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CODIFYING THE ECONOMIC SUBSTANCE DOCTRINE: CLARITY, QUESTIONS AND IMPLICATIONS FOR LIFE INSURANCE PRODUCTS

By John T. Adney, Bryan W. Keene and Joel W. Mann

After years of proposals to “codify” the common law economic substance doctrine, the essence of the doctrine was incorporated into the Internal Revenue Code (the “Code”) near the end of last March, when President Obama signed the Health Care and Education Reconciliation Act of 2010 into law (the “Act”).¹ The Act added to the Code new section 7701(o),² entitled “Clarification of Economic Substance Doctrine,” in an effort by Congress to address what arguably has been an inconsistent application of the economic substance doctrine by the courts. This codification, which also imposes related tax penalties, was meant in part to combat tax shelter schemes and in part to help offset the revenue costs of health care reform. While new section 7701(o) does not do much to change the core principles of the economic substance doctrine, or of the closely-related business purpose test that is now officially a component of the economic substance doctrine (discussed later in this article), it does have potentially serious implications for taxpayers entering into transactions on or after the effective date of the codification and new penalty taxes—March 31, 2010. This article provides a brief background on the economic substance doctrine, with a focus on its prior application to life insurance products, followed by a summary of the codification and new penalties and then by a discussion of some of the codification’s implications for life insurance products and otherwise.

I. BACKGROUND

A. Economic Substance Doctrine

For many years the courts have applied the common law economic substance doctrine to deny tax benefits arising from transactions that do not change a taxpayer’s economic position in a meaningful way apart from federal income tax considerations.³ The origins of the doctrine can be traced back to at least 1935, when the Supreme Court decided *Gregory v. Helvering*.⁴ *Gregory* did not explicitly lay out the economic substance doctrine, but it has since been cited routinely as authority for the doctrine.⁵ If a court determines that a transaction does not result in sufficient non-tax economic benefits, then any tax benefits, such as deductions, that the taxpayer seeks to claim in connection with the transaction will be denied. As the Tax Court has observed:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. 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.⁶

The courts have used this test as an objective measure of the relevant facts and circumstances of a transaction to determine whether sufficient non-tax economic benefits exist.⁷

One such non-tax economic benefit that courts have considered in determining whether a transaction possesses economic substance is the potential for profit or economic gain from such a transaction.⁸ Clearly, transactions that have been found to lack any potential profit outside of tax considerations have been ruled to lack economic substance.⁹ It is those transactions that have the potential for some amount of profit, however, that present the more interesting question—how much profit is enough? In *Sheldon v. Commissioner*, the Tax Court provided some guidance to that question by disallowing interest deductions relating to repurchase agreements of Treasury bills entered into by the taxpayer because “the potential for ‘gain’ . . . [was] infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions.”¹⁰ Thus, according to the Tax Court in *Sheldon*, a transaction’s profit potential must be something more than nominal in comparison to the tax benefits claimed in order for the transaction to have economic substance. Other courts, however, have phrased the economic substance doctrine as requiring a “reasonable possibility of profit,”¹¹ without stating how much profit would be sufficient. Under such an analysis, it is conceivable that a realistic possibility of even a nominal amount of profit would satisfy the requirements of the doctrine. As discussed below, new section 7701(o) addresses this disparity in the courts’ application of the economic substance doctrine to some extent, although the necessary quantum of profit is left in an uncertain state.

B. Business Purpose Requirement and Its Lack of Uniform Application

Courts have also invoked a common law principle closely related to the economic substance doctrine to disallow the claimed tax benefits of a transaction—a requirement that the transaction have a “business purpose” other than tax reduction. This business purpose requirement, in contrast to the economic substance doctrine, has been described as a subjective test, in that it considers a taxpayer’s motivation for entering into a transaction: if the court determines that the taxpayer did not intend the transaction to serve a useful non-tax purpose, then the tax benefits claimed to arise from the transaction will be disallowed.¹² For example, in *Goldstein v. Commissioner*,¹³ the taxpayer sought to reduce the income tax she would have to pay upon winning the Irish Sweepstakes. She did this by borrowing money and purchasing Treasury bills the year she won the sweepstakes. Her plan was to deduct interest expenses under section 163(a) in that year against the sweepstakes income, and to pay tax on interest income when the Treasury bills matured in a later year in which she would be in a lower tax bracket, thus reducing her overall tax bill on the sweepstakes winnings. In disallowing the interest deductions, the Court of Appeals for the Second Circuit stated that section 163(a) “does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.”¹⁴ In other words, a transaction must have a useful business purpose apart from tax considerations for it to be respected under this business purpose requirement.

