- Cf. Reg. section 1.355-2(b)(2), as to non federal tax benefits.
- Financial accounting benefits derived from federal income tax savings and state tax benefits that are similar to or related to the federal tax benefits will not be accepted.
 - Accounting benefit concern derived from Enron usage of accounting profits attributable to additions to deferred tax asset account for future expected acquisition of depreciable property, for example.

Specifics of sec. 7701(o)/Current Operation of ESD

Two Prong Test: The Subjective Prong:

- Closer to core business the better?
 - Consolidated Edison Co. v. United States, 104 AFTR 2d 2009-XXXX (Fed. Cl. 2009) (LIFO case won where property leased was used in same business Con Ed was in)
 - Shell Petroleum, Inc. v. United States, 102 AFTR 2d 2008-5085 (SD Tex 2008) (property sold was business property)
- But sec. 7701(o) says nothing about usual course of business transactions.
 - Query: does not fact that Congress chose to make the test a profits test, and to allow it to satisfy both prongs indicate that Congress understands all businesses and investors intend to make money any way they can, and so there should be no “regular course of business” test? Cf. sec. 162.

Specifics of sec. 7701(o)/ Current Operation of ESD

Penalty: 20% of understatement by reason of transaction for which 2 prong test not met; increased to 40% if transaction not properly and timely disclosed. 6662(b)(6) and (i); no fault-no way out.

- What is the last point at which IRS can assert the penalty? Does it inevitably follow assertion of the ESD and not have to be separately assessed?
- IRS can abate only proportionately to abatement of the tax? No indication in bill.
 - But IRS can decline to assert the penalty even though it assesses an understatement based on ESD (and, of course, can decline to assert the ESD)
 - If IRS foregoes the ESD penalty it can apply the substantial understatement penalty to the understatement; only loses the potential to increase to 40% and to avoid “reasonable cause” exception.
- Does not replace the fraud penalty.
- “By reason of” and “attributable to” (as to 40%) require what degree of relationship to the ESD ground for the assessment? But for? One of several grounds sufficient?
- Disclosure.
 - Cannot be made by amended return after first contact by IRS
 - Must adequately disclose relevant facts affecting the tax treatment. This is same language as used in section 6664(d)(2)(A) with respect to reportable transaction. That section incorporates the regulations of section 6011, which provide a form for disclosure of (a) the expected tax treatment and all potential tax benefits, (b) any tax result protection, and (c) describe the transaction in sufficient detail for the Service to be able to understand the structure and identify the parties .

Specifics of sec. 7701(o)/ Current Operation of ESD

- The 40% penalty also applies if the benefit is disallowed under “any similar rule of law”
 - Undefined.
 - There is no other rule of law than the ESD that denies a tax benefit for failure of taxpayer to prove economic effect and business purpose.
 - JCS-18-10, n. 359 describes similar rule as one applying “similar factors and analysis” by another name.
 - This must mean that the only similar rule of law is a disallowance of a benefit that otherwise qualifies under the law and facts as normally determined through the application of a positive disallowance rule that is in fact the ESD, but which the court has misnamed (perhaps “sham transaction doctrine” or “business purpose doctrine”).
 - Should not mean “sham transaction doctrine” or even lack of “economic substance,” when those terms actually refer to fact finding (for example, the business was not actually operated in the corporation), or if they refer to interpreting a requirement into the statute (“business purpose doctrine”) as in case of Gregory v. Helvering.
 - Beware tendency of IRS to view all fact finding methods (step transaction doctrine, etc.) and interpretive methods as “similar rule of law.”

Nature of the ESD

- IRS and lower federal courts have applied ESD as an anti-abuse test, the failure of which justifies denial of a tax benefit to the taxpayer who planned or arranged the transaction at issue without either or both of (a) economic substance and/or (b) business purpose.
- The economic substance subtest is referred to as the objective prong of the ESD; it requires that the taxpayer prove the disputed transaction was expected to, or did, change the taxpayer's economic positions to some substantial degree (there are variations to this prong).
- The business purpose subtest is referred to as the subjective prong of the ESD; it requires that the taxpayer prove that the disputed transaction had significant business purpose, when compared with the tax benefits, but it is unclear how the comparison should be made.
- Some circuits require that the taxpayer must prove both prongs to prevail. Others require the taxpayer to prove only one; the rest apply a unitary (flexible) approach.

Nature of ESD

- ESD has been applied most frequently in perceived “tax shelter” cases, especially where the taxpayer relied on one or more of:
 - Partnerships and partnership allocations;
 - Transactions, including partnership, with tax-indifferent persons;
 - losses or other deductions; and
 - Debt that creates basis or interest deductions.
- Most of these affected areas have their own statutory or regulatory anti-abuse rules (Reg. 1.701-2, 165(c)(2), Reg. 1.165-1(b), 269, and several loss disallowance rules).

Nature of ESD

Is the ESD a Positive Rule of Law?

- A positive rule of law is a rule that if you do a particular act or have a particular set of facts you get a defined tax result.
- Normally courts do not generate positive rules of law, particularly in applying a code based law, but it does happen and is referred to as “common law.”
- In the last 25 years the ESD has come to be identified as a “doctrine” that is applied to deny a tax result for which a transaction qualifies, under the law and facts as normally determined.
- Examples of ESD usage as positive rule of law:
 - ACM Partnership, TC Memo 97-115: “The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.”. (emphasis added) Court could have interpreted regulation, or relied on restrictions on partnerships or loss deductions, but chose to state general positive rule of law.
 - Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985): arguably could have refused to give basis for contingent debt, but chose to create “two prong” test for leveraged lease
 - Rice’s test could have been limited subsequently to leveraged lease cases, as was the approach of Court Holding asking who conducted the negotiations employed mostly in identifying who sold the property.

Nature of ESD

Do the Courts only Apply the ESD When All other Grounds Fail?

- Compare Coltec, 454 F3d 1340 (Fed. Cir. 2006): “Finally, the government argued that the transaction in which the note was exchanged for the liability assumption should be disregarded under the general economic substance doctrine with the result that the basis would not be increased by the amount of the Stemco note.”
 - At least the IRS realized it should present its statutory and factual grounds first.
- With Palm Canyon, TC Memo 2009-288: “We must decide whether Palm Canyon's MLD transaction should be respected for Federal income tax purposes. First, we address whether Palm Canyon's tax treatment of the MLD transaction fits within the literal meaning of the Code, as interpreted by caselaw at the time. Second, we examine whether the MLD transaction should be disregarded under the economic substance doctrine.” But in fact the opinion assumed away or refused to decide several legal and factual issues and focused on the ESD.
- And with Country Pine, TC Memo 2009-251: Legal analysis began and ended with the single issue stated as follows: “ ... a transaction lacked economic substance if: (1) The taxpayer had no business purpose other than obtaining tax benefits in entering the transaction; and (2) the transaction lacks any reasonable possibility of earning a profit.”

Nature of the ESD

Is the ESD distinguishable from (or better than) other legal processes that can be applied in tax cases?

- Does the ESD lead to skipping finding the basic facts that are required by the applicable Code sections? For examples:
 - Did Knetsch decide as a fact whether money was lent on which interest could be paid and deducted?
 - Did Court Holding decide as a fact who sold the property?
 - Did Frank Lyon decide the fact of who owned the property?
 - Isn't there a difference between finding -- for example, that a circular flow of funds means no flow occurred for tax purposes -- versus skipping such fact finding because the taxpayer (1) had no business purpose, and (2) was not going to make any money?
 - Does the ESD end up substituting for the finding of facts required by the Code, and for the nuanced methods of fact finding that courts have always known how to do, the finding only of the two facts that are the test in the court-made ESD?
 - Is this a good result for the government; does it diminish or increase the government's tools?

Nature of the ESD

Is the ESD distinguishable from (or better than) other legal processes that can be applied in tax cases (cont'd)?

- Is it distinguishable from the legal process of statutory interpretation?
 - Is Gregory v. Helvering (1935) an accurate cite for the ESD, or did the Court construe “in pursuance of a plan of reorganization” to mean “in pursuance of a plan of reorganization of a corporation’s business activities” (which Mrs. Gregory’s corporation did not do)?
 - Gregory did not “sham” the transaction or disregard the transitory corporation. 8 years later Moline Properties, 319 U.S. 436 (1943) first announced the view that the corporations in Gregory and Higgins v. Smith (which it cited as examples of sham corporations) flunked the Moline test. Moline does not state the ESD, but rather its own test for respecting the existence of a corporation separate from its shareholders.
- Is ESD better than or even properly distinguishable from other common law tax doctrines and fact finding methods (JCS-3-09 (Sept. 2009) recognized overlapping, confusing, terminology).
 - Substance over form/economic substance fact finding method: Knetsch ruled no borrowing occurred in substance.
 - Step transaction doctrine fact finding method: Court Holding Co. integrated and reversed the steps.
 - Deductions/exemptions are strictly construed/interpretive presumption [many S..Ct. citations available]
 - Rules worked out in specific contexts:
 - When a taxpayer can disregard its own corporation: Moline Properties, Inc.
 - insurance defined by S. Ct. in Le Gierse as requiring risk shifting.
 - contingent debt does not give basis - Albany Car Wheel.

Nature of the ESD

Is the ESD distinguishable from (or better than) other legal processes that can be applied in tax cases (cont'd)?

- Better than statutory and regulatory “trade or business” or profit making requirements (secs. 162 , 165, 183, 212, 357(b), 482 (“evasion”))?
- Better than asserting fraud? Cf. *Higgins v. Smith*, 308 U.S. 473 (1939) (sale to wholly owned corporation to generate loss did not generate loss because taxpayer found not to have actually transferred the property; fraud penalty asserted but rejected by jury and govt. did not appeal); Andrew Mellon was subject to civil fraud trial; Mellon, 36 BTA 977 (1937).
- Question: Is the government better off when it promotes the ESD over statutory interpretation, other legal doctrines, other more targeted statutes and assertion of fraud?

Origins of ESD

A Selective History (note: this history is not intended to justify the ESD historically but rather to argue that it is not explainable by tax history, until recently):

- 1918: S. Ct. relied on substance over form in taxpayer's favor: So. Pac. Co. v. Lowe
- 1920: S. Ct. relied on both substance over form and form over substance in taxpayer's favor: Eisner v. Macomber
- 1935: S. Ct. decided Gregory v. Helvering, which is a case of statutory interpretation, and did not state or apply the ESD, and did not “sham” the transitory corporation, but is commonly cited as authority for the ESD
- 1939: S. Ct. held in taxpayer's favor that sale-leaseback was a secured borrowing, applying equitable fact finding (F. & R. Lazarus)
- 1943: S. Ct. in Moline Properties decided that a very low threshold of corporate business activity or purpose prevents a shareholder from avoiding the two tier tax regime; opinion subsequently cited in support of ESD

Origins of ESD

- 1960: Supreme Court's second use of term "economic substance" in a tax case; quoted trial court's words, and affirmed fact finding that no borrowing occurred: *Knetsch v. United States*
- 1975: TC linked the terms "economic substance" and "tax shelter": *E. Keith Owens* (reviewed) (taxpayer sold stock of corporation that held nothing but cash; held taxpayer received a dividend).
- 1976: First use of "economic substance" in connection with "marketed" individual tax shelter: *Ginsburg, T.C.*
- 1978: *Frank Lyon*: the meaning of this opinion has stumped even Supreme Court justices: "Whatever the language relied on by respondent may mean, our decision in [*Frank Lyon*] to honor the taxpayer's characterization of its transaction as a "sale-and-leaseback" rather than a "financing transaction" was founded on an examination of "the substance and economic realities of the transaction." Thomas, J. in *Neb.v. Loewenstein*, 513 US 123 (1994) (unanimous opinion)
 - SCT's 3d use of the term "economic substance" in deciding the factual issue – who borrowed the money; ruling for taxpayer.

