NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON

CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

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New York State Bar Association Tax Section

Report On Codification Of The Economic Substance Doctrine

This report (the "Report")[1] sets forth certain analyses and proposals of the New York State Bar Association Tax Section with respect to Section 7701(o)[2] and related Code provisions, enacted on March 30, 2010, as part of the Health Care and Education Reconciliation Act of 2010 (the "Reconciliation Act").[3] Section 7701(o) "clarifies" and "enhances" the judge-made "economic substance doctrine" (the "ESD") by, in particular, providing where the ESD is "relevant," a conjunctive test of economic substance and a new statutory standard for profit potential (the "Codified ESD Test"). To encourage taxpayer compliance with Section 7701(o), the Reconciliation Act also amended Section 6662 to impose a 20 percent strict-liability penalty (increased to 40 percent absent adequate disclosure) on understatements attributable to tax benefits denied under Section 7701(o) or any similar rule of law (the "ESD Penalty").

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[1] The principal drafters of this Report are Kirk Wallace and Toby Cozart, with substantial research assistance from Thomas Wood. Very substantial contributions were made by Robert Kantowitz, Peter Blessing and Michael Schler. Other members of the working group, including Kim Blanchard, Sherry Englande, Angelica Kwan, Alexey V. Manasuev, John Sweet, Diana Wollman and Mirt Zwitter-Tehovnik also gave valuable guidance and input. In addition, very helpful comments were received from Robert Cassanos, Sam Dimon, Michael Farber, Andrew Needham and David Sicular. No drafter, member of the working group or member of the Executive Committee necessarily agrees with all aspects of this report.

[2] Unless otherwise indicated, all "Section" references in this Report are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the U.S. Treasury Department ("Treasury") regulations promulgated thereunder ("Treas. Reg." or "Treasury Regulations").

[3] Pub. L. No. 111-152 (2010).

I. **<u>Overview and Summary of Proposals</u>.**

Our reports on previous codification proposals of the ESD[4] expressed the concern that taxpayers and Internal Revenue Service ("IRS") agents would require guidance as to when the ESD and any attendant penalties should properly apply, and that formulating such guidance would not be easy.[5] Now that codification has occurred and taxpayers and the IRS have to work with its concepts, we find it necessary to ask for specific guidance in certain areas.

On September 13, 2010, Treasury issued Notice 2010-62, which offers brief, interim guidance. Notice 2010-62 is helpful as an official confirmation of public statements by various senior IRS and Treasury officials that, in their view, the enactment of Section 7701(o) should not be viewed as a sea change in the scope of the doctrine,[6] though at the same time the Government is not limited in trying to extend the doctrine on a case-by-case basis, even in fact patterns where it may not have been successfully invoked before. While we agree with this view, it does not alleviate the need for guidance in certain key respects. The automatic applicability of the ESD Penalty (in effect, a dramatically higher tax rate on affected transactions) creates a need

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[4] *See New York State Bar Association Tax Section Summary Report on the Provisions of Recent Senate Bills That Would Codify the Economic Substance Doctrine*, 2003 N.Y. ST. B.A. TAX SEC. REP. 1032 (the "2003 Report"); *New York State Bar Association Tax Section Report on the Treasury's Proposal to Codify the Economic Substance Doctrine*, 2000 N.Y. ST. B.A. TAX SEC. REP. 977 (the "2000 Report").

[5] More generally, our reports had expressed various reservations about codification of the ESD. Treasury and the IRS had similarly opposed such legislation. *See, e.g.*, *Economic Substance Doctrine Would Create More Problems Than It Solves, Says Korb*, TAX NOTES TODAY (Tax Analysts), 2008 TNT 32-3, Feb. 15, 2008 (comments of Donald Korb, former IRS Chief Counsel).

[6] *See, e.g.*, *Official Says Codifying Doctrine Will Not Materially Affect IRS's Enforcement Views*, DAILY TAX REP. (BNA), 132 DTR G-1, July 13, 2010 (comments of William Alexander, IRS Associate Chief Counsel (Corporate)); *Codification of Economic Substance Will Not Lead to Broader Application, Attorneys Say*, DAILY TAX REP. (BNA), 106 DTR G-4, June 4, 2010 (same).

for some definition or clarification of the scope that simply did not exist to the same degree before. The ESD Penalty is truly a sea change.

Further, Section 7701(o) and the ESD Penalty do contain newly articulated concepts and the wording is in certain places unclear and confusing, and would benefit from guidance at least as much as any other new statutory provision. In those areas, Notice 2010-62 does not shed enough light and, for the reasons we set out below, we hope that Treasury and the IRS can quickly provide more substantial guidance clarifying the new provisions and how the IRS will administer them.

As discussed below, one of our major concerns, especially given the nature of the ESD Penalty, is the potential for honest misuse of Section 7701(o) by the IRS. In the absence of some guidance as to when the IRS can appropriately raise Section 7701(o), it would not be surprising to see field-level IRS agents raising it routinely in taxpayer audits, which obviously would have detrimental consequences for the tax system.

We are aware that many in government, as well as some in the private sector, have opposed the promulgation of a so-called "angels list" of transactions or types of transactions that are per se exempt from attack under Section 7701(o).[7] Furthermore, Notice 2010-62 includes a statement that the government does "not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."[8] We recognize the concerns that animate this position; however, we also believe that clarifying the proper scope of Section 7701(o), Section 6662(b)(6) and Section 6662(i) is

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[7] *See, e.g.*, *No "Angel List" Guidance Planned for Economic Substance, Official Says*, DAILY TAX REP. (BNA), 88 DTR G-8, May 10, 2010 (comments of Robert Crnkovich, senior counsel for Treasury's Office of Tax Policy).

[8] Notice 2010-62, Section B.

important and reasonable for taxpayers to request. Accordingly, we encourage Treasury to issue guidance confirming at least that certain existing legal doctrines do not fall under the statutory definition of the ESD, and we believe that this can be done without limiting the government's or the courts' ability to continue to develop the ESD on a case-by-case basis in the future. Furthermore, to provide taxpayers and field-level IRS agents with as much direction as possible, we believe that Treasury and the IRS should also issue guidance clarifying to the extent feasible other specific aspects of Section 7701(o) as discussed herein.

For reasons evident from the discussion below, we believe that guidance is needed in respect of the Profit Potential Test, from the standpoint of the government and taxpayers as potential litigants, as well as the general standpoint that a fair and efficient tax system should allow taxpayers to conduct their affairs with reasonable knowledge of what the tax laws are, especially where the consequences of being wrong include an automatic, strict-liability penalty. Notice 2010-62, which says that the government will "apply existing relevant case law and other published guidance,"[9] is simply not enough. The courts do not bring cases and generally do not raise the ESD on their own initiative. Thus, it is no more than fair to ask the government to articulate, at least in a broad sense, what standards it intends to apply. An objective of the legislation was consistency in application of the ESD by the courts, and that objective would be served by guidance on certain fundamental issues.

The following is a brief summary of our recommendations for guidance by Treasury and the IRS:

- Guidance clarifying that, for purposes of Section 7701(o), "the" ESD refers only to judge-made rules of statutory construction that deny the tax benefits of a transaction if a court has analyzed both the economic substance and business or non-tax purpose of

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[9] Notice 2010-62, 2010-40 I.R.B. 411, § C.

such a transaction (or at least has referred to the applicability of such a two-prong test) and found it lacked either or both. Specifically excluded would be other doctrines, such as substance over form, step transaction and adequate business purpose (in the sense where it is used separately from the ESD). This is important given that the literal wording of Section 7701(o)(5)(A) could otherwise be read to expand the ESD to any transaction where the taxpayer needs only the most minimal of business purposes (and economic substance is not evaluated or referred to at all).

- Similarly, guidance clarifying the meaning of the phrase "any similar rule of law" in Section 6662(b)(6), to the effect that a rule of law is not a similar rule of law if it is not based on an analysis of both the economic substance and non-tax purpose of the transaction in question (regardless of whether the court found that either or both was lacking). Such guidance should also coordinate the ESD Penalty with the scope of the ESD as more precisely articulated along the lines suggested above.

- Guidance enunciating a few principles identifying broad categories of transactions to which the ESD (as defined in Section 7701(o)(5)(A)) is not "relevant." In particular, these principles would confirm that the ESD is not relevant to (i) any tax elections granted to taxpayers under the Code or the Treasury Regulations, and (ii) where the circumstances of the transaction are such that the tax benefits are "clearly consistent" with the provisions and purposes of the Code or Regulations. (Nevertheless, in the appropriate situations, a court could hold that the ESD is relevant to a series of transactions that include one or more elections on the ground that the election is being used in a way inconsistent with Congressional intent, or a court could strike down an election or transaction under another doctrine of U.S. tax law.)

- Given how important the pre-tax profit test (the "<u>Profit Potential Test</u>"), of Section 7701(o) is likely to be, guidance as to the proper application of the "present value" concepts under the provision, including how to determine what discount rate or rates are to be used.

- If feasible, guidance under Section 7701(o)(2) addressing (i) which expenses (*e.g.*, actual or imputed financing costs) should be taken into account under the provision, and under what circumstances; and (ii) the application of Section 7701(o)(2) to transactions whose economics are based (in part or largely) on tax benefits arising from specific incentives granted by Congress.

- Guidance that either confirms that foreign income taxes should not be treated as "expenses" for purposes of the Profit Potential Test or details the limited situations in which they should be.

- Although current LB&I practice[10] providing that the ESD Penalty is not assertable without the express review and consent of an IRS District Counsel is a laudable first step, at least until the courts, Treasury or the IRS provide further clarification, we

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[10] *See* LB&I (formerly LMSB) Directive LMSB-4-0910-024 (Sept. 14, 2010).

believe that the ESD Penalty should not be assertable without express review and consent of the IRS Chief Counsel.

- Guidance aligning the disclosure requirements of Section 6662(i) with the administration of the substantial understatement penalty of Section 6662(b)(6). Among other things, in addition to the guidance provided by Notice 2010-62, this guidance should explain that disclosure will be considered "adequate" for purposes of Section 6662(i) if it supplies the information required by Revenue Procedure 2010-15.[11]

II. Background.

A. Traditional Understanding of the ESD.

As we observed in the 2000 Report and the 2003 Report, the ESD and the related business purpose doctrine are rules of statutory and regulatory interpretation devised by the courts to prevent taxpayers from applying statutory language in a manner that is inconsistent with its purpose and produces incongruous results.[12] The jurisprudential roots of the ESD can be traced to *Gregory v. Helvering*[13] although, the "modern" ESD typically involves very different situations[14] and has evolved into a differently articulated test. *Gregory* requires a balancing between permitted tax motivations and impermissible tax avoidance. Historically, the ESD's application is limited to

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[11] 2010-7 I.R.B. 404 (Jan. 27, 2010).

[12] *See, e.g.*, Saba P'ship v. Comm'r, T.C. Memo. 1999-359, at 120 (noting that the ESD is a "'canon of statutory interpretation that statutes should not be read to create "absurd results"'" (quoting Horn v. Comm'r, 968 F.2d 1229, 1239 (D.C. Cir. 1992))), *vacated on other grounds*, 273 F.3d 1135 (D.C. Cir. 2001).

[13] 293 U.S. 465 (1935).

[14] The "modern" ESD typically involves so-called tax shelters, where a transaction is entered into to generate a loss that will be used to offset income from some unrelated transaction or activity. *See*, *e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 248 n.31 (3d Cir. 1998) (citing *Gregory*, 293 U.S. at 468-69; N. Indiana Pub. Serv. Co. v. Comm'r, 115 F.3d 506, 512 (7th Cir. 1997); Kraft Foods Co. v. Comm'r, 232 F.2d 118, 127-28 (2d Cir. 1956)); *see also* Yosha v. Comm'r, 861 F.2d 494, 497, 500 (7th Cir. 1988) ("Many transactions are largely or even entirely motivated by the desire to obtain a tax advantage. But there is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer such an advantage. . . . Straddles that involve no market risks are not economically substantial straddles and hedges; they are artifices created by accomplices in tax evasion . . . .").

where it is appropriate to prevent taxpayers from entering into tax-motivated transactions to obtain tax benefits under circumstances in which Congress (or Treasury, in the case of Treasury Regulations) did not intend them to be available.[15] The ESD serves as a policing mechanism over what are obviously "mixed-motive" transactions.[16] That is, it is perfectly appropriate, and expected, that taxpayers respond to the income tax incentives, disincentives, and rules that Congress and Treasury have provided, but they must do so in settings where more is going on than merely gaining income tax benefits. Further, although the dividing lines here are not clear, at a minimum, the results must not be clearly contrary to the intent of Congress. For convenience, we will call this fundamental notion the "Mixed-Motive Principle." More recent cases continue to recognize the Mixed-Motive Principle,[17] although a few others, in what the courts felt were

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[15] For instance, even though Congress has granted taxpayers the right to deduct expenses and losses, Congress presumably did not intend, in most contexts, to grant deductions for payments with no "substance" or "purpose" other than securing the deductions themselves. *See, e.g.*, Goldstein v. Comm'r, 364 F.2d 734, 741 (2d Cir. 1966) ("[T]his provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction . . . .").

[16] One thoughtful commentator gave this summary:

> A central theme [underlying *Gregory* and subsequent cases] is how to reconcile the conflicting tensions between (i) the reality and legitimacy of taxpayers taking into account tax considerations and (ii) preserving the integrity of the tax system, setting limits to prevent the tax system from becoming self-defeating. Judge Hand sought to reconcile these conflicting tensions in *Gregory* and subsequent cases by requiring that a transaction, to be respected, must appreciably affect the taxpayer's beneficial interest, apart from taxes to assure that the transaction genuinely involved *mixed motives.*

Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 TAX LAW. 1, 5 (1999) (emphasis added).

[17] *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998); ASA Investerings P'ship v. Comm'r, 201 F.3d 505 (D.C. Cir. 2000); Consol. Edison v. United States, 90 Fed. Cl. 228 (2009); AWG Leasing Trust v. United States, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

abusive cases, implicitly have not.[18] As we discuss below, determining whether Section 7701(o) merely updates and makes relatively modest adjustments to the Mixed-Motive Principle, or, to the extent it has not been substantially limited by the courts already, severely restricts it,[19] may be one of the key questions for taxpayers, Treasury, the IRS and the courts.

Over time, in attempting to grapple with the question of Congressional intent and whether more is going on than gaining tax benefits, the ESD, as with other aspects of the tax law, has grappled with and come to incorporate time value concepts, albeit not consistently or with uniform results. For example, early in the development of the law regarding leveraged lease transactions, the Tax Court suggested in *Hilton v. Commissioner*,[20] in dictum, that the ESD should be applied by using a 6% compounded discount rate. In its per curium affirmance of the Tax Court's decision, the Ninth Circuit weakened the authority of the Tax Court's dictum by observing, "we deem the six percent rate to be for illustrative purposes only. No suggestion of a minimum required rate of return is made."[21] Subsequently, in the often-cited case of *Estate of Thomas v. Commissioner*,[22] the Tax Court retreated from its position in *Hilton* because it did not "feel competent, in the absence of legislative guidance, to require that a particular return must be

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[18] *See, e.g.*, Altria Group, Inc. v. United States, 694 F. Supp. 2d 259, 285 (S.D.N.Y. 2010); Wells Fargo & Co. v. United States, 91 Fed. Cl. 35 (2010), *appeal docketed,* No. 2010-5108 (Fed. Cir. Apr. 16, 2010).

[19] Of course, there is no agreement on what the starting point is for this comparison. Many would argue the ESD, properly applied, already was, or should be interpreted to be, fairly restrictive with respect to mixed-motive transactions. For those with that view, Section 7701, even if it does severely limit the Mixed-Motive Principle, does not necessarily represent a particularly large or new development in the law.

[20] 74 T.C. 305, 353 n.23 (1980), *aff'd*, 671 F2d 316 (9th Cir. 1982).

[21] 671 F.2d 316, 317 (9th Cir. 1982). *See also* Sacks v. Comm'r, 69 F.3d 982, 991 (9th Cir. 1995) (citing *Hilton,* the court stated that an investor is not "bound to discount the future at the rate the Commissioner thinks prudent").

[22] 84 T.C. 412 (1985).

expected before a 'profit' is recognizable . . . . Our sole task here is to determine whether a profit was reasonably likely on these facts in order to find that tax avoidance was not the sole motivation for the transaction."[23] (We understand that for decades, until recently, these authorities provided the principal guidance on which responsible tax practitioners have based their opinions on such transactions.)

A principal difficulty with *Hilton*, *Estate of Thomas* and their progeny is that the courts in these cases never specified which discount rates might be used. Indeed, many courts have upheld lease transactions without requiring a discounting of profit.[24] To some extent, in the leasing arena at least, it seemed that courts accommodated this uncertainty by permitting risk-adjusted discount rates to be utilized in situations where they found the transactions to be abusive on other grounds, as part of the justification for treating the transactions as lacking in economic substance.[25] In the meantime, initially outside of the context of leasing transactions, a contrary view, stemming primarily from the landmark case of *ACM Partnership v.*

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[23] *Id.* at 440 n.52. In addition, the Tax Court distinguished its discounting method in *Hilton* as "dictum in the context of circumstances bordering on the egregious." *Id.*

[24] *See, e.g.*, Consol. Edison Co. of N.Y., Inc. v. United States, 90 Fed. Cl. 228, 328-29 (2009); Johnson v. Comm'r, 11 Cl. Ct. 17, 36 (1986); Gefen v. Comm'r, 87 T.C. 1471, 1499 (1986).

[25] *See, e.g.*, Pacheco v. Comm'r, 57 T.C.M. (CCH) 739, 744 (1989); Sacks v. Comm'r, 64 T.C.M. (CCH) 1003 (1985), *rev'd on this ground*, 69 F.3d 982 (9th Cir. 1995). The district court in *Altria Group v. United States* adopted a different approach, in which it held that although an undiscounted profit might be sufficient to satisfy economic substance prong of the ESD, a jury is nevertheless free to take the taxpayer's cost of funds into account in determining whether it was motivated solely by tax avoidance. 694 F. Supp. 2d at 285. Under the Codified ESD, we expect that this approach will not likely be very relevant in the future, because, as discussed in Section III(E)(1) below, the legislative history indicates that taxpayers may rely on the Profit Potential Test, which now clearly involves present value calculations, to satisfy both prongs. *See* H.R. Rep. No. 111-443, at 298 & n.137 (2010); JCX-18-10, at 155 & n.356; *see id.* at 298; JCX-18-10 No. 7 (both reports state that "*if a taxpayer relies on a profit potential*, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits" (emphasis added)).

