I. The Common Law Economic Substance Doctrine

The economic substance doctrine states that a transaction’s tax benefits will not be allowed if the transaction does not have economic substance. The common law doctrine is an effort by the courts to enforce Congress’s statutory intent in situations in which a literal reading of the Code would allow a taxpayer to circumvent this intent. A report by the 2005 Joint Committee on Taxation stated that:

> Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by the Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining overall respect for the tax system. A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. JCT, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05) (Jan. 27, 2005).

While there is agreement among the courts about the general definition of the doctrine and its purpose, the same cannot be said about a test to determine when a transaction has economic substance. Some courts use a single-element test and some use a two-element test:

**The Single-Element Test.** A transaction has economic substance if, viewed objectively, there is a nontax business purpose for the transaction. The taxpayer’s subjective intentions regarding the transaction are not taken into account (Coltec Industries, 454 F3d 1340 (Fed. Cir. 2006)).

**The Two-Element Test.** A transaction has economic substance if (1) the transaction, viewed objectively, has economic substance and (2) the taxpayer has a subjective business purpose for the transaction. *Frank Lyon v. U.S.*, 435 U.S. 561 (1978).

Adding to the confusion, courts that have adopted the two-element test for economic substance have not been consistent in applying it, in some cases requiring that both the elements be satisfied (a “conjunctive” test), in others requiring that either one of the two elements be satisfied (a “disjunctive” test), and in others only taking both elements into consideration as part of the determination of whether a transaction has economic effects other than those derived from its tax benefits. *Pasternak v. Comr.*, 990 F2d 893, 898 (6th Cir. 1993) (applying a conjunctive test); *Rice’s Toyota World v. Comr.*, 752 F2d 90 (4th Cir. 1985) (applying a disjunctive test); *IES Industries*, 253 F3d 350 (8th Cir. 2001); *ACM Partnership*, 157 F3d 231 (3d Cir. 1998); *James*, 899 F2d 905 (10th Cir.); *Sacks*, 69 F3d 982 (9th Cir. 1995).

II. Types of Cases Invoking the Economic Substance Doctrine

The Economic Substance Doctrine has been applied in a variety of transactions:
Sale Leaseback Transactions. In *Rice’s Toyota World v. Comr.*, 752, F.2d 90 (4th Cir. 1985), Rice agreed to purchase a computer on a nonrecourse installment loan basis at $1,455,227, which was much more than its fair market value, and then lease it back to the seller. Rice took accelerated depreciation deductions on the inflated purchase price and intended to “walk away” from its installment obligation after harvesting all the depreciation deductions. (NOTE: at the time, there were no depreciation recapture rules in place on abandonment of property)

Life Insurance Policy Loan Interest Deductions. In *Comr. v. CM Holdings*, 301 F.3d 96 (3d Cir. 2002), CM Holdings purchased life insurance policies on 1,430 of its employees. CM Holdings overfunded the policies and then borrowed 90 percent of the cash value at a very high interest rate. CM Holdings then deducted the interest payments as a business expense even though the interest payments increased the cash value of the policies owned by CM Holdings.

Contribution to Corporate Subsidiary and Subsequent Sale of Stock. In *Coltec Industries v. U.S.*, 454 F.3d 1340 (Fed. Cir. 2006), Coltec Industries, Inc. (Coltec) entered into a so called contingent liability tax shelter designed by Arthur Andersen. The transaction at issue involved Coltec’s transfer of assets into a subsidiary in exchange for stock in a Section 351 transaction, and the subsidiary’s assumption of contingent asbestos related liabilities. Coltec subsequently sold the high basis stock to an unrelated third party at a significant discount, thereby generating a $378.7 million capital loss. Coltec took the position that the contingent liabilities assumed by the subsidiary did not reduce the basis of the stock pursuant to Section 357(c)(8).

III. Economic Substance Doctrine Applied in the Eighth Circuit

The Eighth Circuit follows the two-element, disjunctive test. *IES Industries, Inc. v. U.S.*, 253 F.3d 353 (8th Cir. 2001); *Shriver v. Comr.*, 899 F.2d 726 (8th Cir. 1990).

IV. Economic Substance Doctrine Applied in Gift and Estate Tax Cases

The history of the applicability of the economic substance doctrine in estate and gift tax cases is well established, just as it is in income tax cases.

*Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001), aff’g. T.C. Memo. 1999-29 (recharacterizing transfers to brother’s children as indirect transfers to donor’s children; donors not entitled to gift tax annual exclusions for transfers lacking economic substance);
Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991) (transfer to third party with retransfer to son was indirect transfer to son); Schultz v. United States, 493 F.2d 1225, 1226 (4th Cir. 1974) (reciprocal gifts to extended relatives were gifts to each donor’s children);

Vose v. Commissioner, 284 F.2d 65, 68-69 (1st Cir. 1960) (transfers of certificates of trust indebtedness were outright gifts to recipients, rather than gifts in trust);

Estate of Schuler v. Commissioner, T.C. Memo 2000-392 (reciprocal transfers to extended family members were indirect gifts to each donor’s children);

Estate of Bies v. Commissioner, T.C. Memo. 2000-338 (transfers to daughters-in-law who retransferred to their spouses were indirect gifts to donor’s sons);

Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (same).

The Eighth Circuit has stated in upholding the Tax Court’s application of the reciprocal trust, or reciprocal transaction, doctrine to determine that transfers lacked economic substance for gift tax purposes:

Substance over form analysis applies equally to gift tax cases .... It is impliedly included in the gift tax statute itself - including indirect transfers within the definition of a taxable gift. See Sec. 2511(a). “‘The terms ‘property,’ ‘transfer,’ ‘gift,’ and ‘indirectly’ are used in the broadest and most comprehensive sense:... [they] are designed to cover and comprehend all transactions... whereby... property or a property right is donatively passed. Sather v. Comr, 251 F.3d 1174 (8th Cir. 2001).

The application of the economic substance doctrine in transfer tax cases is not limited to determining the true transferor or transferee, but also applies to determine the nature of the property transferred. For example, the Tax Court in Estate of Murphy, T.C. Memo. 1990-472, applied a two-element analysis, focusing on a decedent’s subjective intention and on the objective economic facts to disregard the decedent’s transfers of two fractional gifts of stock in a closely-held corporation because she retained effective control of the corporation and the transfers did not appreciably affect her beneficial interests except to reduce transfer taxes. See also Griffin v. United States, 42 F.Supp.2d 700 (W.D. Tex. 1998) (aggregating two transfers and determining no fractional discount applicable in valuing transfer).

Most recent transfer tax cases, however, focus mostly on Sections 2036 (the strings section) and 2703 (rights and restrictions disregarded in valuation cases involving family members) and not
on the economic substance doctrine. The two last Tax Court cases that addressed these matters were Strangi and Knight.

**Estate of Strangi**, 115 T.C. 478 (2000) (reversed and remanded, 293 F.3d 279 (5th Cir. 2002); T.C. Memo 2003-145 (May 20, 2003)). In *Strangi*, the decedent with a terminal illness established a Texas limited partnership with his son-in-law acting as the decedent's power of attorney. Approximately 75 percent of the $10 million in assets contributed to the limited partnership consisted of cash and securities and no active business was conducted by the limited partnership. Control of the general partner was given to the decedent’s four children prior to his death. The estate applied a 43.75 percent combined discount for marketability and lack of control.

The IRS asserted that the formation of the limited partnership and its funding of the personal and investment assets of the decedent lacked economic substance. The Tax Court disagreed holding that the only legal hurdle that the decedent needed to jump prior to his death to show economic substance was to make sure that the limited partnership was validly formed under state law, which it was. The Tax Court went further by stating that in the context of valuation cases, Congress intended Sections 2036 and 2703 to apply.

Although *Strangi* was later reversed and remanded, it was not reversed on it holding relative to the Economic Substance Doctrine.

**Knight v. Comr.**, 115 T.C. 506 (2000). Knight was decided concurrently with Strangi and its holding and rationale with respect to the economic substance doctrine was the same – if the formalities of state law were followed with respect to formation of the entity, then the entity and transaction will be respected.

In *Knight v. Commissioner* (115 TC 506), Herbert D. and Ina F. Knight formed the Herbert D. Knight family limited partnership under Texas law on December 28, 1994. They transferred $2 million in real and personal property to the partnership. In return, each spouse received 50 units and a 50% interest in the partnership. Simultaneously, the Knight Management Trust and trusts for their two grown children were created. Each child was beneficiary and trustee of their own trust. The Knights each transferred 1.5 units to the Knight Management Trust and 22.3 units to each of the children’s trusts. The partnership agreement prohibited withdrawal from the partnership or return of contributions or capital account balances.