The requirement of a business purpose has been used somewhat interchangeably with the economic substance doctrine, resulting in a lack of uniform application of the latter by the courts.¹⁵ Some courts have required the transaction to pass both tests in order for it to be respected for federal tax purposes.¹⁶ As the Sixth Circuit Court of Appeals phrased the requirement in *Pasternak v. Commissioner*, “[t]he threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”¹⁷ Other Courts of Appeals have permitted claimed tax benefits if the transactions giving rise to them exhibited either a subjective business purpose *or* objective economic substance.¹⁸ Still other Courts of Appeals have viewed the inquiry as not involving a “rigid two-step analysis,” instead describing the two doctrines as “simply more precise factors to consider” in

determining whether to respect a transaction.¹⁹ This lack of uniformity among the appellate courts in applying the “objective” economic substance doctrine and the “subjective” business purpose requirement was a primary target of the clarifications intended by new section 7701(o).

C. Economic Substance as Applied to Life Insurance

The courts have applied the economic substance doctrine in one form or another to life insurance products for many decades. In *Knetsch v. United States*,²⁰ the Supreme Court found a transaction involving annuity savings bonds to be a “sham” that lacked economic substance. In that case, the taxpayer purchased annuity bonds bearing interest at 2.5 percent and financed the transaction by borrowing money and prepaying interest at 3.5 percent.²¹ Because the taxpayer could realize no profits aside from the anticipated tax benefits of claiming deductions for the prepaid interest, the Supreme Court disallowed the interest deductions. Quoting the trial court’s opinion, the Court stated that “there was no commercial economic substance . . . to the transaction.”²² The Court also noted that the net cash value of the annuity bonds would not exceed the amounts the taxpayer paid as interest until 10 years had passed, and even at the end of the annuity bonds’ term of 30 years they would be worth only \$1,000, which the court characterized as a “relative pittance.”²³ Interestingly, this was the first instance in which the Supreme Court used the term “economic substance” in a tax case involving life insurance products.

The United States Court of Claims dealt with the application of the economic substance doctrine to transactions involving non-business life insurance contracts in *Coors v. United States*.²⁴ In that case, the Internal Revenue Service (the “Service”) challenged a wife’s claimed deductions for interest on loans used to pay premiums for life insurance contracts that she owned on the life of her husband. The contracts were purchased prior to the effective date of amendments made to section 264 that limited the deductibility of interest on loans (including policy loans) used to purchase or carry life insurance.²⁵ In determining whether the loans had economic substance, the court noted that the taxpayer’s subjective intent in purchasing the contracts and borrowing against them was to provide insurance coverage on the life of the family provider,²⁶ and that there was no evidence that tax considerations had affected the taxpayer’s decisions in any way. Further, substantial death benefits remained under the contracts even after the outstanding loans were subtracted.²⁷ With these

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considerations in mind, the court held that the contracts insuring the husband's life provided substantial and economically significant protection to the wife and children.²⁸ This economic protection distinguished the case from *Knetsch*, as did the facts that the interest was not prepaid and the loans were straightforward, ordinary, and not specifically tailored to the policyholder.²⁹ In contrast, when interest was prepaid on a loan that was specifically tailored to a policyholder, the Court of Appeals for the Tenth Circuit has denied deductions for interest on loans against life insurance contracts.³⁰

The Service has also asserted the economic substance doctrine to challenge interest deductions in the context of business-owned life insurance. In *Campbell v. Cen-Tex*,³¹ a construction company purchased life insurance contracts covering its key employees in order to meet obligations under its deferred compensation plan and its stock option and redemption plan, and it borrowed against those contracts. The business prepaid four annual premiums for the contracts, and it then effected loans secured by the contracts. The Court of Appeals for the Fifth Circuit held the borrowing transactions to have economic substance,³² distinguishing the case from *Knetsch* by noting that the death benefits and cash values of the contracts in question would be significant at the end of 20 years, even if maximum loans were taken against the contracts each year.³³ As the court observed, "in addition to net benefit accruals, the policies would have, at the end of twenty years, with maximum loans effected, cash surrender values in excess of \$200,000. These potential death benefits and cash surrender values cannot be brought within the *Knetsch* characterization of a 'relative pittance.'"³⁴ The court further distinguished the transaction from that in *Knetsch* with the observation that the life insurance in *Cen-Tex* fulfilled a "bona fide business purpose and an economic objective" in assisting the business in meeting obligations under its employee benefit plans.³⁵

