

Thursday, October 21, 2010

## Economic Substance Doctrine: The IRS' Newly Fortified Weapon

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The Internal Revenue Service has always had non-statutory doctrines available to combat transactions it does not like. The "substance over form" doctrine is used to disallow tax benefits from transactions whose form differs from its substance. Assume a shareholder capitalizes a corporation with \$1,000 and loans it \$100,000. The large debt is to permit the corporation to deduct the interest. The IRS might seek to disallow the corporation's interest deduction on the grounds that the loan is really equity, not debt. The "step transaction" doctrine is used to treat separate transactions or

steps as a single, unified transaction for tax purposes. Assume a shareholder who is under contract to sell his stock transfers some of it to a charitable remainder trust. A charitable remainder trust, if properly used, would: give the shareholder a current deduction for the present value of the charity's right to receive the assets on the shareholder's death; pay the shareholder an income stream for the rest of the shareholder's life; and not pay capital gains tax on the sale of the stock. The IRS might treat the stock owned by the charitable remainder trust as still owned by the shareholder, and tax the gain to the shareholder.

The doctrine that the IRS has used recently with increasing frequency is the "economic substance" doctrine. Under this doctrine the IRS seeks to deny tax benefits from transactions that do not result in a meaningful change to the taxpayer's economic position other than reducing federal income tax. The IRS successfully used this doctrine to strike down most of the 1990s tax shelter transactions, e.g., Son-of-Boss, LILO (lease in/lease out transactions) and other well-publicized abusive structures.

As part of the Health Care and Education Reconciliation Act of 2010, Congress adopted a provision "clarifying" (and for the first time codifying) the economic substance doctrine. The main provision is unremarkable: a transaction shall be treated as having economic substance only if it changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction. This sets to rest a disagreement among the Federal Circuits about whether one or both of those tests must be met. New Section 7701(o) helpfully provides that, as to individuals, the doctrine will only apply to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. In other words, estate planning structures should be exempted. It also provides that the "transaction" to be scrutinized may be a series of transactions. That provision has far-reaching implications.

The new law's penalty provision will have the greatest impact: a 20 percent accuracy-related penalty on any underpayment of income tax due to "any disallowance of claimed tax benefits by reason of a transaction lacking economic substance...or failing to meet the requirements of any similar rule of law."

### SPECIAL REPORT

#### Top Women Lawyers

Our annual list of the Top Women lawyers in the state.



Thursday, May 12, 2011

### Discipline

#### Receiver Sues Sedgwick For Malpractice

Sedgwick LLP has been hit with a \$200 million malpractice suit over its work for accused fraudulent investment company Medical Capital Holdings Inc.

### Health Care & Hospital Law

#### Former Biotech GC Acquitted

A U.S. judge acquitted former GlaxoSmithKline general counsel Lauren Stevens on Tuesday of all six charges against her in an investigation of the company's marketing practices for an anti-depressant.

### Zoning, Planning and Use

#### The Curse of Chavez Ravine

Are the Dodgers' financial problems a case of delayed retribution for how Dodger Stadium came about? By **Gideon Kanner** of Loyola Law School

### International

#### The Benefits of Bilateral Investment Treaties When Investing in China

Bilateral investment treaties operate as "free insurance" with its minimal costs and direct benefits. By **Allan Marson, Grant Hanessian,** and **Michiel Kloes** of Baker & McKenzie

### Construction

#### What to Do With a Busted Project

Distressed real estate projects are getting a shot of much needed adrenaline from preferred equity. By **Anita F. Sabine** of O'Melveny & Myers LLP

### Letter to the Editor

#### America Is a Fair Country

Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

### Criminal

#### Panel Lawyers Could Be Curtailed

A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

### Judge Bars Gang Injunction Enforcement

A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.



First, the penalty is increased to 40 percent unless the transaction is disclosed. Many taxpayers and tax advisors will be uncomfortable disclosing a transaction to the IRS. Will the disclosure lead to an audit? Based on experience with existing reporting forms, e.g., IRS Form 8275-R, used when a taxpayer takes a position inconsistent with an IRS regulation, the answer is "no." Will the IRS view the disclosure as an admission that the transaction may lack economic substance? Based on experience with existing IRS Form 8886 (Reportable Transaction Disclosure Form), the answer is "no." Will millions of disclosure forms now pour into the IRS National Office, accomplishing the opposite of which was intended by the new law, making oversight of such transactions impossible? It is too soon to tell.

Second, there is no "reasonable cause" exception to the penalty's application. The taxpayer cannot show, as is the case with the existing accuracy-related, civil fraud and reportable transaction penalties that the taxpayer acted with reasonable cause and in good faith. As a matter of public policy it makes no sense to treat a transaction, which lacks economic substance, more harshly than civil fraud.

Third, the penalty applies not just to the economic substance doctrine, but to "any similar rule of law." That means that even if the transaction has economic substance, the penalty will apply if the IRS believes that the substance is different than the form the taxpayer adopted. The new law may have only codified and clarified the economic substance doctrine, but it has put powerful teeth into all the non-statutory doctrines available to the IRS.

Fourth, due to the large, strict liability penalties, the balance of power in an audit will shift dramatically once an IRS agent raises the possibility that a transaction fails the economic substance doctrine. Once that occurs, the taxpayer and tax advisor will be more pliable in negotiating any open issues. As a club to get taxpayers to agree to pay the tax without penalties, the IRS may use the assertion of the failure of a transaction to meet the newly fortified economic substance doctrine.

Fifth, we have no certainty about which transactions must be examined in light of the economic substance doctrine. Although the legislative history lists four transactions that will not be impacted by the newly codified doctrine, the IRS has indicated it will not issue an "angel list." As a result, a threshold question is going to be whether transactions must be examined in light of the economic substance doctrine at all. If the conclusion is that the doctrine might apply, then each step of a pending transaction must now be examined carefully. It is unclear which step the IRS and a court might scrutinize in determining whether the transaction as a whole has economic substance. This may result in tax advisors recommending structures that have less advantageous tax results. Defining the "transaction" becomes extremely important.

The uncodified economic substance doctrine was a powerful tool for the IRS. With the strict liability penalty, it is a weapon that may change the face of tax and business planning.

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## Judicial Profile

### Making Her Mark

A framed reproduction of Botticelli's Calumny of Apelles hangs in U.S. Magistrate Judge Jennifer L. Thurston's chambers. The colorful painting, rich in allegory, depicts Slander dragging Innocence - the victim of false accusations by Envy,

## Intellectual Property

### Nevada Newspaper Pursues Copyright Cases

Despite some recent unfavorable court rulings, a Nevada company appears to be doubling down on its bet that suing hundreds of defendants for infringing the copyright of a Las Vegas newspaper is a winning strategy.