Commissioner,[26] emerged that "present value adjustments are, as the courts have recognized, an appropriate means of assessing the transaction's actual and anticipated economic effects."[27] Although there may be a legitimate argument that this principle is merely dictum, and should be limited, for example, to the valuation of liquid investments, it has recently been used in a high profile case to support the discounting of cash flows arising from a leveraged lease transaction at the taxpayer's cost of funds.[28] Whatever lingering debate there may have been about applying time value concepts generally in the ESD context, however, has been resolved. Section 7701(o)(2) now provides a clear directive that all "relevant" transactions must be tested using present value concepts if the taxpayer seeks to rely on the Profit Potential Test.

Finally, we also note that the ESD is not applicable ("relevant") to deny tax benefits arising from *every* tax-motivated transaction that lacks a business purpose or economic substance or both. As we observed in the 2000 Report and the 2003 Report, given its role as a rule of statutory and regulatory interpretation, the courts have historically denied tax benefits under the ESD only if allowing them, under the taxpayer's particular circumstances, would be contrary to the intent of the drafters of the relevant statute or regulation. For instance, in *Cottage Savings Ass'n v. Commissioner*,[29] a taxpayer entered into a tax-motivated transaction (*i.e.*, an exchange of economically similar mortgage portfolios) solely for the purpose of accelerating the deduction of an otherwise unrealized economic loss. Notwithstanding that the exchange lacked a non-tax business purpose and did not meaningfully change the taxpayer's economic position, the Supreme

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[26] 157 F.3d 231 (3d Cir. 1998).

[27] *Id.* at 259 (citing, arguably out of context, the Ninth Circuit's opinion in *Hilton*, among other authorities).

[28] Wells Fargo & Co. v. United States, 91 Fed. Cl. 35, 82 (2010), *appeal docketed,* No. 2010-5108 (Fed. Cir. Apr. 16, 2010).

[29] 499 U.S. 554 (1991).

Court refused to disallow the deduction on the grounds that the transaction did qualify as an "exchange" under the terms of Section 1001 and the regulations thereunder *and* that the Commissioner did not convince the Court that Congress and Treasury could not have reasonably contemplated the availability of a loss deduction under these circumstances.

B. Recent History of ESD Codification.

There have been various proposals to codify the ESD in recent years.[30] Like Section 7701(o), nearly all such proposals would have "clarified" the ESD by providing a so-called conjunctive test of economic substance.[31] Most such proposals would also have imposed some form of strengthened penalty on understatements attributable to violations of the ESD. We were critical of such proposals in our previous reports. For instance, we addressed the 2000 Proposal in our 2000 Report, arguing that it did not accurately reflect the ESD as articulated by the courts and that, read literally, it would potentially apply to a wide range of transactions that are neither primarily tax-motivated nor particularly "abusive."

We took a similarly critical position in our 2003 Report with respect to the 2003 Proposal, which, with certain important exceptions, was generally consistent with the basic framework of Section 7701(o) and amended Section 6662. We argued in our 2003 Report that the

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[30] *See, e.g.*, The American Worker, State and Business Relief Act of 2010, H.R. 4213, 111th Cong. § 421; The Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242, 110th Cong. §§ 511, 512, 513 (the "2007 Proposal"); The Telephone Excise Repeal and Taxpayer Protection and Assistance Act of 2006, S. 1321, 109th Cong. §§ 801, 802 (the "2006 Proposal"); The CARE Act of 2003, S. 476, 108th Cong. §§ 701, 704, 717; The Jobs and Growth Reconciliation Tax Act of 2003, H.R. 2046, 108th Cong. §§ 311, 314, 327 (together with the codification proposal from the CARE Act of 2003, the "2003 Proposal"); The Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong. (the "2000 Proposal"). For a comprehensive list of recent codification proposals, see Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 TAX NOTES 289, 289-90 n.3 (Apr. 19, 2010).

[31] We use the phrase conjunctive from the perspective of what the taxpayer needs to establish to prevail against an ESD-based attack.

literal provisions of the 2003 Proposal, like those of the 2000 Proposal, would have unwarranted and unintended effects on a wide range of common, and legitimate, business transactions. We also argued that the 2003 Proposal, if enacted, would require a massive regulatory project, and that a wholesale delegation of rulemaking responsibility to Treasury by Congress would be irresponsible, as well as ineffective.

Finally, earlier this year, the current House Rules Committee decided to include a codification proposal, along with certain related enforcement measures, in its health care reconciliation package.[32] On March 30, 2010, as part of Congress' comprehensive overhaul of the national health care system, the President signed the Reconciliation Act into law.

C. Summary and Background of Enacted Provisions and the House and JCT Reports.

Like previous codification proposals, Section 7701(o) arose out of dissatisfaction with certain aspects of and inconsistencies in the common law. Indeed, it may be fair to summarize the enactment of Section 7701(o) as having had two main goals (leaving aside the ESD Penalty): (i) to override a circuit split on whether the taxpayer needed both "business purpose" and "economic substance" or only one or the other and (ii) to establish that, on a present value basis, pre-tax profit must be substantial in comparison to the tax benefits claimed.

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[32] Many observers have suspected that recent codification proposals, including the version ultimately enacted under the Reconciliation Act, have been promoted, at least in part, because of their revenue-raising, or budget-scoring, potential. However, according to the estimates of the Joint Committee on Taxation (the "Joint Committee"), the potential revenue effects of codifying the ESD have decreased considerably over the past several years. For instance, the Joint Committee estimated that the 2006 Proposal, in tandem with associated penalties, would raise more than $17 billion in revenue for the government during the ten-year period following its enactment. *See* JCX-29-06 (June 28, 2006). By contrast, the Joint Committee's recent estimate of the revenue effects of Section 7701(o) and amended Section 6662 projects an increase of only $4.5 billion over the next decade. *See* JCX-17-10 (Mar. 20, 2010).

The House Budget Committee's report on the Codified ESD (the "House Report")[33] explains the pre-enactment state of the law as follows:

> There is a lack of uniformity regarding the proper application of the economic substance doctrine. [Citing *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988.)] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (*i.e.*, the objective component) and business purpose (*i.e.*, the subjective component) in order for the transaction to survive judicial scrutiny. [Citing, as examples, *Pasternak v. Commissioner*, 990 F.2D 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the

[33] H.R. Rep. No. 111-443. There is some question as to whether the House Report is technically an official part of the Reconciliation Act's legislative history and whether, in fact, Section 7701(o) has "official" legislative history. The House Report is based on the explanation of the ESD codification proposal provided by the House Ways and Means Committee on October 14, 2009. The House Ways and Means Committee explanation, however, was prepared for H.R. 3200, which contained provisions that ultimately were not included in Section 7701(o) – these provisions included eliminating a reasonable-cause exception to penalties for "specified persons" and provided for a strict-liability penalty for tax shelters. After H.R. 3200, there were three more versions of proposed codification of the ESD before the Reconciliation Act: (i) H.R. 3962 (the Affordable Health Care for America Act that passed the House of Representatives on November 7, 2009), which made some technical changes to H.R. 3200, (ii) a version in the January 2010 efforts to meld H.R. 3962 with H.R. 3590 (passed by the Senate on December 24, 2009), which dropped the "specified persons" provision and the tax shelter-related penalty, among other changes and (iii) H.R. 4213, the Tax Extenders Act of 2009, which was passed by the Senate in March of 2010. Finally, the House of Representatives Rules Committee wrote what became the Reconciliation Act as an amendment in the nature of a substitute to H.R. 4872, and there was no new House (or Senate) report. The Joint Committee's technical explanation of the new provisions, JCX-18-10 (Mar. 21, 2010) (the "Joint Committee Report"), on the other hand, was prepared to explain the Reconciliation Act provision. Unlike a House Report, the Joint Committee Report is, however, not considered to be an official part of a law's legislative history. *See, e.g.*, Hutchinson v. Comm'r, 765 F.2d 665, 669-70 (7th Cir. 1985) (noting that, while Joint Committee explanations do not "rise to the level of legislative history, because [they are] authored by Congressional staff and not by Congress . . . such explanations are highly indicative of what Congress did, in fact, intend"). In the case of the Joint Committee Report, however, because it was released four days before either chamber of Congress voted on the Reconciliation Act in its final form (and nine days before the President signed the legislation into law), and is the only piece of Congressional explanation with respect to the actual legislation that was enacted, it should be viewed as carrying relatively more authoritative weight than a Joint Committee explanation not prepared and published substantially contemporaneously with the passage of the subject legislation. *See, e.g.*, Robinson v. Comm'r, 119 T.C. 44, 73 (2002) (observing that, because a Joint Committee staff summary "was provided to the Members of the House and Senate for their reference before Congress enacted TRA 1986 . . . consequently it is part of the history of the legislation").

taxpayer was motivated by profit to participate in the transaction."); *Klamath Strategic Investment Fund v. United States*, 568 F. 3d 537 (5th Cir. 2009) (even if taxpayers may have had a profit motive, a transaction was disregarded where it did not in fact have any realistic possibility of profit and funding was never at risk).] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction. [Citing, as examples, *Rice's Toyota World v. Commissioner,* 752 F.2d 89, 94 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); and *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001).] A third approach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits. [Citing, as examples, *ACM Partnership v. Commissioner,* 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").][34]

Congress' stated rationale for enacting a conjunctive Codified ESD Test was to clarify the status of the ESD under the body of disparate cases applying, or attempting to apply, an economic substance analysis. Thus, according to the House Report:

> A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. The Committee recognizes that the IRS has achieved a number of recent successes in litigation. The Committee believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences.[35]

By the statute's literal terms, the Codified ESD Test applies, uniformly, to any transaction to which the ESD (as defined under Section 7701(o)) is "relevant." If applicable, the Codified ESD Test requires that:

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[34] H.R. Rep. No. 111-443, at 293 & nn.109-112 (2010).

[35] *Id.* at 295.

- the transaction in question meaningfully changes the taxpayer's economic position (apart from federal income tax effects), and
- the taxpayer has a "substantial purpose" for entering into the transaction (apart from federal income tax effects).

Under conditions specified in the statute, taxpayers are permitted, but not required, to satisfy either prong (or both prongs) by relying on the expected pre-tax profitability of the transaction (the "Profit Potential Test").

In the context of the Profit Potential Test, both the House and Joint Committee Reports provide that Section 7701(o)(2)(A) "does not *require or establish* a specified minimum return that will satisfy the profit potential test."[36] This contrasts starkly with previous codification proposals. These prior proposals would have required not only that the present value of the reasonably expected pre-tax profit from a transaction be substantial in relation to the present value of the transaction's expected net tax benefits, but also that such pre-tax profit exceed a "risk-free rate of return."[37] As we discuss further below, it is unclear just what to make of this. Seemingly, Congress recognized the interplay between profit and other non-tax factors in the ESD inquiry and wanted to clarify that even when a taxpayer relies wholly or partly on pre-tax profit, the necessary level of profit cannot be specified in the abstract without analyzing the facts and circumstances of the particular case. Thus, for example, a different level of pre-tax profit might be required in transactions supported by certain tax-independent considerations other than the transaction's

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[36] H.R. Rep. No. 111-443, at 298; JCX-18-10, at 155 (emphasis added).

[37] *E.g.,* S. 1321, 109th Cong. § 801. As explained by the Joint Committee staff in a report accompanying President Obama's fiscal year 2010 budget proposal, in each of the nine economic substance codification bills that passed the Senate in the 108th and 109th Congresses, relying upon profit potential, the taxpayer's reasonably expected profit from the transaction was required to exceed a "risk-free" rate of return. JCS 3-09, at 53 n.150 (Sept. 2009).

profitability, particularly where those other considerations do not satisfy the ESD standing alone.[38] Similarly, consistent with its requirement that cash flows be discounted to a present value, Congress might have intended to incorporate the flexibility established by the cases that declined to impose any particular pre-tax return requirement. As those cases, particularly *Estate of Thomas v. Commissioner*,[39] deferred to future Congresses to supply a specific return requirement, it would follow that Congress would have to explain that the statutory profit test neither requires nor establishes a specified minimum return.

Beyond the "no specified minimum" comment, the House Report and the Joint Committee Report do not shed much light on how to apply the Profit Potential Test; nor does Notice 2010-62. Nevertheless, some taxpayers may try to parse the reports closely (notwithstanding the issues as to their status as authority)[40] and will note that the reports summarize prior case law as follows, using identical text and, with one potentially meaningful (or merely confusing) exception, identical footnote citations:

> Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential. In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to

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[38] *Cf.* Consol. Edison Co. of N.Y., Inc. v. United States, 90 Fed. Cl. 228, 326-30 (2009). Although the court in *Consolidated Edison* noted that the taxpayer's 4.44% pre-tax yield "is above the amount cases have previously acknowledged as sufficient pretax profit," *id.* at 326, it ruled that the leasing transaction in that case satisfied the ESD based in part on the presence of other tax-independent factors. *Id.* at 340-41. Similarly, as discussed in section III(E)(5)(e) in the text below, some transactions with a 2-4% pre-tax IRR could potentially be considered demonstrating sufficient profit under the statutory profit test, provided that the taxpayer's investment is truly at risk.

[39] 84 T.C. 412, 440 n.52 (1985). See the discussion in Section II.A, *supra*.

[40] *See* discussion *supra* at note 33.

> the tax benefits.[41] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits. [House Report, note 118; Joint Committee Report, note 312.[42]] In these cases, in assessing whether a reasonable possibility of profit exists, it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected tax benefits.[43]

To explain the new statutory profit test, although they used different footnotes, both the House Report and the Joint Committee Report also set forth the same text:

> Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-income-tax purpose for entering into such transaction. The provision does not require or establish a minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. [House Report, note 137; Joint Committee Report, note 356.] Fees and

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[41] In both the House and Joint Committee Reports, H.R. Rep. No. 111-443, at 294, n.117; JCX-18-10, at 145, n.311, the text references the following footnote:

> See, e.g., Goldstein v. Comm'r, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); Sheldon v. Comm'r, 94 T.C. 738, 768 (1990) (stating that "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[42] In the Joint Committee Report, JCX-18-10, at 145, n.312, the text references the following footnote, which is the same as the House Report referenced at this location, *see* H.R. Rep. No. 111-443, at 294, n.118, except for the additional citation to the *Wells Fargo* case:

> *See, e.g.*, *Rice's Toyota World v. Comm'r*, 752 F. 2d 89, 94 (4th Cir. 1985) (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 781 (5th Cir. 2001) (applied the same test, citing Rice's Toyota World); *IES Indus. v. United States*, 253 F.3d 350, 354 (8th Cir. 2001); *Wells Fargo & Co. v. United States*, No. 06-628T, 2010 WL 94544, at *57-58 (Fed. Cl. Jan. 8, 2010).

[43] H.R. Rep. No. 111-443, at 294 (footnotes and citations omitted); JCX-18-10, at 144-45 (footnotes and citations omitted).

other transaction expenses are taken into account as expenses in determining pre-tax profit.[44]

The House Report includes footnote 137 in this location, which says, "Thus, a 'reasonable possibility of profit' alone will *not* be sufficient to establish that a transaction has economic substance."[45] In contrast, in the same location the Joint Committee Report's footnote 356 cites various cases together with helpful parenthetical explanations:

> *See, e.g.*, Rice's Toyota World v. Comm'r, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); Compaq Computer Corp. v. Comm'r, 277 F.3d at 781 (applied the same test, citing Rice's Toyota World); IES Indus. v. United States, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").[46]

As we discuss below, it is unclear how to interpret these footnotes and what significance they have.

To describe prior case law in the first of the above-excerpted texts, the Joint Committee Report cited *Wells Fargo & Co. v. United States*[47] in its footnote 312 for the proposition that a reasonable possibility of pre-tax profit must exist. In that case, in holding that various "sale-in-lease-out" or "SILO" transactions lacked profit potential, the Court of Federal Claims took the taxpayer's overall cost of capital into account.[48] As we discuss below, the question of whether indirect costs (either specific costs or a general or overall cost of capital) should be taken into account in calculating pre-tax profit is, at least under one approach to the

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[44] H.R. Rep. No. 111-443, at 298 (footnotes omitted); JCX-18-10, at 154-55 (footnotes omitted).

[45] H.R. Rep. No. 111-443, at 298 n.137.

[46] JCX-18-10, at 155 n.356.

[47] 91 Fed. Cl. 35 (2010), *appeal docketed,* No. 2010-5108 (Fed. Cir. Apr. 16, 2010).

[48] *See Wells Fargo*, 91 Fed. Cl. at 83 ("Wells Fargo's cost of funds alone turns the SILOs into a losing proposition . . . . [A]side from the net present value analysis and the lengthy deferral of payments . . . there was no reasonable possibility of profit from the SILOs simply because the expected non-tax investment return was less than Wells Fargo's cost of funds.").

Profit Potential Test, fundamental. Hence, given that the Joint Committee Report subsequently omitted any citation to *Wells Fargo* in footnote 356, explaining the new statutory test may lead some taxpayers to argue, rightly or wrongly, that omission evidences an intent to overrule, limit or, at the least, not fully endorse that decision. Others, who take a different view of the Profit Potential Test, may say that Section 7701(o) has independently resolved this aspect of the dispute in *Wells Fargo* because, as we discuss below, under that view a cost of funds (at some rate) would be automatically imputed.[49]

In addition, some may argue that footnote 356 of the Joint Committee Report, which references and purports to explain the same text as footnote 137 in the House Report, limits the amount of pre-tax profit required by the new statutory test. In footnote 356, the Joint Committee Report, in its explanation of the statutory profit formulation, did not repeat its citation to the cases that it (like the House Report) had cited as standing for the proposition that the "profit potential must be more than nominal" as compared to tax benefits (*i.e.*, *Goldstein* and *Sheldon*).[50] Rather, the Joint Committee Report cited the cases -- except for *Wells Fargo* -- that it had earlier cited, in footnote 312, as standing for the proposition that "it may be sufficient if there is a *nominal* amount of pre-tax profit as measured against expected tax benefits" (*i.e.*, *Rice's Toyota World*, *Compaq* and *IES*).[51] On balance, however, to many of us, the reasons for footnote 356's citing to the cases (other than *Wells Fargo)* in footnote 312 and yet omitting *Wells Fargo* are, frankly,

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[49] No matter what view is adopted, other aspects of the dispute in *Wells Fargo*, such as what present value and what rates to apply, remain. *See* note 118, *infra*.