Origins of the ESD

Frank Lyon cont'd

- The following is the sentence J. Thomas questioned, and the source of claims that Lyon supports the ESD: “In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance [*alleged prong #1*] which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations [*alleged prong #2*], 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. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts.” (emphasis added)
- 1979: First reference to “economic substance test,” which was test for respecting partnership allocations of losses: *Holladay v. Commissioner*, 72 T.C. 571 (1979), *aff'd*, 649 F.2d 1176 (5th Cir. 1981).

Origins of ESD

- 1981: Alvin Warren writes important article on the “economic profit doctrine”: 59 Taxes 985 (1981).
- 1983: Tax Court in Rice’s Toyota, at request of IRS attorneys, moved beyond sections 163 and 167 analysis of Estate of Franklin and Pleasant Summit and read Frank Lyon to allow shamming entire transaction when nonrecourse debt exceeded property value. This was a pivotal shift from the Tax Court’s own prior handling of excess debt cases.
 - Query: did or should court have applied a positive rule of law or did/should it have found that Taxpayer did not owe the nonrecourse debt that provided it depreciable basis because the debt exceeded the value of the security by 50%?
 - Tax Court seemed to want to go beyond Estate of Franklin, somehow
 - Tax Court started on this reasoning by stating: “The leading case supporting the existence of a sham transaction theory is Gregory...”
Was that correct?
- 1985: 4th Circuit in Rice’s Toyota stated: “The tax court read Frank Lyon . . . to mandate a two-pronged inquiry to determine whether a transaction is, for tax purposes, a sham.”

Origins of ESD

- 1987: Tax Court develops approach to individual tax shelters of contrasting “generic tax shelters” with “synthetic tax shelters”: Rose (reviewed).
- 1988: First federal tax case referring to “economic substance doctrine”: Georgia Cedar Corp. TC Memo 1988-213 (issue was existence of debt).
- 1988: First reference to “economic substance doctrine” in Tax Notes, in connection with Georgia Cedar: 39 Tax Notes 970 (May 23, 1988).
- 1991: observers viewed Rice’s Toyota test as a gloss on Frank Lyon to be applied to leveraged leases; Bates and Cooper, J Taxn
- 1994: First federal district court tax opinion to refer to “economic substance doctrine”: Peerless Ind., Inc. v. US

Origins of ESD

- 1997: ACM Partnership held installment sales transaction lacked economic substance and business purpose; viewed as watershed for application of ESD
- 2000: Last reference to “generic tax shelter” in federal tax opinion: IRS v. CM Holdings, Inc.
- 2004: Long Term Capital Holdings applied “unitary” ESD analysis
- 2010: adoption of section 7701(o).

The ESD as a Combination of “Rules”: “Economic substance” and “Business purpose”

Normal Rules

Fact finding: what happened?

Commonly considered factors include both economic substance and profit potential, which is an aspect of economic substance

Legal interpretation: what does the law require?

Extensions of Normal Rules

Fact finding: Schering-Plough (it looks like a loan)

Legal interpretation: Gregory v. Helvering (in its day looked like an extension); Gitlitz (we don't care what makes sense)

Positive Rule of Law

Tax benefits under subtitle A with respect to a transaction are not allowable (a) if the transaction does not change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (b) unless the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Cf.: Existing Anti-Abuse Rules

- Section 269: if a taxpayer does certain defined acts with a principal purpose of tax avoidance the Secretary can disallow deductions, etc.
 - The defined acts are (a) acquire control of a corporation, or (b) acquire the assets of a corporation (not already controlled) with a carryover basis.
- Reg. sec. 1.165-1(b): “Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss. “
- Reg. sec. 1.1002-1(b): a nonrecognition rule does not apply unless the transaction satisfies the words of the Code and underlying purpose of the nonrecognition provision.
- Reg. sec. 1.701-2: the Commissioner can recast a transaction to satisfy the intent of subchapter K if a partnership is formed or availed of in connection with a transaction that is contrary to the intent of subchapter K, despite compliance with the literal words of the law.
 - The relevant facts and circumstances focus on using the partnership to reduce tax liability; they call for a business purpose, but do not measure the substantiality of profit.
- As a subset of nonrecognition rules, Reg. sec. 1.368-1 requires that:
 - corporate reorganizations be analyzed under the step transaction doctrine,
 - Requires: business exigencies (codifying Gregory), the underlying purposes and assumptions of section 368 satisfied, bona fide execution of the acts contemplated by the plan, bona fide satisfaction of the code description of the reorganization, no abrupt departure from normal reorganization procedure on which the imposition of tax is imminent, not a mere device that puts on the form of reorganization, a business or corporate purpose.

Cf. Anti-Abuse Rules (cont.)

- In contrast, the ESD is by far the least circumscribed rule because:
 - (1) unlike section 269 it is not triggered by defined objectively determinable transactions;
 - (2) unlike all of the other rules it is not limited to a particular type of tax benefit (deductions, nonrecognition, partnership, reorg.);
 - (3) unlike all of the others it requires a measurably significant profit motive;
 - (4) unlike Reg. section 1.1002-1(b) and 1.368-1 it does not have decades of Supreme Court and other case authority defining exactly what the underlying purposes of the nonrecognition rules are;
 - (5) it requires the Service to determine the intent of Congress on a case by case basis, whereas section 269 does not do that at all, Reg. section 1.1002-1(b)/1.368-1 presumes that Congress intended nonrecognition rules to be strictly construed, and Reg. sec. 1.701-2 presumes the same for the utilization of partnerships.
 - But cf. fn. 414 of JCX-11-10 which attempts to liken the ESD's emphasis on Congress purpose to Reg. 1.269-2

Taxpayer Successes against ESD

After ACM in 1997, the only cases taxpayers have won as of this date under the ESD have been:

- UPS of America, Inc. (11th Cir. 2001) (did not mention ESD by name);
- IES Industries (8th Cir. 2001) (did not mention ESD by name);
- Compaq Computer (5th Cir. 2001);
- Shell Petroleum, Inc. (SD Tex 2008);
- Sala, (D. Colo. 2008) (did not mention ESD by name);
- Countryside Limited Partnership, T. C. Memo 2008-3;
- TIFD-III-E, Inc. v. United States, on remand, (D. Conn. Oct. 7, 2009) (did not mention ESD by name).
- Consolidated Edison Co. (Fed. Cl. 2009) (LILO transaction)

Observation: several of the taxpayer victories would not be considered to involve commonly duplicated “tax shelters,” but rather to be “one off” transactions.

Future Supreme Court Review of Codified ESD?

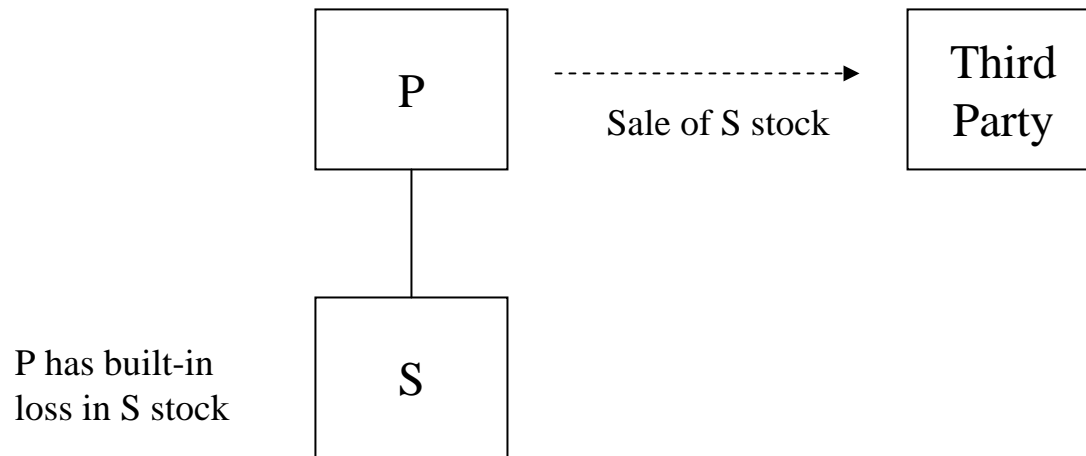
- “Will the Supreme Court ever revisit economic substance? ... Presumably such arguments will become moot if Congress proceeds with efforts to codify the economic substance doctrine.” Fn. 1
- Conversely, S. Ct. might observe that:
 - Congress did not undertake to define when the ESD applies;
 - Congress assumed courts have made that determination;
 - Some courts have suggested that S. Ct. has created and defined the ESD;
 - S. Ct. has not created or defined an ESD;
 - Sec. 7701(o) puts the courts squarely in the business of calling off the literal meaning of the Code when an IRS agent thinks congress could not have had that particular taxpayer in mind.
- Will perceived literalist bent of S. Ct. mean that S. Ct. will be less likely to brook ignoring words of code?
 - Gitlitz: Code means what it says about S corporation stock basis even if it makes no tax sense.
 - UDI, Inc.: Treasury regs say there is only a CNOL and no separate NOLs, so Treasury must be held to its regs even if makes no tax sense.

•Fn. 1 Gomez, PLI Tax Strategies 2009 (Oct. 30, 2009)

PRACTICAL CONSIDERATIONS GOING FORWARD

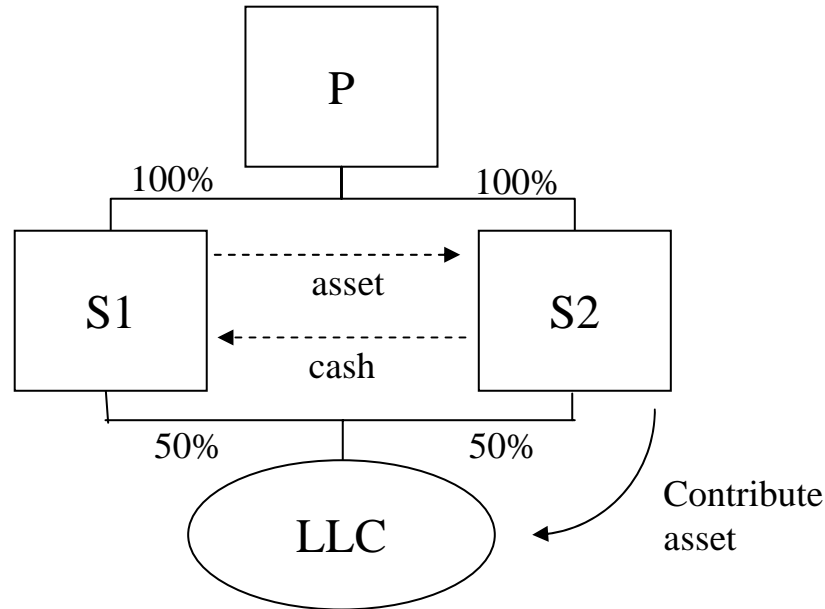
Examples

Sale to Recognize Loss



- May a taxpayer sell stock solely to recognize a loss under the Federal Circuit's analysis in *Coltec*? No profit, no business purpose. Presumably non contrary to intent of Congress? How do you know that?
- The Supreme Court in *Cottage Savings* allowed a taxpayer to exchange mortgage securities for other mortgage securities and recognize a loss. The transaction was done solely for tax purposes and was disregarded for regulatory purposes.

