Order Code RS22586
January 29, 2007

CRS Report for Congress

The Economic Substance Doctrine: Recent Significant Legal Decisions

Erika Lunder
Legislative Attorney
American Law Division

Summary

The economic substance doctrine is a judicially developed doctrine that has become one of the IRS's primary tools in fighting abusive tax shelters. The doctrine permits transactions lacking in economic substance to be disregarded for tax purposes. In 2006, four significant decisions dealing with the doctrine were issued by U.S. courts of appeals. In the 110th Congress, S. 96 (Export Products Not Jobs Act) has been introduced to codify the doctrine. This report discusses the doctrine's development and the four cases and summarizes the bill. It will be updated as events warrant.

An *abusive tax shelter* is generally defined as a transaction that technically complies with the Internal Revenue Code but results in unreasonable tax consequences that are not intended under the Code.[1] The economic substance doctrine is one tool that the IRS has for fighting abusive tax shelters. It is a judicially developed doctrine that allows the IRS and courts to disregard transactions that were made for tax-avoidance purposes and lack economic substance.[2]

The economic substance doctrine is rooted in several Supreme Court decisions. The first is *Gregory v. Helvering*,[3] where the Court stated that while "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted," a transaction will be disregarded for tax purposes if it was not "the thing which the statute intended."[4] In that case, the Court, looking at whether a stock transfer qualified as a tax-free reorganization, disregarded the transaction because there was no "business or corporate purpose" for the

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[1] For more information on tax shelters, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals Considered in the 108th Congress*, by Jane G. Gravelle.

[2] There are several related doctrines, including the substance-over-form doctrine, the step transaction doctrine, and the business purpose doctrine.

[3] *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[4] *Id*. at 469.

companies involved and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[5] In *Knetsch v. United States*,[6] the Court applied the *Gregory* analysis in determining whether a taxpayer could deduct interest arising from a transaction in which, among other things, he bought bonds using a promissory note and effectively paid the note's interest due at the beginning of each year with money he borrowed prospectively from the bonds' value at the end of the year. The Court disregarded the transaction because it "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax" and refused to believe, without evidence of legislative intent, that Congress intended to provide tax benefits for a sham transaction.[7] The Court in *Frank Lyon Co. v. United States*[8] further explained that a transaction should be recognized for tax purposes if

> there is a genuine multiple-party transaction with economic substance which 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....[9]

In 2006, four important tax shelter cases were decided by U.S. courts of appeals. In all four cases, the economic substance of the transaction was at issue. The next section of this report looks at these cases. Because this report focuses on the economic substance doctrine, the other tax aspects of the cases are not discussed. It is, however, important to note that courts in these cases found that the challenged transactions complied with the relevant statutory requirements in the Internal Revenue Code. It should also be noted that the factual situations are summarized and may not include all parties to or all aspects of the transaction.

Coltec Indus. v. United States. The transaction at issue in this case involved two Coltec subsidiaries: A and B. A gave a promissory note worth $375 million and property worth $4 million to B in exchange for stock in B and B's assumption of A's future asbestos liabilities. The value of the note was calculated to cover the liabilities. A then sold its stock in B for $500,000. Coltec claimed that A had a $378.5 million loss from the sale of the stock. Coltec asserted that A's basis in the stock was $379 million (the value of the note and property) and did not have to be reduced by the value of the assumed asbestos liabilities under the contingent liability rules in IRC § 358(d)(2). The IRS challenged, among other things, the transaction's economic substance.

In 2004, the Court of Federal Claims held that the economic substance doctrine was an unconstitutional violation of the separation of powers doctrine.[10] The court reasoned that because Congress had the authority to write the tax laws, it was unconstitutional for courts to require taxpayers to meet criteria beyond compliance with the congressionally

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[5] *Id*. at 469-70.

[6] Knetsch v. United States, 364 U.S. 361 (1960).

[7] *Id*. at 366-67.

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

[9] *Id*. at 583-84.

[10] Coltec Indus. v. United States, 62 Fed. Cl. 716, 752-56 (Fed. Cl. 2004).

written statutes. The court explained that taxpayers needed to be able to rely on the tax code's statutory language and that it was unfair to apply the economic substance doctrine on top of the statutes because of its unpredictability and ambiguity. The court dismissed the idea that Supreme Court and Federal Circuit decisions had endorsed the use of the economic substance doctrine, finding instead that the holdings in those cases relied on the statutory language and only used the doctrine as support for their conclusions. The court also noted that the doctrine's constitutionality had not previously been challenged and believed that recent case law raised questions about the doctrine's viability.

