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Practitioners, Government Officials Debate
Codification of Economic Substance
by Jeremiah Coder

Summary by **taxanalysts**

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William Sabin Jr., special counsel (litigation) in the IRS Large and Midsize Business Division, told practitioners that earlier this decade several courts criticized the government for raising economic substance as a primary argument and held the doctrine inapplicable, if not unconstitutional. Sabin spoke on his own behalf at a District of Columbia Bar Taxation Section Tax Audits and Litigation Committee program on developments concerning the economic substance doctrine.

At the time, "many professionals both inside and outside the government held similar disparaging views" on the use of the doctrine, Sabin said. But now, by Sabin's count, the government has a 10-0 track record in recent appellate court

decisions involving tax shelter cases.

Sabin said judicial receptivity to the government's arguments "speaks volumes." The doctrine has "proven very effective and very reliable," he said.

The government recently had a big win in *Southgate Master Fund*, Sabin said. In that case, the district court broke the shelter transaction into two parts, holding that while Southgate had economic substance in its acquisition of nonperforming loans, the subsequent reorganization did not, tainting the whole deal, he said. Doctrinally, the court's views on economic substance were "not that novel," he said. (For the opinion in *Southgate Master Fund LLC et al. v. United States*, No. 3:06-cv-02335 (D.C. Tex. Aug. 18, 2009), see [Doc 2009-18785](#) or [2009 TNT 160-6](#).)

In discussing the remanded *Castle Harbour* case, Sabin said the Second Circuit, in applying the facts and circumstances test set forth by the Supreme Court in *Commissioner v. Culbertson*, 337 U.S. 733 (1949), to determine if the partnership was a sham, reached the conclusion that that test was broader than the economic substance test. "It's an unusual holding," he said, because other courts have construed the tests to be mostly identical. (For the Second Circuit's opinion in *TIFD III-E Inc. v. United States*, No. 05-0064-cv (Aug. 3, 2006), see [Doc 2006-14691](#) or [2006 TNT 150-8](#).)

Adam Gropper, legislation counsel for the Joint Committee on Taxation, also speaking on his own behalf, said legislation in the House and Senate to codify the economic substance doctrine differs from previous legislation in that it would apply strict liability penalties when a transaction is found to lack economic substance. It is not the goal of either bill to alter the taxation of transactions that are chosen based on comparative tax advantages consistent with the tax code, he said. The "when and whether" to apply economic substance is not meant to be changed either, he added. (For tax-related excerpts of the House-passed Affordable Health Care for America Act (H.R. 3962), see [Doc 2009-24979](#) or [2009 TNT 217-25](#). For the Stop Tax Haven Abuse Act (S. 506), see [Doc 2009-4588](#) or [2009 TNT 39-28](#).)

There are minor differences between the House and Senate bills regarding the penalty rate, base amount calculation, procedure, interest deductions, and applicable defenses, Gropper said. Perhaps one of the most notable differences between the two bills is that the House version would apply a penalty to any economic-substance-like factors, even if not called by that name, he said. For some large corporations, H.R. 3962 would also remove a reasonable cause defense for all five underpayment categories in section 6662(b) and replace it with a strengthened reasonable cause standard. Although the bill does not define reasonable belief that a transaction is more likely than not to be proper, the concept draws on section 6664 regulations for reportable transactions, he said, adding, "It basically means

you have to have an opinion that says the right things, written by the right guy, and that's a very different standard than the old reasonable cause standard."

Stuart J. Bassin of Baker & Hostetler LLP wondered if codification would change application of the doctrine and how enactment might affect prior case law. Christopher Rizek of Caplin & Drysdale said it might be possible to have a noneconomic deal (as contemplated by Congress) to which application of credits such as the credit for low-income housing could change the transaction to an economic deal that could fail the economic substance test and end up incurring a strict liability penalty. "That's a crazy result," he said.

Gropper said the bills' legislative history implies that codification shouldn't threaten transactions that have tax benefits clearly consistent with the code.

Tax Analysts Information

Code Sections: Section 6664 -- Penalty Definitions and Special Rules
Section 6662 -- Accuracy-Related Penalty

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Author: Jeremiah Coder

Institutional Author: Tax Analysts

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