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# Potential Codification Of "Economic Substance" Doctrine

By Bruce Givner[1]

## *I. ORIGIN OF THE ECONOMIC SUBSTANCE DOCTRINE*

*Frank Lyon Co. v. United States*[2] is not just a seminal case, but an interesting and, perhaps, misunderstood one. The issue in this case was whether the arrangement between the bank and the Frank Lyon Co. was a sale-leaseback, as argued on the taxpayers' behalf by former Solicitor General Erwin Griswold,[3] or a financing transaction as argued by the IRS.[4] If the arrangement was a sale-leaseback, Frank Lyon Co. would be entitled to deductions for interest on its mortgage and construction loan and depreciation on the building.

The IRS argued that the "transaction in its entirety should be regarded as a *sham*." The agreement "as a whole...was only an elaborate financing *scheme*...." Frank Lyon Company was "but a *conduit* used to forward the mortgage payments, made under the *guise* of rent paid by [the bank] to Lyon, on to New York Life as mortgagee." This, the IRS claimed, was the "*true substance of the transaction* as viewed under the microscope of the tax laws. Although the arrangement was cast in sale-and-leaseback form, *in substance* it was only a financing transaction...." [emphasis added]

Justice Blackmun, writing for the court, held that there must be a "genuine multiple-party transaction with *economic substance* which is compelled or encouraged by business or regulatory realities, is imbued with *tax-independent considerations*, and is *not shaped solely by tax-avoidance features* that have *meaningless labels* attached." [emphasis added]

*Frank Lyon Co.* established the "two-prong" test for economic substance: objective economic substance and subjective business purpose. The IRS and the FTB, constantly cite Justice Blackmun's strong words, which are the fount of the economic substance doctrine.[5] What is often forgot – what makes the case arguably entitled to the label "misunderstood" - is that the taxpayer won.

Since *Frank Lyon Co.*, the Supreme Court has not returned to the "economic substance" fray. As a result there has been no clear enunciation of the economic substance doctrine ("ESD"). The most important later case is probably *Rice's Toyota World, Inc. v. Comr.*[6] The Fourth Circuit interpreted the two-prong test established by the Supreme Court in *Frank Lyon Co.* as a disjunctive test: a transaction has no economic substance if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and...the transaction has no economic substance because no reasonable possibility of profit exists."

## *II. RECENT (PRE-2007) LEGISLATIVE EFFORTS*

Congress has tried several times in recent years to "codify" or "clarify" the ESD.[7] Some of those attempts include the: (i) Jobs and Growth Reconciliation Tax Act of 2003 (P.L. 108-27), (ii) proposed Care Act of 2003, passed by the Senate on April 9, 2003, (iii) JOBS Act of 2004,[8] (iv) proposed Highway Reauthorization and Excise Tax Simplification Act of 2005, and (v) proposed Tax Shelter and Tax Haven Reform Act of 2005. In each of these legislative attempts, the ESD provisions failed to survive passage.

## *III. 2007 LEGISLATIVE EFFORTS TO CODIFY THE ECONOMIC SUBSTANCE DOCTRINE*

### A. The Proposed 4H Act

On October 4, 2007, the Senate Finance Committee ("SFC") approved codification of the ESD. The SFC intended the ESD codification to raise approximately $10 billion, to offset most of the $16 billion price tag of the proposed Heartland, Habitat, Harvest, and Horticulture Act of 2007 (the "4H Act").[9]

According to the SFC press release, the proposed 4H Act is designed to create a trust fund to help ranchers and farmers hurt by crop and livestock losses, convert a number of conservation payment programs into tax credit programs, and offer additional incentives for rural economic development and energy-related tax relief to aid agricultural producers. It is too soon to know if this provision will be introduced into Congress and enacted into law.[10] However, on November 6, acting Agriculture Secretary Conner announced that President Bush will veto the bill in part because it includes new tax increases.

