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ECONOMIC SUBSTANCE

PRIMER

Introduction

Economic substance is an anti-abuse doctrine that analyzes suspect business transactions for a motive other than the obtaining of a tax advantage. Certain strategies involving, for example, corporate reorganizations, acquisitions or sales, financings, partnership structures, loans and deductions, or various tax shelter arrangements may offend the purpose underlying sections in the Internal Revenue Code (IRC) that minimize tax liability.[1] While some transactions technically comply with the rules that lead to a tax benefit, they violate the spirit in which those benefits are offered. When this happens, the Internal Revenue Service (IRS) is not obligated to respect the transaction or the tax effects that would flow from it, because such a transaction has no "economic substance." Factors such as the origin, structure, and economic effects of the transaction; effects of the transaction besides profit; and the risk level undertaken by the taxpayer have been considered by the courts to be relevant when determining economic substance.

The result of such a finding can be severe. A taxpayer responsible for transactions lacking economic substance will be subject to a general penalty of 20% of the disallowed tax benefits related to the transaction.[2] If there was inadequate disclosure of relevant facts about the non-economic substance transaction, the penalty increases to 40%.[3] Taxpayers are precluded from relying on "reasonable cause" defenses if subjected to either of these penalties.[4]

The Law

The doctrine of economic substance originally arose out of common law. The seminal case from 1935 is *Gregory v. Helvering,*[5] which is still cited in court cases that deal with economic substance. In that case, the Supreme Court of the United States found the taxpayer's transaction to be only "masquerading" as a corporate reorganization,[6] since the sole object and accomplishment of it was "…not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner."[7] The Court held that, although taxpayers may arrange their affairs in a way to minimize tax, a transaction with only a tax avoidance purpose and no business purpose, substance, or utility, must be disregarded. Such a transaction would lie outside the plain intent of the applicable law which provided the tax benefit and tax authorities are thus entitled to tax such a transaction. To hold otherwise would "deprive the statutory provision…of all serious purpose." [8]

In 2010, the economic substance doctrine was codified at IRC § 7701(o). Section 7701(o)(5)(A) defines it as the "common law doctrine under which tax benefits… with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." In terms of when to apply the doctrine, § 7701(o)(5)(C) maintains that "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [§ 7701(o)] had never been enacted."

The Legal Test

Section 7701(o)(1) provides that a transaction will be treated as having economic substance only if:

A. the transaction changes the taxpayer's economic position in a meaningful way (apart from Federal income tax effects); and

B. the taxpayer has a substantial purpose for entering into such a transaction (apart from Federal income tax effects).

The first arm of the test is "objective" and requires the taxpayer to show a measurable, meaningful, non-tax change in economic position after the transaction. This can often be shown by the generation of profit, or the realistic potential for it. The second arm of the test is subjective. It requires that the taxpayer prove an intention to achieve a substantial, non-tax purpose through the transaction (also called a "business purpose"). Examples other than a straightforward profit motive might include a desire to diversify business or reduce business risk.

Prior to codification of the economic substance doctrine, there was inconsistency amongst circuit courts as to how to apply the test.[9] Codification confirmed that the two arms of the test were conjunctive and that both must be satisfied.

Relevant Factors

In conducting the test, courts account for the origin, structure and economic effects of the transaction. Factors around the effects of the transaction other than profit and the level of risk the taxpayer assumed in the transaction can also be relevant.

Origin of the Transaction

A transaction's origins, including how it was formed and negotiated, and why, are relevant because they speak to the transaction's "economic reality." For example, in *Frank Lyon Company v. United States*,[10] it was significant that the transaction involved several unrelated organizations engaged in a competitive bidding process. The negotiations, which were described as having "bona fide character," involved comparing the various proposals; and the transaction had a nonfamily and non-private nature throughout. The court concluded there was economic substance.

