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# Economic Substance Doctrine—Six Months After Codification

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Bruce Givner looks at the economic substance doctrine six months after codification.

## Introduction

After many years of consideration, Congress, as part of the massive health care bill, finally codified the economic substance doctrine as new Code Sec. 7701(o). In the ensuing six months, much has been written, no cases under the new law have been decided, and one item of regulatory guidance has been issued. Given the potential scope of the law and the magnitude of the strict liability penalties, practitioners are well advised to continuously survey the developments. This article is one attempt to provide an update.

## Purpose of the New Law

The Committee Report describes the purpose of new Code Sec. 7701(o):

> The provision clarifies and enhances the application of the economic substance doctrine.

However, we know that the IRS was, at best, unenthusiastic about codification, if not downright hostile. Therefore, it is easier to understand that the real purpose was to raise revenue. During the past seven years that revenue estimate started at $11.5 billion, rose to $17.5 billion during the height of the tax shelter craze, and finally fell to $4.5 billion when enacted, primarily due to the IRS's successes in court.

## The New Law

New Code Sec. 7701(o) is entitled "Clarification of economic substance doctrine." The first paragraph sets to rest one issue by adopting the conjunctive test. As a result, a transaction will be sustained only if both of the following are true:

(1) It changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position.

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

Note that the parenthetical is the same in both "prongs." Note also that the first "prong" is objective and the second is subjective.

The second paragraph of the new subsection provides a "Special rule where taxpayer relies on profit potential." It applies if a taxpayer relies on "profit potential" in trying to meet either of the two tests (the "change in a meaningful way" or the "substantial purpose" test). It articulates a "present value" calculation without defining two key terms:

> The potential for profit of a transaction shall be taken into account ... only if the present value of the reasonably expected pre-tax profit ... is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

First, to determine the "present value," we must know the proper interest rate to be applied in a particular transaction. For example, the present value of $100,000 in five years at five percent is $78,353. Change the interest rate to 10 percent and $100,000 in five years is worth $62,092. Different taxpayers may use different interest rates in valuing investments.

Second, what profit is substantial? Is a 15-percent pre-tax profit on a particular transaction substantial?

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Is a 30-percent-pre-tax profit substantial? Again, different taxpayers may have different expectations about profit margins. Are the two factors related? Does the percent that is substantial depend upon current interest rates? In other words, when the mid-term AFR is 1.7 percent, a 10-percent pre-tax profit may be substantial. But if the mid-term AFR is 10 percent, then 10 percent may not be substantial. Without defining the key terms, tax advisors are left to guess. Will the IRS issue a notice or regulations giving examples of what constitutes the appropriate interest rate and "substantial" in various situations?

The third paragraph of the new subsection provides that "State and local tax benefits" are "treated in the same manner as a Federal income tax effect." That makes sense to the extent that the state and local tax is measured on the same basis as the federal tax, *e.g.*, California's general conformity to federal income tax laws. However, what if the structure is designed to save California property taxes? For example, consider a building in California worth $10 million that has been owned by the same person for many years, so that it has an assessed value of $10,000, and is subject to $100 per year in property taxes. By contrast, were it reassessed to current fair market value, the property taxes would be $100,000 per year. A transaction is structured to transfer it from the owner to a buyer in a way that keeps the assessed value at $10,000. That would be a transaction that changes—in a meaningful way—the taxpayer's economic position, apart from federal income taxes, and the taxpayer certainly has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

The fourth paragraph provides that "Financial accounting benefits" shall not be considered as a purpose for entering into a transaction if the origin of the benefit is a reduction of federal income tax.

The fifth, and final, paragraph provides definitions and special rules. First, it defines the economic substance doctrine as the "common law doctrine under which tax benefits ... with respect to a transaction are not allowable if [it] does not have economic substance or lacks a business purpose." In other words, that definition restates the first paragraph (the two-prong test). Second, it excludes transactions by individuals that are not entered into for trade or business purposes or for the production of income. For example, estate tax and most charitable planning should not be subject to the economic substance doctrine test. However, what if the transaction results in the creation of the charitable remainder unitrust? That is a structure that results in the "production of income," so it may not be exempt from the economic substance doctrine. Third, it provides that the application of the doctrine shall be made in the same way as it was before Code Sec. 7701(o) was adopted. However, that is of little comfort because there is no assurance that the IRS will take such a narrow view of the legislation.