In 2006, the U.S. Court of Appeals for the Federal Circuit reversed and remanded the lower court's decision, describing the holding as "untenable."[11] The appellate court, noting that the economic substance doctrine had been recognized in several Supreme Court and Federal Circuit cases and in tax treatises, found no precedent for holding the doctrine to be unconstitutional.[12] The court explained that the doctrine was similar to other canons of statutory construction, upheld by the Supreme Court as constitutional, that permitted courts to look beyond the statutory language if legislative intent would otherwise be violated. The court then laid out five principles of the doctrine: (1) a transaction without economic substance is disregarded for tax purposes, regardless of the taxpayer's motive for entering into it; (2) the taxpayer has the burden to prove the transaction's economic substance; (3) an objective test is used to determine whether there is economic substance; (4) the transaction that is tested is the one giving rise to the tax benefit; and (5) inter-company transactions that do not affect third-party economic interests deserve close scrutiny.[13] Using these principles, the court determined that the Coltec transaction lacked economic substance because it did not "effect[] any real change in the flow of economic benefits, provide[] any real opportunity to make a profit, or appreciably affect[] Coltec's beneficial interests aside from creating a tax advantage."[14]

Black & Decker Corp. v. United States. Black & Decker Corp. (BDC), after realizing $300 million in capital gains from the sale of assets, took part in a transaction seeking to create a capital loss. First, BDC transferred $561 million in cash to a subsidiary in exchange for stock and the subsidiary's assumption of BDC's future health benefits claims, which had an estimated present value of $560 million. One month later, BDC sold the stock for $1 million to an unrelated third-party. The subsidiary then lent $564 million to BDC's parent company, which the parent company repaid in monthly installments designed to furnish the subsidiary with funds to pay the benefit liabilities. BDC claimed a $560 million loss from the sale of stock. BDC asserted that its basis in the stock was $561 million and was not reduced by the value of the assumed liabilities under the contingent liabilities rules in IRC § 358(d)(2). The IRS disallowed the loss.

The district court agreed with BDC's characterization of the transaction.[15] The court stated that, under Fourth Circuit precedent, the question was whether "the taxpayer was

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[11] Coltec. Indus. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006).

[12] *See id.* at 1352-54.

[13] *See id.* at 1355-57.

[14] *Id*. at 1360.

[15] Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (N.D. Md. 2004).

motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."[16] The fact that the taxpayer's sole motivation was tax avoidance was undisputed. With respect to the test's objective second prong, the court stated it would be met if the business engaged in "bona fide economically-based business transactions."[17] The court found that the transaction met this standard because it had "very real economic implications" for the health plan participants and the businesses involved in the transaction because the subsidiary had assumed the administration of the benefit plans, was responsible for paying the claims, had proposed cost containment strategies that had been implemented, and had always had salaried employees.[18] Thus, the court found that the transaction had economic substance and granted BDC's motion for summary judgment.

The U.S. Court of Appeals for the Fourth Circuit disagreed with the district court.[19] Because BDC had conceded the subjective prong of the test, the court looked only at the objective prong. The appeals court stated that the lower court had misapplied that prong by focusing on the subsidiary's business activities, when the test actually required looking at whether the transaction had a reasonable expectation of profit outside of the tax benefits.[20] The court therefore found that many of the facts upon which the district court had based its decision (e.g., the fact that the subsidiary had salaried employees and paid claims as they came due) were irrelevant. Thus, the court reversed the district court's decision and remanded the case for further proceedings to determine the economic substance issue.

Dow Chem. Co. v. United States. Dow entered into a plan under which it bought corporate-owned life insurance (COLI) policies, of which it was the owner and beneficiary, on the lives of more than 21,000 employees. The company paid the premiums by borrowing funds from the insurers using the policies' cash value as collateral and by making partial withdrawals from the policies' cash value. The plan was not expected to generate positive pre-deduction cash flows or earn significant inside build-up (i.e., earn interest on the policies' value) unless Dow made substantial investments of cash into the plan. The plan also limited Dow's potential mortality gain (i.e., its potential to profit by being paid more death benefits than expected because of a high number of deaths). Dow deducted more than $33 million for interest paid on loans used to pay the premiums. The IRS disallowed the deductions, arguing that the transaction lacked economic substance.

The district court held that the transaction did not lack economic substance.[21] The court began by stating that the economic substance doctrine required the court to determine whether the transaction "has any practicable economic effects other than the

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[16] *Id*. at 623.

[17] *Id*. at 624.

[18] *Id*.

[19] Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006).

[20] *See id.* at 441.