Structure of the Transaction

Factors such as the rigidity of the transaction's structure and the independent activities of the participating entities outside of the transaction may indicate whether there is an element of artificiality. For example, in *Boca Investerings Partnership v. United States*,[11] it was significant that the participants used a complicated partnership structure despite evidence of simpler alternatives that would have cost millions of dollars less to implement. It was also found that two entities had been "concocted" for the occasion of the transaction—neither of which had previously existed or served any other purpose. The Court concluded that the only "logical explanation" for the formation of the partnership and the new entities was to exploit the relevant tax law. The transaction, therefore, lacked any non-tax business purpose.[12]

Economic Effects of the Transaction

Factors such as pre-tax profitability are relevant in determining whether the transaction meaningfully changes the taxpayer's economic position. For example, in *Knetsch v. United States*,[13] the taxpayer purchased annuity bonds from an insurance company, which were financed with loans from the very same insurance company in amounts large enough to keep the net cash value of the annuity at a "relative pittance" of $1000. Although the taxpayer possessed an annuity contract of some value, the transaction "did not appreciably affect his beneficial interest except to reduce his tax [through interest deductions]."[14] The Supreme Court considered § 7701(o)(2)(A), which provides that the profit potential of a transaction shall be considered in an economic substance determination "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." It ultimately disallowed the interest deductions as they bore no commercial economic substance to the transaction overall.

Effects of the Transaction Besides Profit

Some business transaction may be considered genuine despite failing to result in a profit. Effects other than profit can be evidence of a transaction's substantial purpose if they are genuine, such as transfers of property or the creation of a new business product. In *Higgins v. Smith*,[15] the taxpayer deducted losses incurred in transferring securities to his own wholly owned corporation. Although legal title passed to the corporation, the taxpayer retained control of the securities. The Supreme Court held that "transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration [as proper transactions]."[16] Because control over the securities did not change, there was no true transfer of property for tax purposes and the taxpayer was not entitled to deduct the losses.

Taxpayer's Risk Level

The extent of the taxpayer's risk exposure is also relevant in determining whether the transaction was bona fide. In *Frank Lyon Company*,[17] the taxpayer assumed the risk of building depreciation, liability for substantial ground rent, and the risk of lessee default. A Supreme Court majority found it significant that the obligations and risk exposure fell solely to the taxpayer and their business.[18] The Court considered the taxpayer's risk level and held that there was a genuine transaction with economic substance, compelled by business realities.[19]

Tax Foresight

Tax Foresight's Economic Substance Classifier asks you to complete a questionnaire about the facts of your scenario. Each of the questions represents a factor found to inform court decisions about whether the economic substance test has been met. Once you answer all the questions, Tax Foresight will compute the likelihood of the transaction being found to have economic substance, comparing your scenario to previous relevant cases.

Endnotes

1 Christopher Yan, Economic Substance: A Machine Learning Perspective on the Multi-Factorial Analysis, Lexology (Jul. 11, 2019), https://www.lexology.com/library/detail.aspx?g=281977be-06e5-4e77-a57f-fe0caa4defc7.
2 IRC §§ 6662(a) and (b)(6); § 6676(a).
3 IRC §§ 6662(i)(1) and (2).
4 IRC § 6676(c).
5 Gregory v. Helvering, 293 U.S. 465 (1935).
6 *Id*. at 470.
7 *Id*.at 469.
8 *Id*. at 470.
9 IRS LB&I Directive "Exhibit 4.46.4-4 Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties", https://www.irs.gov/irm/part4/irm_04-046-004#idm139936223748640.
10 *Frank Lyon Company v. United States*, 435 U.S. 691, 582 (1978).
11 *Boca Investerings Partnership v. United States*, 314 F.3d 625, 631 (D.C. Cir. 2003).
12 *Id*. at 632.
13 *Knetsch v. United States*, 364 U.S. 361, 366 (1960).
14 *Id*. at 366.
15 *Higgins v. Smith*, 308 U.S. 473, 474 (1940).
16 Id. at 476.
17 *Frank Lyon Company v. United States*, 435 U.S. 561, 583 (1978).
18 *Id*. at 577.
19 *Id*. at 583, 584.