[50] *See* JCX-18-10, at 145 & n.311; H.R. Rep. No. 111-443, at 294 & n.117. These cases are more specifically described in the text as concluding "that the economic risks and profit potential were insignificant when compared to the tax benefits." *Id.*

[51] JCX-18-10, at 155 n.356 (emphasis added). *But see* note 52 *infra*.

unclear. The statute is clear, however, that a substantiality comparison is required for the Profit Potential Test.

In not including a minimum pre-tax return requirement, Congress has opened up the possibility that, at least in certain cases, a taxpayer's pre-tax rate of return need not exceed its overall cost of funds (unless of course, those costs are properly directly attributable to the transaction). This possibility would suggest that the holding in *Wells Fargo* is not necessarily endorsed. Or, more narrowly, because, among other things, *Wells Fargo* involved fully defeased lease transactions in which the court viewed the taxpayer as being insulated from any meaningful risk of loss, perhaps footnote 356 suggests that where the taxpayer's investment is exposed to material risk (or other tax-independent factors are present unlike the facts in *Wells Fargo*), Congress intended to leave open the possibility that a lesser pre-tax return may be sufficient.

Alternatively, another possible, and more straightforward, interpretation of footnote 356 is that the Joint Committee Report merely intended to provide case authority for the statutory requirement that the requisite profit be *reasonably expected*.[52] This view would tend to minimize the significance of this footnote being different from footnote 137, though it seems like an obvious point. Other interpretations are of course possible, and, in any event, it may be unwise to attempt to parse legislative history in such an exacting manner.

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[52] Although the cases cited in footnote 356 of the Joint Committee Report include three of the cases cited in footnote 312, which the Report stated supports merely nominal pre-tax profit, as compared to tax benefits, footnote 356 contains a parenthetical explanation of *IES Industries* whereas footnote 312 does not. This parenthetical explains that this case stands for the proposition that "the application of the objective economic substance test involves determining whether there was a 'reasonable possibility of profit . . . apart from tax benefits.'" JCX-18-10, at 155 n.356. This proposition differs from, and is not necessarily inferred by, the proposition drawn from the four cases in the text at footnote 312, that "it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected tax benefits." JCX-18-10, at 145 & n.312. Accordingly, footnote 356 may be intended only to clarify the concept of reasonable expectation in the statutory formulation.

This leads us to pose a question that we think helps to illuminate the fundamental tensions at play in determining how to interpret Section 7701, and the Profit Potential Test in particular. As we understand it, responsible taxpayers have typically premised their mixed-motive transactions on the notion that more than a "reasonable possibility of pre-tax profit" has been required and that the transactions have to be reasonably expected to yield a significant, periodically compounded, internal rate of return. For transactions to which Section 7701(o) applies, *i.e*., not ones where the tax results are "clearly consistent"[53] with the Code, Regulations and Congressional intent, did Congress intend to change the treatment of such transactions?

Take such a transaction that is reasonably expected to generate a meaningful and positive pre-tax economic yield, but one that (after reduction for all direct transaction cost, but disregarding any indirect financing costs and disregarding any expected tax benefits) is less than the taxpayer's own allocable overall pre-tax cost of funds. If the after-tax yield is attractive, a rational taxpayer, absent any other (including ESD) constraints, will enter into this transaction if it offers a favorable after-tax yield, as compared to other investments and the taxpayer's allocable after-tax cost of funds. This transaction invokes the Mixed-Motive Principle at its simplest, because the taxpayer relies on both tax benefits and pre-tax cash flows. Post-codification of the ESD, however, if the Profit Potential Test is understood to impute indirect funding costs broadly to reduce the amount of pre-tax profit or to require, in determining the numerator for the Profit Potential Test, a net present valuing of cash flows, using the taxpayer's overall pre-tax cost of funds as the discount rate, the taxpayer's mixed-motive transaction may very well not survive

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[53] It is worth noting that this phrase is taken from the House Report, H.R. Rep. No. 111-443, at 296 n.124; the JCT Report does not use the adverb "clearly." *See* note 93, *infra*.

Section 7701(o) scrutiny, unless the result is clearly intended by Congress, because it will have no "pre-tax profit."[54]

Alternatively, many would argue that in light of the more recent ESD cases, if a transaction results in a pre-tax loss (taking into account all economically allocable expenses), Congress intended that taxpayers would only be able to secure tax results of such a transaction if they were consistent with the intent of Congress. Most of us believe that, given the case law developments over the past 10 years (or more), this is not a large change in prior law and it will not inhibit a large number of normal business transactions.

Much of what we explore in this Report is, in essence, tied to the foregoing example and these related questions. Is Section 7701(o) meant merely, perhaps, to raise the bar somewhat and to make the test more uniform? That is, when the result is not clearly intended by Congress, is Section 7701(o)'s goal to make sure that the profit is not *de minimis*, to require that present value concepts are always used and that the size of the expected tax benefits is also taken into account – but not effectively to prohibit this type of transaction? If so, how can Section 7701(o) be applied without creating a wide opening for potentially abusive transactions? Or, is Section 7701(o) meant to permit mixed-motive transactions only when they are clearly consistent with Congressional intent, and how is the scope of Congressional intent to be identified and applied predictably? It is curious that Congress did not provide greater lucidity on this issue.

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[54] Again, to be clear, if the taxpayer is confident (contrary to our base-case assumption about what constitutes a mixed-motive transaction) that the ESD is in fact not "relevant" to her transaction, or if special rules are promulgated for that type of transaction that are designed to make the Profit Potential Test easier to satisfy because, for example, Treasury and the IRS determine that, although not exactly exempt from the ESD, the transaction is of the sort that Congress intended to encourage, provided that it had some minimum profitability or other positive indicia, then the transaction can survive, post-enactment of Section 7701(o).

D. A Comment About Leasing and Other Similar Financing Transactions.

The questions raised, or alluded to above, are likely important to many types of transactions, but without a doubt, we understand that such questions as whether to account for indirect costs and correct approaches to present valuing for the purposes of the Profit Potential test (in essence, whether a minimum return is in fact required and, if so, how one determines what it might be) are particularly sensitive issues for leveraged leases and other similar asset-based financing structures that are designed to shift tax benefits to a passive investor who has the capacity to use the tax benefits, while capturing for another investor as many of the benefits and burdens of ownership of the asset as is otherwise permitted under the law. These financings, often called "tax equity financing" structures, are the kinds of transactions, including specifically leases and flip partnership transactions, that the IRS and the courts have addressed extensively, and for which the IRS has promulgated comprehensive guidelines.[55] Presumably because leasing transactions raise so many substantive issues, both the House Report and the JCT report singled them out as needing to "continue to be analyzed in light of all the facts and circumstances."[56]

Although some taxpayers assert that these authorities, while not purporting to construe the ESD, imply that tax equity financings that satisfy the guidelines will satisfy the ESD,[57] as well as the Codified ESD, and one might easily question whether the government would

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[55] Since 1975, the IRS has published detailed guidelines that taxpayers must follow to obtain a private ruling respecting leveraged lease transactions. Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, *modifying and superseding* Rev. Proc. 75-21, 1975-1 C.B. 715. Similarly, since 2007, the IRS has maintained and expanded guidelines that a wind energy flip partnership claiming production tax credits must follow in order for its tax allocations to be respected on audit. Rev. Proc. 2007-65, 2007-45 I.R.B. 1, *modified by* Ann. 2009-69, 2009-40 I.R.B. 475.

[56] H.R. Rep. No. 111-433, at 296; JCX-18-10 at 153.

[57] *See* Johnson v. United States, 11 Cl. Ct. 17, 26-27 (1986) (explaining that Rev. Proc. 75-21 sets forth a minimal "level of profit motivation" that does not require a "dominant profit motive").

be constrained by these guidelines if it decided to challenge transactions under the Codified ESD. The government has argued in a number of cases that the leasing guidelines do not address whether leasing transactions satisfy either the ESD or, implicitly, the Codified ESD.[58] Similarly, the wind energy guidance only applies, by its terms to the issue of whether the transaction's tax allocations satisfy Section 704(b), and those regulations clarify that they do not address whether allocations meet ESD requirements.[59] Finally, even if the leasing and flip partnership guidelines were recognized as exempting transactions from the Codified ESD, even those guidelines are not broad enough to cover many leasing and flip partnership transactions that are currently being done in the marketplace.[60] Hence, many taxpayers are left to wonder whether, as under prior practice, a pre-tax internal rate of return ("IRR") in the range of roughly 2-4% will generally be deemed sufficient if these transactions are indeed subject to Section 7701(o) and not clearly intended by Congress. In one of the SILO and lease-in, lease-out ("LILO") cases decided before *Wells Fargo* and the enactment of Section 7701(o), a federal district court held that the transactions satisfied the ESD on the strength of a pre-tax profit that was in line with that practice.[61] This concern is

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[58] Post-Trial Reply Memorandum for Defendant at 37, Wells Fargo & Co. v. United States, 91 Fed. Cl. 35 (2010), *appeal docketed*, No. 2010-5108 (Fed. Cir., Apr. 16, 2010); Memorandum for Defendant in Opposition to Post-Trial Motions at 24, Altria Group, Inc. v. United States, 694 F. Supp. 2d 259, 285 (S.D.N.Y. 2010) (No. 06 Civ. 9430).

[59] *See* Treas. Reg. § 1.704-1(b)(1)(iii) ("[A]n allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (*see, e.g.*, Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966)) . . . .").

[60] For example the leasing guidelines do not permit fixed-price lessee purchase options and the wind energy guidance does not apply to other types of renewable energy transactions or to transactions that utilize investment tax credits (or Treasury cash grants), rather than production tax credits.

[61] *See* Consol. Edison v. United States, 90 Fed. Cl. 228, 326 (2009) (government's leasing experts testified that pre-tax IRRs "between 2% and 4%" are common); AWG Leasing Trust v. United States, 592 F. Supp. 2d 953, 980 (N.D. Ohio 2008) (banks "typically receive . . . between 2.5% and

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exacerbated by the committee reports attempting to explain the Profit Potential Test solely by reference to existing case law, without clarifying what it means for profit to be more than nominal or how it must be present valued, and not explaining whether or not Congress intended for the Profit Potential Test to effect a change of this sort.

If Treasury and the IRS determine that the better interpretation of the Profit Potential Test would, if applied to leasing and tax equity financing transactions that are not abusive but are nonetheless not clearly intended by Congress, radically and inappropriately harm that industry, then the Government may want to address those sorts of transactions with specific guidance, such as an update to the leasing, wind energy and similar guidelines or other means, that would instruct taxpayers as to the proper method for conducting those transactions such that they were sufficiently economic to be viewed as "appropriate" and not in violation of Section 7701(o). Treasury and the IRS may identify other potentially affected industries.

E. The Creation of the Strict-Liability ESD Penalty Heightens the Need for Guidance.

While any statute with substantial uncertainties in its operation is, appropriately, typically the subject of clarifying regulations, given the strict-liability ESD Penalty, it would be especially appropriate for Treasury to provide guidance in connection with the ESD.

More broadly, strict-liability penalties do not sit harmoniously with so-called living doctrines – that is, evolving, dynamic aspects of the law, like the ESD. In the case of Section 7701(o), there are additional issues, such as whether or not codification of the ESD has in principle,

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3.5% on their leveraged lease transactions"). It is our understanding that tax equity investments in renewable energy flip partnership transactions are generally structured to have a 2-3% pre-tax IRR, taking any tax credits (or Treasury cash grants) into account as a cash equivalent. Although the court in *AWG Leasing* ruled in favor of the taxpayer on ESD grounds, it ruled against the taxpayer on other substance over form principles. In *Consolidated Edison*, the court implied that the profit projected by the taxpayer was sufficient for ESD purposes, but it also identified other tax-independent purposes that supported its decision. 90 Fed. Cl. at 340-41.

or effectively in practice, overruled the presumptions at the heart of the Mixed-Motive Principle with respect to transactions that will have to rely on the Profit Potential Test. We believe that, because the ESD Penalty heightens the stakes involved in the difficult task of discerning the dividing lines, guidance in certain areas is even more appropriate.

F. Summary of Premises.

Accordingly, from this background and the language of the statute itself, we take certain fundamental conclusions and these serve as the premises of this Report. They are as follows:

1. Courts are free to continue to apply the ESD to old and new types of transactions (though they will certainly be cognizant of the ESD Penalty in doing so) and to interpret Section 7701(o) itself. Section 7701(o) does not "freeze" the ESD to its prior scope; nor does it expand it.

2. As reflected the legislative history and the text of Section 7701(o)(5)(C), Congress intended the answer to the fundamental question of when the ESD is "relevant" to be unaffected by the enactment of Section 7701(o).

3. The principal point of enactment of Section 7701(o) is to clarify *how* the doctrine is to apply once it is determined to be relevant: *i.e.*, that the transaction in question have both "economic substance" and a substantial non-tax purpose, and that, if a taxpayer is looking to profit potential to satisfy either or both of those tests, the pre-tax profit must be "substantial" in comparison to the tax benefits, and that comparison must be made on a present value basis.

4. The legislative history and to some extent the $4.5 billion revenue estimate suggest that, although Section 7701(o) represents an expansion of situations where the ESD is expected to disallow the taxpayer's claimed tax benefits, it does not necessarily represent a wholesale expansion. That is, Section 7701(o) is not meant to be "strict in theory, but fatal in fact."

5. As discussed below, Congress has left many unanswered questions in the statutory language. To help courts, the IRS and taxpayers, it would reflect good tax policy for Treasury to provide guidance in as many areas as possible to the extent doing so is consistent with the purposes of an anti-abuse statute such as Section 7701(o).

6. Even leaving aside other considerations, the ESD Penalty alone is reason for Treasury to issue guidance. Strict-liability penalties are inherently

unreasonable if the taxpayer does not have clear guidance on what behavior will subject it to the penalty. Further, all penalty provisions, especially strict-liability ones, are to be interpreted narrowly.[62]

These premises and conclusions inform and guide the remainder of this Report.

III. Analysis of Specific Provisions.

A. Statutory Definition of the ESD.

Section 7701(o)(5)(A) defines the ESD as "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."[63] This statutory definition is crucial because the Codified ESD Test applies only if the ESD, as defined under the statute, is "relevant" to the transaction in question (though, as discussed below, the ESD Penalty can apply to "any similar rule of law"). Thus, how broadly or narrowly the statutory definition is ultimately construed is the principal determinant of which transactions are subject to the Codified ESD Test.

None of the House Report, the Joint Committee Report or Section 7701(o)(5)(A) itself clarifies the intended scope of the statutory definition of the ESD. In fact, the House Report observes that the statutory definition "includes *any* doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for both."[64] It is unclear whether the plain language of the statute is consistent with this statement, and this statement also cuts against other indications of Congress' views in the Reconciliation Act's legislative history. Further, Section

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62 *See, e.g.*, Comm'r v. Acker, 361 U.S. 87, 91 (1959) ("We are here concerned with a taxing act which imposes a penalty. The law is settled that 'penal statutes are to be construed strictly,' [Fed. Commc'ns Comm'n v. Am. Broad. Co., 347 U.S. 284, 296], and that one 'is not to be subject to a penalty unless the words of the statute plainly impose it,' [Keppel v. Tiffin Sav. Bank, 197 U.S. 356, 362]. *See, e.g.*, [Tiffany v. Nat'l Bank of Mo., 18 Wall. 409, 410; Elliott v. R.R. Co., 99 U.S. 573, 576].").

63 Section 7701(o)(5)(A).

64 H.R. Rep. No. 111-443, at 297 n.134 (emphasis added). JCX-18-10, at 154 n.353.

7701(o) purports not to alter or supplant any other rule of law, "including any common-law doctrine or provision of the Code or regulations or guidance thereunder."[65]

Nonetheless, given the plain language of the statutory definition, it is possible that an IRS agent could interpret Section 7701(o)(5)(A) quite broadly. Under such an approach, "the" ESD could include, for purposes of Section 7701(o), *any* doctrine under which at least one court has ruled that a transaction requires some sort of business purpose – "substantial" or not and regardless of whether such transaction has been previously thought to involve the familiar two-prong ESD analysis – in order for the consequences of the transaction to be respected for tax purposes. Any such transaction would be susceptible to attack under Section 7701(o) on audit, forcing the taxpayer to defend the transaction's tax benefits either by demonstrating that the transaction satisfies the Codified ESD Test or by arguing, for instance, that it has been respected under "longstanding judicial and administrative practice."[66] Given the nature of the ESD Penalty, one need only think of the *Cottage Savings* transaction before the Supreme Court's ruling to understand that, absent guidance, this could change the stakes for ordinary forms of traditional tax planning in ways we think were clearly not intended by Congress.

We are aware, of course, that various judge-made doctrines – the ESD, the business purpose doctrine, and the basic common-law principle of "substance over form" – are not always easy to distinguish under pre-Reconciliation Act law.[67] They are, however, in fact, distinguishable, and we do not believe that Congress intended the rubric of the ESD as codified by Section 7701(o)

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[65] H.R. Rep. No. 111-443, at 298. Previous codification proposals would have included this proviso in the statute itself. *See, e.g.*, H.R. 2046, 108th Cong. § 311.

[66] *See* H.R. Rep. No. 111-442, at 296; JCX-18-10, at 152.

[67] *See* H.R. Rep. No. 111-443, at 292 ("These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants."); JCX-18-10, at 142 (same).

to encompass these other doctrines. We believe that guidance can and should harmonize the words of Section 7701(o)(5)(A) with the underlying policy of the Codified ESD Test (*i.e.*, denying unintended tax benefits derived from "empty" transactional forms) and legislative intent.