> The economic substance doctrine has been with us for decades. New Code Sec. 7701(o) is merely a "clarification" that makes the penalties the most important part of the new law.

Finally, it provides that "transaction," the term that is subject to scrutiny under new Code Sec. 7701(o), can be a series of transactions. That gives a great deal of freedom to the IRS and the courts. The IRS can bifurcate a transaction in which independent activities with nontax objectives are combined with an unrelated item having only tax avoidance objectives. In other words, defining the "transaction" will allow the IRS to—in some situations—determine the result.

## Is There Anything New?

The IRS's view is that this is not a change in the law, but rather "a legislative endorsement of existing law." Important commentators have also discounted the idea that much has changed. In his article, *"Codification" of the Economic Substance Doctrine—Much Ado About Nothing?* Richard Lipton wrote:

> The statutory language emphasizes that the economic substance doctrine can be applied only to transactions that would have been subject to attack under the common law, without taking into account the enactment of §7701(o). Thus, with the exception of the new "strict liability" penalty, the new legislation does not represent a significant change in the law, and concerns about the impact of §7701(o) appear to be overblown. [Emphasis added.][1]

## The New Penalties

The economic substance doctrine has been with us for decades. New Code Sec. 7701(o) is merely a "clarification" that makes the penalties the most important part of the new law. Code Sec. 6662, the accuracy-related penalty, has been amended to include a new type of underpayment. Code Sec. 6662(b)(6) states that any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of Code Sec. 7701(o)) or failing to meet the requirements of any similar rule of law.

As a result, there is now a penalty equal to 20 percent of the portion of any underpayment attributable to any disallowance of claimed tax benefits due to a transaction lacking economic substance or failing to meet the requirements of any similar rule of law. In determining whether this penalty applies, Code Sec. 6662(i)(2) provides that amendments or supplements to an already-filed return are not considered if the amendment or supplement is filed after the taxpayer is contacted by the IRS regarding examination of the return (or an earlier date specified by regulations).

Even more important, Code Sec. 6664(c)(2) provides that the "reasonable cause" exception that generally applies to other penalties does not apply to an understatement attributable to the lack of economic substance in a transaction. In other words, the penalty is a "strict liability" or "no fault" penalty—no matter the facts and circumstances surrounding the transaction, if a court determines that the transaction lacked economic substance, the 20-percent penalty applies.

Even worse, the penalty is increased to 40 percent for any portion of an underpayment due to a transaction that is found to lack economic substance and as to which the relevant facts affecting the tax treatment of the transaction are not adequately disclosed in the return or in a statement attached to the return.

## The New Notice

On September 13, 2010, the IRS issued Notice 2010-62,[2] applicable to transactions entered into on or after March 31, 2010. The Notice provides only a little guidance on open issues.