Accelerating a Built-In Gain

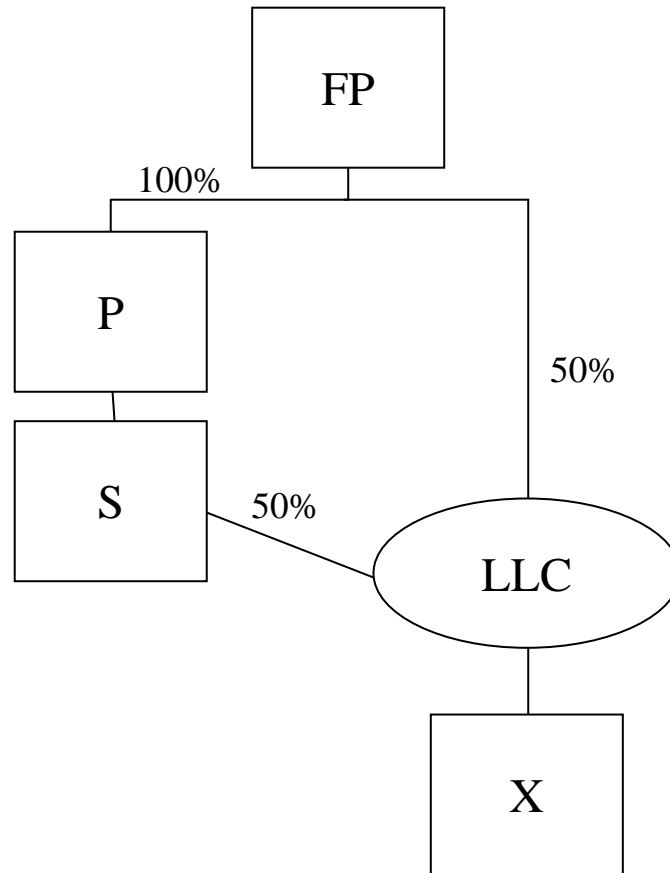


Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2, and they file a consolidated return. In Year 1, S1 sells an asset to S2 for cash, resulting in a deferred intercompany capital gain. In Year 3, the P group has a capital loss that it would like to use, so S2 contributes the asset to a newly formed LLC owned by S1 and S2.

Result: Because the asset is no longer owned by a member of the P consolidated group, the deferred capital gain should be triggered, which P wants in order to utilize other losses.

Analysis: No business purposes, no profit potential from contribution. Contrary to intent of Congress?

Busting Consolidation -- Example 1

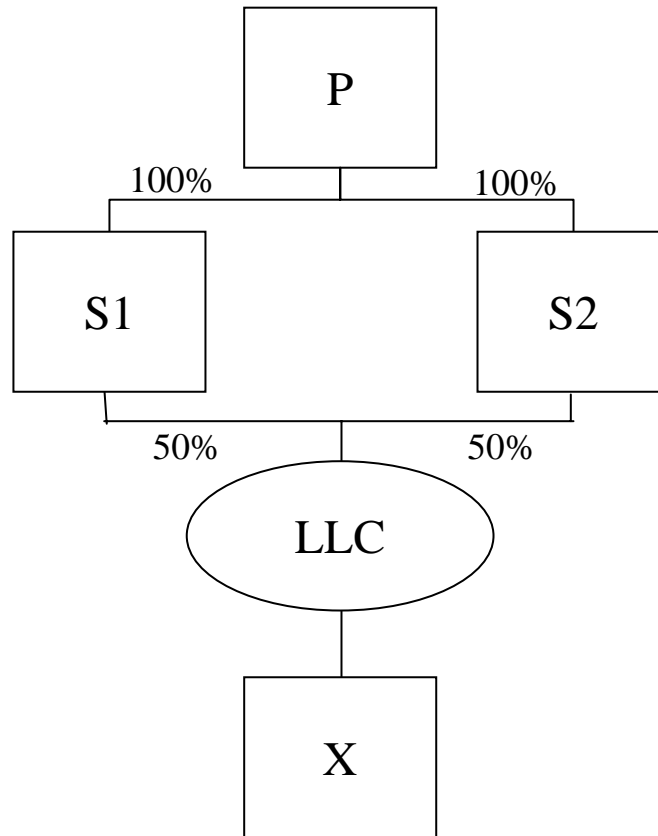


Facts: FP, a foreign corporation, owns 100% of the stock of P, which owns all of the stock of S, which owns all of the stock of X. P, S, and X file a consolidated return. In order to deconsolidate X, S contributes the stock of X to an LLC formed by S and FP.

Result: Because X is no longer an includible corporation, it should not be a member of P's consolidated group.

Analysis: No business purpose and no profit potential.

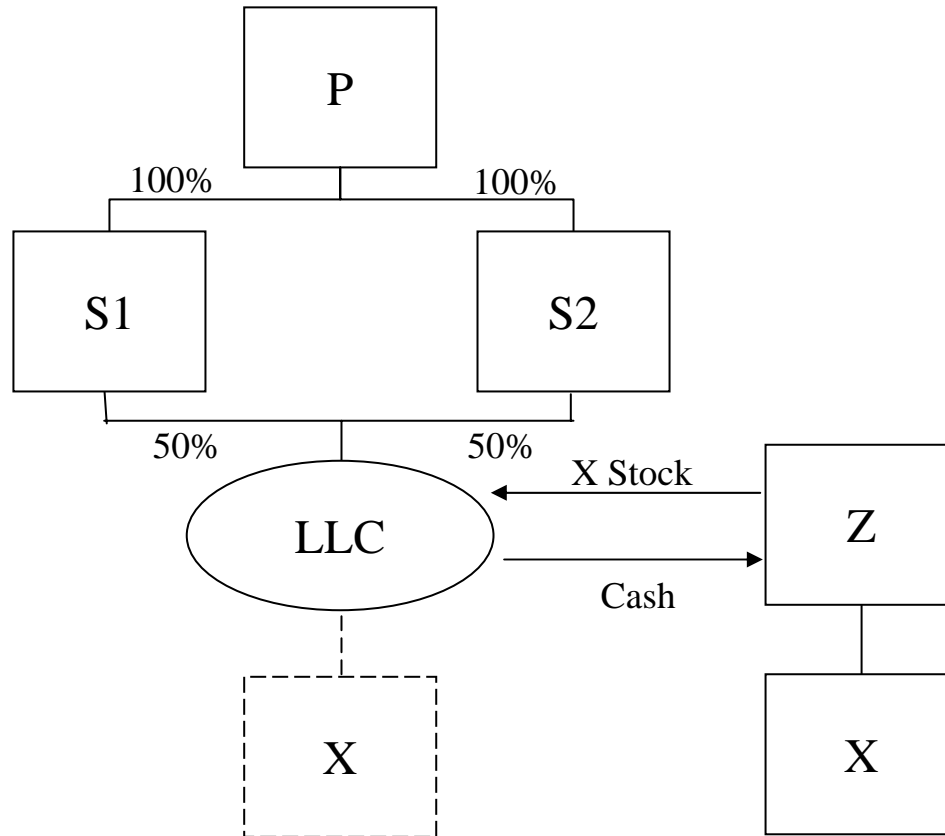
Busting Consolidation -- Example 2



Facts: P, a domestic corporation, owns 100% of the stock of S1, S2, and X, and they file a consolidated return. In order to deconsolidate X, P contributes 50% of the X stock to each of S1 and S2, and S1 and S2 contribute the X stock to a newly formed LLC.

Result: Because X is no longer an includible corporation, it should not be a member of P's consolidated group. No business purpose and no profit potential.

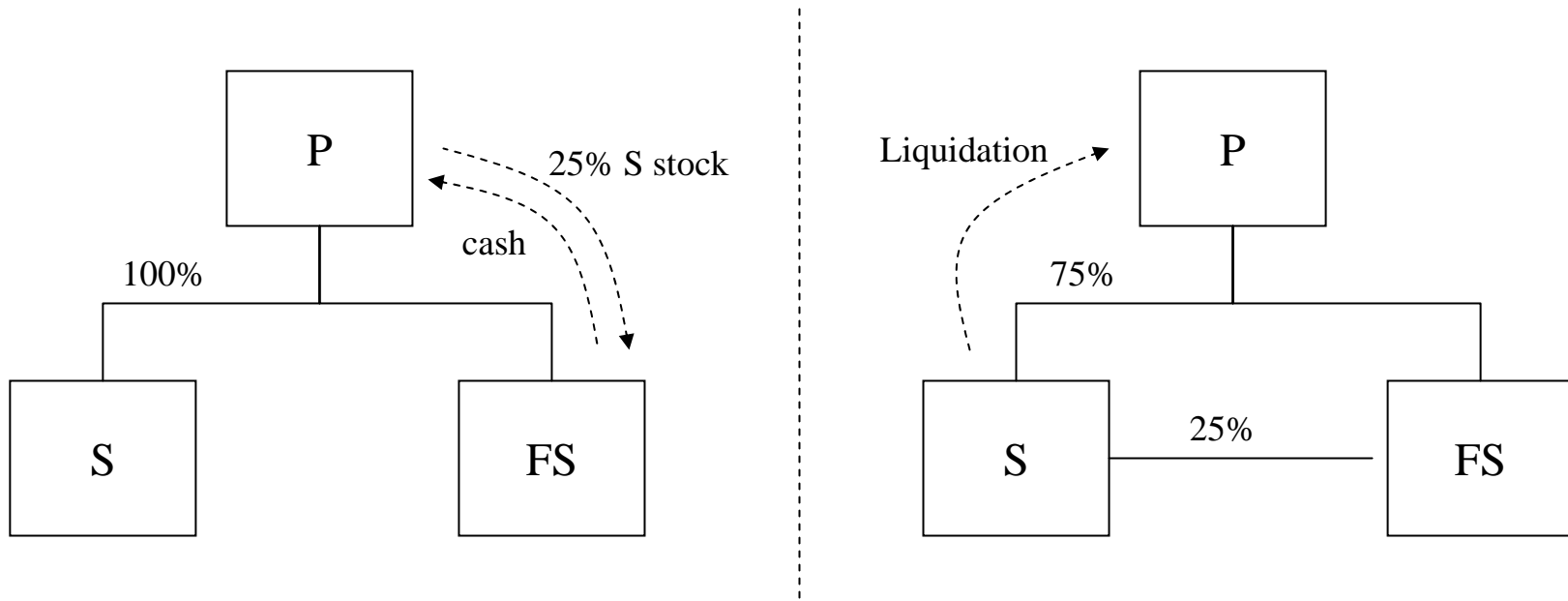
Avoiding Loss Disallowance Rules



Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2. The P group wants to purchase the stock of X from Z, but X has built-in gain assets that could trigger the application of the loss disallowance rules if the P group later disposes of the stock of X. To avoid the potential application of the loss disallowance rules, S1 and S2 form LLC, and LLC acquires the stock of X.