The Tax Court applied a 15 percent combined minority and marketability discount, but gave no reason as to how it arrived at 15 percent. The Tax Court rejected the IRS’s economic substance doctrine argument and reasoned that a hypothetical willing buyer and willing seller would not disregard the limited partnership and, therefore, neither should the court.

V. The Codification of the Economic Substance Doctrine
On March 30, 2010, President Barack Obama signed into law the Health Care and Education Reconciliation Act of 2010 (the “Reconciliation Act”). See Appendix A for the economic substance doctrine as codified. Section 1409 of the Reconciliation Act (adding Section 7701(o) of the Code) codifies the economic substance doctrine and adds a new penalty regime for transactions lacking economic substance. According to the Technical Explanation accompanying the Reconciliation Act, the new provision “clarifies and enhances the application of the economic substance doctrine.” Specifically, the Reconciliation Act provides that for any transaction to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if:

1. the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer’s economic position, and

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

The taxpayer is permitted to rely on factors other than profit potential to demonstrate that these requirements are satisfied. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected pretax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

The “clarification” and “expansion” of the economic substance doctrine are expected to have a significant effect on tax planning. Transactions that may have satisfied the disjunctive test or pretax profit standards of existing case law in many circuits will need to be reconsidered in light of the codification. In addition, the codification provides a powerful tool for IRS audit teams and the IRS’s enforcement and litigation activities. The codification provision will apply to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after the date of enactment.

In addition to codifying the economic substance doctrine, the provision adds a new penalty for underpayments and understatements attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance as defined in the new codification provision or by reason of failing to satisfy the requirements of any similar rule of law (i.e., tax benefits disallowed under common law applications of economic substance and similar rules). The penalty generally is 20 percent but is increased to 40 percent if the taxpayer fails to adequately disclose the relevant facts affecting the tax treatment of the item. Notice 2010-62 states that adequate disclosure can only be accomplished if made on Form 8275 or 8275R (or as otherwise provided by published guidance). The codification provision also provides that the reasonable cause exception, normally applicable to accuracy-related penalties, does not apply in the case of a transaction lacking economic substance. This is a significant expansion from the standards of existing case law.
The good news for estate planners is that it appears that Section 7701(o) does not apply to estate planning. Section 7701(o) applies only to transactions entered into in connection with a trade or business activities engaged in for the production of income. However, many aspects of estate planning involve transactions with trades or business and activities for the production of income, such as the creation of family limited partnerships and limited liability companies. Recent courts prior to the enactment of Section 7701(o) have refused to apply the economic substance doctrine to such entities in valuation cases (i.e., Strangi and Knight, supra) and Section 7701(o) specifically states that the determination of whether the economic substance doctrine applies shall be made in the same manner as before the enactment of Section 7701(o).

VI. IRS Guidance On Enforcement of Economic Substance Doctrine

In recently issued Notice 2010-62, the IRS indicated that it will continue to rely on “relevant” case law in applying the two-element conjunctive test of Section 7701(o). The term “relevant” will not mean cases that applied a single-element test or a two-element disjunctive test. Also, the IRS does not intended to issue further guidance on the kinds of transactions to which the economic substance doctrine may apply, indicating that they are leaving future guidance strictly to the courts.

On July 15, 2011, the IRS issued a directive to its examiners and for counsel indicating that the approval must first be acquired from the IRS Director of Field Operations before asserting a lack of economic substance penalty. The directive also outlined several specific sets of facts and circumstances under which it likely would or would not be appropriate for agents to assert the economic substance doctrine.

On April 1, 2012, the IRS issued a Chief Counsel Notice (“CCN”) that provides guidance on the coordination between the Chief Counsel’s office and various units within the IRS and Department of Justice. CCN-2012-008. The CCN builds on prior IRS directives which requires the approval of the appropriate Director of Fields Operations before raising the codified doctrine and penalties in order to ensure proper and consistent application.

Comment [DR2]: IRS TELLS ITS PERSONNEL HOW TO APPLY ECONOMIC SUBSTANCE DOCTRINE & PENALTIES

Click here for the text of IRS’s Chief Counsel Notice CC-2012-008, “Coordination Procedures for the Economic Substance Doctrine and Related Penalties.” [link omitted]

A new Chief Counsel Notice (CCN) provides guidance on the coordination between Counsel and various units within IRS and the Department of Justice (DOJ) to ensure that the economic substance doctrine and related penalties are only raised in appropriate cases. The CCN builds on prior IRS directives which require the approval of the appropriate Director of Field Operations (DFO) before raising the codified doctrine and penalties in order to ensure proper and consistent application.