- **Conjunctive Test.** It warns taxpayers that the IRS will now apply the conjunctive test: (1) a 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. The disjunctive test, previously permitted in the Fourth and Eighth Circuits, is clearly no longer acceptable.
- **No Angel List.** Consistent with previous statement by IRS officials and recommendations by academics, there will be no general administrative guidance about the types of transactions to which the economic substance doctrine either applies or does not apply.
- **Present Value.** The IRS will only consider the taxpayer's profit motive if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed were the transaction respected. No discount rate or test of substantiality is articulated.
- **Foreign Taxes.** The IRS intends to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.
- **Penalties.** The motive to disclose under new Code Sec. 6662(i) is to avoid an increase from 20 percent to 40 percent for any disallowance of claimed tax benefits due to a transaction lacking economic substance. The Notice divides its guidance into two types of transactions: nonreportable and reportable. For nonreportable transactions, disclosure is measured by the rules currently required for the substantial understatement penalty of Code Sec. 6662(d). Disclosure under Rev. Proc. 94-69 is also acceptable. In both schemes, Forms 8275 and 8275-R are used. For reportable transactions, the disclosure must meet both the requirements for nonreportable transactions and those under the separate reportable transaction rules. For this purpose, Form 8886 is used.
- **No LTRs.** The IRS announced it will not issue any LTRs or determination letters regarding whether the economic substance doctrine is relevant to any transaction or whether the doctrine complies with the requirements of the doctrine.
- **Comments.** The IRS requested comments by December 3, 2010, about the disclosure requirements, and the relationship of those requirements and the proposed uncertain tax position (UTP) schedule. (Schedule UTP has engendered its own cascade of controversy, and is beyond the scope of this article.)

## The New Directive

One day after the Notice, Heather Malloy, the Commissioner of LMSB, issued a "Directive," which provides as follows:

> To ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6), any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.[3]

Though this Directive is "not an official pronouncement of law, and cannot be used, cited, or relied upon as such," it suggests that the IRS is concerned that the new penalty be used sparingly. Though limiting approval of application of the penalty to 12 directors does not assure uniformity, it is a positive development.

## Difficult Questions

The legislative history tells us that the enactment of Code Sec. 7701(o) was not intended to alter the tax treatment of certain basic business transactions, which under long-standing judicial and administrative practice have been respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. The Joint Committee explanation included four examples, with an express statement that these examples are illustrative and not exclusive:

- The choice between capitalizing a business enterprise with debt or equity.
- A U.S. person's choice between using a foreign corporation or a domestic corporation to make a foreign investment.
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C.
- The choice to use a related-party entity in a transaction, provided that the arm's-length standard of Code Sec. 482 and other applicable concepts are satisfied.

The Joint Committee explanation states that leasing transactions, like all other types of transactions, will need to be analyzed under all of the facts and circumstances. The fact that a transaction meets the requirements for specific treatment under a provision of the Code is not determinative of whether the transaction (or series of transactions of which it is a part) has economic substance.

Since the list is not exclusive, it implies that many common planning techniques will be respected. Are the four transactions mentioned in the legislative history the beginning of an "angel list"?

## Other Transactions?

The feedback from the IRS has not been clear. Speaking at an ABA meeting in May, one senior IRS official said: "I didn't say we would not [issue an angel list], it just will be difficult. ... The IRS may be in the business of issuing a lot of private rulings."[4] The same official, speaking at a different conference in the same month, said: "The economic substance doctrine is already out there. The statute doesn't require that we come up with a rigid set of rules and regulations. Furthermore, being an anti-abuse rule, any sort of bright-line guidance would be difficult to craft. The doctrine must remain sufficiently flexible to go after transactions it was designed to go after."[5]

What about a "check-the-box election" to obtain the benefit of a different choice of entity? Although the choice will be made only for tax reasons, this should be viewed as having economic substance because the taxpayer must abide by the tax consequences of the entity chosen.

At the American Bar Association Section of Taxation Meeting in Toronto, Treasury Deputy Tax Legislative Counsel Byron Christensen said, in response to a question about the application of the doctrine to Code Sec. 1031 exchanges, that where the doctrine has not applied in the past, the government does not intend to find new ways to apply it in the future.

## Impact on Business Transactions

A threshold question is going to be whether transactions must be examined in light of the economic substance doctrine at all. That is an issue that, at least at this point in the development of the law, without an "angel list," is not free from doubt.

If the conclusion is that the doctrine might apply, then each step of a pending transaction must now be examined carefully. It is unclear on which step the IRS and a court may focus in determining whether the transaction as a whole has economic substance. This may result in tax advisors recommending structures which have less advantageous tax results. Defining "the transaction" becomes very important.