Result: Because X is not an includible corporation, it should not be a member of P's consolidated group. The use of the LLC had no business purpose and no profit potential.

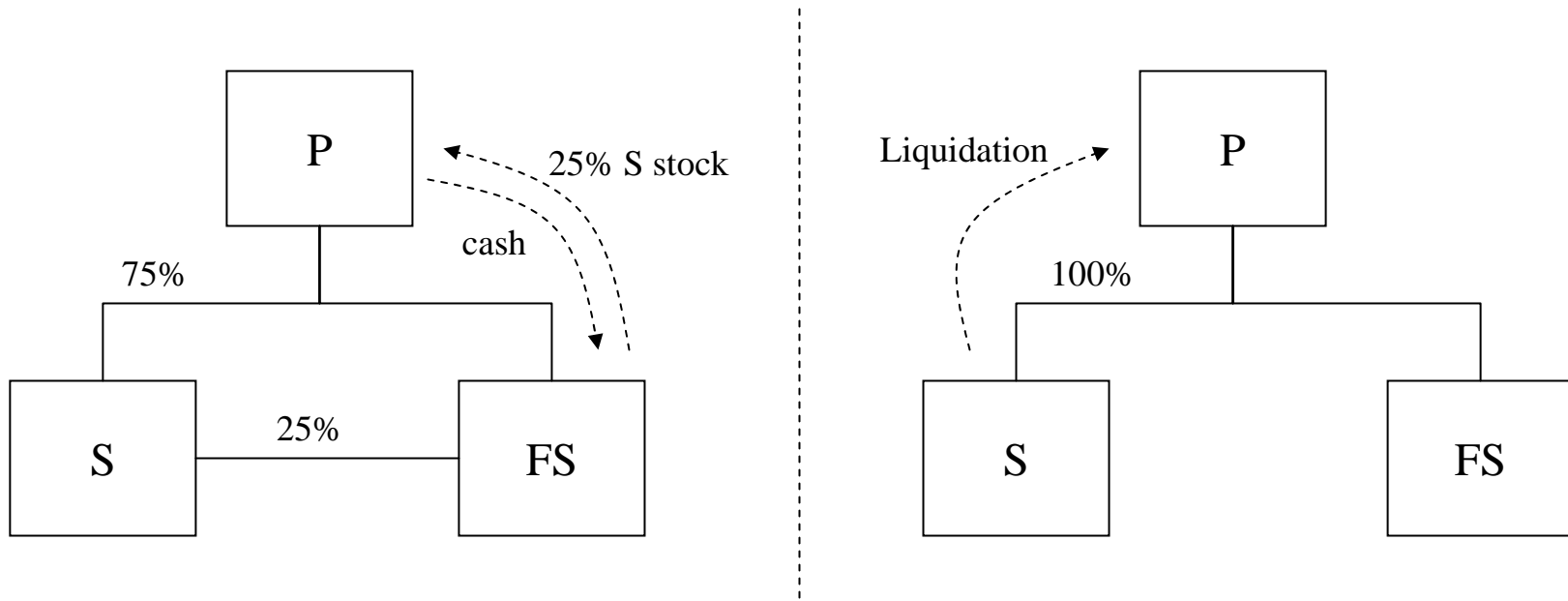
Section 331 Liquidation



Facts: P, a domestic corporation, owns all of the stock of S, which is a domestic subsidiary, and FS, which is a foreign subsidiary. P has a \$100 basis in its S stock. The value of its S stock is \$10. If P liquidates S, the loss in the S stock will not be realized. P therefore sells 25% of the S stock to FS and, after a period of time, S liquidates into P.

Result: P should recognize the loss on the remaining 75% of stock in S. There was no business purpose or non-tax profit potential for the division of ownership.

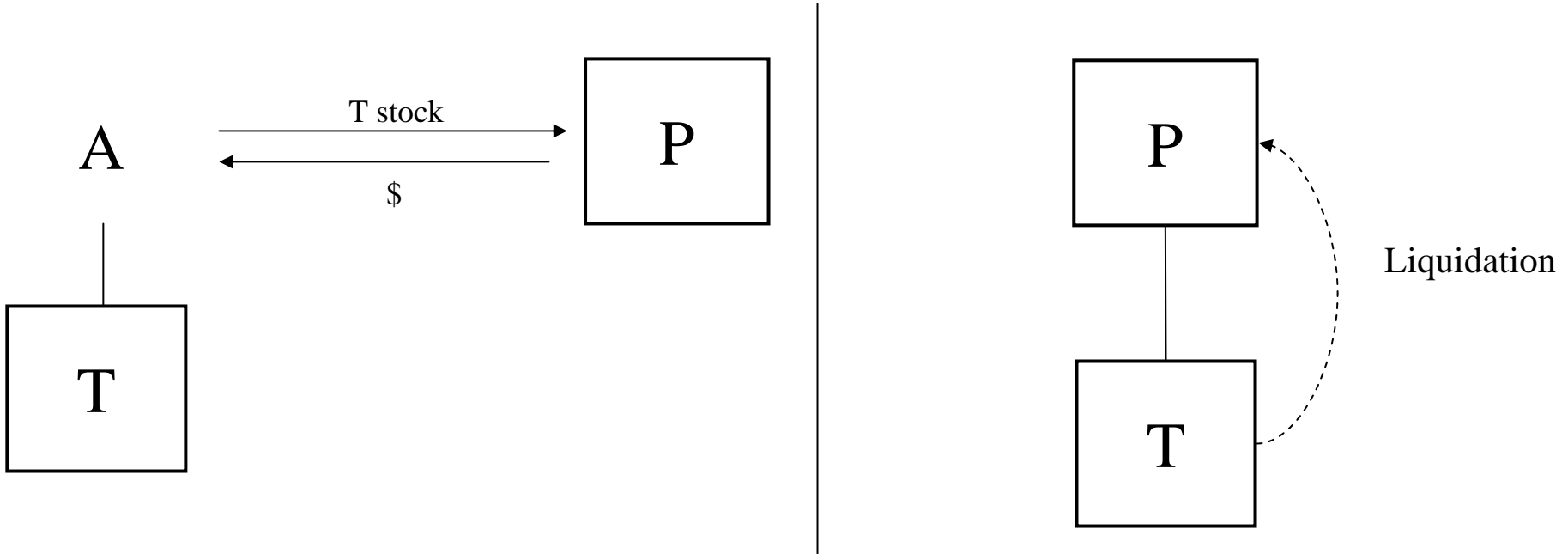
Section 332 Liquidation



Facts: P, a domestic corporation, owns 75% of the stock of S, which is a domestic subsidiary, and 100% of FS, which is a foreign subsidiary. P has a \$10 basis in its S stock. The value of its S stock is \$100. If P liquidates S, the gain in the S stock will be realized. P therefore purchases 25% of the S stock from FS *before a decision to liquidate is made*, and, after a period of time, S liquidates into P.

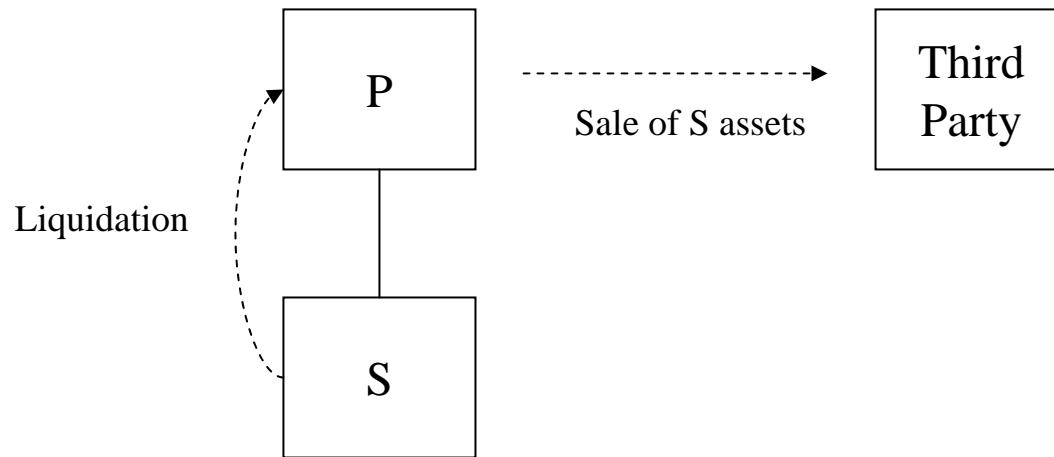
Result: P should not recognize the gain on the liquidation under section 332. Business purpose and non-tax profit potential?

Purchase and Liquidation



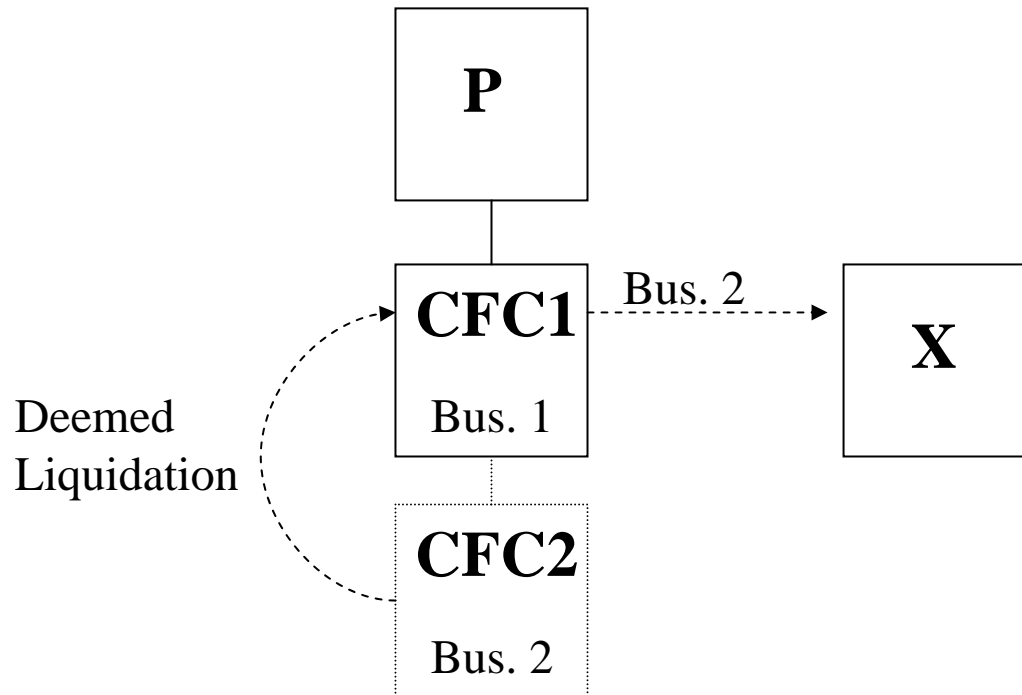
- Section 269(b) states deductions, credits, or other allowances may be disallowed, but only if the liquidation occurs within 2 years after a QSP.
- Does *Coltec* and other recent caselaw replace section 269(b), or mean that a liquidation 2 years and a day after a QSP can result in such a disallowance?