A brief survey of Subchapter C, for instance, reveals a litany of authorities applying the step transaction doctrine or the "substance over form" principle without even attempting to evaluate the economic substance of the transaction in question.[68] None of these cases or the doctrines articulated in them should be viewed as examples of cases where the ESD was used to determine the result. Nor is this concept limited, of course, to Subchapter C. A recent example in

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[68] *See, e.g.*, Comm'r v. Court Holding Co., 324 U.S. 331 (1945) (applying substance-over-form principles in reordering the steps of a transaction formally structured as an asset sale followed by a tax-free corporate liquidation; no economic substance analysis); McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982) (applying the step transaction doctrine, in a case that predated Treas. Reg. Section 1.368-1(e), to find that post-merger sales of stock caused a merger to fail the Section 368(a) "continuity of interest" requirement; no economic substance analysis); Tribune Co. v. Comm'r, 125 T.C. 110 (2005) (applying substance-over-form principles in characterizing the disposition of a corporation's subsidiary, which had been formally structured to meet the literal requirements of Section 368(a)(1)(A) and (a)(2)(E), as a taxable sale; no economic substance analysis); Martin Ice Cream Co. v. Comm'r, 110 T.C. 189 (1998) (applying substance-over-form principles to find that a corporation's 51 percent shareholder, not the corporation itself, was taxable on gain from the sale of ice cream distribution rights; no economic substance analysis); Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025 (1976) (applying the "binding commitment" test to find a lack of Section 368(c) "control" with respect to a purported Section 351 exchange; no economic substance analysis); King Enters., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) (applying the step transaction doctrine in analyzing the acquisition of a target corporation's stock in exchange for a mix of stock and non-stock considerations, together with a subsequent merger of the target corporation with and into the acquiring corporation, as a "unified transaction" that qualified as a "Type A" reorganization; no economic substance analysis); Rev. Rul. 70-140, 1970-1 C.B. 73 (applying step-transaction principles in ruling that the incorporation of a sole proprietorship did not qualify as a Section 351 exchange because of a subsequent prearranged sale of the newly formed corporation's stock to a third party; no economic substance analysis); Rev. Rul. 67-448, 1967-2 C.B. 144 (applying step-transaction principles in ruling that the merger of a transitory subsidiary with and into a target corporation may qualify as a "Type B" reorganization if the "solely for voting stock" requirement is met; no economic substance analysis).

the Subchapter K arena is *Canal Corporation and Subsidiaries v. Commissioner*,[69] where the Tax Court found a disguised sale to have occurred because the purported indemnity written by one partner, who had hoped that the existence of the indemnity would increase its share of the partnership's liabilities under Section 752, was found to create "no actual economic risk of loss."[70]

Accordingly, we recommend that Treasury issue guidance providing that Section 7701(o)(5)(A) incorporates only the existing judicial doctrine that repudiates abusive tax results by applying a two-prong analysis – whether that is articulated by asking (i) if the transaction had an economic effect *and* whether there was a non-tax purpose or (ii) if the transaction had an economic effect *or* whether there was a non-tax purpose. (We refer to this inquiry as "Two-Prong Economic Substance Analysis.")

For instance, clarifying that the statutory definition of the ESD refers only to judge-made rules of statutory construction will sweep out a host of anti-abuse rules under the Code or the Treasury Regulations that serve other anti-abuse functions. A contrary result, we believe, is clearly at odds with the legislative intent behind the statute and would create needless uncertainty for taxpayers. For instance, placing statutory or regulatory anti-abuse rules on a par with the ESD for purposes of Section 7701(o) would fly in the face of the ESD's traditional role as a true

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[69] Tax Ct. Rep. (CCH) 58,298 2010 WL 3064428 (2010).

[70] 2010 WL 3064428, at *8. Although there may be debate about the accuracy and legitimacy of the court's analysis in *Canal Corp.,* there can be no debate about whether the court used the ESD to reach its decision. It did not cite any ESD cases and did not engage in any ESD analysis. Granted, the court did want to understand whether the indemnification agreement in question had any "economic substance," but that is a typical and normal inquiry as part of determining whether or not the purported indemnitor was to be allocated a share of the partnership's liabilities under Section 752. Having determined that the indemnity "created no more than a remote possibility that [the indemnitor] would actually be liable for payment," it was quick work for the court to determine that the indemnitor "should not be allocated any part of the debt." *Id.* at *12.

"backstop" to the Code and the Treasury Regulations, and would be a fundamental and unintended shift that is not even mentioned as a possibility in the House or JCT Reports.

This will also preclude the awkward possibility, discussed above, that "the" ESD could literally include any doctrine under which at least one court has ruled, without ever discussing or considering economic substance, that a transaction requires some sort of minimal business purpose in order for its consequences to be respected for tax purposes. We believe that Congress did not intend Section 7701(o)(5)(A) to embrace, for example, the relatively light business purpose analysis that one court has applied to otherwise garden-variety Section 351 exchanges.[71]

Furthermore, we believe that such guidance should also expressly provide that other doctrines, such as "substance over form," "adequate business purpose" and "step transaction" are not, standing alone, examples of the ESD, and instances where courts have applied such concepts (and not engaged in Two-Prong Economic Substance Analysis) are not ESD cases. This would provide a better delineation that would allow the IRS, taxpayers and judges to know with more accuracy when the ESD Penalty is to be applied, while allowing the IRS and courts to continue to invoke other doctrines that have been traditionally applied to strike down transactions with much less uncertainty about whether or not the ESD Penalty should or should not apply. In that vein, we discuss the ESD Penalty next.

B. <u>ESD Penalty and Related Disclosure Requirements</u>.

In addition to enacting Section 7701(o), the Reconciliation Act amended Section 6662 to provide a new strict-liability ESD Penalty and related disclosure requirements. These

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[71] *See, e.g.*, United States v. Caruth, 699 F.2d 1017 (9th Cir. 1983).

rules apply to transactions entered into after March 30, 2010.[72] Congress apparently believed that strong enforcement measures were necessary to encourage taxpayer compliance with Section 7701(o). According to the House Report:

> The Committee believes that a stronger penalty under Section 6662 should be imposed on understatements attributable to noneconomic substance and similar transactions, to improve compliance by deterring taxpayers from entering such transactions. The Committee is concerned that under present law there is a potential to avoid penalties in such cases (based for example on certain levels of tax advice), and that the potential that a taxpayer in such cases may pay only the tax due plus interest is not a sufficient deterrent. The Committee therefore believes it is appropriate to impose a new strict-liability penalty in such cases.[73]

Under new Section 6662(b)(6), the 20 percent accuracy-related penalty of Section 6662(a) will now apply to any understatement attributable to "any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (as determined under Section 7701(o)) or failing to meet the requirements of any similar rule of law."[74] Nearly all previous codification proposals included comparable enforcement measures and would have imposed some sort of heightened penalty on a similar class of transactions.

The legislative history of the Reconciliation Act makes it clear that taxpayers are truly strictly liable for the ESD Penalty. For instance, according to the House Report:

> No exceptions (including the reasonable cause rules) to the penalty are available (*i.e.*, the penalty is a strict-liability penalty). Thus, under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a

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72 H.R. Rep. No. 111-443, at 305.

73 *Id.* at 304.

74 *But see* The Growing Our Manufacturing Employment Act of 2004, S. 2155, 108th Cong. § 301 (2004) (no penalty provisions); The Dayton Fair Tax Cut Act of 2003, S. 135, 108th Cong. § 411 (2003) ("A disallowance is [subject to the penalty] if such disallowance is on account of . . . a lack of economic substance (within the meaning of section 7701(n)(1)) for the transaction giving rise to the claimed benefit . . . a lack of business purpose for such transaction or because the form of the transaction does not reflect its substance, or . . . a failure to meet the requirements of any similar rule of law.").

penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law.[75]

To this end, the Reconciliation Act also amended Section 6664(c) to provide that the "reasonable cause" exception of Section 6664(c)(1) will not apply to any portion of an underpayment attributable to one or more transactions subject to the ESD Penalty.[76] Similarly, the Reconciliation Act amended Section 6676 to provide that an excess refund claim attributable to any transaction subject to the ESD Penalty will not be treated as having a reasonable basis under Section 6676(a).[77]

The scope of Section 6662(b)(6) needs to be as clear as possible in order to provide taxpayers with fair notice and limit, to an appropriate degree, the ability of field-level IRS agents to assert the ESD Penalty. Unfortunately, the intended reach of the ESD Penalty is unclear from the amended statutory text of Section 6662. Particularly troubling, we believe, is the inherent elusiveness of the phrase "any similar rule of law," which is underscored by certain inconsistencies in the Reconciliation Act's legislative history. For instance, the House Report observes that the ESD Penalty "would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is [sic] required under the provision for an economic substance analysis, even if a different term is used to describe the penalty."[78] This language differs from the corresponding footnote in the Joint Committee Report, which refers more broadly to the application of "similar" (not necessarily "the same") factors and analysis.[79] The House Report also omits language from the Joint Committee's technical explanation of the 2003 Proposal indicating

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[75] H.R. Rep. No. 111-443, at 304.

[76] § 6664(c)(2).

[77] § 6676(c).

[78] H.R. Rep. No. 111-443, at 304 n.161.

[79] JCX-18-10, at 155 n.359.

that Congress' primary focus was on other judge-made doctrines.[80] Given these uncertainties, it is unclear whether the IRS could impose the ESD Penalty with respect to a transaction that fails, for instance, a statutory or regulatory anti-abuse rule that is not the historic ESD or the Codified ESD Test going by another name.[81]

Under new Section 6662(i), the ESD Penalty is increased, from 20 percent to 40 percent, in the case of any portion of an underpayment attributable to "one or more nondisclosed noneconomic substance transactions."[82] For these purposes, the term "nondisclosed noneconomic transaction" includes any portion of a transaction described in Section 6662(b)(6) (*i.e.*, any transaction lacking economic substance, as determined under Section 7701(o), or failing to meet the requirements of any similar rule of law) "with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return."[83]

Thus, whether the increased 40 percent ESD Penalty applies with respect to a particular transaction turns on the concept of "adequate" taxpayer disclosure. Neither the House Report nor Section 6662(i) itself indicates what constitutes adequate taxpayer disclosure for

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[80] *See* JCX-47-03, at 110 ("For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.").

[81] To be sure, the failure of a court to recite talismanic phrases should not prevent the application of Section 6662(b)(6) if the substance of the analysis focuses on the core questions of the ESD – *i.e.*, whether there is sufficient economic effect and a sufficient non-tax purpose for the transaction.

[82] Section 6662(i)(1). At least structurally, this approach differs from most previous codification proposals, which would have made 40 percent the default rate and decreased it to 20 percent only if the taxpayer complied with the applicable disclosure requirements. Section 6662(i) flips the burden of inertia in the taxpayer's favor.

[83] Section 6662(i)(2). For these purposes, except as provided in Treasury Regulations, an amended tax return (or a supplement to a tax return) will not be taken into account if filed after the taxpayer has been contacted for audit (or such other date as is specified by Treasury). *See* Section 6662(i)(3); H.R. Rep. No. 111-443, at 304.

purposes of the new ESD Penalty provisions.[84] However, because the language of Section 6662(i) tracks that of Section 6662(d)(2)(B),[85] we believe that the new provision should be interpreted in a manner that is consistent with Treasury's administration of the substantial understatement penalty under Section 6662(b)(2).

The Reconciliation Act did not codify a comprehensive scheme for administering the ESD Penalty. By contrast, the 2007 Proposal included a number of express administrative rules, including a chain-of-command system for reviewing and approving an IRS agent's assertion and compromise of the ESD Penalty. The Senate Finance Committee's report on the 2007 Proposal summarized these provisions as follows:

> Regardless of whether the transaction was disclosed, a penalty under the provision cannot be asserted until there has been a review and approval by the Chief Counsel of the Internal Revenue Service (or, if so delegated, a branch chief within the office of Chief Counsel) and the taxpayer has had the opportunity to submit a written statement in connection with the review. Once the penalty has been asserted following such National Office review, the penalty cannot be compromised for purposes of a settlement without approval of the Chief Counsel (or, of so delegated, a branch chief within the office of Chief Counsel). The penalty can be compromised in such event only to the extent the underlying understatement with respect to which it was asserted is also compromised.[86]

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[84] By contrast, and uniquely, the 2000 Proposal included a number of detailed statutory rules with respect to the adequacy of such disclosure. Specifically, the taxpayer would have been required to disclose to the IRS "appropriate documents describing the transaction" within 30 days after closing, as well as submit various materials with the its tax return, including "a detailed description of the facts, assumptions of facts, and factual conclusions with respect to the business or economic purposes or objectives of the transaction that are relied upon to support the manner in which it is reported on the return." H.R. 2255, 106th Cong. § 4 (2000).

[85] Section 6662(d)(2)(B)(ii)(I) provides that, for purposes of the substantial understatement penalty under Section 6662(b)(2), the amount of an understatement is reduced by any portion of the understatement attributable to any item if "the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return," so long as there is a reasonable basis for the taxpayer's treatment of the item.

[86] S. Rep. No. 110-206, at 100-101 (2007).

Other previous codification proposals contained similarly detailed administrative rules.[87] Although Congress ultimately decided not to codify a comprehensive administrative scheme, we believe that Treasury can (and should) promulgate such rules as quickly as practicable, at least on an interim basis.

We recommend that Treasury issue guidance addressing these important substantive and procedural aspects of Section 6662(b)(6) and (i). Perhaps most importantly, such guidance should clarify the meaning of the phrase "any similar rule of law" in Section 6662(b)(6). Specifically, we propose that the ESD Penalty not be assertable:

- on or with respect to a denial of tax benefits under any provision of statutory or regulatory law (*e.g.,* Section 269, the partnership anti-abuse rule of Treas. Reg. Section 1.701-2, or the original issue discount anti-abuse rule of Treas. Reg. Section 1.1275-2(g)), unless the lack of economic substance is independently determined; or

- with respect to any transaction to which the ESD (as defined in Section 7701(o)(5)(A)) is considered not relevant for purposes of the Codified ESD Test.

Further, we recommend that Treasury clarify that:

- a similar rule of law is only one where the Traditional Two-Prong ESD analyses has been applied (regardless of the labels employed by the court); and

- other non-statutory doctrines that do not repudiate abusive tax results by virtue of the underlying transaction's fundamental lack of economic substance (*e.g.,* "step-transaction" or "substance-over-form" recharacterization) are not similar rules of law.

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[87] *See, e.g.*, S. 1321, 109th Cong. § 802 (2005-06) ("If the 1st letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals has been sent with respect to a penalty to which this section applies, only the Commissioner of Internal Revenue may compromise all or any portion of such penalty."); S. 2210, 108th Cong. § 303 (2003-04) ("The exercise [of the Commissioner's authority to compromise the penalty] shall be at the sole discretion of the Commissioner and may be delegated only to the head of the Office of Tax Shelter Analysis. The Commissioner, in the Commissioner's sole discretion, may establish a procedure to determine if a penalty should be referred to the Commissioner or the head of such Office for a determination [as to a potential compromise] . . . . Notwithstanding any other provision of law, any determination [as to a potential compromise] may not be reviewed in any administrative or judicial proceeding.").

Finally, at least until sufficiently detailed substantive guidance is issued, we believe that Treasury should establish procedures to ensure that the ESD Penalty is not asserted inappropriately. Accordingly, although we are encouraged by the rule reflected in LMSB-20-0910-024 requiring IRS Director of Field Operations approval for assertion of the ESD Penalty, we think that National Office-level coordination is needed. Hence, we recommend that Chief Counsel's office review and approve each assertion of the ESP and the ESD Penalty.

Finally, we agree with Treasury guidance in Notice 2010-62 aligning the disclosure requirements of Section 6662(i) with Treasury's administration of the substantial understatement penalty of pre-Reconciliation Act Section 6662(d)(2)(B) (without regard to Section 6662(d)(2)(C)) and that disclosure is to be made on Form 8275 or 8275R.

Notice 2010-62 provides that:

> If a disclosure would be considered adequate for purposes of section 6662(d)(2)(B) (without regard to section 6662(d)(2)(C)) prior to the enactment of section 1409 of the [Reconciliation] Act, then it will be deemed to be adequate for purposes of section 6662(i). The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS consistent with the instructions and other guidance associated with those subsequent forms, publications, or other guidance. Disclosures made consistent with the terms of Rev. Proc. 94-69 also will be taken into account for purposes of section 6662(i).[88]

We would recommend, however, that Treasury issue additional guidance that specifies that disclosure will be deemed adequate for purposes of Section 6662(i) if it supplies the information required by Revenue Procedure 2010-15.[89] These simple proposals, which we believe would make the ESD Penalty more administrable, should help to ensure that taxpayers are not compelled

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[88] Notice 2010-62.

[89] 2010-7 I.R.B. 404.

to disclose why a specific item is being disclosed – which, given the context, would effectively be an admission that the transaction in question is subject to Section 7701(o) on the merits.

C. Statutory "Relevance" Limitation.

Crucially, under Section 7701(o)(1), the Codified ESD Test applies only if the ESD is "relevant" to the transaction in question. Thus, the concept of relevance acts as a critical governor on the potentially overbroad application of the ESD, (and hence the ESD Penalty), beyond where intended. Similarly, under the 2007 Proposal, the Codified ESD Test would have applied only "[i]n any case in which *a court determines that* the economic substance doctrine is relevant for purposes of this title to a transaction."[90] Thus, the applicability of the Codified ESD Test would have been contingent on a judicial determination regarding the relevance of the ESD to the transaction. In contrast to both of these approaches, the 2003 Proposal apparently would have applied to *all* transactions, regardless of whether the type of transaction in question had ever invited judicial scrutiny under the traditional concept of the ESD (or any other rule of law, for that matter).

Section 7701(o) provides that the determination of whether the ESD is relevant to a transaction must be made in the same manner as if the statute had never been enacted.[91] In this connection, the Reconciliation Act's legislative history provides a number of helpful interpretive insights. For instance, according to the House Report, Section 7701(o) "does not change current law standards in determining when to utilize an economic substance analysis."[92] Instead, if the tax benefits in question are "clearly consistent" with all applicable provisions of the Code, as well as

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[90] S. 2242, 110th Cong. § 511; *see also* S. 1321, 109th Cong. § 801 (similar language).

[91] Section 7701(o)(5)(C).

[92] H.R. Rep. No. 111-443, at 295-96; *see also* JCX-18-10, at 152.

the purposes of such provisions, "it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine."[93]

The House Report also observes that the enactment of Section 7701(o) will not affect the status of certain basic transactions that have traditionally not been considered subject to the ESD:

> The new provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (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 in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[94]

Significantly, the House Report emphasizes that the foregoing list of transactions is illustrative and not exclusive.[95] Indeed, at a minimum, it appears that Congress has given Treasury an opportunity to give guidance that clarifies the limits of Section 7701(o).[96] We understand that one version of such an exercise – formulating a so-called "angels list" of transactions or types of

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[93] *Id.* at 296 n.124 (citing Treas. Reg. § 1.269-2). This language differs from the corresponding footnote in the Joint Committee Report: "If 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 . . . . Thus, for example, it is not intended that a tax credit . . . be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage." JCX-18-10, at 152 n.344.

[94] H.R. Rep. No. 111-443, at 296 (citations omitted); *see also* JCX-18-10, at 153.

[95] H.R. Rep. No. 111-443, at 296 n.125; *see also* JCX-18-10, at 152 n.345.