## Impact on Audits

Once an IRS agent raises the possibility that a transaction fails to meet the economic substance doctrine, the power in the audit shifts dramatically in favor of the IRS. For the agent to raise the doctrine, that must mean—given the new Directive—that the agent has received approval to impose the penalty. At that point the tax advisor and the taxpayer are facing an uphill battle, which is likely to make them more pliable in negotiating any open issues. Assertion of the economic substance doctrine can easily become a weapon that the IRS uses to get taxpayers to agree to pay the tax with no penalties.

> A threshold question is going to be whether transactions must be examined in light of the economic substance doctrine at all.

## Scope of the Common Law

Assume Corporation 1 has a significant loss in Corporation 2's debt instruments. Corporation 1 sells the debt instruments and buys Corporation 3's debt. Corporation 3 is in the same industry as Corporation 2 and has a similar economic profile and credit rating. The loss probably should be recognized, despite the Code Sec. 1091 wash sale rule, because the issuer has changed.

Now assume Corporation 1 owns Treasury bonds maturing on December 31, 2015, in which it has a loss. Corporation 1 sells the bonds and buys an equal amount of bonds maturing on June 30, 2016. Economically, Corporation 1's risk profile is almost unchanged. However, it was clear under old law that the loss would be recognized (and the wash sale rules would not apply).

Congress indicated that common law continues to apply, meaning that the economic substance doctrine does not. However, does Corporation 1 have a "substantial business purpose" for selling the bonds and replacing them with bonds that are economically similar (though not so similar that the wash sale rules would apply)? The economic benefits for this transaction were probably not "substantial" in comparison to the tax benefits. However, the weighing of benefits does not arise unless the economic substance doctrine is relevant to a transaction. Therefore, the determination of the scope of the common law will be critical in the future for this type of transaction.

## Impact on Other Anti-Abuse Rules

*Gregory v. Helvering*,[6] perhaps the best-known tax avoidance case, is one of the rocks on which all anti-abuse doctrines are founded. It held that a reorganization was "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner." It had nothing to do with a lack of economic substance. The series of transactions constructed by the taxpayer had economic substance, but the taxpayer was trying to do one thing and disguise it as another.

The substance over form doctrine from *Gregory* is accompanied by other anti-abuse doctrines, *e.g.*, the step-transaction doctrine and the business-purpose doctrine. Each re-characterizes a transaction in accordance with what the taxpayer has done instead of the form the taxpayer has adopted. Only when a taxpayer purports to do something but actually does nothing is the economic substance doctrine the right tool. Professor Abrams gives this example of the perils using *Frank Lyon*:[7]

> The taxpayer invested $500,000 of its own money and the proceeds of a $7.1 million loan to purchase a building from Worthen Bank. The taxpayer then leased the building back to Worthen for a minimum of 25 years, with every dollar of rent pledged to service the acquisition loan. Worthen was responsible for all taxes and other expenses related to the building and was obligated to pay rent net of any claim or expense. Upon a total casualty or complete condemnation, the taxpayer would receive insurance and condemnation proceeds sufficient to amortize its cash investment plus interest at 6 percent. The IRS treated the transaction as a financing device by Worthen, but the taxpayer claimed it was a sale by Worthen sufficient to shift depreciation deductions from Worthen to the taxpayer. In an opinion long

on lists and short on guidance, the Supreme Court held for the taxpayer. But the circuit court had held for the government. And the trial court, like the Supreme Court, had held for the taxpayer. The circuit court's holding ultimately was determined to be wrong, but it surely was not unreasonable. Thus, it seems that both characterizations were reasonable. Yet had the taxpayer guessed wrong, even with full disclosure, application of the newly codified economic substance doctrine would bring with it an automatic 20 percent penalty.[8]

The future of this newly fortified econimic substance doctrine is still unfolding. What will it be when it grows up?

## Strict Liability Penalties

One problem with the strict liability penalties is that they will deter business transactions. In the past, tax advisors could tell clients that there was a marginal risk that the government would make an economic substance argument. Were the government to be successful in that argument, the transaction would not achieve its intended result. However, penalties were unlikely. Now, the marginal risk of losing an economic substance argument on the merits results in a 20-percent to 40-percent strict liability penalty. Some taxpayers will use their business judgment not to enter into certain transactions.