[21] Dow Chem. Co. v. United States, 250 F. Supp. 2d 748 (E.D. Mich. 2003).

creation of income tax losses," and, if so, whether the "taxpayer had a legitimate profit motive in entering into the transaction."[22] The court, looking at prior cases in which courts had held COLI plans to lack economic substance, determined the test would be met if the transaction generated positive pre-deduction cash flow and it was possible for Dow to profit from both inside build-up and mortality gain. The court determined that these factors were met because the net present value of the policies was positive, the plan allowed for inside build-up, and the plan did not completely eliminate the transfer of risk.[23]

The Sixth Circuit Court of Appeals reversed the district court.[24] Although the appellate court found that the lower court had properly framed the inquiry by looking at the plan's key characteristics to determine whether it lacked economic substance, it disagreed with the district court's findings on each factor.[25] Specifically, the appellate court stated the district court erred by not looking at Dow's past conduct in determining the likelihood that Dow would make the significant future investments necessary for the plan to eventually have positive pre-deduction cash flow and generate inside build-up. The court found that Dow's past conduct made such future conduct unlikely. The appellate court also stated that the district court wrongly required that the plan not provide *any* possibility of mortality gain, and found that while the plan did allow for the possibility of such gain, it was basically designed to make the mortality provisions neutral. Based on these factors, the court held that the plans lacked economic substance and should be disregarded for tax purposes. Dow filed a petition for certiorari with the Supreme Court on October 4, 2006.

TIFD III-E Inc. v. United States. The taxpayer, which leased airplanes, among other business activities, became concerned during a downturn in the airline industry and entered into a transaction intended to partially monetize the value of its airplanes. The taxpayer formed a limited liability company (LLC) and then transferred airplanes worth $294 million and $246 million in cash to it. Two foreign banks then invested $117.5 million in the LLC. The LLC's operating agreement called for it to distribute most of its income to the banks each year. There was a significant difference between the bank's book income and tax income. This was because the book income had been reduced by expenses that included depreciation. The tax income, on the other hand, was not reduced by depreciation because the airplanes had already been fully depreciated for tax purposes. While the banks received most of the income, the operating agreement granted the taxpayer management control over the LLC. The operating agreement also called for the LLC to annually buy back a percentage of the banks' ownership interest so that the banks would be bought out after eight years. The overall effect of the transaction was that during the eight-year period, the taxpayer was able to partially monetize the airplanes by having access to the funds that the banks invested and the banks received a steady rate of return on their investment. The IRS argued that the transaction should be disregarded.

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[22] *Id*. at 799-800.

[23] *See id.* at 806-11.

[24] Dow Chem. Co. v. United States, 435 F.3d 594 (6th Cir. 2006), *petition for cert. filed*, 75 USLW 3207 (U.S. Oct. 4, 2006) (No. 06-478).

[25] *See id.* at 600-05.

The district court held that the transaction had economic substance.[26] The court explained that the economic substance doctrine requires the court "examine both the subjective business purpose of the taxpayer for engaging in the transaction and the objective economic effect of the transaction."[27] The court stated that the precedential decisions in the Second Circuit were unclear as to whether both prongs of the test had to be met. This was unimportant to the court, however, because it found that the transaction satisfied both tests.[28] The court reasoned that the transaction had economic effect because the banks had invested $117.5 million and received a percentage of the LLC's income in return and that the taxpayer had a subjective business purpose in participating in the transaction because it needed to raise capital. The court then looked at whether the banks were actually partners in the transaction.[29] The court found that they were because there were legitimate business reasons to create the LLC and the banks had an active stake in the LLC because its investment returns depended on the LLC's business performance.

In 2006, the U.S. Court of Appeals for the Second Circuit reversed the lower court's decision.[30] The appellate court did not disagree with the lower court that the transaction had economic substance due to the company's non-tax motive to raise equity capital. Instead, the appeals court found that the lower court erred in not looking at whether the banks were truly partners under the test developed in the Supreme Court's decision in *Comm'r v. Culbertson*.[31] The court stated that under *Culbertson*, it had to "determine[] the nature of the interest based on a realistic appraisal of the totality of the circumstances."[32] The court found that the banks did not have any real equity interest because their "interest was in the nature of a secured loan, with an insignificant equity kicker," which meant that "only in a negligible fashion was their well-secured interest intertwined with the fortunes of the business."[33] Thus, the appellate court did not find the *Culbertson* test to be met and held that the transaction should be disregarded for tax purposes.

Legislation in the 110th Congress. S. 96 (the Export Products Not Jobs Act) would codify the economic substance doctrine. The bill creates criteria for determining whether a transaction has economic substance, which apply once a court decides that the doctrine is relevant in the case. The bill also creates a new penalty for understatements of tax attributable to transactions lacking economic substance. The penalty equals 40% of the understatement and is reduced to 20% if the transaction was adequately disclosed. The bill also denies a deduction for interest on underpayments attributable to such transactions.

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[26] TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004).

[27] *Id*. at 108-09.

[28] *See id.* at 109-11.

[29] *See id.* at 111-14.

[30] TIFD III-E, Inc. v. United States, 459 F.3d 220 (2nd Cir. 2006).

[31] Comm'r v. Culbertson, 337 U.S. 733 (1949).

[32] TIFD III-E, Inc., 459 F.3d at 231.

[33] *Id*. at 241.