In more recent years, the courts have applied the economic substance doctrine to deny interest deductions and other tax benefits associated with broad-based, leveraged corporate-owned life insurance ("COLI") arrangements,³⁶ which came under criticism in the early 2000s as "janitor insurance."³⁷ In a typical arrangement, businesses would enter into contracts insuring the lives of large numbers of their employees, pay premiums designed to enhance the contracts' cash values rapidly, borrow heavily against the contracts' cash values (sometimes at inflated interest rates), and deduct the interest with respect to that indebtedness to offset other taxable income. Although

section 264 sets forth specific rules governing the deductibility of interest on indebtedness incurred in connection with life insurance contracts, the Service repeatedly challenged the deductibility of such COLI-related interest.³⁸

The main argument that the Service advanced in these cases was violation of the economic substance doctrine and business purpose requirement. For example, in *Dow Chemical Corp. v. United States* (the most recent of the leveraged COLI cases), the Court of Appeals for the Sixth Circuit denied the interest deductions associated with Dow's COLI contracts by invoking the economic substance doctrine.³⁹ There, the court stated that the contracts did not exhibit any of the non-tax benefits that courts had previously determined relevant to the economic substance of a permanent life insurance contract—positive cash flows, "inside build-up," and the potential for mortality gains.⁴⁰ Interestingly, the court in *Dow Chemical* required, as a condition for upholding the claimed interest deductions, that the COLI arrangement exhibit both economic substance and a business purpose, and it noted that because the COLI policies lacked economic substance, it was "unnecessary to discuss Dow's subjective motivation."⁴¹ This illustrates a willingness by the Service and the courts to look to the underlying economics of COLI arrangements as well as the intent of the business in purchasing them in affirming or denying the desired federal income tax treatment.

II. CODIFICATION

As noted previously, the Act added new section 7701(o) to the Code, along with new tax penalties that the Service may impose with respect to transactions that lack economic substance. A discussion of both, in turn, follows.

A. New Section 7701(o)

Under new Code section 7701(o), a transaction (including a series of transactions) will exhibit economic substance and thus retain its federal income tax benefits only if it meets both prongs of the following two-prong test:

- 1) The transaction must change in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and
- 2) The taxpayer must have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

In other words, a transaction will retain its intended tax benefits only if it passes an objective analysis of the economic effects on the taxpayer as well as a subjective analysis of the taxpayer's motives for entering into the transaction. Thus, the codification effectively combines the economic substance doctrine and the business purpose requirement under the rubric of a single statutory "economic substance" rule.⁴² It is important to note, however, that this new economic substance rule does not apply to individuals, except in cases where transactions are entered into in connection with a trade or business or where an activity is engaged in by the individual for the production of income.⁴³ This contrasts with the doctrine's usage by some courts—such as in the *Coors* case (discussed above)—that previously have applied the economic substance doctrine to the personal transactions of individuals, although the new statute does not purport to alter the application of the common law doctrine in instances beyond the statute's scope.

The two-prong test of section 7701(o) need only be passed "in the case of any transaction to which the economic substance doctrine is relevant."⁴⁴ Therefore, the new rule is not intended to alter the flexibility of the courts' current standards in determining when to utilize an economic substance analysis.⁴⁵ In that regard, according to the legislative history of the Act (the "Joint Committee Explanation"), "[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed."⁴⁶

Further, the Joint Committee Explanation states that new section 7701(o) is not intended to disrupt the tax treatment of certain basic transactions that are not currently subject to the economic substance doctrine. These transactions include:

- 1) the choice between capitalizing a business enterprise with debt or equity;
- 2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
- 3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and
- 4) the choice to utilize a related-party entity transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.⁴⁷

The Joint Committee Explanation goes on to note that the determination of whether any transaction meets the requirements for specific treatment under any of these provisions remains a question of facts and circumstances.⁴⁸

New section 7701(o) provides special rules for taxpayers choosing to rely on profit potential to satisfy the economic substance test. Section 7701(o)(2)(A) states that profit potential will be taken into account for this purpose 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." (Emphasis added.) Under this rule, such a reasonably expected, substantial pre-tax profit can be used to satisfy both the objective, first prong of the statute's test as well as the subjective, second prong. However, fees and other transaction expenses must be subtracted from pre-tax profit before determining whether the profit is substantial.⁴⁹ (What constitutes a "substantial" pre-tax profit is discussed later.)