Another problem faces tax advisors with clients about to engage in a transaction. What if the transaction will generate large tax savings, and there is an alternate way to structure the transaction that results in less favorable tax consequences? Must the advisor search for that less favorable alternative?

Yet another problem with the strict liability penalties is that we do not know how much more broadly they will be applied than to transactions lacking economic substance. The language of Code Sec. 6662(b)(6) is as follows:

> Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of §7701(o) or failing to meet the requirements of *any similar rule of law.* [Emphasis added.]

The scope of the "any similar rule of law" language is unclearly broad. Is every other anti-abuse rule a "similar rule of law"? To avoid the penalty, taxpayers who lose on the merits in a dispute with the IRS must argue for a narrow interpretation of Code Sec. 7701(o) and a narrow interpretation of "similar rule of law" in Code Sec. 6662(b). What if the transaction has economic substance but is part of a step-transaction? What if the transaction has economic substance, but the IRS believes that the substance is different from the form? Notice 2010-62 did nothing to address this concern. Taxpayers must now be concerned not only with whether a challenge to their return is upheld, but the grounds on which such a challenged is based.

## Disclosure

Should taxpayers start disclosing every transaction to reduce the risk of an additional 20-percent strict liability penalty? As an analogy, when IRS Form 8886 (*Reportable Transaction Disclosure Statement*) first came on the scene, there was a great deal of concern that the mere filing of the form would generate an audit. So far the number of audits triggered by the filing of a Form 8886 has been, to say the least, underwhelming. Similar stories can, no doubt, be told about the filing of IRS Forms 8275 (*Disclosure Statement*) and 8275R (*Regulation Disclosure Statement*). Movie buffs will recall the last scene of RAIDERS OF THE LOST ARK (also known as INDIANA JONES AND THE RAIDERS OF THE LOST ARK). Back in Washington, D.C., the Army intelligence agents tell a suspicious Indy that the Ark of the Covenant, which he has spent the entire film chasing, "is someplace safe," to be studied by "top men." In reality, the Ark has been sealed in a wooden crate, labeled "top secret" and stored in a giant government warehouse filled with countless similar crates, never to be found again.

At a minimum, should taxpayers start disclosing any transaction in which a loss is recognized, even if the loss is a real economic loss, unless the transaction involves a sale of assets to unrelated third parties? Or might that disclosure be viewed as an "admission" that the taxpayer was concerned about whether that transaction would be respected?

## Impact of Other Defects

What if a transaction that lacks economic substance also is deficient in some other aspect? Several decisions involving Son-of-BOSS transactions concluded that a contingent liability had to be treated as a liability, thereby eliminating the claimed tax benefit from the transaction. In those cases, the deficiency was not due to the application of the economic substance doctrine, so the new penalty would not seem to apply.

## Recent Cases

The cases involving the economic substance doctrine that have been issued after the enactment of Code Sec. 7701(o) are not direct authority on the new world of "clarification." However, they warrant close scrutiny as the best tea leaves we have to read until the first actual Code Sec. 7701(o) case is decided.

*Nevada Partners Fund, LLC, Fidelity International Currency Advisor A Fund, LLC, Stobie Creek Investments, LLC* and *Bemont Investments, LLC*[9] all involved Son-of-BOSS transactions: the taxpayer contributed a large asset and large liability to a partnership and claimed, under *G. Helmer*,[10] that the liability did not reduce its basis in the partnership, which later turned into a loss.

*Nevada Partners*, unlike the others, relied on the partnership anti-abuse rule of Reg. §1.701-2 to disallow the loss. However, it discussed the economic substance doctrine. *Fidelity International* explained the economic substance, sham transaction, step transaction, partnership anti-abuse, loss recognition and other relevant doctrines and rules, and ultimately found that under either the objective or subjective analysis, the transactions were not entered into for profit and that they had no business purpose other than tax avoidance. *Stobie Creek* held that, although the literal application of the Code may have permitted the transactions, the tax treatment must follow the economic reality. *Bemont Investments* refused to believe that the taxpayer's large loss was somehow related to a proposed tender offer. The court then focused on the absence of a profit potential and the absence of a business purpose.