[96] Previous codification proposals would have specifically authorized Treasury to issue exemptions from the Codified ESD Test. *See, e.g.*, S. 1321, 109th Cong. § 801 ("The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection. *Such regulations may include exemptions from the application of this subsection*." (emphasis added)).

transactions that are *per se,* or even presumptively, exempt from attack under Section 7701(o) – is fraught with difficulties. Categorical exemptions from the Codified ESD Test risk being misused by overly optimistic (or overly aggressive) taxpayers that might take enumerated items out of context or exploit unintended ambiguities. Of course, such exemptions also risk being so under-inclusive or simplistic as to be useless, and they can also create unwarranted negative implications about transactions not specifically covered by the exemptions. On the other hand, given the statute's drafting ambiguities and the strict-liability penalty, we do recommend that Treasury take some steps to guide taxpayers and the IRS.

As part of our 2003 Report, we provided an illustrative list of transactions that we, as practitioners, considered essentially uncontroversial under the traditional conception of the ESD, but that could have been swept within the reach of (and would likely have flunked) the 2003 Proposal's version of the Codified ESD Test.[97] Unlike the enacted version of the Codified ESD Test, the 2003 Proposal's version appeared to have almost unlimited application. By contrast, the enacted version of the Codified ESD Test applies only if the ESD is relevant to the transaction in question, a limitation that we believe Congress intended to have real consequences. We believe that Treasury and the IRS can and should exercise their regulatory authority under Section 7701(o) to explain the principles behind, and the limits to, Section 7701(o).

We recommend that Treasury set forth a few principles identifying broad categories of transactions to which the ESD (as defined in Section 7701(o)(5)(A)) will not be considered relevant. We believe that this approach finds ample support in both the legislative history of the Reconciliation Act and Section 7701(o) itself. The House Report indicates that

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[97] The examples from the 2003 Report are attached hereto as Appendix 1. We believe that the examples continue to be transactions to which the ESD is not "relevant" within the meaning of Section 7701(o).

Congress intended Treasury and the IRS to have broad powers to implement Section 7701(o), and the "relevance" limitation of Section 7701(o)(1) invites explanation. To be clear, Treasury would not be ruling that the transactions covered by such principles generate unassailable tax results, rather, this guidance would merely make it clear that such transactions cannot be attacked using Section 7701(o) and the strict-liability penalty of Sections 6662(b)(6) and (i). The proper conceptual approach to this guidance should reflect certain common sense principles that we believe will ultimately make Section 7701(o) more administrable. We propose that these principles be expressly included in Treasury's guidance. This guidance could be supplemented with specific examples.

- First, the guidance should clarify that all tax elections granted to taxpayers under the Code or the Treasury Regulations are exempt from scrutiny under Section 7701(o). These "transactions" can have neither economic substance nor any sort of business purpose, apart from achieving a desired set of tax results.[98] Further, all acts that can be accomplished by such an express election should similar be beyond challenge under Section 7701(o).[99] Nevertheless, of course, in appropriate situations, *e.g.*, when the overall result is inconsistent with Congressional intent, a court could hold that the ESD is relevant to a series of transactions that includes one or more of these sorts of elections.

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[98] *See* Robert Cassanos, *Economic Substance, Business Purpose, and Tax Elections*, Tax Forum No. 578, at 5 (Nov. 1, 2004) ("By definition, tax elections are tax-motivated. They have no business purpose. They have no economic substance. Therefore, a tax election should never be tested against a 'purpose' or 'substance' standard. The existence of a tax election is, in practice, a declaration by the taxing authority that it has little or no stake in the tax characterization of the transaction or entity in question, so it is in effect formally or informally delegating the choice of that characterization to the taxpayer.").

[99] For example, if a taxpayer were to form an entity that is a *per se* corporation under Reg. Section 301.7701-2 and then decide to convert it under state law to an LLC where it would default to status as a disregarded entity, that process should not be treated any differently than if the taxpayer had formed an LLC, initially elected to have it be treated as a corporation and later elected to have it treated as a disregarded entity under Reg. Section 301.7701-3. The first change is accomplished by means of an affirmative act and a default classification and obviously would require more "effort" than the second which is simply two tax elections and has some non-tax consequences. Nonetheless, analytically, both are equivalent for federal income tax purpose and one should not be favored over the other. Hence, they should be judged by the same standards.

- Second, consistently with the legislative history, the guidance should clarify that the ESD is not relevant if the tax benefits arise in circumstances that are clearly consistent with the provisions and purposes of the Code or Regulations. To supplement that clarification, guidance could clarify situations where the ESD *is* relevant; for example, among other circumstances, where tax benefits are generated in a way that, although it satisfies the technical or literal requirements of the Code or Regulations, the result is to shelter or offset income generated by one or more unrelated transactions and the circumstances are such that Congress or Treasury could not reasonably have intended the benefits to be available under the relevant provisions of the Code or Regulations.

Obviously, to help prevent abuse, we would expect the Treasury and the IRS to monitor taxpayer behavior and judicial decisions and to update their guidance accordingly.

D. Codified ESD Test.

If applicable, the Codified ESD Test provides that a transaction will be treated as having economic substance only if:

- the transaction changes the taxpayer's economic position "in a meaningful way" (apart from federal income tax effects) (the "Economic Effect Test"),[100] and
- the taxpayer has a "substantial purpose" for entering into the transaction (apart from federal income tax effects) (the "Substantial Purpose Test").[101]

Clarifying that the statutory version of the ESD involves a conjunctive analysis was, as noted earlier, one of the driving forces behind Section 7701(o). According to the House Report:

> The provision clarifies that the economic substance doctrine involves a conjunctive analysis – there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's

[100] *See* Section 7701(o)(1)(A).

[101] *See* Section 7701(o)(1)(B). Section 7701(o) contains a few miscellaneous rules that supplement Section 7701(o)(1) and govern whether certain specific items are taken into account for purposes of the Codified ESD Test. These provisions include Section 7701(o)(2), discussed below, which governs when a transaction's profit potential may be taken into account under the Codified ESD Test; *see also* Section 7701(o)(4) (providing that, for purposes of the Substantial Purpose Test, achieving a financial accounting benefit will not be treated as a purpose for entering into a transaction if the financial accounting benefit originates from a reduction of federal income tax); Section 7701(o)(3) (providing that, for purposes of both prongs of the Codified ESD Test, any state or local income tax effect that is "related" to a federal income tax effect will be treated in the same manner as the latter).

> subjective motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests . . . in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the Federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.[102]

Consistent with pre-Reconciliation Act law, the House Report makes it clear that the Economic Effect Test involves an "objective" inquiry, and that the Substantial Purpose Test involves a "subjective" inquiry. We think these two inquiries are but two sides of a single coin.[103] That is, these tests are "simply more precise factors to consider" in determining "whether a transaction has any practical economic effects other than the creation of tax benefits."[104] Section 7701(o)(2) now provides that the taxpayer can satisfy this standard (*i.e.*, the two "prongs") if it satisfies the Profit Potential Test, notwithstanding the existence of evidence that it took taxes savings into account in entering into the transaction.

Thus, Section 7701(o)(2) puts crucial importance on the Profit Potential Test. A transaction that is relying on profit potential and that fails the test will fail the ESD unless the taxpayer can make the difficult showing that the result of the transaction is clearly intended by Congress. On the other hand, a transaction that satisfies the test is automatically protected from

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[102] H.R. Rep. No. 111-443, at 297; *see also* JCX-18-10, at 153-54.

[103] The Second Circuit used this approach in *Goldstein.* As the court said in its conclusion:

> On the other hand, and notwithstanding Section 163(a)'s broad scope[,] this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction: and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential.

Goldstein v. Comm'r, 364 F.2d 734, 741-42 (2d Cir. 1966).

[104] H.R. Rep. No. 111-443, at 293 n.112.

application of the ESD, even if the result of the transaction is clearly inconsistent with the intent of Congress. It is therefore critical to draw the line in a reasonable place.

E. Profit Potential Test.

As the foregoing notes, setting out the Economic Effect Test and the Substantial Purpose Test as two separate tests is merely a way of stating the complicated question at the heart of the ESD that attempts to distinguish legitimate, mixed-motive transactions from illegitimate, solely tax-motivated ones.[105] Unfortunately, as far as we can tell, the "Profit Potential Test" provided by Section 7701(o)(2) created something rather more or very much less than a mere clarification.

Although it is clear that if the taxpayer does choose to rely on the transaction's profit potential to satisfy either or both of the Economic Effect Test and the Substantial Purpose Test, the profit potential will be taken into account 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.[106] Beyond this point, however, very little about the Profit Potential Test is clear.

1. Background.

Section 7701(o)(2)(A), establishing the Profit Potential Test, reads:

> The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of

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[105] *See, e.g.*, Yosha v. Comm'r, 861 F.2d 494, 497 (7th Cir. 1988). *See also* Zmuda v. Comm'r, 731 F.2d 1417, 1421 (9th Cir. 1984) ("[T]he Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation."); ASA Investerings P'ship v. Comm'r, 201 F3d 505, 513 (D.C. Cir. 2000) (same) (citing *Zmuda*).

[106] Section 7701(o)(2)(A).

the expected net tax benefits that would be allowed if the transaction were respected.

As a guide to understanding the mathematical computations required under the Profit Potential Test, this statutory profit requirement could be understood as Congress' desire to set a more uniform rule than existed previously, for measuring the (non-tax) profit potential in relevant mixed-motive transactions. Under this interpretation, these transactions should generally be respected if the transaction affects the taxpayer's beneficial interest "enough," other than just by reducing its taxes.[107] The Supreme Court's decision in *Frank Lyon Co. v. United States*[108] is consistent with this: a transaction has economic substance when it is "compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[109] Hence, the interpretation would conclude, to determine whether profit potential appreciably affects the taxpayer's beneficial interest, *i.e.*, sufficiently embodies tax independent considerations, Congress has clarified that the reasonably expected pre-tax profit must be *substantial* in relation to expected net tax benefits, after the profit and tax benefits are discounted to present value. Even if this

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[107] *See generally Smith*, *supra* note 16, at 1, 4, 22. This approach, however, arguably was ignored (or rejected without comment) in the decision in *Altria Group v. United States,* 694 F. Supp. 259 (S.D.N.Y. 2010), where a district court permitted a jury to take the taxpayer's cost of funds into account in finding that the taxpayer was motivated solely by tax avoidance when it entered into LILO and SILO transactions that had an expected pre-tax rate of return that was lower than such cost of funds. *Id.* at 285 ("[T]he factfinder might conclude from the fact that a transaction is cashflow negative on a pretax basis that the tax avoidance was the primary, perhaps the only, factor motivating the transaction.").

[108] 435 U.S. 561 (1978).

[109] *Id.* at 583-84. By definition, the Mixed-Motive Principle historically has, in general, allowed taxpayers to enter into transactions that would not be attractive "but for" the availability of tax benefits. As the Supreme Court stated in *Frank Lyon*, "[t]he fact that favorable tax consequences were taken into account by [taxpayer] Lyon on entering into the transaction is no reason for disallowing those consequences." *Id.* at 580.

approach is correct, however, Congress provided no guidance as to what the appropriate present value methodology is for this purpose and as we have discussed above, existing case law is of little help.

Although, as we discuss below, the words of Section 7701(o)(2) are far from self-executing, very generally, we think, in enacting Section 7701(o)(2), that Congress was saying that to rely on the Profit Potential Test in situations where the ESD is relevant (*i.e.*, the tax benefits are not manifestly "clearly consistent" with all applicable provisions of the Code and their purposes), then the tax benefits should be permitted only where there was a reasonable expectation that, on a time value basis, the taxpayer would earn a positive return, not counting tax benefits. In addition, to distinguish the new test from some prior courts' decisions, the new statutory test also mandates that the return (on a time value basis) must be substantial in comparison to the expected federal income tax benefits. Hence, in a very rough way, we think one could say that the Profit Potential Test means to ask "Is there meaningful profit to be expected?" – while also understanding that it is the value of the tax benefits that move the transaction from "meaningfully" profitable to "much more" profitable. Beyond this rough paraphrasing, however, lies confusion and disagreement.

Practitioners and commentators have long understood that the question of whether (and in what way) time value of money should be taken into account in assessing a transaction's profit potential poses a conceptual conundrum at the core of the ESD. If future pre-tax cash flows must be discounted at a fixed rate, for example 6% per annum, then an investment that has a per annum expected pre-tax IRR that is lower than that discount rate, as it will have a negative net present value, must be seen as having no pre-tax profit potential. On the other hand, a transaction with, for example, a 2%, 3% or 4% expected pre-tax IRR might very well pass muster under the

pre-Section 7701(o) ESD on the ground that, in keeping with *Frank Lyon*, pre-tax IRR of that size constitutes a substantial economic interest that proves the transaction is not shaped and motivated solely by tax avoidance. Courts have unquestionably decided that a pre-tax profit is required for cash flows that do not need to be discounted, but at the same time, many courts and taxpayers have understood that setting the requisite economic return as applied to future cash flows is necessarily arbitrary and raises some basic tax policy concerns.[110] Without guidance from Treasury or the IRS, it seems unclear whether or not Section 7701(o), although clarifying that time value concepts must be used, has settled the most fundamental aspect of this conundrum.

The disagreement over exactly how to apply the Profit Potential Test can be summarized as follows:

- The PV of Profit Approach: This interpretation would argue that the statute makes most sense, in the context of the Mixed-Motive Principle, including Supreme Court cases like *Frank Lyon*, and the House and Joint Committee Reports' explanation that no minimum return is required or established to satisfy the Profit Potential Test, if it is applied literally: calculate reasonably expected pre-tax profit (*i.e.*, net cash flow in excess of expenses) on an undiscounted basis, discount it to present value, do the same for the expected tax benefits, and compare the former to the latter. If the former (the present value of the reasonably expected pre-tax profit) is substantial in comparison to the latter (the present value of the expected tax benefits), then the Profit Potential Test is passed; if not, it is failed. Literalism is, however, not always (or perhaps even usually) the best approach to interpreting an anti-abuse rule, and certainly is not compelled in this case.[111]

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[110] *See generally* Alvin C. Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985, 987 (1981). To establish this point, Professor Warren reasoned, "[the requirement of a full market, pre-tax return] is logically incoherent because it ignores the fact that capital markets will take preferential tax treatment into account in setting relative prices." *Id.* at 987. In investment transactions motivated by financial returns, moreover, a taxpayer's overall cost of funds rate will typically be less than its expected after-tax yield. If a profit must be substantial compared to tax benefits, then after allocating the cost of funds, the required profit could easily approximate or exceed a full market return.

[111] To illustrate the PV of Profit Approach, we can take a simplified example: assume an initial investment of $100 with no other cash flows other than an expected return of $117 at the end of year 5. This investment has an approximate IRR of 3.19% per annum. If the $17 of profit is

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versus

- The Net Present Value Approach: Given the explicit introduction of present value principles in the statute itself, an alternative interpretation is to treat a transaction as "profitable" only if the net present value ("NPV") of the cash flows from the transaction is positive. A transaction would therefore satisfy the Profit Potential Test only if the NPV of all pre-tax cash flows is "substantial" relative to the NPV of the expected tax benefits. This approach, of course, does effectively require the return to be greater than the discount rate, though the choice of that rate may vary from case to case, with no minimum set, because any return that does not exceed the discount rate will end up generating a negative net present value and will, hence, automatically fail the Profit Potential Test. On the other hand, it has the advantage of simplifying most if not all of the issues relating to imputation of indirect financing costs.[112]

Before we turn in depth to the discussion of the two approaches, however, we think the question of transaction expenses needs to be addressed. That is, regardless of whether one adopts the PV of Profit or the Net Present Value Approach, one has to determine what the negative cash flows of the transaction are. The principal cost of any transaction is likely to be financing costs, and hence we address those next. After one determines the financing costs and other transaction costs that should be treated as negative cash flows, the question of discounting and the rate at which to discount can be addressed.

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discounted at 1.99%, which is 130% of the mid-term AFR (annual compounding) for December 2010, the present value is \$15.40 (*i.e.*, $17/(1.0199)^5$). If the \$17 of profit is discounted at 6%, the PV is approximately \$12.70 (*i.e.*, $17/(1.06)^5$). Obviously, if one reduced the profit to charge for direct or indirect costs of capital, and if the costs so charged exceeded \$17 (representing a cost of capital at the IRR of 3.19%), the undiscounted and discounted profits would both be negative.

[112] Using the same simplified cash flows as in the example *supra* at note 111, if the discount rate used to determine the PV of cash flows were less than 3.19%, the \$117 of cash flow would have a PV of more than \$100 and the transaction would have a net profit. However, if the discount rate was 3.19% or higher, then the \$117 of cash flow would have a PV of \$100 or less, there would be no net profit and the transaction would *per se* fail the Profit Potential Test. For example, using a 6% discount rate, the PV of the \$117 cash flow is $117/(1.06)^5$, or \$87.43, resulting in a pre-tax loss of-12.57.

2. Which Financing Costs Should Be Treated as Expenses?

Conceptually, the first issue in respect of the Profit Potential Test is which costs are reflected in the determination of profits. The statute provides that "fees and other transaction costs" are taken into account in determining pre-tax profit. When are financing costs, which often are the largest costs that may be considered "transaction costs," to be treated as such for purposes of the Profit Potential Test? The legislative history provides no guidance on this issue.

If Congress intended the Profit Potential Test to be satisfied only in the case of transactions that are expected to generate a positive NPV in accordance with the Net Present Value Approach, then it may have intended to impute a portion of the taxpayer's total aggregate financing costs to *every* transaction (similar, for example, to the allocation of interest expense under the uniform capitalization rules of Section 263A). A Net Present Value Approach typically discounts future cash flows at the taxpayer's cost of funds, which can include its cost of equity capital, even if the taxpayer funded the transaction in question on a debt-free basis; however, the Net Present Value Approach also could be applied by discounting at a different rate, as a court may determine is appropriate.

If Congress instead intended the Present Value of Gross Profit Approach, it is not clear whether financing costs should be treated as transaction expenses only when directly incurred in the transaction or whether *all* transactions must have the taxpayer's implicit cost of funds treated as a transaction expense.