### B. Tax Reduction And Reform Act Of 2007

Three weeks later, on October 25, House Ways and Means Committee Chairman Charles Rangel (D-NY) introduced H.R. 3970 (TRRA 2007). At the time of introduction it was understood that the bill was so sweeping that portions of it would not move forward until 2009 at the earliest due

to President Bush's opposition to a number of the revenue raisers. The provisions destined for 2009 include repeal of the individual alternative minimum tax, imposition of a surtax on upper-income individuals to subsidize tax cuts for lower income individuals, reduction in the corporate tax rate to 30.5%, repeal of LIFO accounting, repeal of the domestic production activities deduction, allocation of expenses as to foreign income. Other portions of the bill, including those extending expiring tax provisions and providing a one-year "patch" to the individual AMT, seemed likely to move forward in a smaller 2007 bill. Indeed, on November 9, 2007, the House passed the Temporary Tax Relief Act of 2007 (HR 3996) by a party-line vote of 216-193.[11]

The "Clarification of the economic substance doctrine" included in the TRRA 2007 was estimated to raise only $3.59 billion over ten years. Why did this legislation estimate revenue potential of $3.59 billion when the 4H Act – only 3 weeks earlier – had relied on such a provision for almost $10 billion? IRS Chief Counsel Donald Korb, speaking on October 31, 2007, at the UCLA Tax Controversy Institute, speculated that the dramatic reduction was out of belated recognition of the IRS's victories using the ESD in the Appeals courts in 2006 (discussed below).

## *IV. THE ECONOMIC SUBSTANCE DOCTRINE PROVISION*

### A. The ESD Provisions Of The 4 H Bill And TRRA 2007 Are Similar

#### *1. Continued Judicial Flexibility*

Some might think that the test of when a transaction has economic substance is the most important part of any codification. Arguably of more importance, however, is when to apply the ESD analysis. Both proposals purport to leave that decision up to the court. The 4H Act is the more explicit of the two: "In any case in which a court determines that the economic substance doctrine is relevant for purposes of this title to a transaction...." Proposed §7701(p)(1)(A). TRRA simply provides "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." Proposed §7701(p)(5)(D). However, the IRS can determine that the ESD is relevant at will by disallowing a transaction based on the lack of economic substance. Therefore, tax advisors will be unable to give taxpayers comfort that the penalty will not be asserted in cases where a "more likely than not" opinion is not provided. As a result, those transactions may have to be disclosed.

#### *2. Conjunctive Analysis*

A transaction has economic substance only if the taxpayer establishes that it changes the taxpayer's economic position in a meaningful way (apart from federal income tax consequences) and the taxpayer has a substantial non-federal-tax purpose for entering into it.

#### *3. Specifically Identified Transactions*

The October 26 Baucus report, which accompanies the 4H Act, indicates that the new law would not alter "certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages." The report mentions (1) the choice between capitalizing a business with debt or equity; (2) a U.S. person's choice between using a foreign or domestic corporation to make a foreign investment; (3) the choice to enter one or a series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to use a related-party entity in a transaction, provided the IRC §482 arm's length standard and other "applicable concepts" are satisfied. "Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances." Perhaps this report would impact interpretation of TRRA 2007, were that bill to become law.

#### *4. Penalties*

Earlier failed efforts to codify the ESD had a 40% penalty. The 4H Act version calls for a smaller penalty – 30% for undisclosed transactions, reduced to 20% if the transaction is disclosed. There are no exceptions, e.g., for reasonable cause or reliance on a tax advisor's opinion. Also, deductions are not allowed for interest paid or accrued on any underpayment of tax which is attributable to any noneconomic substance underpayment (whether or not disclosed). TRRA 2007 calls for a 40% penalty for nondisclosed transactions, but lacks the 4H Act's disallowance of interest provision.

#### *5. Effective Date*

Either new law would apply to transactions entered into after the date of enactment.

## *V. U.S. TREASURY'S RESPONSE*

In response to the 4H Act, Karen Sowell, Deputy Assistant Treasury Secretary (tax issues) told an ALI-ABA conference audience "[T]he administration is not in favor of codification and feels economic substance is better left to the courts."[12] She indicated that increased transparency and favorable rulings for the government, plus the negative publicity for offenders, render codification unnecessary.