The Act also speaks to whether and how taxpayers can point to taxes other than federal income taxes in attempting to satisfy the new statutory economic substance test. For example, the statute directs the Treasury Department to publish regulations "requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases."⁵⁰ Thus, "in appropriate cases," foreign tax *liability* generated by a transaction that is subject to the economic substance test will be subtracted from the transaction's "pre-tax" profit in determining whether that profit is "substantial" enough to satisfy the test. On the other hand, it appears that foreign tax *savings* generated by a transaction can augment the transaction's pre-tax profit potential for purposes of the new rules. For example, the Service has previously concluded that, in the context of corporate distributions, a valid business purpose may exist for U.S. tax purposes when a corporate distribution substantially reduces the amount of tax withholding required by a foreign country.⁵¹ The Act does not appear to disrupt this view, as it merely directs the Treasury

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Department to promulgate regulations addressing the effect of foreign taxes that present a drag on the transaction's true economics; the directive does not extend to foreign tax savings that actually enhance those economics. Thus, it would seem that the treatment of potential foreign tax savings will continue to be governed by prior law.⁵²

In addition to foreign taxes, the Act provides guidance on how state or local income taxes will be reflected in the new statutory economic substance test. In particular, it says that for purposes of both prongs of the test, "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."⁵³ As indicated previously, the two prongs of the test require a meaningful change in the taxpayer's economic position and a substantial purpose for entering the transaction, both determined "apart from Federal income tax effects." Likewise, by virtue of the provision just quoted, the two prongs will be applied "apart from state and local tax effects" if those effects are "related" to a federal income tax effect. This treatment of state and local taxes appears to conflict with a view the Tax Court has previously expressed, in which it indicated that the reduction of state taxes can constitute a valid business purpose.⁵⁴ Thus, the inclusion of the state and local taxes rule in the new statute suggests that Congress may have a dim view of transactions that have little economic substance other than a reduction in such taxes. This is an interesting contrast to the treatment of foreign tax savings under the new rules, which, as indicated above, appear to still be available as evidence of economic substance and a business purpose. In any event, the treatment of transactions that rely on state or local tax effects for their validity, which may hinge on what it means for such effects to be "related" to a federal income tax effect, is currently unclear and likely will be made on a case-by-case basis.

In addition to clarifying how taxes other than federal income taxes are reflected in the new economic substance analysis, the Act also creates a special rule for financial accounting benefits. The realization of such benefits has occasionally been argued to constitute a valid non-tax business purpose that may save a transaction from failing the business purpose requirement.⁵⁵ New section 7701(o)(4) states that for purposes of satisfying the subjective, second prong of the test, "achieving a financial 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." In other words, for example, a corporate taxpayer could not argue an improved position on its books of account as a substantial business purpose

if such position were created by the tax benefits it was seeking to claim. As the Joint Committee Explanation notes, "[c]laiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (*i.e.*, reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement."⁵⁶ Such a claim was made in *Winn-Dixie Stores, Inc. v. Commissioner*, where a projected pre-tax book value of certain leveraged COLI contracts showed a loss while the after-tax value of those contracts showed a profit.⁵⁷ The Tax Court held that COLI contracts in question were entered into without any business purpose other than tax savings, and the Court of Appeals for the Eleventh Circuit affirmed this holding.⁵⁸

B. Penalties

Prior to the Act, in a case where the common law economic substance doctrine was invoked to disallow claimed tax benefits, a penalty relating to the understatement of income potentially applied.⁵⁹ While that penalty remains intact, the Act creates a new, additional penalty that the Service may assess for the underpayment of federal income tax attributable to tax benefits that are disallowed because the transaction purportedly giving rise to them lacks economic substance or fails to meet the requirements of "any similar rule of law."⁶⁰ The new penalty amounts to 20 percent of the underpayment relating to such a transaction, and the penalty rate is increased to 40 percent if the taxpayer did not adequately disclose the relevant facts affecting the tax treatment of the transaction on its tax return.⁶¹

Unlike many other penalties for underpayment of federal income tax, the penalty added by the Act is a strict liability penalty.⁶² In other words, no "reasonable cause" or other exceptions apply on which a taxpayer might rely to avoid the penalty. In many cases, such "reasonable cause" exists, and provides an exception to the imposition of an underpayment penalty, where a taxpayer reasonably relies on an opinion of counsel that concludes there is a greater than 50 percent chance the tax treatment of a transaction will be sustained if challenged by the Service.⁶³ In the case of an underpayment of tax due to a lack of economic substance, however, the taxpayer simply cannot avoid the penalty, whether through an opinion of counsel or otherwise.⁶⁴

III. IMPLICATIONS

A. Remaining Questions

Although section 7701(o) clarifies that its objective and subjective tests both must be met in order for a transaction

to have economic substance, several aspects of the new enactment remain unclear. Perhaps the logical first question is “when does the economic substance doctrine apply?” Section 7701(o) and the Joint Committee Explanation make clear that the new economic substance test is only to apply when the doctrine is “relevant,” and the determination of whether the doctrine should be applied is to be made as if the new section had not been enacted.⁶⁵ As the Joint Committee Explanation states, section 7701(o) “does not change present law standards in determining when to utilize an economic substance analysis.”⁶⁶ Although at first blush it would seem that this statement means that nothing has changed, there are particular practical issues that warrant consideration.