Liquidation and Sale



- In *Commissioner v. Court Holding*, the Supreme Court held that a liquidation of a corporation followed by a sale of the corporation's assets resulted in tax to the corporation because "a sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title." However, five years later, in *U.S. v. Cumberland Public Service Co.*, the Court held that a liquidation followed by a sale did not result in tax to the corporation. The Court stated, "The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."
- In both *Court Holding* and *Cumberland* the sole purpose of the liquidation was to reduce tax; why did *Cumberland* win? Did the S. Ct. not understand the ESD?

Check-and-Sell Transaction

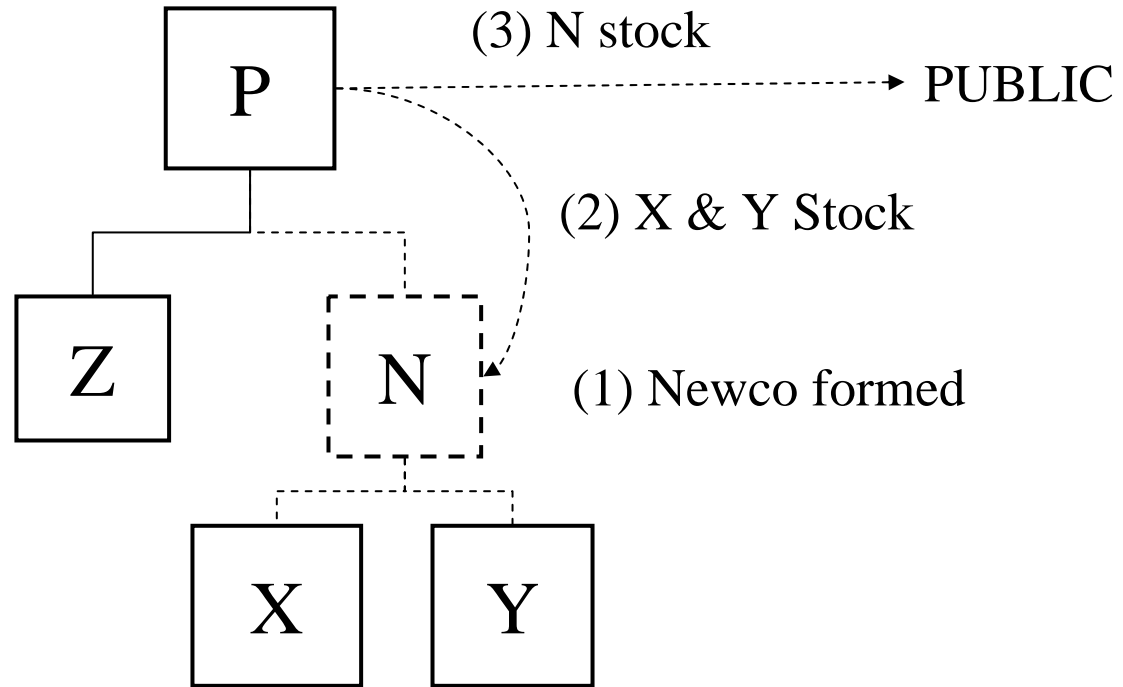


Facts: P owns 100 percent of CFC1, which engages in business 1. CFC1 owns 100 percent of CFC2, which engages in business 2. CFC1 and CFC2 are controlled foreign corporations incorporated in the United Kingdom. On Date 1, P causes CFC1 to check-the-box for CFC2, which results in a deemed section 332 liquidation of CFC2. Immediately thereafter, P causes CFC1 to sell all of the assets of business 2 (i.e., CFC2 assets) to X for cash.

Issue: Under the rationale of *Dover Corp. v. Commissioner*, 122 T.C. 134 (2004), the income generated from the sale does not constitute Subpart F income. Was there a business purpose or profit potential from checking the box?

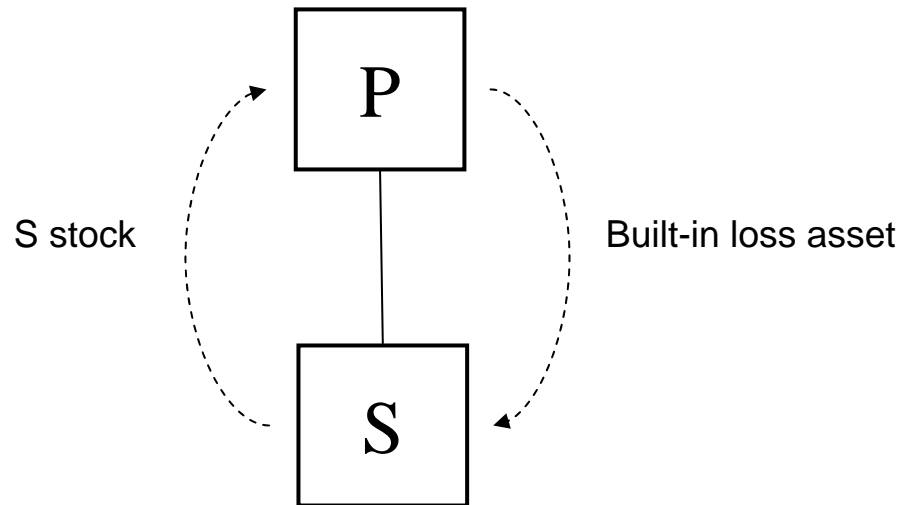
Busted Section 351 Transaction to Make Section 338(h)(10)

Election



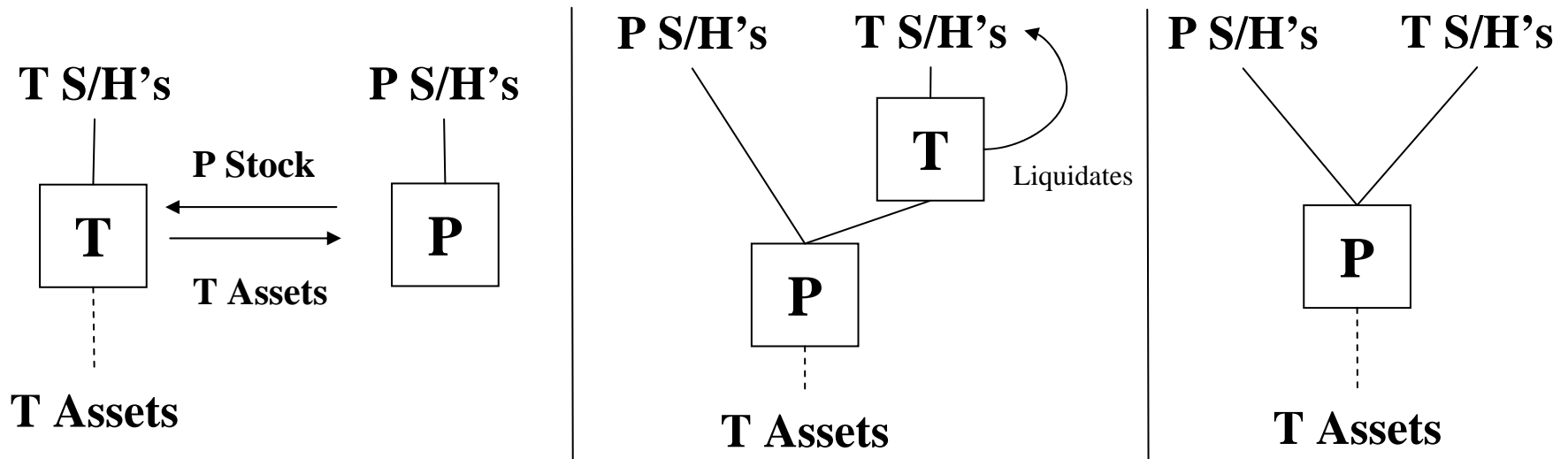
- A corporation transfers stock of a subsidiary to a newly formed subsidiary (“Newco”) for its stock and sells that stock to the public to “bust” the section 351 transaction and to be eligible to make the section 338(h)(10) election for Newco.
- Was there a business purpose or profit potential for the step of busting the 351?

Section 351 Transaction with Built-in Loss Asset



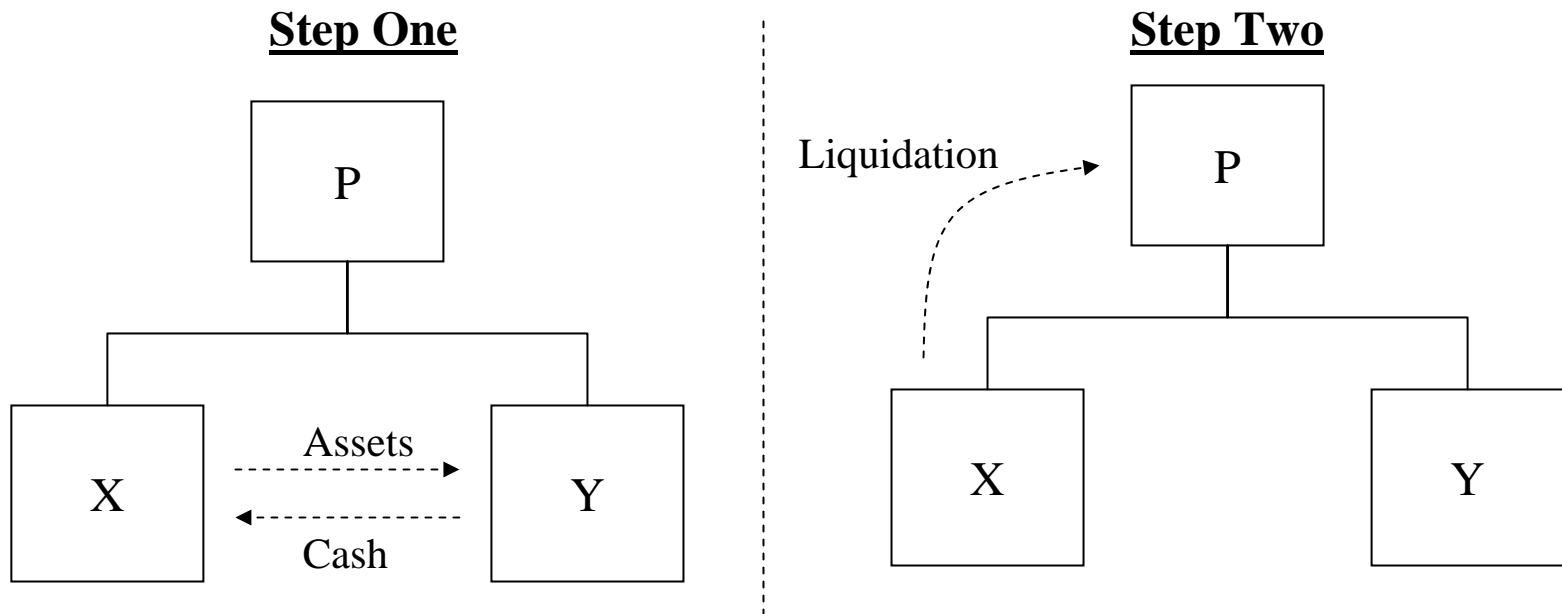
- A corporation transfers an asset with a built-in loss to its subsidiary in exchange for subsidiary stock. Does S hold the transferred asset with a carryover basis and/or does P obtain the S stock with an exchanged basis?
- Is duplicating a loss through a corporation inherently subject to ESD, despite enactment of section 362(e)(2)?
- What if section 362(e)(2) does not apply? *See Shell Petroleum Inc. v. United States*, 2008-2 USTC ¶50,422 (S.D. Tex. 2008); *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009).