In *D.D. Child*,[11] Dr. Child bought and deducted casualty insurance from an offshore company. The premium was based on the amount of income he wanted to shelter from tax and was higher than premiums for actual insurance bought in the domestic market. The policy was unnecessary because Dr. Child's existing policies covered the same potential claims, and no claims were paid during any of the eight years at issue. There was no written contract between Dr. Child and the offshore carrier other than the initial contract that expired after one year. The only record of premium payments was an undated Quicken file.

Eight months after obtaining the insurance policy from the offshore carrier, Dr. Child received a home equity loan from a Utah company related to the offshore carrier. The loan had an interest rate of almost 11 percent, while the doctor's existing loan on the property was under six percent. The mortgage to secure the loan was not recorded. The loan had a stated credit limit of $50,000, but Dr. Child had an unpaid balance of over $215,000 at the time of the audit (not far from the total premiums paid of $283,000, especially considering the fees paid to the promoter). Dr. Child did not list the loan as a debt on a loan application; nor did he pay off the loan when he sold the property.

Judge Kroupa applied the conjunctive test, citing *ACM Partnership*,[12] even though Dr. Child is from Utah, so that the Ninth Circuit's view would prevail. In the Ninth Circuit, at least before the "clarification" of the economic substance doctrine, the approach was that "economic substance and business purpose [are] 'simply more precise factors to consider' in determining whether a transaction has any practical economic effects other than the creation of tax benefits." Judge Kroupa then easily concluded that it "was not a true insurance arrangement with practical economic consequences." Not only did it lack economic substance, but it was a "sham transaction."

In *C.E. Sala*,[13] the 2007 District Court opinion found that the government's fraud case involving a Son-of-BOSS tax shelter was hampered by the absence of indicia of concealment or misrepresentation of his economic activity. On appeal the government's primary argument was that the transaction lacked economic substance. Of the five post–Code Sec. 7701(o) Son-of-BOSS decisions, this is the most important since it is an appellate decision that reversed a lower court decision and addressed most of the Code Sec. 7701(o) issues.

Mr. Sala earned $60 million in 2000. His wholly owned S corporation, Solid Currencies, Inc., bought long and short foreign currency options and contributed them to a partnership, which existed for only a few weeks and liquidated before the end of the year. Relying on *Helmer*, Solid's basis in its partnership interest was calculated by disregarding the short options and the cash contributions. Therefore, the S corporation's basis in the property it received from the partnership upon liquidation was $61 million. The corporation sold the property for less than $1 million, so that Sala could claim a $60 million loss. Sala participated in the program after the IRS issued Notice 2000-44, setting forth its position that such transactions do not give rise to an allowable deduction.

Judge Murphy, writing for the Tenth Circuit, held that whether a transaction lacks economic substance is a question of law. He then identified the particular step, in a series of transactions that spanned multiple years, to which he applied the conjunctive test. He disregarded the fact that the transaction had some profit potential, because $550,000 in potential profits was dwarfed by the $24 million in tax savings.

This short (barely seven-page) opinion is significant in what it says and in the questions that it raises. The court uses the language of "lack of economic substance." However, the facts suggest it is really a situation in which the substance is different from the form adopted by the parties. That is what happened in *Knetsch*.[14] In *K.F. Knetsch*, the Supreme Court confirmed that the taxpayer did not borrow money and could not, therefore, deduct interest supposedly paid on the loan. The Supreme Court recognized that when taken together, the two transactions amounted to doing nothing at all. That was not a matter involving the economic substance doctrine, a phrase which did not appear in the law for another 18 years. It will be a shame if courts will rush to use the economic substance doctrine and give up the common-law role of fact finding.