Relying on the case law, with no further guidance, to divine which financing costs to be taken into account for purposes of the statutory Profit Potential Test does not seem to us the proper answer. For many years, courts did not impute a cost of capital, whether debt or equity, as an item of expense when looking to see if a transaction was entered into with an adequate profit

potential.[113] In *Casebeer v. Commissioner*,[114] the Ninth Circuit held that interest on recourse purchase money notes, which were incurred to finance computer lease transactions and secured by the leased equipment, was properly taken into account for purposes of calculating the leases' pre-tax profit potential. The court rejected – apparently as a factual matter – the taxpayers' argument that their decision to incur recourse indebtedness "was based on an analysis of their entire portfolio rather than on isolated transactions," instead finding that the notes constituted an "element" of the leases.[115]

With similar effect, but a divergent analysis, in *Wells Fargo & Co. v. United States*,[116] the Court of Federal Claims held that various "sale-in-lease-out" or "SILO" transactions did not satisfy the ESD, among several other grounds for disregarding those transactions. For purposes of calculating the pre-tax profit potential of the SILO transactions, the court effectively took the taxpayer's overall cost of capital into account.[117] The approach espoused in *Wells Fargo* if applied broadly, would represent a fundamental change in this area. As discussed in Section

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[113] Generally, as discussed in Section II(A) above, prior to the Third Circuit's decision in *ACM Partnership,* courts had declined to apply discount rates that reflected prevailing interest rates. For example, in Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995), the Ninth Circuit, in reversing the Tax Court, said (albeit without further analysis) that an investor is not "bound to discount the future at the rate the Commissioner thinks prudent." *Id.* at 991 (citing Hilton v. Comm'r, 671 F.2d 316 (9th Cir. 1982)). By both implication and practice, this restraint extended to the use of discount rates based on the taxpayer's allocable funding costs.

[114] 909 F.2d 1360 (9th Cir. 1990).

[115] *Id.* at 1366.

[116] 91 Fed. Cl. 35 (2010), *appeal docketed*, No. 2010-5108 (Fed. Cir. Apr. 16, 2010).

[117] *See id.* at 82 ("Wells Fargo's cost of funds alone turns the SILOs into a losing proposition . . . . [A]side from the net present value analysis and the lengthy deferral of payments . . . there was no reasonable possibility of profit from the SILOs simply because the expected non-tax investment return was less than Wells Fargo's cost of funds."); *see also* Altria Group, Inc. v. United States, 694 F. Supp. 2d 259, 284 (S.D.N.Y. 2010) (observing that, for purposes of measuring pre-tax profit potential, "[p]resent value analysis . . . seeks to determine whether an investment's expected returns exceeds [sic] the costs of pursuing the investment, including the investor's cost of capital").

II(C) above, it is not at all clear from the legislative history that Congress rejected (or endorsed) this approach; nor is it clear whether this result will be upheld on appeal.[118]

In any event, we think that there is a noncontroversial starting point. At a minimum, financing costs directly related to a project should be taken into account, including, for example, costs associated with debt secured by relevant property or incurred by a special purpose vehicle used for the transaction or series of transactions. In fact, there is long-standing administrative precedence for adopting the "directly related" concept as the definitive requirement: since 1975, the IRS's guidance on advance rulings for leveraged leases have required only that "direct costs to finance" an equity investment are to be taken into account.[119] (The leasing guidance, of course, is not an interpretation of the Potential Profit Test, or even the ESD more broadly, despite occasional taxpayer arguments to the contrary.)

The further question of whether expenses of a general and unrelated nature, such as a business' overall cost of capital, including both debt and equity, should be treated as expenses of

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[118] A review of the record in the case and some of the briefs submitted by the parties indicates that the court in *Wells Fargo* was taking into account the taxpayer's cost of debt capital as if the investment was fully debt financed, without regard to how the taxpayer actually financed the investment. First, it is clear that in comparing the bank's anticipated pre-tax return to its "cost of funds for the leasing business," *Wells Fargo*, 91 Fed. Cl. at 82, the court was referring only to the leasing business's cost of debt capital, not its cost of debt and equity capital. Johnson Transcript at 1850-54, *Wells Fargo,* 91 Fed. Cl. 35 (No. 06-628T). Second, as evidence of that business's cost of debt capital, the court relied upon an internal bank document that the taxpayer's witness testified was used to price its desired yield spread over its cost of funds, Johnson Transcript at 1850-54, *Wells Fargo*, 91 Fed. Cl. 35 (No. 06-628T), and that those costs were assumed to be the bank's costs "of borrowing to directly match the maturity and repayment schedules of various loans." Defendant's Exhibit No. 526 at 1, *Wells Fargo*, 91 Fed. Cl. 35 (No. 06-628T). However the taxpayer's reply brief in the appeals case points out that the government's expert testified that he could find no evidence that any matched funding was ever implemented for the transaction. Reply Brief for Plaintiff-Appellant at 35-36, Wells Fargo v. U.S., No. 06-CV-628 (Fed. Cir. Aug. 23, 2010); Lys Transcript at 4583-84, *Wells Fargo*, 91 Fed. Cl. 35 (No. 06-628T).

[119] Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, § 4.06(1), *superseding* Rev. Proc. 75-21, 1975-1 C.B. 15.

the transaction when examining a mixed-motive transaction is more difficult. In the interests of transparency and fair tax administration, we encourage Treasury and the IRS to articulate a workable standard for when indirect financing costs will be taken into account for purposes of the Profit Potential Test.

Given that nothing in the statutory formulation of "fees and other transaction expenses" expressly includes the cost of financing and the legislative history is silent, one approach would be to read covered "transaction expenses" narrowly and to clarify that only where such costs are directly connected to the transaction in question should they be taken into account for purposes of the Profit Potential Test. Under this approach, the taxpayer would have to demonstrate, under general principles of tax law, that it did not incur the financing costs in connection with, or for the purpose of financing, the transaction in question. In applying this standard, only if the taxpayer has incurred *specific* costs to fund the transaction (and, if the planning is successful, generate the desired tax benefits) should the costs reduce the pre-tax profit. Under this approach, it may be instructive to consider the attribution standards in Sections 246A, and 265(a)(2), as well as the IRS's lease ruling practice, to determine when the funding may be incurred for the purpose of investing in the transaction subject to ESD scrutiny (the "Relevant Investments").[120] The "directly attributable" standard of Section 246A(d)(3)(A) (though there based on the legislative history), is used to attribute indebtedness to the purchase or carrying of portfolio stock otherwise eligible for a favorable dividends-received deduction, which was enacted to prevent the abuse of taxpayers deducting interest expense on attributable indebtedness against

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[120] We fully recognize that Sections 246A and 265(a)(2) are not clear analogies to the "transaction cost" determination for the Profit Potential Test. Each of those Code sections includes, as part of their statutory language, general attribution principles (*e.g.,* "directly attributable to" and "for the purpose of"), as well as exceptions for debt expenses related to non-"portfolio" investments.

largely untaxed dividends.[121] One might also look to the authorities under the "incurred or continued to purchase or carry" standard of Section 265(a)(2), given that the purpose of that standard is to prevent tax-exempt income from being funded by a deduction-generating source.[122]

Under this approach, Treasury and the IRS might also consider a variety of authorities interpreting Sections 246A and 265(a)(2), that use "nonpurposive" principles that

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[121] *See, e.g.*, Rev. Rul. 88-66, 1988-2 CB 34. In Revenue Ruling 88-66, the IRS said (omitting citations):

> The legislative history provides that the "directly attributable" requirement is satisfied if there is a direct relationship between the debt and an investment in stock. Congress decided against incorporating an allocation or apportionment formula or a fungibility concept; thus, section 246A does not apply merely because of the existence of outstanding commercial paper that is issued as part of an ongoing cash management program or deposits received by a depository institution in the ordinary course of its business.
>
> However, where indebtedness is clearly incurred for the purpose of acquiring portfolio stock or otherwise is directly traceable to the acquisition, the indebtedness constitutes portfolio indebtedness. For example, any nonrecourse loan secured in whole or in part with portfolio stock is portfolio indebtedness. Further, section 246A of the Code is also applicable where the indebtedness is directly attributable to the carrying of portfolio stock. For example, section 246A applies if portfolio stock is acquired by a corporation using its equity, and later the corporation borrows money using the portfolio stock as security, if the purchaser could reasonably have been expected to sell the portfolio stock rather than incur the indebtedness.

[122] Revenue Procedure 72-18, 1972-1 C.B. 740, § 4.03 (applicable to individuals) states:

> The purpose to purchase or carry tax-exempt obligations generally does not exist with respect to indebtedness incurred or continued . . . in connection with the active conduct of trade or business . . . unless it is determined that the borrowing was in excess of business needs. However, there is a rebuttable presumption that the purpose to *carry* tax-exempt obligations exists where the taxpayer reasonably could have foreseen at the time of purchasing the tax-exempt obligations that indebtedness probably would have to be incurred to meet future economic needs of the business of an ordinary, recurrent variety. *See* Wis. Cheeseman v. United States, 388 F.2d 420, 422. The presumption may be rebutted, however, if the taxpayer demonstrates that business reasons, unrelated to the purchase or carrying of tax-exempt obligations, dominated the transaction.

could be used in combination with, or in lieu of, the above "purposive" attribution principles so as to limit or expand their range of application. These include whether (a) the Relevant Investments are directly traceable[123] to the incurrence of the funding; (b) the Relevant Investments could not have been made "but for" the incurrence or continuation of the funding or are otherwise directly economically dependent upon such incurrence or continuation; and (c) the Relevant Investments are part of a business or activity that is not economically distinguishable from the business or activity in which the funding is incurred or continued, *e.g.,* because the need for the funding is determined (or "dominated") by the (non-tax) requirements of such other business or activity. The number of these principles is large, as is their possibly appropriate combinations.

This "direct only" approach is by no means compelled, however, and significant arguments can be made against it. In the first place, perhaps a broader imputation of interest costs rule should be looked to as a model. Section 263A(f)(2)(A)(ii), for example, uses the so-called avoided-cost method. Using that approach as a model, perhaps it would be appropriate to allocate all interest expense to reduce pre-tax profit to the extent the taxpayer's interest cost would be deemed reduced had the transaction not been undertaken. Under this approach, the amount of interest deemed attributable to the transaction would not depend on whether the taxpayer actually would have used the amounts otherwise invested in the transaction to repay or reduce debt. Instead, the avoided-cost method is based on the assumption that debt of the taxpayer would have been repaid or reduced without regard to the taxpayer's subjective intentions or to restrictions (including legal, regulatory, contractual, or other restrictions) against repayment or use of the debt

[123] Although a discussion of the tracing concept is beyond the scope of this Report, we note that Treas. Reg. § 1.163-8T(c) contains elaborate rules designed, among other things, to apply this concept in determining how to allocate interest expense among different activities and expenditures for purposes of applying limitations under various provisions of the tax law.

proceeds.[124] Of course, in that respect, the avoided-cost approach is arguably quite distinct from Section 7701(o)'s instruction to take "fees and other transaction costs" into account, but, nonetheless, such an approach may avoid an unduly limited approach to interpreting what as an economic matter such costs are.

Furthermore, if indirect financing costs of a transaction are not taken into account, this means that the "profit" of a transaction for purposes of Section 7701(o) is higher than the true economic profit to the taxpayer. This in turn means that a transaction might satisfy the Profit Potential Test even though there is no real economic profit to the taxpayer. This would permit taxpayers to enter into transactions with no real economic profit, but with a definitional profit for purposes of the Profit Potential Test because indirect costs are not taken into account. The taxpayer might thereby obtain significant tax benefits not intended by Congress because the transaction would satisfy the Profit Potential Test and thus satisfy the Two-Prong Economic Substance Analysis. In determining whether to count all indirect costs (including, potentially equity costs) in the Profit Potential Test, the government must balance this concern from not counting those costs against the concern that, if all such costs are taken into account, it will be very difficult for many mixed motive transactions that are not of a type clearly intended by Congress to satisfy the ESD.

If the Net Present Value Approach to the Profit Potential Test is adopted, *and if* an assumed cost of debt capital is used as a single discount rate for all cash flows, then there would be no need to separately address the allocation of indirect costs of debt capital. Under that approach, the process of determining the net present value of the cash flows would produce the same result whether one imputes the indirect debt or not, as one would be treated as incurring a cost of capital

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[124] Treasury Reg. § 1.263A-9(a)(1).

on the equity portion equal to the cost on the debt-financed portion.[125] For example, if one assumes that a taxpayer is generally one-third debt financed at an average debt cost of 9%, and makes an investment of $100 that yields 10% per annum, a net present value calculation of the pre-tax cash flows that attributes the indirect financing costs should begin with a negative cash flow of only $66.67 (*i.e.*, the portion of the investment not deemed funded by the indirect debt) and would have annual positive cash flows of only $7 (*i.e.*, the $10 of gross yield minus 9% of the deemed debt-funded portion, or $3). Likewise, the cash received at the end of the transaction should be reduced by the $33.33 needed to pay down the principal of the debt. On the other hand, of course, the determination of indirect financing costs, if any, would need to be made under the PV of Profit Approach. Furthermore, this determination also would need to be made under the Net Present Value Approach in any case in which the discount rate selected is different than the overall rate on the indirect financing (whether debt equity, or both). Finally, we acknowledge that this example assumes away difficult issues such as whether to determine the cost of debt financing on a group-wide basis, how to reflect different tenors of outstanding debt, and how to deal with fluctuations in the amount of and interest rates on relevant debt.

Particularly in light of *Wells Fargo* and *Altria*, the Treasury and the IRS may wish to consider whether and how a taxpayer's overall cost of capital should be dealt with, including, possibly, in the context of financing costs. Relevant policy questions include whether enterprises that raise capital with equity should be favored over those that use debt financing, whether a distinction between preferred stock and senior debt is sensible, and whether a transaction should

[125] A similar result obtains if the discount rate (or the indirect costs) should also include the cost of equity (if calculable).

automatically satisfy the ESD test if its when pre-tax profits, when calculated giving limited or no effect to indirect costs, are substantial in relation to tax benefits.

We understand that it would be typical, from the standpoint of a common equity holder, to treat a fixed or floating rate preferred instrument return as a financing cost, and therefore we believe that it may be appropriate to treat such a return on an instrument issued by, for example, a special purpose vehicle, or on a preferred instrument issuance that is connected with the transaction in question, as a financing cost. Many of us find it difficult, however, to view the "costs" of common equity as a transaction cost, in the sense of "fees or other transaction costs." Rather, we think that accounting for the cost of common equity capital is properly done through whatever discounting mechanism is applicable under the statute, as discussed further below.

In any event, absent guidance, disputes between the IRS and taxpayers over attribution of borrowing to the investment seem inevitable, and no single method seems *a priori* correct. Hence, although depending on one's view as to the intended sweep of Section 7701(o), broader or narrower approaches to cost imputation seem defensible, it is likely more important that Treasury clarify if one (or more) of these, or some other approach, is the one it favors.

3. Should Foreign Tax Liabilities Be Treated as an Expense?

The other potential "expense" that we think Treasury and the IRS could address is foreign tax liability. Ideally, Treasury and the IRS would either confirm that foreign income taxes should never be treated as "expenses" for purposes of the Profit Potential Test or detail the limited cases in which they should be.

Like previous codification proposals, Section 7701(o) provides that, for purposes of calculating pre-tax profit, fees and other transaction expenses will be taken into account as

expenses.[126] In a nod to the IRS's ultimate loss in both *Compaq Computer Corp. v. Commissioner*[127] and *IES Industries, Inc. v. United States*,[128] the statute also directs Treasury to issue Treasury Regulations requiring foreign taxes to be treated as expenses in "appropriate cases."[129] As we believe that there are few, if any, such cases, this approach is a welcome departure from the approach of previous codification proposals, which would have made such treatment mandatory.[130]

On balance, we are of the view that the Codified ESD should not properly be determined to be "relevant" to claiming foreign tax credits, at least not in other than unusual cases. Given the premise of the foreign tax credit system that a foreign income tax is in effect a substitute for a domestic income tax and the set of statutory and regulatory requirements and anti-abuse protections now in place (including the noncompulsory charge rules, the holding period requirements of Sections 901(k) and 901(l), the structured passive investment arrangement rules under Section 901, the new Section 909 anti-"splitter" rules and the partnership anti-splitter rules of 1.704-1(b)(4)(viii), one can make a strong argument that the Codified ESD is not an appropriate policing mechanism. This conclusion can be read into the holdings of the cases cited above, which in effect expressed this concept by not treating the taxes as an expense in testing profit. Further, we find it instructive that Notice 2004-19, 2004-1 C.B. 606, in withdrawing Notice 98-5[131]

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[126] § 7701(o)(2)(B).

[127] 277 F.3d 778 (5th Cir. 2001).

[128] 253 F.3d 350 (8th Cir. 2001).

[129] § 7701(o)(2)(B).

[130] *See, e.g.*, H.R. 3962, 111th Cong. § 562.

[131] Notice 98-5, 1998-1 C.B. 324, contemplated that regulations would apply an economic profit test to disallow credits for foreign taxes generated in an arrangement such as those described above

(cont'd)

following the decisions referenced above, and announcing a continuing desire to stop "abusive" transactions, did not invoke or even allude to the ESD. Rather, the Notice said:

> The IRS will continue to scrutinize abusive transactions that are designed to generate foreign tax credits. In appropriate circumstances, the IRS will challenge the claimed tax consequences of such transactions under the following principles of existing law: the substance over form doctrine, the step transaction doctrine, debt-equity principles, section 269, the partnership anti-abuse rules of §1.701-2, and the substantial economic effect rules of §1.704-1.[132]

We note the contrary view that foreign tax credits should be treated as expenses for purposes of the ESD in transactions that reach results that can be considered abusive. Under this view, if there is little or no real profit potential in a transaction and the "profits" arise largely from foreign tax credits, one might logically equate foreign tax credits to tax benefits, such as deductions and investment credits. In certain cases taxpayers affirmatively seeking out "foreign tax credit-rich" transactions had purchased and immediately sold shares of stock around dividend payment dates, in effect stripping the dividend and foreign tax credits. While the taxpayers ultimately prevailed in court in the two decisions noted above, Congress determined to enact Sections 901(k) and 901(l) to condition the foreign tax credits in post-effective date transactions on the taxpayer meeting a holding period requirement with respect to the shares. While Congress has legislated to stop these particular transactions, it clearly intended to leave open in Section 7701(o) the possibility that the ESD might be applied to analogous transactions not covered by such specific legislation.

To be sure, those and other changes to the Code and the Treasury regulations in recent years have been effective, in our view, to curtail on a going-forward basis types of

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if the reasonably expected economic profit were determined to be insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement.

[132] Notice 2004-19.

transactions in which taxpayers have sought out foreign tax credits to use excess limitation in a manner deemed clearly inconsistent with Congressional intent, and future changes or fine-tuning no doubt would result and be similarly effective if other abusive transactions develop. The ESD in this area appears to be of relevance primarily as a litigating tool to sidestep the fact that such changes are not made retroactively. The IRS in Notice 98-5 did attempt to adopt rules analogous to the ESD to foreign tax credits (with treatment of foreign taxes as an expense as a key component), and abandoned the effort as the result of conceptual and practical difficulties. We see little benefit in attempting such a broad endeavor at this point. This is not to foreclose the possibility that sham-like cases might arise of a type not addressed by the regulations in which foreign tax credits may be involved and with respect to which the ESD may be appropriately invoked on a targeted basis. We are not aware of such cases today, and we therefore urge a limited application of the rule to address such cases if they are identified.