Background on the economic substance doctrine. The economic substance doctrine began as a common law doctrine under which the IRS determined whether the federal tax benefits of a transaction aren't allowable if the transaction doesn't have economic substance or lacks a business purpose.

As part of the Health Care and Education Reconciliation Act of 2010, Congress enacted new Code Sec. 7701(o), which provides for the codification of the economic substance doctrine and the addition of substantial penalties for transactions that are found to lack economic substance. Under Code Sec. 7701(o), for transactions entered into after Mar. 30, 2010, and for underpayments, understatements, and refunds and credits attributable to transactions entered into after Mar. 30, 2010, a transaction to which the economic substance doctrine is relevant is treated as having economic substance under a conjunctive two-prong test only if-apart from Federal income tax effects both:

1. The transaction changes the taxpayer's economic position in a meaningful way; (Code Sec. 7701(o)(1)(A)) and
2. The taxpayer has a substantial purpose for entering into the transaction. (Code Sec. 7701(o)(1)(B)) That is, the taxpayer's non-Federal-income-tax purpose for entering into a transaction must be "substantial."

The codified economic substance doctrine only applies to an individual who entered into a transaction in connection with a trade or business or an activity engaged in for the production of income. (Code Sec. 7701(o)(5)(B)) Additionally, under Code Sec. 7701(o)(5)(C), the determination of whether the doctrine is relevant to a transaction "shall be made in the same manner as if this subsection has never been enacted."

Background on penalties. For underpayments attributable to transactions entered into after Mar. 30, 2010, a 20% strict liability penalty applies to an underpayment attributable to any disallowance of claimed tax benefits by reason...
Appendix A

H.R. 4872, P.L. 111-152, Health Care and Education Reconciliation Act of 2010, Enrolled, as Signed by the President on March 30, 2010

* * *

Section 1409. Codification of Economic Substance Doctrine and Penalties.

(a) In General.—Section 7701 of the Internal Revenue Code of 1986 is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

“(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.”.

(b) Penalty for Underpayments Attributable to Transactions Lacking Economic Substance.—

(1) In general.—Subsection (b) of section 6662 is amended by inserting after paragraph (5) the following new paragraph:

“(6) 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.”.

(2) Increased penalty for nondisclosed transactions.—Section 6662 is amended by adding at the end the following new subsection:

“(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.”.

(3) Conforming amendment.—Subparagraph (B) of section 6662A(c)(2) is amended—

(A) by striking “section 6662(b)” and inserting “subsections (h) or (i) of section 6662”; and
(B) by striking “gross valuation misstatement penalty” in the heading and inserting “certain increased underpayment penalties”.

c) Reasonable Cause Exception Not Applicable to Noneconomic Substance Transactions.—

(1) Reasonable cause exception for underpayments.—Subsection (c) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;
(B) by striking “paragraph (2)” in paragraph (4)(A), as so redesignated, and inserting “paragraph (3)”;
(C) by inserting after paragraph (1) the following new paragraph:

“(2) Exception.—Paragraph (1) shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).”.

(2) Reasonable cause exception for reportable transaction understatements.—Subsection (d) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;
(B) by striking “paragraph (2)(C)” in paragraph (4), as so redesignated, and inserting “paragraph (3)(C)”; and
(C) by inserting after paragraph (1) the following new paragraph:

“(2) Exception.—Paragraph (1) shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6).”.

d) Application of Penalty for Erroneous Claim for Refund or Credit to Noneconomic Substance Transactions.—Section 6676 is amended by redesignating subsection (c) as subsection (d) and inserting after subsection (b) the following new subsection:

“(c) 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.”.
(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.

(2) Underpayments.—The amendments made by subsections (b) and (c)(1) shall apply to underpayments attributable to transactions entered into after the date of the enactment of this Act.

(3) Understatements.—The amendments made by subsection (c)(2) shall apply to understatements attributable to transactions entered into after the date of the enactment of this Act.

(4) Refunds and credits.—The amendment made by subsection (d) shall apply to refunds and credits attributable to transactions entered into after the date of the enactment of this Act.