“C” Reorganization



- What if, as is likely the case, certain steps are undertaken solely to come within the reorganization provisions in section 368? For example, assume that substantially all of a target corporation's assets are acquired by another corporation solely in exchange for voting stock. If that corporation liquidates following the asset transaction to come within the terms of a "C" reorganization, is the liquidation step subject to risk because it occurred solely for tax reasons?

'D' Reorganizations – Cash – Rev. Rul. 70-240

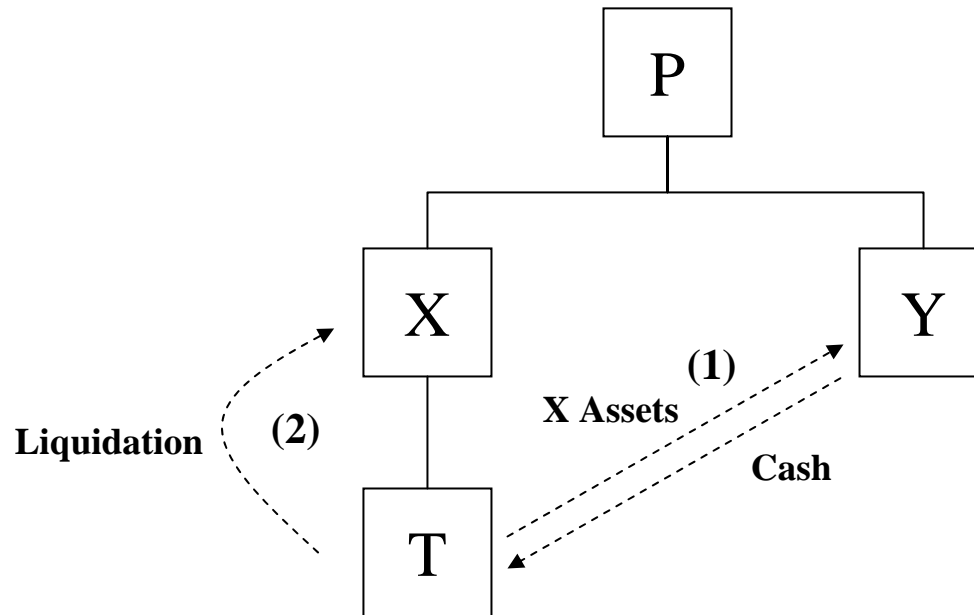


Facts: P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

Result: This transaction qualifies as a tax-free 'D' reorganization under section 368(a)(1)(D), according to Rev. Rul. 70-240.

Analysis: Assume the business purpose was to extract cash from Y tax free (under sec. 356, the boot was limited to the gain in the X stock, which here was zero). There was no other business purpose or economic change of ownership.

All-Cash 'D' Reorganizations – Consolidation



Facts: P owns all of the stock of X and Y. X owns the stock of T. P, X, Y, and T are members of a consolidated group. T transfers its assets to Y in exchange for cash and immediately thereafter liquidates into X.

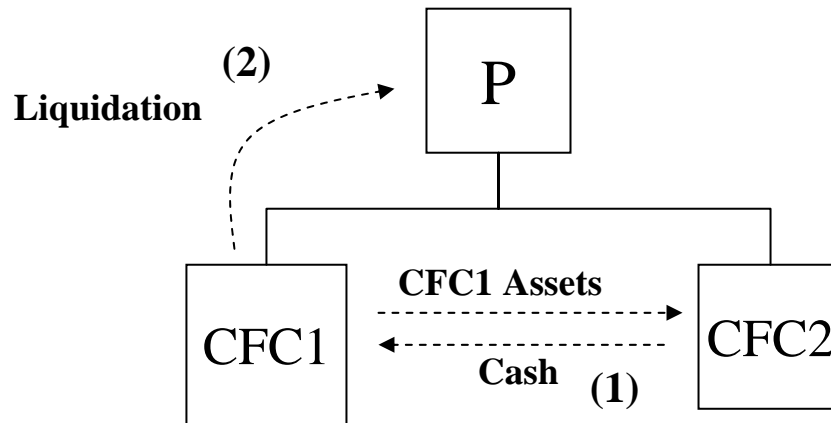
Result: In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to T in exchange for T's assets; (ii) T is treated as distributing the Y stock to X in a liquidation; and (iii) Y is treated as redeeming its stock from X for cash. See Treas. Reg. § 1.1502-13(f) and (f)(7), ex. 3.

The final D regulations confirm that the remaining basis or ELA in the Y stock treated as redeemed will shift to a "nominal share" issued by Y. See Treas. Reg. § 1.368-2(l). An ELA will give rise to a deferred gain when the nominal share is treated as distributed from X to P in order to reflect actual stock ownership.

P may be able to avoid this result by having Y actually issue a single share of stock to T or by contributing a share of Y stock to X.

Question: Does the issuance of the one share have business purpose or economic substance?

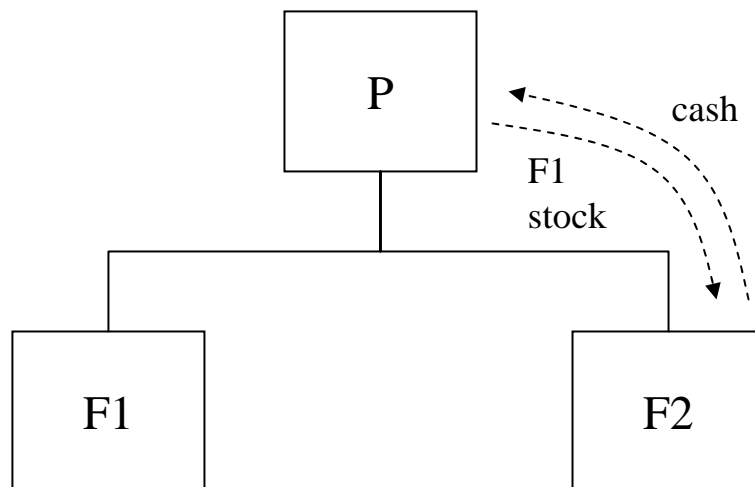
All-Cash 'D' Reorganizations – Foreign-to-Foreign



Facts: P owns all of the stock of CFC1 and CFC 2. CFC 1 and CFC 2 are foreign corporations. CFC 1 transfers its assets to CFC 2 in exchange for cash and immediately thereafter liquidates into P.

Result: This transaction should be treated as a valid “D” reorganization. See Treas. Reg. § 1.368-2(l); but see *Schering-Plough v. Corp. v. United States*, No. 05-2575 (D. N.J. Aug. 28, 2009) (implying that efforts to repatriate foreign income without income inclusion will be rejected under the ESD).

Section 304 Cross-Border Transaction

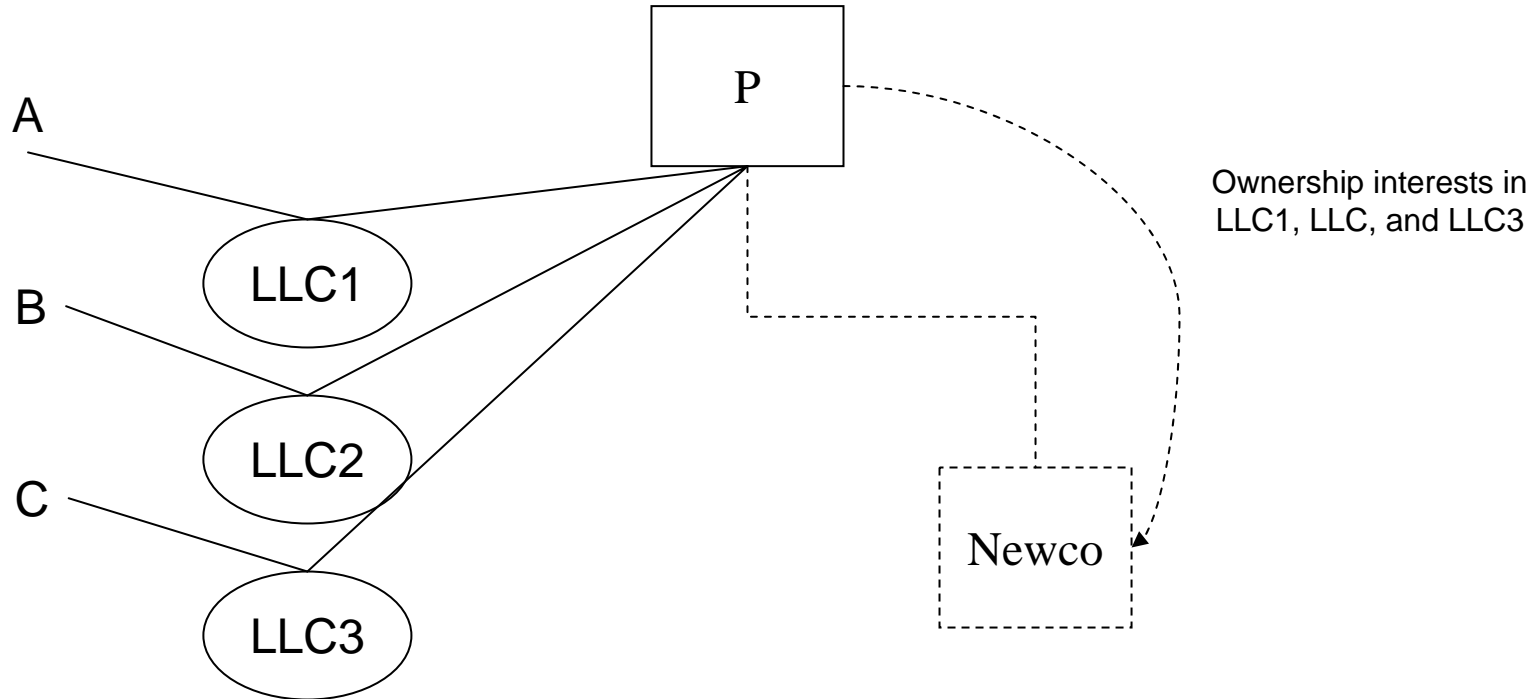


Facts: P, a domestic corporation, owns all of the stock of F1 and F2, both of which are foreign corporations. F2 has excess foreign tax credits. P sells F1 stock to F2 in exchange for cash in a transaction the sole purpose of which is to pull foreign tax credits out of F2.