A major problem with the economic substance doctrine is on display in *Sala*. If the loss was fictional, then there is no loss for purposes of Code Sec. 165. If that is true, then the IRS and the courts never have to get to the economic substance doctrine because that doctrine only operates to disallow results otherwise available to the taxpayer.

*Keller*,[15] the most recent case, is an example of the overly broad use of the economic substance doctrine. The IRS asked the district court judge to overturn a prior ruling that an estate was entitled to deduct interest on a loan from a related partnership on the ground that the loan lacked economic substance and was created for the purpose of generating a deduction. As this case arose in the Fifth Circuit, the conjunctive test applied. However, the court had no difficulty concluding that the loan imposed liability on the estate in the event of default, charged interest at the applicable federal rate, resulted in millions of dollars of interest being paid and reported as income to the partnership and was motivated by the need to preserve liquidity of the estate.

## Conclusion

The uncodified economic substance doctrine was a powerful tool in the hands of the IRS. Codification alone would have been an interesting, if awkward, step. It would have taken taxpayers, their advisors and the IRS many years to understand how the newly "clarified" and "codified" doctrine would be interpreted and co-exist with other anti-abuse doctrines.

However, the strict liability penalty makes what would otherwise be an intellectually interesting oddity into one fraught with danger for taxpayers and their tax advisors trying to wrestle with real business transaction and current reporting obligations. The future of this newly fortified economic substance doctrine is still unfolding. What will it be when it grows up? Will it raise revenue? Will it stifle economic activity? Will it create a deluge of reporting? Will it tilt the audit battlefield unfairly in favor of the IRS agent? Will it create a tidal wave of new litigation? As of today, the questions vastly outnumber the answers.

**ENDNOTES**

1 112 J. TAX'N 6, June 2010, at 325.

2 Notice 2010-62, IRB 2010-40.

3 LMSB-20-0910-024, entitled "Directive For Industry Directors; Director, Field Specialists; Director, Pre-Filing and Technical Guidance; Director, International Compliance, Strategy and Policy," at 2.

4 Robert Crnkovich, Senior Counsel for the Treasury's Office Of Policy, speaking at an ABA Section of Taxation meeting in May, 2010, quoted in *No "Angel List" Guidance Planned For Economic Substance, Official Says*, 88 DTR G-8 (May 10, 2010).

5 *Treasury Official Solicits Comments For Economic Substance Guidance Projects*, 93 DTR G-7 (May 17, 2010).

6 *Gregory v. Helvering*, SCt, 35-1 USTC ¶9043, 293 US 465.

7 *Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561.

8 *Did Healthcare Reform Repeal the Partnership Anti-Abuse Rule?* 51 TAX MGMT. MEMO. 299 (August 30, 2010), Howard E. Abrams, at 308.

9 *Nevada Partners Fund, LLC*, DC-MS, 2010-1 USTC ¶50,379; *Fidelity International Currency Advisor A Fund, LLC*, DC-MA, 2010-1 USTC ¶50,418; *Stobie Creek Investments, LLC*, FedCl, 2008-2 USTC ¶50,471, 82 FedCl 636, *aff'd*, CA-FC, 2010-1 USTC ¶50,455, 608 F3d 1366; *Bemont Investments, LLC*, DC-TX, 2010-2 USTC ¶50,551.

10 *G. Helmer*, 34 TCM 727, Dec. 33,225(M), TC Memo. 1975-160.

11 *D.D. Child*, 99 TCM 1230, Dec. 58,165(M), TC Memo. 2010-58.

12 *ACM Partnership*, CA-3, 98-2 USTC ¶50,790, 157 F3d 231.

13 *C.E. Sala*, DC-CO, 2008-1 USTC ¶50,308, 552 FSupp2d 1167.

14 *K.F. Knetsch*, CtCls, 65-2 USTC ¶9560, 172 CtCls 378, 348 F2d 932.

15 Docket No. 6.02-cv-20489 (D.C. S.D. Texas Sept. 14, 2010).