In his remarks to the UCLA Tax Controversy Institute on October 31, 2007, IRS Chief Counsel Donald Korb suggested that the flexible judicial rule of economic substance is superior to a statute. He indicated that the current proposals are driven by revenue, and it is far from certain whether any revenue will, in fact, be raised. This proposal is the latest example of the piling on of penalties, which were originally designed to encourage compliance, but do not achieve their intended result. Also, given the serious nature of the penalty, judges may be encouraged to make Solomonic decisions where taxpayers lose the case in chief but avoid the imposition of penalties. The change in the law, the availability of these new penalties, risks shifting attention from the transactions to the penalty itself.

### *VI. THREE 2006 IRS APPEALS COURT VICTORIES*

The favorable rulings for the government referred to by Karen Sowell, the Deputy Assistant Treasury Secretary include three 2006 Appeals Court decisions involving sophisticated taxpayers who: (i) acquired life insurance on 21,000 employees, which generated a $33,000,000 interest deduction;[13] (ii) moved liabilities associated with asbestos litigation to a subsidiary to protect the parent, generating a $378,000,000 loss on the sale of the subsidiary;[14] and (iii) established a partnership with Dutch banks involving 63 aircraft, allocating $310,000,000 of taxable income to the banks.[15] When the IRS challenged the tax consequences, these taxpayers chose to pay the tax and sue for a refund. Presumably these taxpayers wanted to have their transactions adjudicated under "the literal terms of the statute".[16] Were they concerned that a Tax Court judge would be more likely than other Federal trial judges to (i) find a tax motive; and (ii) apply non-statutory rules such as the ESD? We cannot know. However, these victories have encouraged the IRS to continue, if not broaden, its use of non-statutory doctrines as part of its arsenal.[17]

### *VII. CALIFORNIA'S ECONOMIC SUBSTANCE RULE*

In the Fall, 2003, California's Tax Shelter legislation was signed into law,[18] generally effective January 1, 2004. One of the most significant provisions of that legislation was the new penalty for an understatement attributable to a transaction that lacks economic substance. "A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction."[19] The penalty is 40%. However, similar to the proposed Federal rule, the penalty is reduced to 20% if the taxpayer "adequately disclosed" on the return the "relevant facts affecting the tax treatment of the item."[20] The authors stated that it was not intended to create a new test, and that the FTB should rely upon "the common law economic substance doctrine."[21]

In the three years since the new law became effective, no cases have yet been decided involving California's economic substance rule. However, the Franchise Tax Board has not been shy about asserting, on audit, that structures lack economic substance and are subject to the 40% penalty.[22]

### *VIII. IS CALIFORNIA'S RULE CONSTITUTIONAL?*

As with the proposed Federal rule, this is a strict liability penalty: there are no exceptions, including reasonable cause. However, the FTB's Chief Counsel may compromise all or any portion of the penalty in certain situations.[23] The statute provides the Chief Counsel's "sole discretion" may not be delegated and, further, may not be reviewed in any administrative or judicial proceeding."[24]

Marty Dakessian, Esq., former counsel to the Vice Chair of the State Board of Equalization, argues that the lack of judicial review violates Article XIII, §32 of the California Constitution.[25] He also suggests that the lack of judicial review violates the due process requirements of the Fourteenth Amendment of the U.S. Constitution and the similar protection of Article I, §7 of the California Constitution.[26]

### *IX. THE DANGER OF AN OVERBROAD APPLICATION OF THE DOCTRINE*

Assume John Smith hires Joe Lawyer, Esq. to set up the John Smith Foundation. Joe Lawyer drafts the trust, submits the foundation for a favorable determination letter under IRC §§501 and 509, receives the favorable letter from the IRS National Office, and approval from the State of California. John Smith contributes $200,000 and takes an income tax deduction for that amount. Can the IRS (and FTB) attack the deduction because (i) John Smith is the sole officer of the John Smith Foundation, so he has not given up control of the contributed funds;[27] (ii) John Smith lacked a "business purpose" to set up the foundation; (iii) the foundation didn't change John Smith's economic position in a meaningful way (apart from federal income tax consequences); and (iv) John Smith didn't have a substantial non-federal (or non-California) tax purpose for establishing the Foundation?

The moral of this story is that if the IRS and the FTB can use the economic substance doctrine at any time, without restriction, we would not have an Internal Revenue Code (and the corresponding provisions of the Revenue & Taxation Code where the California legislature has conformed to Federal tax law). Therefore, we must rely on

continuing good judgment by the administrative agencies and, where there are lapses, the courts to prevent overreaching.