Result: Section 304 applies to the transaction so that earnings are repatriated and foreign tax credits are pulled out of F2.

Question: Is this result questionable under the ESD because there was no business purpose or profit potential?

Roll-up Transaction



- Assume that a parent corporation converts several LLCs or partnerships into a corporation in a roll-up transaction. Is this transaction subject to review if the roll-up was done in part to combine income and loss?
- Proposals indicate may be within safe harbor?

Appendix

- 2010
- Wells Fargo & Co. v. United States, 105 A.F.T.R. 2d 377 (Fed. Cl. 2010) [G; SILO; relied on both fact finding and ESD]

- 2009
- Palm Canyon X Investments, LLC, TC Memo 2009-288 (Son of Boss/Helmer; ESD only)
- Country Pine LLC v. Commissioner, T.C. Memo. 2009-251, [G; CARDS; ESD only]
- Consolidated Edison Co. v. United States, 104 AFTR 2d 2009-XXXX (Fed. Cl. 2009) [T; LILO].
- Marriott Int'l Resorts v. United States, 83 Fed. Cl. 291 (2008, aff'd per curiam, 104 AFTR 2d 2009-XXXX (Fed. Cir. 2009) [G; Helmer type case; did not rely on ESD; like Kornman]
- TIFD-III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006), on remand, 104 AFTR 2d 2009-XXXX (D. Conn. Oct. 7, 2009) [T; partnership loss generator, income deflector; based on "literalist" reading of § 704(e)]
- Maguire Partners-Master Investments, LLC v. United States, 2009-1 USTC ¶ 50,215 (C.D. Cal. 2009) [G; Son-of-Boss/Helmer-type partnership contingent liability basis/loss case; relied primarily on ESD, but also relied on Korman decision and Reg. 1.752-6, i.e. contingent liability was a liability]
- Southgate Master Fund, LLC v. United States, No. 3:06-cv-2335-K, (N.D. Tex., August 18, 2009) [G; partnership basis/loss case; congress fixed the loophole by 2004 amdt. to §704(c), but opinion viewed the amdt. as clarifying prior law (which would seem to make ESD unnecessary, but opinion applied it anyway]
- New Phoenix Sunrise Corp. v. Commissioner, 132 T.C. No. 9 (April 9, 2009) [G; Son-of-Boss/Helmer-type partnership contingent liability basis/loss case; opinion only relied on doctrines.]
- Schering-Plough Corporation v. United States, No. 05-2575 (D.N.J. August 28, 2009) [G; CFC repatriation plan using swap, income deferral; applied ESD to find "loan" from CFC]
- Klamath Strategic Investment Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Texas 2007), aff'd 568 F.3d 537 (5th Cir. 2009) [G; Son-of-Boss (BLIPS)/Helmer-type partnership contingent liability basis/loss case; ESD only]
- Clearmeadow Investments LLC v. United States, 2009-1 USTC ¶ 50,449 (Ct. Fed. Cl. 2009) [G; Son-of-Boss/Helmer-type partnership contingent liability basis/loss case; relied solely ESD]
- Altria Group, Inc. v. United States, No. 1:06-CV-09430-RJH-FM (S.D.N.Y.) *motion for judgment NOV and new trial denied* (March 17, 2010) [G; LILO; jury verdict]
- American Boat Co. LLC v. United States, 104 AFTR 2d 2009-6666 (7th Cir. 2009) [G (on merits); Son of Boss/Helmer type transaction; lower court found lack of ES]

- 2008
- Kornman & Assoc., Inc. v. United States, 527 F. 3d 443 (5th Cir. 2009) [G; Son of Boss/Helmer type transaction; did not rely on ESD because summary judgment]
- Cemco Investors LLC v. United States, 515 F. 3d 749 (7th Cir. 2008) [G; Helmer type transaction; did not rely on ESD; disagreed with Klamath and relied on regulation]
- BB&T Corp. v. United States, 2007-1 USTC ¶ 50,130 (M.D.N.C. 2007), aff'd 523 F.3d 461 (4th Cir. 2008) [G; LILO case, sale-leaseback; depreciation, amortization, interest deduction sought; no true debt]
- Countryside Limited Partnership, T. C. Memo 2008-3 [T; partnership distribution, gain nonrecognition, basis issue; ruled debt "real"]
- AWG Leasing Trust v. United States, 592 F. Supp. 2d 953 (N.D. Ohio 2008) [G; SILO; sale-leaseback; depreciation, amortization, interest deduction sought; no true debt]
- Petaluma FX Partners v. Commissioner, 131 T.C. No. 9 (2008) [G; penalties issue only: partnership lacked economic substance]; rev'd on jurisdictional grounds, 105 A.F.T.R. 2d 435 (D.C. Cir. 2010)
- Sala v. United States, 552 F. Supp. 2d 1167 (D. Colo. 2008) [T; foreign currency trading/loss, partnership, Helmer-type transaction]
- Stobie Creek Investments, LLC v. United States, 82 Fed. Cl. 636 (2008) [G; Helmer type partnership/loss transaction]

Appendix

- Shell Petroleum, Inc. v. United States, 102 AFTR 2d 2008-5085 (SD Tex 2008) [T; shifting of corporate losses; court distinguished Coltec; IRS asserted section 482 too late, but still rejected]
- Fifth Third Bancorp v. United States, No. 1:05-CV-350 (4/18/2008 (G; LILO; jury verdict on ESD)
- Enbridge Energy Co., Inc. v. United States, 553 F. Supp. 2d 716 (S.D. Tex. 2008) aff'd, (11/10/2009, 5th Cir); [G; midco transaction; treated intermediary as “conduit” and did not rest on ESD; aff'd as “substance over form doctrine”]

- 2007
- Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), vacating and remanding 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128), cert. denied, 127 S. Ct. 1261 (Mem.) (2007) [G; “liability management company tax shelter”]
- Dow Chem. Co. v. United States, 250 F. Supp. 2d 748 (E.D. Mich. 2003), rev'd 435 F.3d 594 (6th Cir. 2006), cert. denied 549 U.S. 1205 (2007) [G; COLI, no true debt; interest deductions denied]
- Jade Trading LLC, et. al. v. United States, 80 Fed. Cl. 11 (2007), aff'd 2010 U.S. App. LEXIS 5901 (Fed. Cir. 3/23/2010) [G; Helmer-type options partnership/loss case; losses denied]
- H. J. Heinz v. United States, 76 Fed. Cl. 570 (2007) [G; Loss ded.; corporate Reg. 1.302-2(c) basis shift, like Notice 2001-45, corrected by Reg. §1.1059(e)-1]
- The Dow Chemical Co. v. United States, 435 F. 3d 594 (6th Cir. 2006), cert. denied (2/2/2007) [G; COLI]

- 2006
- Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 2004), rev'd and remanded, 436 F.3d 431(4th Cir. 2006) [G/T; “liability management company” case; T won on law, remanded on economic substance]

- 2005
- Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd 150 Fed. Appx. 40 (2nd Cir. 2005) [G; “lease stripping” transaction utilized partnership allocation rules to produce extremely high basis in property to be sold at loss]
- AMC Trust v. Comr., T.C. Memo 2005-180 [G; “asset protection trusts”]
- Santa Monica Pictures LLC v. Commissioner, T.C. Memo 2005-104 [G; shifting of losses in partnership; some similarities to Shell; Reg. §1.701-2 could have applied but not cited; Section 1016(a)(1) could have been relied on but was not; no business purpose for partnership]

- 2003
- American Electric Power, Inc. v. United States, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001), aff'd, 326 F.3d.737 (6th Cir. 2003) [G; COLI; no debt, interest deduction denied]
- Andantech, LLC v. Commissioner., T.C. Memo 2002-97, aff'd, 331 F.3d 972 (D.C. Cir. 2003) [G; sale/leaseback, lease stripping transaction involving foreign partners and shifting income to them while obtaining depreciable basis without tax cost]
- Ballard v. United States, 321 F.3d 1037 (11th Cir. 2003) [G; Fraud]
- Saba Pship v. Commissioner, TC Memo 2003-31 [G; partnership loss generator utilizing installment sale rules, like ACM; required non-tax business purpose for partnership, year predated Reg. §1.701-2]
- Boca Investorings Partnership v. United States, 314 F. 3d 625 (D.C. App. 2003) [G; ACM-type transaction; decided on the basis that partnership could be disregarded because it lacked a business purpose]

Appendix

- 2002
- Rogers v. United States, 281 F.3d 1108 (10th Cir. 2002) [G; reported bad debt loss rejected NOT on economic substance doctrine but on substance over form recharacterization of type of transaction]
- IRS v. CM Holdings, 301 F. 3d 96 (3d Cir. 2002) [G; COLI case generated interest deductions; COLI plans stopped by 1996 legislation]

- 2001
- Winn-Dixie v. Commissioner, 113 T.C. 254 (1999) aff'd, 254 F.3d 1313 (11th Cir. 2001) [G; COLI; no debt, interest deduction denied]
- IES Industries v. United States, 253 F.3d 350, 358 (8th Cir. 2001) [T; foreign tax credit on ADR sales]
- Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 781 (5th Cir. 2001) [T; foreign tax credit on ADR sales]
- United Parcel Service of America, Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001) [T; assignment of income to related foreign corporation; business purpose found; likened to Frank Lyon]
- Keeler v. Commissioner, 243 F.3d 1212 (10th Cir. 2001) [G; individual tax shelter and §§165 and 183 applied to deny losses on derivative trading straddles, but used ES]

- 2000
- ASA Investorings v. Commissioner, 201 F. 3d 505 (D.C. Cir. 2000) [G; partnership loss generator utilizing installment sale rules, like ACM]
- Salina Partnership, TC Memo 2000-352 [G; Helmer-type options partnership/loss case; court rejected IRS “sham” and ESD argument, but construed statute to find “liability” contrary to Helmer]
- IRS v. CM Holdings, Inc., 254 B.R. 578 (DC DE 2000) [G; this is the last opinion to refer to the “generic tax shelter” idea; it noted that no court of appeals had adopted it and that the Tax Court appeared to have abandoned it], aff'd, 301 F. 3d 96 (3d Cir. 2002).