4. The Profit Potential Test – PV of Profit and Net Present Value Approaches.

The Net Present Value Approach is generally supported by the principles of sound financial analysis, and those who favor it argue that there is more than enough room in the statute's wording to accommodate this approach.[133] Moreover, they identify a genuine concern that to do otherwise would frustrate the very purpose of codification of the ESD by allowing tax benefits potentially to be justified by a noneconomic profit. They believe that Congress intended that only a transaction with true economic profit should be exempt from the requirement that the tax results be clearly intended by Congress; that transactions without such profit should be required to rely on the exemption for cases where the tax results are clearly intended by Congress; and that certain

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[133] That is, the "present value of . . . pre-tax profit" could be read to be essentially equivalent to "the pre-tax profit determined on a present value basis," *i.e.*, by discounting cash flows. The "substantial" comparison would be made using such result.

traditionally accepted mixed-motive transactions should be accorded legitimacy on that basis (if possible, confirmed in guidance from Treasury and the IRS at least acknowledging this principle with as much specificity as feasible).

On the other hand, those who favor the PV of Profit Approach believe that the Profit Potential Test's use of the phrases "present value of . . . pre-tax profit" clearly has a different meaning than "net present value of pre-tax cash flows." In addition, they ask what purpose is served by the requirement that the present value of pre-tax profit be substantial in relation to the net tax benefits, if it is not intended to clarify the quantum of pre-tax profit that is essential to a legitimate mixed-motive transaction. These proponents believe that the Profit Potential Test should be interpreted as an appropriate balance between the refusal of the pre-*ACM Partnership* courts to impose time value concepts without Congressional instructions and the judicial use of those concepts by other courts (whether appropriately or not) – in such a way that could cause historically accepted mixed-motive transactions to fail the ESD unless the transactions are deemed of a type clearly contemplated by Congress. (As discussed above, in both cases, one must determine which expenses are appropriately chargeable to the "transaction" so that the correct amount of "profit" (or the correct negative cash flows) is calculated in the first instance.)

Under the legislative history, no minimum return is "required" (*i.e.*, a demarcation of below which the taxpayer fails) or "established" (*i.e.*, a demarcation at (or above) which the IRS cannot challenge) for all cases, leaving the amount of return to be dealt with on a case-by-case basis. As discussed below, the PV of Profit Approach depends on the view that Section 7701(o) is to be read to preclude a requirement that the taxpayer reasonably expect at least a "risk-free" pre-tax rate of return.

A literal reading of Section 7701(o)(2)(A) might be supported based on this conclusion, the conclusion that the ESD is "relevant" to leasing and similar tax equity financing transactions, the fact that there is no indication that Congress intended to overrule *Frank Lyon* or, more generally, the Mixed-Motive Principle, and the concern that such transactions cannot adequately be defended on the basis that they are clearly intended by Congress. Under this approach, Congress clarified that no minimum return is established or necessarily required, and intended to bring some level of economic reality (*i.e.*, time value concepts) to the ESD, but did not intend to eliminate legitimate mixed-motive transactions that could not be defended as clearly intended by Congress (and did not intend to create a special rule for leasing and similar tax equity financing transactions). Under this approach one should measure the "present value" of the (nominal, not itself discounted on a time value basis) "pre-tax "profit" in comparison to the "present value" of the projected net tax benefits" and deem the Profit Potential Test satisfied only where the ratio of one to the other is above some minimum amount.

However, as we discuss below, this approach could, if taken to the extreme, create results that would be antithetical to Section 7701(o)'s stated mission of "clarifying" and "enhancing" the ESD. Moreover, as we discuss below, the Net Present Value Approach better reflects how financial analysts typically determine the time value of cash flows and, thus, more clearly embodies that principle of the *ACM Partnership* case, particularly as it seems to have been applied in the *Wells Fargo* case.[134] Moreover, as discussed above, it also may prove to provide a relatively simple solution to the difficult questions raised over whether one should (and if so, how) impute the costs of indirect debt financing to reduce "pre-tax profit" for purposes of the Profit Potential Test.

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[134] *See* discussion *supra* at notes 117 &118.

These tensions inexorably lead to the question of whether Congress intended to grant a broad exclusion from the ambit of the Codified ESD for certain traditional leasing and similar tax equity financing transactions, among other categories of transactions previously presumed to be legitimate where the exemption for results not clearly intended by Congress is not available. The legislative history says transactions, including specifically "leasing transactions," must "continue to be analyzed in light of all the facts and circumstances," other than "certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages."[135] (This discussion[136] in the legislative history refers by footnote to, among other authorities, the Supreme Court's decision in *Frank Lyon*[137] which is generally relevant to every leasing case of which we are aware.)[138] One reasonable interpretation of this is that the Codified ESD applies (is relevant) generally to leasing and similar transactions.

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[135] H.R. Rep. No. 111-433, at 296; JCX-18-10, at 152-53.

[136] H.R. Rep. No. 111-433, at 296 n.130; JCX-18-10, at 153, n. 350.

[137] Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

[138] Cases that suggest that Congress intended leasing transactions to have favorable treatment do not conclude that such transactions are exempt from the ESD, but rather that the ESD must be applied to them in a manner that does not conflict with Congressional intent. The leading case of this kind is Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995), *rev'g* 64 T.C.M. (CCH) 1003 (1985). In *Sacks*, the Ninth Circuit rejected the Tax Court's use of a 17% per annum discount rate in concluding that an equity investment in solar energy equipment lacked economic substance. It reasoned that an investor is not "bound to discount the future at the rate the Commissioner thinks prudent," *id.* at 991, citing its prior opinion in Hilton v. Commissioner, 671 F.2d 316 (9th Cir. 1982). In addition, the Ninth Circuit observed that "[a]bsence of pre-tax profitability does not show 'whether the transaction had economic substance' . . . where Congress has purposely used tax incentives to change investors' conduct." 69 F.3d at 991 (citation omitted). However, the Ninth Circuit determined that the case was controlled by *Frank Lyon* and determined that, based on various indicia of substance other than pre-tax profitability, the transaction had economic substance.

And yet, there is no obvious support for the notion that Section 7701(o)(2)(A) was intended to invalidate broad categories of transactions that a wide variety of practitioners had previously considered appropriate and to which the IRS has not objected. This point is reinforced by the public statements of a number of senior Treasury and IRS officials confirming that those officials do not generally view Section 7701(o) as being intended to have this effect.[139] And nothing in the House Report or the JCT Report commands the Profit Potential Test, whether or not the Net Present Value Approach is adopted, to cause such a radical change. Indeed nothing in those Reports prevents the conclusion that leasing and similar tax equity financing transactions whose results are consistent with Congressional intent do not have to be tested in the first place.

Consistent with this, those of us who favor the Net Present Value Approach (including most of our Executive Committee) generally would not, at least without further specific Congressional or administrative action, expect Section 7701(o) to be applied in such a way as to change radically the economic bases for these transactions in their traditional manifestations (*i.e.*, excluding, e.g., SILOs and LILOs). For example, the Net Present Value approach could in fact be applied (*e.g.*, "based on all the facts and circumstances," in appropriate cases, using a very low discount rate might be authorized and the meaning of "substantial" might be small)[140] or the Codified ESD might be found to be simply not "relevant" to leasing and similar transactions that achieve results that are "clearly consistent" with the purposes of all (other) applicable provisions of the Code.[141]

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[139] *See, e.g., Codification of Economic Substance Doctrine Not a Change in Substantive Law, Says IRS,* Daily Tax Report (BNA), Oct. 7, 2010 (193 DTR G-3).

[140] This approach would, however, diverge from the standard approach of traditional financial analysis.

[141] H.R. Rep. No. 111-433, at 296 n.124; *see also* JCX-18-10, at 152 n.344.

On the other hand, absent favorable guidance from the Treasury or IRS, we suspect that many transactions that take intended advantage of Congressional tax incentives may be thought to be subject to the Profit Potential Test of the Codified ESD, and for those transactions and many others, the answer will remain unclear. Accordingly, we turn back to a more detailed examination of the computational issues raised by the Profit Potential Test.

5. Discount Rate and Related Computational Issues.

Notice 2010-62 says only that "in performing [the comparison of present values] calculation, the IRS will apply existing relevant case law and other published guidance." As discussed above, the relevant case law does not clarify certain key terms, including especially "profit," "present value" and "substantial." For reasons discussed above, we recommend that Treasury and the IRS clarify the methodology in respect of the Profit Potential Test. Because most pre-Reconciliation Act courts did not use present value (or time value) concepts in their analyses and because Congress did not resolve a number of key issues, without further Treasury and IRS guidance, the Profit Potential Test may well be unusable. At the extreme, a court could find that Section 7701(o), in some cases at least, lacks the clarity required for the imposition of penalties. In any event, it could easily deter taxpayers from entering into transactions that Congress intended to permit.

a. What Is To Be Present Valued?

It would be extremely helpful for Treasury and the IRS to explain what the "present value" of "pre-tax profit" means. As noted above, we think the purpose of the test is to determine whether, where no other means exists to satisfy either or both of the Economic Effect Test and the Substantial Purpose Test, the transaction has a pre-tax profit and whether such profit is "substantial" enough to be sufficient. So understood, it seems very odd to say that the test could be

met where the pre-tax profit does not equal at least a risk free rate of return. However, the drafting history of the statute clearly reflects an intentional (*i.e.*, non-accidental) deletion of a requirement that a transaction necessarily have a risk-free return. Thus, it seems that in some cases such a return may not be necessary. This conundrum calls out for guidance from the government.

The most obvious approach that such guidance might take would be acknowledging that it would be very odd to treat a transaction whose cash flows generate a negative net present value (at any "normal" discount rate) as having a positive "pre-tax profit" on a present value basis, to say that Congress meant to require that a net present value of all pre-tax cash flows (positive and negative) be calculated. Certainly, for example, a court might determine that this is the correct way to apply time value of money principles to the pre-tax profit requirement. Indeed, as we understand it, this approach would be more generally typical of how financial analysts would determine the time value of cash flows. The fact that it is not the most literal reading of the statute need not be a fundamental impediment, given that the legislative history's comment about not necessarily requiring a minimum return need not prohibit this approach assuming that this approach is adopted in such a way as to permit flexibility in choosing the discount rate.

Further supporting this approach is that fact that it does not require the taxpayer (or the IRS) to find a methodology to determine the times at which "profit" should be deemed to be paid. Second, one can point to the vagueness, discussed above, of the phrase "net tax benefits," which constitutes the "denominator" of the Profit Potential Test, as a demonstration that a purely literal interpretation of Section 7701(o)(2)(A), as with most any part of the Code, is of course neither necessary nor expected. Admittedly, however, interpreting the ambiguity inherent in "net

tax benefits"[142] is not as challenging as reading "present value of pre-tax profits" to mean "net present value of pre-tax cash flows," "pre-tax profit construed on a present value basis" or some other formulation that would achieve the result required by the Net Present Value approach.

Some question whether it is appropriate to attribute this level of imprecision to a statute which was, prior to its enactment, considered carefully by a number of Congressional committees, Treasury and bar, financial accounting and industry groups over a span of many years, and that Congress could have easily adopted words different from those that it did. This leads others to support the more literal, PV of Profit Approach: determine what the pre-tax profit is (*i.e.*, the gross (non-discounted) cash outlays minus the gross cash inflows) and then discount that amount to the present, using an appropriate discount rate, and making reasonable assumptions about when such pre-tax profit will occur. This approach would allow a gross (i.e., undiscounted) pre-tax profit of (say) 2%-4% per annum to be discounted (for example, at some multiple of the AFR) and tested for "substantiality" against the present value of the net tax benefits.

Under the PV of Profit Approach, however, because one can calculate a discounted present value only by first establishing when the cash flows occur, one has to derive (or "invent") a methodology for determining the times at which profit should be deemed realized. The statute, of

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[142] To be clear, we do not think that it can be taken to mean "net cumulative tax benefit," because a transaction that takes advantage only of a tax timing benefit, such as accelerated depreciation, would generate a negative net present value in the Profit Potential Test's denominator, as a result of computationally deferring early period tax savings to match them up with subsequent taxes. The adjective "net" also does not imply or support adding "cumulative" to the statute, because "net" most commonly and naturally means tax benefits net of tax detriments over the period in question. Nor does the plural form, "net tax benefits," commonly mean "net cumulative tax benefit"; to the contrary, it most commonly means the set of net tax benefits generated over multiple periods.

course, does not provide or even hint at when a taxpayer's investments and profit should be taken into account. Hence, even the PV of Profit Approach needs "non-literal" help.[143]

As noted above, applying the Net Present Value Approach would mean that Section 7701(o) has the effect of raising the bar, at least in the case of traditional leasing or similar tax equity financing transactions, if the transaction in question were required to rely on the Profit Potential Test to satisfy Section 7701(o). Congress expressed no specific intent to do so, however, and we are not aware of Congress having even considered whether it was substantially expanding the scope of transactions that would fail an ESD analysis, nor certainly that it intended Section 7701(o) to disallow the typical tax benefits arising from conventional project financing, leasing and similar transactions, other than those considered abusive (apart from the quantum of profit potential). Hence, we recommend that Treasury and the IRS conduct modeling analyses in respect of certain types of transactions under various commercial scenarios. To the extent that guidance treating certain transactions of this type as satisfying the ESD is deemed appropriate, we recommend that Treasury and the IRS take those analyses into account in determining the appropriate construction of the Profit Potential Test and to what types of transactions it should apply.

b. What Discount Rate?

Treasury and the IRS should consider addressing whether the discount rate for pre-tax profit should reflect the taxpayer's own cost of funds or a cost of funds computed solely by

[143] It would not be all that difficult, however, to establish a conservative approach for determining the times at which profit should be deemed realized. For example, a relatively conservative method for determining how much profit should be allocated to a positive pre-tax cash flow would be to compute a present value for the transaction's cash flows using a discount rate equal to the transaction's pre-tax IRR, and treat the excess of each such cash flow over its present value as "profit." Other methods that might treat profit as earned more rapidly could also be appropriate if consistent with the given transaction's economics.

reference to prevailing interest rates. Conventional financial profitability analysis, in which an investor takes its cost of funds into account in determining whether a proposed investment will yield an attractive profit would typically take this approach. Thus, using the taxpayer's incremental or overall cost of funds may be appropriate in particular under the Net Present Value Approach.

On the other hand, using a discount rate determined by the taxpayer's overall funding costs (*i.e*., funding costs not directly related to a transaction) would have roughly the effect of reducing the present value of pre-tax cash flow or profit (as the case may be) by such funding costs. In addition, a discounting method that uses a taxpayer's own incremental or overall cost of funds as the discount rate would favor taxpayers (such as banks that pay no or very little interest to their depositors) that have an overall cost of funds that is less than prevailing interest rates.[144]

Alternatively, perhaps a prevailing interest rate should be used, such as the AFR or a tax-exempt rate determined under Section 1288(b). If the statutory test is determined to require taxpayers to discount pre-tax profit, without taking into account their particular risks of earning that profit, then discounting at a prevailing interest rate, such as one determined by reference to risk-free rates (*e.g.,* the AFR or some multiple thereof), may be more appropriate. Indeed, the statute mandates that the present value of the *reasonably expected* pre-tax profit must be determined, not the present value of all potential pre-tax profit. This suggests that the "profit" must first be adjusted to ensure that only what is reasonably expected is discounted. Further, by

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[144] To promote fairness among different taxpayers and to implement policy with respect to transactions that utilize tax incentives, Treasury and the IRS should consider whether such taxpayers should be given an advantage in the application of the Profit Potential Test by allowing their low cost of funds to be used to discount pre-tax profit.

requiring *reasonably expected* profit to be discounted, the statute offers no suggestion that taxpayers need to use discount rates that accurately reflect their risks of earning less than what is reasonably expected.

As discussed below, based on our preliminary analysis of various hypothetical transactions, if the PV of Profit Approach is adopted, using a discount rate derived from a prevailing interest rate would permit many, if not all, of the transactions that have previously been considered legitimate under the ESD to pass the Profit Potential Test. However, we have also observed that many taxpayers have overall funding costs (as typically measured by a weighted average pre-tax cost of capital) that significantly exceed the range of interest rates that accomplish this result. On the other hand, if the Net Present Value Approach is adopted, transactions bearing a 2-4% IRR that were previously considered legitimate could easily fail the Profit Potential Test if either prevailing interest rates or the taxpayer's cost of funds is used to discount pre-tax cash flows. It thus can be seen how critical it is that Treasury and the IRS issue guidance concerning the extent to which such transactions must pass muster under the Profit Potential Test and if so how that test is to be applied. To the extent that they believe that Congress intended to invalidate such transactions going forward, basic tax policy (and fairness) would suggest that they should inform taxpayers. The strict-liability ESD Penalty makes that position even more compelling.

c. Same Discount Rate for Numerator and Denominator?

Treasury and the IRS should clarify whether the same single discount rate must be used to discount both pre-tax profit and net tax benefits. At first blush, it might seem that consistency would require that the same discount rate should be used and, upon consideration, that may well be the correct answer. In this case, however, because there are two qualitatively different types of cash flows at issue, Treasury and the IRS may wish (or need) to give some guidance.

Discount rates are merely the rates of return on comparable investments that are chosen to permit a present valuation of a set of cash flows. Thus, a reasonable discount rate for pre-tax profit could be determined by looking at the pre-tax investment yields[145] on a non-tax-favored investment with a comparable level of risk.[146] Hence, a pre-tax discount rate clearly seems required for the pre-tax profit discount calculation.

Similarly, a reasonable discount rate for a stream of taxes and tax savings arising from a transaction could be determined by the after-tax investment yields on comparable, taxable transactions that have very little pre-tax cash flow. This rate, not surprisingly, would be an after-tax rate. This discount method, as a factual matter, would likely lead to discount rates that do not have a simple mathematical relationship with discount rates used to present value pre-tax cash flows for the profit ratio.