## *X. CONCLUSION*

California tax lawyers should monitor these new attempts to codify the ESD. Congress must raise revenue to pay for a variety of measures and it apparently views the ESD as a source of billions of dollars of revenue. So, regardless of whether the 4H Act or the TRRA 2007 pass, we should remain alert in monitoring the codification status of the ESD. Codification of the ESD, if accomplished, would certainly make our practices more interesting.[28]

## *ENDNOTES*

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2. *Frank Lyon Co., v. U.S.*, 435 U.S. 561 (1978).

3. He served as Solicitor General of the United States (1967-1973) under Presidents Johnson and Nixon. He also served as Dean of Harvard Law School for 21 years.

4. The famous first paragraph of the court's analysis is often quoted, in whole or in part: "This Court, almost 50 years ago, observed that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930). In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. E.g., *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940). In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," *Commissioner v. Tower*, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S. at 255. *See* also *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260, 266-267 (1958); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). Nor is the parties' desire to achieve a particular tax result necessarily relevant. *Commissioner v. Duberstein*, 363 U.S. 278, 286 (1960)."

5. The economic substance doctrine is manifested elsewhere, e.g., on the face of the Code in Subchapter K. IRC §704(b): Determination Of Distributive Share. A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect."

6. *Rice's Toyota World, Inc. v. Comr.*, 752 F.2d 89 (4th Cir. 1985).

7. *See* Keinan, 508 T.M., *The Economic Substance Doctrine*, ¶VIII, "Legislative Proposals To Codify The Economic Substance Doctrine," ¶A "Overview."

8. Pub. L. No. 108-357.

9. October 4, 2007, Press Release from Max Baucus, Chairman, of the U.S. Senate Finance Committee.

10. The plethora of congratulatory press releases by elected officials, including Senators Stabenow of Michigan and Kent Conrad of North Dakota, and powerful special interest groups, e.g., National Farmers Union, the American Agricultural Movement and the National BioDiesel Board, suggest passage is a distinct possibility. In an October 23, 2007, teleconference on charitable planning, Conrad Teitell mentioned the proposed 4H Act in a way to suggest that it has a great deal of momentum behind it. The proposed 4H Act came up during a charitable planning discussion because §203 would make permanent the special provision of §170 of the Code that encourages contributions of capital gain real property for conservation purposes.

11. The bill increases AMT exemptions for married and single persons, extends a number of popular tax benefits and raises taxes on hedge fund managers. Senate Finance Committee Republicans expressed support for the AMT relief and tax extenders, but suggest that tax increases required under the Democratic "pay-go" provisions be eliminated from the bill.

12. Retail Industry Leaders Association Weekly Tax Update, October 8, 2007, Published by the Tax Policy Services Group, Deloitte Tax LLP.

13. *Dow Chemical Co. v. U.S.*, 97 AFTR 2d ¶2006-671 (6th Circuit).

14. *Coltec Industries, Inc.* 98 AFTR 2d ¶2006-5249 (CA Fed.).

15. *TIFD III-E, Inc.*, 98 AFTR 2d 2006-5616 (CA-2).

16. That phrase appears in the Appeals court decision in *Coltec, supra*, note 16.

17. Tax Analysts, *Tax Notes Today*, July 13, 2006: "The government touted the victory as proof it is on the right path in fighting tax shelters on economic substance grounds. "Courts are increasingly recognizing that abusive transactions often lack economic substance. This decision is a resounding endorsement of our position," said IRS Chief Counsel Donald Korb in a written statement about the appeals court's decision.

Eileen O'Connor, assistant attorney general for the Tax Division, said "the decision confirms that the losses created by contingent liability tax shelters are not deductible and represents a significant advance in the Justice Department's ongoing effort to prosecute tax shelter cases."

18. 2003 Cal. Stat. ch. 654.

19. CRTC §19774(c)(2), second sentence.

20. CRTC §19774(b)(1).

21. "The bills have been amended to limit the applicability of the penalty for 'noneconomic substance' transactions. It is our intent that the FTB rely upon the common law economic substance doctrine and that the penalty language contained in this section shall not be adopted by a court as a substantive definition other than for purposes of the penalty." September 11, 2003 letter to Senate President pro Tempore John Burton and Assembly Speaker Herb Wesson, from Gilbert Cedillo and Dario Frommer, reprinted in Senate Journal, Sept. 11, 2003.

