May 21, 2003

Economic Substance Examples

A. Compliance with Bright-Line Tests

1. Corporation Y has 100 shares outstanding. Corporation Y's largest shareholder owns 79 shares. Corporation X purchases the 79 shares of Corporation Y for good and valid business reasons with an expectation of profit. Several years later Corporation X concludes that it could obtain significant tax advantages if it could consolidate with Corporation Y. Corporation X approached the holders of the remaining 21 shares of Corporation Y to purchase some or all of their shares. All of the shareholders indicate that they did not wish to sell.

   Corporation X convinces a shareholder to sell one share at a price well in excess of its fair market value. The transaction is not a sham. However, Corporation X has no realistic expectation of profit on the single share of Corporation Y that is purchased. Corporation X's sole motivation in purchasing the share was to be able to consolidate with Corporation Y. [No expectation of profit or non-tax motive, no consolidation?]

2. C Corporation is owned by 76 U.S. individuals. The shareholders of C would like to make an S election. One of C's shareholders buys out the smallest C shareholder at a price well in excess of the fair market value of that shareholder's shares. The purchasing shareholder has no expectation of profit on the purchased shares. The purchasing shareholder's sole motivation was to permit C Corporation to qualify for an S election. [No non-tax motive, no valid S-election?]

3. Similar facts to 1, except that Corporation X wants to be able to qualify for Section 332 treatment if Corporation Y ever liquidates. Accordingly, Corporation X purchases one share of Corporation Y at a price well in excess of its fair market value:

   (i) as a cautionary matter, prior to there being any discussions about a liquidation; or

   (ii) at a time when the idea of liquidating Corporation Y has been floated as one of several strategic options, but no serious discussion has taken place concerning Corporation Y's liquidation; or

   (iii) after a Strategic Committee has been formed to make recommendations to the Board of Directors concerning the direction of the company and liquidation is one of several proposals the Strategic Committee will consider; or

(iv) the Strategic Committee has recommended to the Board that Corporation Y be liquidated as the best strategic option, but no board action has occurred; or

(v) the Board has adopted a plan of liquidation but it has not been approved by shareholders; or

(vi) the Board has adopted the plan and it has been approved by the shareholders.

How are these questions resolved under the proposed statute?

Is the result under the statute any different than what one would anticipate under current law?

B. Subchapter C Problems

1. F Corporation agrees to acquire G Corporation in a stock-for-stock exchange. F Corporation wishes to make a §338 election with respect to G Corporation. F Corporation is concerned that it could not make the election because the stock-for-stock exchange will be a B reorg. Accordingly, F adds a small (but not *de minimis)* amount of cash consideration to the transaction. F's sole motivation in adding the cash consideration is to bust the B and thereby achieve qualified stock purchase. [No non-tax motive, no § 338 election?]

2. X Corporation owns stock of 4 subsidiaries – M, N, O and P. X wishes to spin off N. M and N are each good 5-year businesses, 0 and P are not. X Corporation is not eligible to spin off N because X Corporation is not directly engaged in a trade or business and cannot meet the holding company test of Section 355 which would require substantially all of X's assets to be stock of subsidiaries directly engaged in a trade or business. X liquidates M for the sole purpose of avoiding the holding company test so that X will be directly engaged in the operation of a trade or business. X then spins off N. [These are essentially the facts of Rev. Ruling 74-79] [No non-tax motive, no valid spin-off?]

3. For a number of years, Company Y had accumulated earnings and profits and current losses. Because it could not use the tax deduction for interest, it issued a class of fixed rate preferred shares. Y's fortunes have now improved to the point where it is profitable, and Y decides to refinance the preferred stock by issuing subordinated debt. The debt is objectively more costly (aside from tax benefits) in that the stated rate of interest is higher than the fixed dividend rate and the holders have a creditor claim against Y (albeit a subordinated one). The reason for the refinancing is to reduce

after-tax costs due to the interest deduction. [No non-tax motive, no interest deduction?]

4. Company Y wishes to acquire Company X for cash, but Company X's largest shareholder, individual, does not want to recognize gain. Individual owns 20% of Company X's stock. To accommodate Individual by qualifying the transaction for treatment under Section 351, Company Y forms a new holding company, Holdco, to which the Company Y shareholders transfer their stock in exchange for Holdco stock, and the Company X shareholders transfer their stock in exchange for cash, except in the case of Individual who receives Holdco stock. Because Company Y is a public company, the transaction using Holdco requires a public filing, shareholder approval, modification of some contracts, etc. A direct cash acquisition of the Company X stock would not have required shareholder approval of Company Y's shareholders and would have been less costly. The selected structure is purely tax motivated and it is an inefficient way to accomplish Company Y's objective of acquiring Company X. This transaction is fairly routine today, but would it pass muster under the proposal?