This investment-based method of determining a discount rate for tax flows is not the only one, however, and it suffers from the fact that yields on comparable, competitively bid tax-advantaged (*i.e.*, legitimate mixed-motive) transactions are not readily available. An alternative method that is appropriate in transactions that take advantage of tax-timing benefits, such as those associated with accelerated cost recovery deductions, arises from the observation that these transactions are economically equivalent to loans from the government at a zero interest

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[145] The pre-tax rate is the expected investment yield divided by the result of one minus the then applicable tax rate.

[146] Under Section 382(f)(2), for instance, an adjusted federal long-term tax-exempt rate is computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds for bonds with remaining periods to maturity of more than nine years. *See* Rev. Rul. 86-133, 1986-2 C.B. 59; s*ee also* Section 1288(b) (requiring tax-exempt rates to be used to compute original issue discount on tax-exempt obligations under Sections 483 and 1274); Rev. Rul. 2010-24, 2010 I.R.B. LEXIS 6 (Table 2 specifies adjusted AFRs for purposes of Section 1288(b) for the month of October, 2010).

rate. Based on that observation, the present value of tax benefits may be determined by using the after-tax equivalent of then prevailing commercial borrowing rates.

It seems much more likely to us, however, that Congress intended that both the numerator and denominator employ the same discount rate, even if, in the abstract, a financial analyst would not derive the present value of tax benefits using a pre-tax discount rate. That is, given that the task mandated by the Profit Potential Test is a comparison of (a) the present value of pre-tax profit and (b) the present value of tax benefits, if the same discount rate is not used for both (a) and (b), then the comparison is of apples to oranges. We doubt the Congress intended such a result.

In our view, the determination of an appropriate rate for discounting tax benefits would benefit greatly from guidance by Treasury and the IRS.

d. Clarify the Meaning of Net Tax Benefits?

We believe that there is some ambiguity in the concept of "net tax benefits." This term could mean either the actual taxes and tax savings expected by the taxpayer, or, more subtly, just the incremental tax benefits that are the focus of the ESD inquiry.[147] Thus, for example, consider a transaction involving an existing investment which, because of a decline in its market

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[147] *Cf.* Klamath Strategic Inv. Fund *ex rel.* St. Croix Ventures v. United States, 568 F.3d 537, 545 (5th Cir. 2009) ("Various courts have held that when applying the economic substance doctrine, the proper focus is on the particular transaction that gives rise to the tax benefit, not collateral transactions that do not produce tax benefits." (citing Coltec Indus. v. United States, 454 F.3d 1340, 1356-57 (Fed Cir. 2006); Nicole Rose Corp. v. Comm'r, 320 F.3d 282, 284, (2d Cir. 2002))). Under the Codified ESD, a determination must be made as to whether the transaction constitutes a meaningful change of economic position. This raises the question, "As compared to what?" In many cases, such as the "built-in loss" transaction discussed in the text, the answer to the question may determine what the "net tax benefits" are for purposes of the Profit Potential Test. *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 236, 264 (1999). We observe that this question may not satisfactorily frame the issue we identify with respect to accelerated depreciation, however, particularly if the taxpayer does not have the choice to use a purely economic depreciation schedule.

value, would, if sold by the taxpayer, result in a substantial tax loss. Suppose that by using a complex transaction, the taxpayer believes it can generate a larger loss. Although we hesitate to address this issue abstractly, in general we believe that the term "net tax benefits" does not refer to the tax loss benefit that the taxpayer would realize if it sold the investment outright but only the incremental benefit it seeks by using the complex path. In the context of long-term transactions that involve accelerated cost recovery deductions or permissible taxable income deferrals (such as low-high rental income patterns under Section 467), a similar distinction arises because to the extent such transactions merely take advantage of purely economically determined taxable income and losses (and not tax incentives), arguably they should not, in general, be subject to the ESD. Thus, for example, it may be appropriate for taxpayers to treat only the "tax deferral" benefits of certain transactions as "net tax benefits" (*e.g.,* the differences between available cost recovery deductions and economic depreciation). We recommend that Treasury and the IRS consider this issue for resolution in published guidance.

e. What Is "Substantial"?

After resolving the above computational issues, parties applying the Profit Potential Test must finally grapple with the remaining question: namely, what does "substantial" mean, as applied in assessing whether the statutory profit ratio is satisfactory? We do not believe the answer to this question can be readily divined from analogous uses of the term "substantial" in other parts of the tax law.[148] Perhaps a pragmatic approach is more appropriate: "substantial" might be defined by reference to the ratios that will appropriately distinguish those transactions

[148] *See* Treas. Reg. § 1.279-3(c)(2), defining "substantial" as 5% or more. *See also* Section 751(b)(3), defining "substantial" as 20% or more; Section 168(d)(3), defining "substantial" as 40% or more; Section 382(l), defining "substantial" as one third or more.

that are legitimate from those that are not, based on the choice of discount rates and a reasonable resolution of the expense and computational issues.

Our analysis of the relationship between discount rates and substantiality thresholds has been sharpened by a numerical analysis of how Section 7701(o)(2)(A) might apply in practice. To that end, we have considered a number of examples of hypothetical investments and numerical modeling of their cash flows and tax benefits.[149] Because of the legal and financial complexity of this analysis, a discussion of which we believe is beyond a sensible scope for this Report, and because they depend on decisions that only the government or courts can make, we recommend that Treasury and the IRS and any other interested parties undertake such analyses. To the extent the PV of Profit Approach is deemed appropriate, and the Treasury and IRS do not think that the relevant transactions are exempt from ESD because the results are clearly intended by Congress, we think it would be instructive for Treasury and the IRS to examine a range of mixed-motive transactions that they view as non-abusive (*e.g.,* with pre-tax IRRs that make the transactions unobjectionable) and apply a methodology and a range of reasonable discount rates and profit ratio thresholds to determine whether the Profit Potential Test would invalidate broad categories of these transactions. For example, if "substantial" means 30%, modeling could determine the discount rates (perhaps expressed as a multiple (*e.g.,* 120%) of the AFR) that would be required to cause a transaction with a 2%, 3% or 4% (or higher) pre-tax IRR to fail the Profit Potential Test. Treasury and the IRS could decide, based on those results, on a safe harbor or

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[149] As discussed above, the Profit Potential Test, for those transactions where the ESD is deemed "relevant," cannot avoid invalidating broad categories of such transactions previously considered legitimate, subject to the defense that the results are clearly intended by Congress, if: (i) all pre-tax cash flow must be discounted to present value using a market discount rate, instead of just (undiscounted) pre-tax profit or (ii) the taxpayer's indirect cost of funds must be taken into account in computing either undiscounted or discounted pre-tax profit. Hence, in our hypotheticals, we present valued gross, pre-tax profit and did not treat indirect cost of funds as an expense.

definitive basis, where to set the meaning of "substantial" and what discount rate is appropriate. It also might shed light on whether or not the PV of Profit Approach is appropriate. If so, this modeling exercise would also permit Treasury and the IRS to examine which discount rates and profit ratio thresholds might cause the Profit Potential Test (to the extent required to be applied) to validate transactions that have historically conservatively been considered not sufficiently "economic." Obviously, it would be inappropriate to set these key parameters at levels that could have that effect.

In conclusion, unlike ESD interpretation and practice before Section 7701(o), which was based primarily on an assessment of the transaction's pre-tax IRR Section 7701(o), now seems to require both the IRS and taxpayers to make complex present-value determinations to apply the Profit Potential Test that could easily be the subject of extensive and excessively expensive disputes. We believe it would be highly beneficial to all if Treasury and the IRS would clarify the correct approach to, and the mechanics for making, these determinations as soon as possible, so that the parties to legitimate transactions can make modifications to their transactions to avoid exposure to the new strict-liability ESD Penalty.

6. Specific Congressional Incentives.

Finally, we urge Treasury and the IRS to provide more specific guidance as to how the Profit Potential Test should apply to transactions whose economics are largely based on tax benefits arising from specific congressional incentives (*e.g.*, various credits or accelerated depreciation deductions). In framing this guidance, Treasury and the IRS should keep in mind the Joint Committee Report's explanation that Congress did not intend "that a tax credit . . . be

disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage."[150]

We understand that the prevailing practice is to treat tax credits in the same manner as cash in computing pre-tax profit. Although it might render invalid many transactions previously believed to be acceptable, another alternative in some circumstances (*e.g.,* some transactions involving the investment tax credit) might be to ignore the credits in calculating both the pre-tax profits and the net tax benefits. So long as Congress actually enacted such tax credits to encourage the specific type of investment or activity in question, we believe that both of these approaches are a reasonable accommodation under the Profit Potential Test,[151] and we propose that the validity of one or the other be expressly confirmed in Treasury Regulations (albeit perhaps as a safe harbor and not a substantive legal principle).[152] Further, for these types of transactions it might be appropriate for Treasury, just as it might be for leveraged lease and similar transactions, to establish safe harbors for when transactions of this nature are deemed to satisfy Section 7701(o) by

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[150] JCX-18-10, at 152 n.344.

[151] *But see*, Friendship Dairies, Inc. v. Comm'r, 90 T.C. 1054, 1065 (1988), in which the Tax Court declined to treat the broad-based investment tax credit (which was available under prior law) as a reduction of the cost of the property on the grounds that the credit was not intended to be a subsidy but merely a substitute for a "capital investment deduction." By contrast, using the distinction drawn by the Tax Court, we believe that the energy investment tax credit under Section 48 is a subsidy that Congress intended to be used to "transform unprofitable transactions into profitable ones." 90 T.C. at 1065-66. The Joint Committee Report identifies other tax credits that serve a similar purpose, including those arising under Sections 42 (low-income housing credits), 45 (production tax credits), 45D (new markets tax credits) and 47 (rehabilitation credits). *See also* JCX-18-10, at 152 n.344.

[152] We also note that it is far from clear whether Congress intended such transactions to be subject to the Codified ESD Test at all. *See, e.g.*, Sacks v. Comm'r, 69 F.3d 982, 991 (9th Cir. 1995) ("Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits,' where Congress has purposely used tax incentives to change investors' conduct." (quoting Casebeer v Comm'r, 909 F.2d 1360, 1365 (9th Cir. 1990))).

specifying minimum amounts of genuine "at-risk" investment and profit without regard to tax benefits (*e.g.*, a minimum, pre-tax IRR).

F. Aggregation and Disaggregation.

In order to determine whether the Codified ESD is relevant to a particular transaction, and in order to determine whether the transaction satisfies the Codified ESD Test, the transaction itself – the cluster of facts to which a judge would properly apply an economic substance analysis – must be identified. Even if the statutory definition of the ESD accurately reflects the boundaries of the ESD under pre-Reconciliation Act law, the range of transactions to which the ESD is considered relevant will necessarily depend on how the relevant fact pattern is identified.[153]

Unfortunately, the statute provides very little direction in this regard. Section 7701(o)(5)(D) provides only that, for all purposes of Section 7701(o) (including the determination of whether the ESD is relevant to a given fact pattern), the term "transaction" includes a series of transactions. The House Report indicates that Congress intended Section 7701(o) to preserve the analytical flexibility exercised by the courts in cases such as *Coltec Industries Inc. v. United States*[154] and *ACM Partnership*:

[153] *See generally* David P. Hariton, *The Frame Game: How Defining the 'Transaction' Decides the Case*, 63 TAX LAW. 1 (2009).

[154] 454 F.3d 1340 (Fed. Cir. 2006). In *Coltec*, the taxpayer ("Coltec") was faced with potentially massive contingent liabilities stemming from asbestos litigation against Garlock (a subsidiary of Coltec) and Anchor (a subsidiary of Garlock). In a putative attempt to improve Coltec's liability position vis-à-vis the asbestos litigants, Garlock contributed all of the stock of Anchor, along with a $375 million promissory note issued by one of its other subsidiaries, to Garrison (a dormant subsidiary of Coltec). In exchange, Garrison issued shares of common stock to Garlock and assumed all liabilities incurred in connection with asbestos-related claims against Garlock. Garrison also concurrently assumed all management responsibilities with respect to such claims. When Garlock subsequently sold the Garrison stock to two banks for $500,000, Coltec's

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> The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.[155]

It is worth noting in this regard that, unlike Section 7701(o), previous codification proposals included, as part of the Substantial Purpose Test, a requirement that the transaction in question be a "reasonable means" of accomplishing the taxpayer's purpose.[156] Congress omitted this requirement from Section 7701(o) and we think it did so because it realized that such a provision would be redundant. In its only attempt at explaining the Substantial Purpose Test, the House Report quotes the following language from Treas. Reg. Section 1.269-2(b) and the Tax Court's memorandum decision in the *ACM Partnership* case:

> *See, e.g.*, Treas. Reg. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in ACM Partnership . . . the court stated:
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> "Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and

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consolidated group reported a large loss on the sale. Coltec took the position that, under Section 357(c)(3), the assumption of Garlock's contingent liabilities by Garrison was excluded from the calculation of Garlock's basis in the Garrison stock. Analyzing Garrison's assumption of Garlock's contingent asbestos liabilities in isolation, the Federal Circuit ultimately upheld the disallowance of Coltec's loss on the grounds that the liability assumption lacked economic substance.

155 H.R. Rep. No. 111-443, at 296-97 (citations omitted).

156 *See, e.g.*, S. 1321, 109th Cong. § 801; H.R. 2046, 108th Cong. § 311; S. 476, 108th Cong. § 701; *see also* H.R. 2255, 106th Cong. § 3 ("In the case of any transaction which is an integral part of a taxpayer's trade or business and which is entered into in the normal course of such trade or business, the determination of the potential income from such transaction shall be made by taking into account its relationship to the overall trade or business of the taxpayer.").

> means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs."[157]

In addressing the subjective aspect of the ESD, by not including a "reasonable means" requirement in Section 7701(o)(1), Congress, we believe, realized that such a standard is taken into account, as in *ACM Partnership*, in the question of when parts of or steps in an overall transaction should be separated from other parts or steps.

Unfortunately, neither the House Report nor Section 7701(o) itself indicates when aggregation or separation (either by the courts or by field-level IRS agents) is appropriate. For example, some have wondered whether the result in *Shell Petroleum Inc. v. United States*[158] might have been different if Section 7701(o) had been available to the government. We find nothing in the statute or the legislative history that suggest that Congress considered how a "transaction" should be defined in *Shell*-type fact patterns.[159]

The *Shell* court ultimately held, over the government's objections, that the contributed "non-producing" assets, which had zero discounted net cash-flow value, did constitute

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[157] H.R. Rep. No. 111-443, at 297 n.135 (quoting Treas. Reg. § 1.269-2(b); ACM P'ship v. Comm'r, T.C. Memo. 1997-115, at 113).

[158] 102 A.F.T.R.2d (RIA) 2008-5085 (S.D. Tex. 2008).

[159] In *Shell*, the taxpayer ("Shell"), the parent of a consolidated group of financially distressed corporations, formed a new subsidiary, Frontier, as part of a new strategy to improve cash flows and investment returns. Frontier then issued (i) common stock and non-voting preferred stock to two of Shell's subsidiaries in exchange for certain "highly productive" assets; (ii) 900 shares of voting "auction preferred stock" to Western, one of Shell's "old and cold" subsidiaries, in exchange for certain "non-producing," high-basis assets; and (iii) 1100 shares of voting auction preferred stock to unrelated investors in exchange for cash (collectively, the "Frontier Exchange"). Shell took the position that, because the Frontier Exchange was an exchange described in Section 351, Western's basis in the non-voting auction preferred stock was determined by reference to the non-producing assets under Section 358. As a result, Shell argued, Shell's consolidated group recognized a large loss on Western's subsequent sale of that stock. The IRS disallowed the loss, arguing that the non-producing assets, which had zero discounted net cash-flow value, did not constitute "property" for purposes of Section 351(a), and that the Frontier Exchange flunked the ESD. The court ultimately rejected both of these arguments and sustained the taxpayer's position.

"property" for purposes of Section 351(a). We do, of course, accept that the IRS is free to challenge, under Section 7701(o), whether stock is in fact issued in exchange for property in a purported Section 351 exchange with multiple contributions of assets. Indeed, *Shell* supports our general belief that the IRS may challenge, under Section 7701(o), the purported tax benefits of a transaction that may or may not satisfy the literal requirements of the Code or the Treasury Regulations as a factual matter.

The government may also argue that certain contributed assets that have no value are not sufficiently related to other contributed assets that have value, such that the contribution of the former in a purported Section 351 exchange is a separate "transaction" that must independently satisfy the Codified ESD Test. However, the tax benefit desired by the taxpayer in *Shell* was a double deduction for the same economic loss, once on the sale of the preferred stock received on the section 351 transaction and again later on the sale of the contributed assets. Were a new case to arise with facts similar to those in *Shell*, now that Section 362(e) has been enacted, the double deduction would not be possible. Thus, the *Cottage Savings* decision, allowing as it does the taxpayer to determine the timing of recognition of a genuine economic loss, might allow the single economic loss on the sale of the stock. However, this is not clear because unlike in *Cottage Savings* where the taxpayer retained no economic interest in the depreciated assets, the loss on the preferred stock in *Shell* was recognized at a time when the depreciated assets remained in a subsidiary in the Shell group in which Shell owned all the common stock so that Shell retained all the economic upside and downside on the assets. In any event, even if Section 7701(o) would not apply to the facts of *Shell* today because of the subsequent enactment of Section 362(e), this does not answer the question of whether Congress intended the contribution of the non-producing assets

in *Shell* to be a "separate" transaction in a situation where the contribution did in fact result in a double deduction or other significant tax benefit.

While we generally agree that field-level IRS agents (and, of course, the courts) must be allowed to apply the Codified ESD Test in a way that accommodates novel fact patterns and multi-step transactions, we also believe that the discretion of the IRS to "disaggregate" transactions cannot be unfettered without leaving taxpayers at risk of open-ended and unpredictable challenges – with the specter of the strict-liability ESD Penalty looming all the while. Ultimately, of course, many of the situations are likely to be so fact specific that the courts will have to be the ultimate arbiters, but we recommend that Treasury and the IRS should consider issuing guidance setting forth certain principles for determining whether disaggregation of a multi-step transaction is or is not inappropriate, while comporting with Congressional intent to preserve the analytical flexibility of *Coltec*. For example, we think Treasury and the IRS could consider providing that there generally would be no disaggregation if each step of the multi-step transaction is a "reasonable means" of accomplishing the non-tax purpose of the multi-step transaction, the multi-step transaction, taken as a whole, satisfies the Codified ESD Test, and that the overall result is consistent with the intent of Congress. Guidance reflecting this principle, which is far from exhaustive, should help to minimize the potential for IRS misuse of Section 7701(o), while being consistent with Congress' intent to support the Federal Circuit's approach in *Coltec*.[160]

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[160] *See* discussion *supra* note 155.