22. Taxpayers are in the process of protesting NPAs ("notices of proposed assessment") involving over $70,000,000 of taxable income. Given the time involved in (i) the protest process, and (ii) appeal to the State Board Of Equalization, these matters are probably six years away from ultimate resolution.

23. CRTC §19774(d)(1).

24. CRTC §§19774(d)(2) and (d)(3).

25. §32 provides, in relevant part, as follows: "After payment of a tax claimed to be illegal, an action may be maintained to recover the tax paid, with interest, in such manner as may be provided by the Legislature." Courts have interpreted this provision to mean that "A refund action is available *whenever* taxes have been paid more than once, erroneously or illegally collected, or illegally assessed or levied." *Rickley v. County of Los Angeles* (2004) 114 Cal.App.4th 1002 (emphasis added).

26. First, it has been held that "[d]ue process applies to administrative proceedings as well as to judicial proceedings; all that is required, at least in the administrative context, is that the hearing officer or other decision maker be a reasonably impartial, noninvolved reviewer." *Department of Alcoholic Beverage Control v. Alcoholic Beverage Control Appeals Bd.* (2002) 121 Cal.Rptr.2d 729, 99 CA 4th 880, rehearing denied, review denied, certiorari denied, 538 U.S. 924. This is not a terribly controversial proposition. An impartial reviewer would seem to ensure some level of fairness in the proceedings.

In contrast, §19774 purports to allow 'review' only by the FTB Chief Counsel. There is no one within the FTB itself that could be less impartial. The FTB's top lawyer has a legal and ethical duty to zealously protect the interests of his only client, the FTB. The Chief Counsel has historically been involved in FTB administrative appeals and refund litigation. Because he is charged with these responsibilities, the Chief Counsel cannot—ethically, legally or practically—be 'reasonably impartial' or 'noninvolved' when deciding whether to grant a taxpayer relief from the 'noneconomic substance penalty.'

Second, '[e]ssential requirements of due process are met when the administrative body is required to determine existence or nonexistence of necessary facts before any decision is made *and the party is afforded opportunity for review by courts*'. *De Cordoba v. Governing Bd. of Whittier Union High School Dist.* (1977) 71 Cal.App.3d 155 (emphasis added). More specifically, it has been held that '[i]n tax proceedings due process is met if the taxpayer is given an opportunity for hearing in a suit for collection or in a suit for refund after payment.' *People v. Santa Fe Ry. Federal Savings and Loan Association* (1946) 28 Cal.2d 675, 681.

Thus, while due process requires that taxpayers be afforded an opportunity for judicial review, subparagraph (3) of the statute states that assessment of the penalty '[m]ay not be

reviewed in any administrative or judicial proceeding.' This is *per se* a violation of any taxpayer's due process rights. *See* also *Tamble v. Downey* (1951) 104 Cal. App. 2d 810, 811: 'Since the decision of our supreme court in *Standard Oil Co. v. State Board of Equal.*, 6 Cal.2d 557, 59 P.2d 119, our courts are committed to the principle that statewide administrative agencies cannot constitutionally exercise judicial functions. From this it results that due process of law requires a trial *de novo* in the superior court when the findings of such an agency are there attacked by mandamus . . .'

27. in arguing that this transaction lacks "economic substance," by analogy to on-going audits, we would expect the Franchise Tax Board to also cite the following: (i) John Smith could have achieved the same deduction by contributing the money directly to charity (without establishing his own foundation); (ii) although $200,000 went into the foundation, the foundation only has to distribute $10,000 per year; and (iii) John Smith had to go through a number of "steps" in this transaction to establish the foundation, so the "step transaction" doctrine applies.

28. The earliest citation that has yet come to light is *U-Turn*, a sci-fi short story by Duncan Munro (one of the pen names of Eric Frank Russell), 1950: "For centuries the Chinese used an ancient curse: 'May you live in interesting times!' It isn't a curse any more. It's a blessing." Apparently Russell, not the ancient Chinese, made it up.