5. An individual investor owns fixed rate subordinated debt of a very high quality issuer. The investor sells the debt and uses the proceeds to buy preferred stock of the same issuer bearing a coupon that is no higher (or only immaterially higher) than the coupon on the debt. The investor sells the debt and buys the stock solely in order to take advantage of the new rules excluding dividends from income. [No non-tax motive, no dividend exclusion?]

C. <u>Partnership Problems</u>

1. LP a limited partnership has outstanding nonrecourse debt with a guarantee of one of the partners. The partnership starts generating enough tax losses so that the basis limitation under section 704 becomes a factor. The partners contribute funds to pay the lender to release the guarantee, allowing the basis to be allocated to all partners. Is the nonrecourse debt sans the guarantee included in basis? From the perspective of the partners not providing the guarantee, there is no benefit other than a tax benefit. [No non-tax motive, no basis?]

D. <u>Employment Problems</u>

1. Deferred compensation -- Employee working for a highly rated major multinational corporation agrees well in advance to defer receipt of next year's bonus until after retirement. The bonus amount accretes at an interest rate until paid. If the employee received the payment directly, he or she would have invested in a similar conservative investment. [No

meaningful change in the employee's economic position – does the deferral work?]

2. Contribution to IRA – An individual discovers at year end that he or she can make an additional deductible contribution to his or her IRA of $5,000. Not having ready cash, the individual sells $5,000 worth of mutual fund shares in his or her personal brokerage account and contributes the proceeds to his or her IRA. The individual likes the mutual fund as an investment, and has the IRA invest the $5,000 in shares of the same mutual fund . [No change in economic position, no deduction?]

E. Foreign Taxes and Related Matters

1. Foreign bond subject to withholding tax – An individual invests in a 10-year foreign government bond paying 5.5% that is subject to a 10% withholding tax. The cash-on-cash return (treating foreign taxes as a deduction) is 4.95% (90% of 5.5%). The comparable risk free rate on a US government 10-year bond is 5%. [No economic substance because pre-tax profit is less than risk-free rate, no tax credit?]

2. Utility properties subject to high-level of foreign tax – US energy company intends to invest in foreign utility that has long-term power sale contracts and very stable profits because of foreign price regulation. The foreign government imposes a 50% tax rate on business profits. Projections show that pre-tax returns are higher than the risk free rate but not double that rate. The after-tax return (treating foreign taxes as a deduction) is less than the risk free rate of return on a 5 year US government bond. [No economic substance because pre-tax profit is less than risk-free rate, no credits?]

3. BD is a securities dealer operating in London through a subsidiary FBD. In the normal course of its business, the subsidiary buys a stock that is expected to pay a substantial dividend subject to a withholding tax. BD expects to make money from reselling the stock, assuming the withholding tax is ultimately creditable in the U.S. However, if the tax is treated as an expense, the trade would not be profitable. Section 901(k) does not limit the credit. Would it be denied under the statute?

F. Gain and Loss Recognition

1. Bank X owns a portfolio of loans that have declined in value. In order to generate a tax loss, X exchanges the loans for a comparable portfolio of loans that have similar economic terms. The returns on the new portfolio are substantially the same as the returns on the old, so the net economic effect of the transaction is negative due to transaction costs. Does X get the loss? [Has Cottage Savings been overturned?]

2. An individual investor owns 100 shares of stock of a publicly traded corporation. The investor decides at the end of Year One to dispose of the shares immediately. The investor instructs his or her broker to sell the shares at the opening of the market on January 2nd. The broker effects the trade as instructed. The only reason that the individual chooses to sell on January 2nd of Year Two rather than December 30th or 31st of Year One is to defer reporting the gain from the sale. [No non-tax motive, is the transaction deemed to occur in Year One?]

G. <u>Charitable Contribution of Appreciated Stock</u>

1. An S-Corp invests its excess funds principally in broad-based equity indexed mutual funds and cash. Shares of one of the funds are trading at a gain. Instead of contributing $10,000 to the American Red Cross, the S-Corp contributes $10,000 worth of the stock and invests $10,000 in additional shares of the mutual fund. The American Red Cross immediately redeems the mutual fund shares for cash. [No change in economic position, other than in substance the S-Corp has contributed $10,000 in cash to the American Red Cross. Was the contribution and redemption of the shares a reasonable way to make a $10,000 cash contribution?]

H. <u>Specified Subsidies</u>

1. Taxpayer invests in an energy generating facility that produces electricity from a qualified energy resource as defined in section 45. Because of the availability of the credits, taxpayer pays more than the pre-tax market value of the facility. Generally, credits exists to promote investment in property that might not otherwise be attractive economically. But, the investment would generally not give rise to a return greater than a risk-free return. [No pre-tax profit, no credit?]