In a teleconference regarding the economic substance doctrine led by Jasper L. Cummings, Yoram Keinan and Mark J. Silverman, the presenters made the argument that the economic substance of a transaction might always come into question, and the doctrine could be applied any time the two-prong test is failed.⁶⁷ They gave an example of a Revenue Agent who concludes that a transaction “(a) resulted in favorable tax reporting; (b) did not have business purpose; [and] (c) was not expected to make much money.”⁶⁸ The argument is that an agent will be inclined to skip the relevance step, and once the agent reaches the foregoing conclusions, the analysis will be complete. A similar argument made during the teleconference is that a Revenue Agent will likely not conclude that the economic substance doctrine applies unless and until the agent perceives a tax-motivated transaction as according to the facts of the transaction, by which point the agent may already have decided to assert a deficiency.⁶⁹ These outcomes may be realized now that the Service is armed with a new Code section specifically imposing what was once solely a common law doctrine to be determined by the courts.

Setting aside the potential difficulties in determining when the economic substance doctrine applies, the language of section 7701(o) itself opens up questions as to exactly how it applies and how one goes about satisfying the new rules. As noted above, in order to pass the two-prong test a taxpayer must establish that a transaction 1) will have “meaningful” non-tax economic effects, and 2) was entered into for a “substantial” non-tax business purpose.⁷⁰ To establish this, a taxpayer can rely on factors other than the transaction’s profit potential. However, if a taxpayer intends to rely on profit potential to satisfy either prong of the test, the new rules state that “the present value of the reasonably expected pre-tax profit from the transaction [must be] substantial in relation to the present

value of the expected net tax benefits that would be allowed if the transaction were respected.”⁷¹

Thus, the key to satisfying the two-prong test by reference to profit potential is establishing that such profit is reasonably expected to be “substantial” in relation to the claimed tax benefits. The new rules do not define what standard will be used in assessing whether an anticipated profit is substantial in this context. Instead, the Joint Committee Explanation merely cites a blanket statement for support.⁷² The statement, which comes from *Rice’s Toyota World v. Commissioner*, is that “the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits.”⁷³ Although this statement stands for the proposition that there must be at least some amount of profit potential, it does not help in answering what amount might be considered substantial.

Presumably, the potential profit would need to be more than nominal, as noted in the above discussion of *Sheldon v. Commissioner*,⁷⁴ but apart from this, taxpayers will likely remain subject to the Service’s and the courts’ interpretations of what constitutes a substantial profit relative to the transaction’s expected tax benefits. Although not directly applicable, Treasury regulation section 1.170A-9(f)(2), relating to the definition of a “publicly supported” organization, provides an example of a circumstance in which the Service has quantified the term “substantial.” There, “substantial” is defined as 33-1/3 percent. Could it be that this same standard would apply under the new economic substance rule, in that the present value of the reasonably expected pre-tax profits would be required to be at least 33-1/3 percent of the present value of the expected net tax benefits? Even if that were the case, the question remains as to how the present value of such pre-tax profits should be calculated. Should the method be based on a rate of return associated with the related transaction, or perhaps on a riskless rate of return? It is these types of uncertainties that taxpayers, the courts, and the Service must consider now that section 7701(o) has been added to the Code. Thus, taxpayers would be wise to review and understand any standards that the Service and the courts may have applied in this area to date.

B. Uncertainty Moving Forward

In view of the uncertainty regarding potential questions about

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the language of new section 7701(o), both the Service and the Treasury Department are considering releasing guidance on the codification of the economic substance doctrine. The Office of Chief Counsel of the Service has opened a new guidance project regarding section 7701(o), and the Treasury Department has requested comments.⁷⁵ Apart from these developments, it is unclear how the new section will affect the Service's actions in the future. It is possible that new section 7701(o) will provide an additional, more concrete tool to which the Service can refer in questioning certain transactions on audit. As noted above, one practical implication might be that Revenue Agents will be more likely to raise economic substance challenges to transactions. Additionally, the codification of the economic substance doctrine could provide a useful litigation tool for the Service. In fact, the Service's Associate Chief Counsel (Corporate), William D. Alexander, said in public remarks on April 23, 2010, that new section 7701(o) "might actually make it easier" for the Service to prevail in future litigation similar to that in *Shell Petroleum Inc. v. United States*,⁷⁶ a district court case involving the carryback of a consolidated net capital loss in which the Service failed to sustain its challenge to the transaction on economic substance grounds.⁷⁷ Interestingly, Mr. Alexander also recently noted that the codification of the economic substance doctrine would not change the way in which the Service might rule on a particular issue. The Service, according to Mr. Alexander, "assume[s] that the economic substance doctrine exists and has always existed. [The Service] would issue the same ruling that [it] would have issued before" the enactment of the new statute.⁷⁸ While

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perhaps helpful, the latter statement does not alleviate the uncertainty surrounding how the Service will make use of new section 7701(o) in the future.