- 1999
- ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 189 (1997), cert. denied 526 U.S. 1017 (1999) [G; partnership loss generator utilizing installment sale rules, like ACM]

- 1997
- Arrowhead Mtn. Getaway Ltd. v. Commissioner, 119 F. 3d 5 (9th Cir. 1997), aff'g, T.C. Memo 1995-54 [G; individual tax shelter; vacation time shares; no true debt]

- 1996
- Condor Int'l, Inc. v. Commissioner, 78 F.3d 1355 (9th Cir. 1996), aff'g 98 T.C. 203 (1992) [G; Court Holding Co. type case, relying on VI incorporation to shift income]

Appendix

- 1995
- Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995) [T; Rice's Toyota type transaction; held not a sham]
- James v. Commissioner, 899 F.2d 905(10th Cir. 1995) [G; Rice's Toyota type sale-leaseback transaction; partnership used to generate deductions; 1979-1981 tax years]

- 1994
- Peerless Ind., Inc. v. United States, 37 F.3d 1488 (3d Cir. 1994), aff'g, 73 AFTR 2d 94-1242 (ED PA 1994) [G; THE FIRST DISTRICT COURT OPINION THAT USED THE TERM "ECONOMIC SUBSTANCE DOCTRINE" (also economic substance "test"); OID interest deduction case: \$20M 50 year zero coupon note issued to charity for \$23,066, with option to retire note after 5 years for twice the issue price; held no debt]
- -----

- 1993
- Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993) [G; individual tax shelter loss generator from inflating purchase price for nonrecourse debt; master recording lease investment found not to have occurred so no debt and no interest deduction]

- 1992
- Illes v. Commissioner, 982 F.2d. 163 (6th Cir. 1992) [G; individual tax shelter master recording lease loss generator from inflating purchase price for nonrecourse deb found not to have occurred so no debt and no interest deduction]
- Johnson v. Commissioner, 1992-369 [G; individual tax shelter commodities straddle with foreign partners; losses denied because transactions did not occur in fact]

- 1991
- Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991) [G; Rice's Toyota type sale-leaseback transaction; partnership used to generate deductions; 1980-1981 tax years]
- Agro Science Co. v. Comr., 934 F.2d 573 (5th Cir. 1991) [G; partnership utilized to generate deductions based on debt that would not be paid, where no business was conducted; losses denied]
- Lerman v. Commissioner, 939 F.2d 44 (3d Cir. 1991) [G; "London Options Transactions" case involving purported dealer; held no loss incurred because creation of offsetting gains and losses was in violation of exchange rule]
- Bohrer v. Commissioner, 945 F.2d 344 (10th Cir. 1991), affirming Glass v. Commissioner, 87 T.C. 1087 (1986) [G; transactions not entered into for profit under sec. 165; wide scale individual tax shelter called "London Options Transaction"]

Appendix

- 1990
- Sheldon v. Commissioner, 94 T.C. 738 (1990) [G; individual tax shelter; timing mismatch of partnership interest deduction, income inclusion on T-bills investments; dissent urged section 183; only case cited by Treasury in original February 1999 proposal for some codification of doctrine]
- Shriver v. Commissioner, 899 F. 2d 724 (8th Cir. 1990) [G; Rice's Toyota type case]
- Freytag v. Commissioner, 904 F. 2d 1011 (5th Cir. 1990) [G; forward contract straddle loss generator; statute required that transaction be entered into for profits and court found it was not; did not discuss ES or ESD, but did discuss sham]

- 1989
- Esmark, Inc. v. Commissioner, 90 T.C. 171, aff'd, 886 F.2d 1318 (7th Cir. 1989) [T; planned stock purchase/redemption for wanted corporate asset; discussed economics and substance but did not refer to "economic substance" or doctrine]
- Massengill v. Commissioner, 876 F.2d 616 (8th Cir. 1989) [G; individual tax shelter, cattle breeding "investment"; held no investment made, lacked "economic substance"]
- Rose v. Commissioner, 868 F. 2d 851 (6th Cir. 1989) [G; "reproduction masters" tax shelter loss generator from inflating purchase price for nonrecourse debt; court rejected tax court's "generic tax shelter test"; depended on section 167 requirement of trade or business, but referred to sham]

- 1988
- Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988) [G; individual tax shelter investment in gold mining; debt not real, deductions for mining development expenses denied]
- Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988) [G; individual tax shelter based on deductions and losses in straddles in forward contracts; "factual shams," meaning no contract on which loss was claimed actually existed and incurred a loss]
- Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988) [G; individual tax shelter commodity straddle loss transaction; THE FIRST APPELLATE OPINION IN WHICH THE "ECONOMIC SUBSTANCE DOCTRINE" WAS MENTIONED BY NAME in terms of section 165(c)(2) codifying the economic substance doctrine, AT SUGGESTION OF IRS; opinion by Posner, J.]
- Georgia Cedar Corp. v. Commissioner, TC Memo 1988-213 [G; THE FIRST TAX COURT OPINION IN WHICH THE "ECONOMIC SUBSTANCE DOCTRINE" WAS MENTIONED BY NAME, AT SUGGESTION OF IRS; No debt owed, so no interest deduction allowed, based on circular flow of "purchased" property among related foreign and domestic corporations]
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Appendix

- 1987
- Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543 (9th Cir. 1987) [G; applied Harry Margolis system to generate interest deductions on loans that would not actually be paid]
- Robert O. Carlson v. Commissioner, 1987-306 TC Memo [G; like synthetic tax shelters in that property of uncertain value bought for inflated non recourse note; there was an actual cable TV business; stated a rule of law that a transaction entered into without any purpose but tax reduction will be disregarded, as lacking economic substance, citing Law and Estate of Thomas]
- Canfield v. Commissioner, 1987-294 [G; partnership movie investment loss generator from inflating purchase price for nonrecourse debt; cites Rose in same year for “generic tax shelter test”]
- Rose v. Commissioner, 88 T.C. 386 (reviewed) [G; “reproduction masters” individual tax shelter loss generator from inflating purchase price for nonrecourse deb; Tax Court attempted to synthesize meaning of Rice’s Toyota World by distinguishing between “statutory tax shelters,” apparently meaning tax benefits clearly allowed by statute to areas of “tax-preferred activities, such as real property, equipment leasing activities, and oil and gas ventures,” and “generic tax shelters,” which it described as depending on overvalued hard to value assets purchased with inflated nonrecourse notes for the purpose of obtaining depreciation and other expense deductions leading to losses to shelter other income, with the property being books, films, master recordings, mining ventures, inventions or lithographs; as to these the court tried to synthesize a standard that was not solely subjective, as it viewed section 183 to be, but also objective]
- 1986
- Estate of Baron v. Commissioner, 798 F.2d 65 (2d Cir. 1986) [G; individual tax shelter master recording loss generator from inflating purchase price for nonrecourse debt; found not to have occurred so no debt and no interest deduction; Section 183 hobby loss rule applied to individual tax shelter]
- Donal C. Noonan, 1986-449 [G; this was a “test case” for numerous individuals who invested in refrigerated intermodal containers and claimed losses; IRS did not argue lack of substance and court found actual investments and profit motive but notes not intended to be paid and reduced investment allowed]
- 1985
- Estate of Thomas, 84 T.C. 412 (1985) [T; Rice’s Toyota type investment but found “economic substance test” met; this is the first use of “economic substance test” other than in partnership allocation context]
- Rice’s Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985) [G; computer sale-leaseback; depreciation denied because no investment; held lacked “economic substance” under dual test; could have ruled same based on contingent nature of debt that purported to create basis]
- 1979
- Holladay v. Commissioner, 72 T.C. 571 (1979), aff’d, 649 F.2d 1176 (5th Cir. 1981) [G; partnership agreement allocating loss lacked “economic substance”; Tax Court referred for the first time to “economic substance test,” which related to validity of partnership allocations, and was said to come from “judicial gloss” in Kresser v. Commissioner, 54 T.C. 1621 (1970), which did not use term “economic substance.”]
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Appendix

- 1976
- Arnold L. Ginsburg v. Commissioner, T.C. Memo 1976-199 [G; cattle breeding tax shelter; loss deductions denied; second juxtaposition of “tax shelter” and “economic substance”]
- 1975
- E. Keith Owens v. Commissioner, 64 T.C. 1 (1975), reviewed [G; taxpayer sold stock of corporation that held nothing but cash; held taxpayer received a dividend; first juxtaposition of “economic substance” and “tax shelter”]
- -----
- 1970s
- Aiken Industries, Inc. v. Comr., 56 T.C. 925 (1971), acq., 1972-2 C.B. 1 [G; treaty withholding issue; based on agency not on economic substance]
- Audano v. United States, 428 F.2d 251 (5th Cir. 1970) [G; doctor assigns income to trust for children; “ES” not used]
- 1960s
- Frank Lyon v. Commissioner, 435 U.S. 561 (1968) [T; sale-lease back; arms length multi-party transaction in which intermediary party bore risk; the first opinion in which the Supreme Court affirmatively used term “economic substance” to decide whether taxpayer should win]
- -----
- Commissioner v. Hansen, 360 U.S. 446 (1959) [G; Court applied “substance over form” to reject taxpayer’s position that was contrary to the facts in the record as to who owned reserve accounts]
- Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) [G; deduction of prepaid interest on purchase of bonds was not a sham but was not a purposive activity and so section 163 interest deduction denied]
- Perry R. Bass v. Commissioner, 50 T.C. 595 (1963) [T; “ES” not used; like Higgins v. Smith but post Moline, fact found to constitute real corporation]
- Carpenter v. Commissioner, 322 F.2d 733 (3d Cir. 1963) [G; Knetsch-type case; no indebtedness in substance]
- Simon v. Commissioner, 285 F.2d 422 (3d Cir. 1960) [G; president acted as agent for corporation in placing mortgage on property before “contributing” it to corporation; not a contribution to capital but a sale]
- Knetsch v. United States, 364 U.S. 361 (1960) [G; no debt so no interest deduction; second use of term “economic substance” by Supreme Court in a tax case; but only quoted trial court’s words, and did not adopt it]

Appendix

- 1950s
- *Weller v. Commissioner*, 270 F.2d 294 (3d Cir. 1959) [G; Knetsch-type case; no indebtedness in substance]
- *Haas v. Commissioner*, 248 F. 2d 487 (2d Cir. 1957) (reversing decision for IRS and remanding), TC Memo 1959-86 (1959) [G; taxpayer purported to form a partnership with his corporation to operate the partnership business whereby he would fund the operating losses, which he had done previously as contributions to capital; the court of appeals ruled the partnership existed but remanded for the trial court to decide if it was effective to change the operations of the business; held it was not, because nothing in fact changed]
- *Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959) [G; “Livingston” individual tax shelter involving interest and loss deductions that depended on stock buying and lending and short sale transactions with counterparty that did not actually operate a business of buying and selling stock]
- *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953) [T; preferred stock dividend and preplanned sale of stock; reversed by 306]

- 1940s
- *Commissioner v. Court Holding Co.*, 324 U.S. 331(1945) [G; a “who sold the property” case that was really based on finding the shareholders to be the agents of the corporation for its sale of the corporate property]
- *Fernandez v. Wiener*, 326 U.S. 340 (1945) [G; first time Supreme Court used term “economic substance” in tax opinion, in context of death of one spouse of community property marriage caused both change of legal relationships and economic substance]

- 1930s
- *Hesslein v. Hoey*, 18 F. Supp. 169 (SD NY 1937) [T; “economic substance” of transfer of property used in context of completed gift for gift tax purposes]
- *Gregory v. Helvering*, 293 U.S. 465 (1935) [G; a case of statutory interpretations]
- *American Security & Trust Co. v. Tait*, 5 F. Supp. 337 (D Md. 1933) [G; first use of “economic substance” in contest of determining a fact: was the contract a sale?]

- -----
- Earlier
- *Southern Pacific Co. v. Lowe*, 247 U.S. 330 (1918) [T; treated subsidiary’s income as income of parent because “in truth and substance” it was, despite corporate separation]