As indicated previously,⁷⁹ in recent years courts have applied the judicial economic substance doctrine and the business purpose test to deny tax benefits associated with broad-based leveraged COLI. As a result of those decisions and changes in the Code relating to the deductibility of policy loan interest, such leveraged arrangements have generally been abandoned follow-

ing the 1996 change to section 264(a)(4) (although a number of arrangements grandfathered by legislation in 1986 remain in force, for which section 264 continues to allow interest deductions). Conceivably, however, the Service could challenge other types of COLI arrangements that it believes lack economic substance. If the Service were to find particular features of a COLI arrangement to be troublesome, the new statutory economic substance rule could be a convenient avenue for the Service to challenge the arrangement, even absent the aggravating factors involving leverage that were present in the earlier court cases.

In addition to the foregoing implications of new section 7701(o), it is worth considering at least one aspect of the new penalty provisions the Act added to the Code. As noted above, the Act creates a strict liability penalty tax for the underpayment of federal income tax attributable to the disallowance of claimed tax benefits relating to a transaction that lacks economic substance, or to one that fails to meet the requirements of "any similar rule of law."⁸⁰ The Joint Committee Explanation provides some assistance in ascertaining what "any similar rule of law" means, stating that "[i]t is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine."⁸¹ This potentially means that if a similar doctrine, e.g., the "sham transaction doctrine" or the "step transaction doctrine," were to apply to disallow the tax benefits of a transaction, the tax penalty provisions added to the Code by the Act could apply to any underpayment of income tax resulting from the disallowance. Conceivably, this concept could be extended to a common law tax rule developed to apply to insurance products, such as the "investor control doctrine," although this remains unclear. If the new penalty applies, the taxpayer implicated in the transaction would find no refuge in relying on an opinion of counsel, since the new penalty tax is one of strict liability.⁸²

IV. CONCLUSION

Congress's codification of the economic substance doctrine in new section 7701(o) provides a helpful clarification in that it is now understood that to satisfy the doctrine a transaction must pass both the objective and subjective prongs of a two-prong test. Despite this clarification, however, taxpayers would do well to consider several resulting implications, including uncertainties in the interpretation of the wording

of section 7701(o), the way in which the Service will apply the newly codified doctrine, and whether the new strict liability penalty will be assessed when other tax doctrines are invoked. Further, it is possible that the codification of the economic substance doctrine gives the Service a new tool with which it could more aggressively challenge transactions, including those involving life insurance products. Hopefully, the new guidance project that the Service and the Treasury Department have opened will assist them in dispelling unne-

cessary confusion in the application of new section 7701(o) and the related penalties. Achieving greater certainty in this area will become even more important as Congress acts to curb ballooning federal deficits by broadening the tax base and increasing marginal rates, prompting taxpayers to examine additional ways to contain their tax burdens. ◀

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com.

Bryan W. Keene is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at bwkeene@davis-harman.com.

Joel W. Mann is an associate with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jwmann@davis-harman.com.

END NOTES

- ¹ Pub. L. No. 111-152, § 1409 (2010). Since 2001 there have been several proposals in Congress to codify the economic substance doctrine. See S. Amend. 2708 to H.R. 4297, 109th Cong., 2d Sess. (Feb. 2, 2006), section 511, "Clarification of Economic Substance Doctrine"; S. 1054, 108th Cong., 1st Sess. (May 13, 2003), section 301, "Clarification of the Economic Substance Doctrine"; S. 476, 108th Cong., 1st Sess. (Feb. 27, 2003), section 701, "Clarification of Economic Substance Doctrine"; H.R. 5095, 107th Cong., 2d Sess. (July 11, 2002), section 101, "Clarification of Economic Substance Doctrine"; H.R. 2520, 107th Cong., 1st Sess. (July 17, 2001), section 101, "Clarification of Economic Substance Doctrine."
- ² All references to "section" are to sections of the Internal Revenue Code of 1986, as amended.
- ³ See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Dow Chemical Corp. v. United States*, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003), *cert. denied*, 127 U.S. 1251 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004), *cert. denied*, 127 S. Ct. 1261 (2007); *In re C.M. Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002), *aff'g* 254 B.R. 578 (D. Del. 2000); *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).
- ⁴ 293 U.S. 465 (1935).
- ⁵ See, e.g., *Knetsch*, 364 U.S. at 365; *Coltec Industries*, 454 F.3d at 1352.
- ⁶ *ACM Partnership*, 73 T.C.M. at 2215.
- ⁷ See, e.g., *Coltec Industries*, 454 F.3d at 1356 ("the economic substance of a transaction must be viewed objectively rather than subjectively."); *In re CM Holdings*, 301 F.3d at 103 (stating that the objective formulation of the economic substance doctrine is simple: "absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way.>").
- ⁸ See, e.g., *Knetsch*, 364 U.S. 361; *Rice's Toyota World v. Comm'r*, 752 F.2d 89 (4th Cir. 1985); *Goldstein v. Comm'r*, 364 F.2d 734 (2d Cir. 1966); *Sheldon v. Comm'r*, 94 T.C. 738 (1990).
- ⁹ See, e.g., *Knetsch*, 364 U.S. 361; *Goldstein*, 364 F.2d 734.
- ¹⁰ *Sheldon*, 94 T.C. at 768.
- ¹¹ *Rice's Toyota World*, 752 F.2d at 94; *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 781 (5th Cir. 2001).
- ¹² See, e.g., *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998); *Goldstein v. Comm'r*, 364 F.2d 734 (2d Cir. 1966); *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004).
- ¹³ *Goldstein*, 364 F.2d 734.
- ¹⁴ *Id.* at 740.
- ¹⁵ "The casebooks are already glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Comm'r*, 857 F.2d 1383, 1386 (9th Cir. 1988).
- ¹⁶ See, e.g., *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Pasternak v. Comm'r*, 990 F.2d 893 (6th Cir. 1993).
- ¹⁷ *Pasternak*, 990 F.2d at 898.
- ¹⁸ See, e.g., *IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001); *Rice's Toyota World v. Comm'r*, 752 F.2d 89 (4th Cir. 1985).
- ¹⁹ See, e.g., *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998) (citing *Casebeer v. Comm'r*, 909 F.2d 1360, 1363 (9th Cir. 1990)).
- ²⁰ 364 U.S. 361 (1960).
- ²¹ See *id.* at 362-63.
- ²² *Id.* at 364-66.
- ²³ See *id.* at 366 n.3.
- ²⁴ 572 F.2d 826 (Ct. Cl. 1978).
- ²⁵ The court noted that section 264(a)(3) (regarding loans to purchase or carry certain life insurance contracts under a plan that contemplates systematic borrowing of part or all of the contract's cash value) might have had some applicability to the case, but the contracts in question were purchased prior to the Aug. 6, 1963, effective date of section 264(a)(3). Also, the tax years involved in *Coors* preceded the effective date of section 163(h), which generally disallows deductions for "personal interest," and the contracts in *Coors* were issued prior to the addition of section 264(a)(4) to the Code in 1986, which, with certain exceptions, generally disallows deductions for interest on indebtedness with respect to life insurance contracts.
- ²⁶ See *Coors*, 572 F.2d at 834.
- ²⁷ See *id.* at 838.
- ²⁸ See *id.* at 833. The government also argued that the interest paid on the loans was not, in substance, "interest" at all, but rather the payment of premiums for life insurance coverage. Based on this attempted recharacterization of the loans, the government then argued that the "premium" payments were "personal, living, or family expenses" that were nondeductible pursuant to section 262. The court rejected the recharacterization of the loans and concluded that they were, in substance, loans that generated interest expenses.

END NOTES (CONTINUED FROM PAGE 39)

- ²⁹ See *id.* at 835.
- ³⁰ See, e.g., *Golsen v. Comm'r*, 445 F.2d 985 (10th Cir. 1971).
- ³¹ 377 F.2d 688 (5th Cir. 1967).
- ³² See *id.* at 693 ("The policies purchased provided for a beneficial interest. The transaction was not without economic value, economic significance, economic substance, or commercial substance.").
- ³³ See *id.*
- ³⁴ *Id.*
- ³⁵ *Id.* at 692.
- ³⁶ See *Dow Chemical Corp. v. United States*, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003), *cert. denied*, 127 U.S. 1251 (2007); *American Electric Power, Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003), *aff'g* 136 F. Supp. 2d 762 (S.D. Ohio 2001), *cert. denied*, 540 U.S. 1104 (2004); *In re C.M. Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002), *aff'g* 254 B.R. 578 (D. Del. 2000); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001), *aff'g* 113 T.C. 254 (1999), *cert. denied*, 535 U.S. 986 (2002).
- ³⁷ For a discussion of this controversy see Adney, Van Brunt, & Keene, "COLI Reconsidered," 56 *J. Fin. Serv. Prof.*, No. 6, at 41 (2002).
- ³⁸ See *id.*
- ³⁹ *Dow Chemical*, 435 F.3d at 605.
- ⁴⁰ See *id.*; see also *American Electric Power*, 326 F.3d 737; *In re C.M. Holdings*, 301 F.3d 96; *Winn-Dixie Stores*, 254 F.3d 1313.
- ⁴¹ See *Dow Chemical*, 435 F.3d at 605.
- ⁴² See also section 7701(o)(5)(A) ("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.").
- ⁴³ See section 7701(o)(5)(B).
- ⁴⁴ Section 7701(o)(1).
- ⁴⁵ See section 7701(o)(5)(C) ("The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [section 7701(o)] had never been enacted.").
- ⁴⁶ STAFF OF J. COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT," 152 n.344 (JCX-18-10, March 21, 2010) [hereinafter JOINT COMMITTEE EXPLANATION]. There are no other committee reports regarding the Act, and thus its sole "legislative history" is the JOINT COMMITTEE EXPLANATION.
- ⁴⁷ *Id.* at 152-53.
- ⁴⁸ *Id.* at 153.
- ⁴⁹ See section 7701(o)(2)(B).
- ⁵⁰ *Id.*
- ⁵¹ See Rev. Rul. 89-101, 1989 C.B. 67. See also PLR 8705081 (Nov. 6, 1987); PLR 8511086 (Dec. 20, 1984). Private letter rulings issued by the Service do not constitute legal precedent that can be cited or relied upon, except by the taxpayers to which they are issued. See section 6110(k).
- ⁵² JOINT COMMITTEE EXPLANATION, *supra* note 46, at 155 n.357 ("There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law.").
- ⁵³ Section 7701(o)(3).
- ⁵⁴ See *Virginia Historic Tax Credit Fund 2001 LP v. Comm'r*, 98 T.C.M. (CCH) 630 (2009). But see *Treas. Reg. § 1.355-2(b)(5)*, Example (7) (for purposes of section 355, reducing state taxes does not constitute a valid business purpose if the reduction of federal income taxes is greater than the reduction of state taxes).
- ⁵⁵ See, e.g., *American Electric Power, Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003); *Wells Fargo & Company v. United States*, 105 AFTR 2d 2010-377 (Fed. Cl. Jan. 8, 2010).
- ⁵⁶ JOINT COMMITTEE EXPLANATION, *supra* note 46, at 154 n.355 (citing *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio)).
- ⁵⁷ 113 T.C. 254, 287 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).
- ⁵⁸ See *id.*
- ⁵⁹ See section 6662(a) and (d).
- ⁶⁰ See section 6662(b)(6).
- ⁶¹ See section 6662(i).
- ⁶² See section 6664(c)(2) and (d)(2).
- ⁶³ See *Treas. Reg. § 1.6662-4(g)(4)(i)(B)*.
- ⁶⁴ See JOINT COMMITTEE EXPLANATION, *supra* note 46, at 156.
- ⁶⁵ See section 7701(o)(5)(C); JOINT COMMITTEE EXPLANATION, *supra* note 46, at 152.
- ⁶⁶ JOINT COMMITTEE EXPLANATION, *supra* note 46, at 152.
- ⁶⁷ See Jasper L. Cummings, Jr., Yoram Keinan, and Mark J. Silverman, *The Economic Substance Doctrine*, ABA Tax Section Corporate Tax Committee, at 17 (March 31, 2010) available at <http://www.steptoe.com/assets/attachments/4023.pdf> (last visited May 5, 2010).
- ⁶⁸ *Id.*
- ⁶⁹ See *id.* at 19.
- ⁷⁰ See section 7701(o)(1).
- ⁷¹ Section 7701(o)(2)(A).
- ⁷² See JOINT COMMITTEE EXPLANATION, *supra* note 46, at 155 n.356.
- ⁷³ 752 F.2d 89, 94 (4th Cir. 1985).
- ⁷⁴ See *supra* Part I.A.
- ⁷⁵ At a Practising Law Institute conference on May 14, 2010, Robert Crnkovich, senior counsel in the Treasury's Office of Tax Legislative Counsel, requested that taxpayers submit comments and concerns to the Service and the Department of Treasury regarding the government's application of new section 7701(o).
- ⁷⁶ 102 AFTR 2d 2008-5085 (S.D. Tex. 2008).
- ⁷⁷ William J. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service, Address at the Penn State Dickinson School of Law (Apr. 23, 2010).
- ⁷⁸ William J. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service, Address at the Tax Executives Institute's 60th Midyear Conference (Apr. 13, 2010).
- ⁷⁹ See *supra* Part I.C.
- ⁸⁰ See section 6662(b)(6).
- ⁸¹ See JOINT COMMITTEE EXPLANATION, *supra* note 46, at 155 n.359.
- ⁸² See section 6664(c)(1) and (d)(1).