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**ECONOMIC SUBSTANCE DOCTRINE: HOW  
CODIFICATION CHANGES DECIDED CASES**

*Bret Wells*

THE UNIVERSITY OF HOUSTON  
LAW CENTER

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## ECONOMIC SUBSTANCE DOCTRINE: HOW CODIFICATION CHANGES DECIDED CASES

by

*Bret Wells*

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**ECONOMIC SUBSTANCE DOCTRINE:  
HOW CODIFICATION CHANGES DECIDED CASES**

*by*

*Bret Wells*\*

Health care reform mesmerized the nation last spring and created strong rhetoric on all sides. In climatic fashion, on March 25, 2010, Congress passed H.R. 4872, the Health Care and Education Reconciliation Act of 2010 (the Reconciliation Act). This legislation modified legislation that was signed into law several days earlier in H.R. 3590, the Patient Protection and Affordable Care Act (P.L. 111-148). President Obama stated that the passage of these bills represents a major accomplishment for his administration.<sup>1</sup>

Although this legislation will be remembered in the popular press for starting a new chapter in the country's health care system, the passage of the Reconciliation Act also starts an important new chapter in the nation's tax jurisprudence. In this regard, section 1409 of the Reconciliation Act adds a new section 7701(o) to the Internal Revenue Code.<sup>2</sup> This provision seeks to codify and clarify the judicially-created economic substance doctrine. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this respect, the economic substance doctrine is similar to other common law canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.<sup>3</sup> Congress had debated for years whether to codify the judicially

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\* Visiting Professor of Law, University of Houston Law Center. The author wishes to thank Calvin H. Johnson and Ira Shepard for their comments and suggestions on earlier drafts of this manuscript. The views expressed in this paper are solely the views of the author.

1. White House Press Release, Remarks by the President on Health Insurance Reform in Portland, Maine (Apr. 1, 2010), <http://www.whitehouse.gov/the-press-office/remarks-president-health-insurance-reform-portland-maine>.

2. The text of § 7701(a) is in Appendix I.

3. Staff of Joint Comm. on Taxation, 111th Cong., Description of Revenue Provisions Contained in the President's Fiscal 2010 Budget Proposal Part Two: Business Tax Provisions, at 34 (2009); Staff of Joint Comm. on Taxation, 111th Cong., Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, *as amended*, in combination with the Patient Protection and Affordable Care Act, at 142 (2010) [hereinafter Joint Comm. Technical Explanation].

created economic substance and business purpose doctrines, and now that debate is over.<sup>4</sup>

To understand how we got here, it is necessary to consider common *mistakes* that the tax system must protect against.<sup>5</sup> At its core, the U.S. tax system attempts to treat a transaction consistently between parties and consistently over the entire life of a transaction. However, because of the complexity of the U.S. tax system and because business arrangements are often comprised of multiple steps from a tax perspective, the literal application of the U.S. tax laws to complex business transactions can create fundamental “transactional inconsistencies.” Such inconsistencies represent a *mistake* from a tax policy perspective, but tax *mistakes* happen.<sup>6</sup> A *mistake* can be further categorized as either a whipsaw *mistake*, a double dip *mistake*, or a loss or a tax credit generator *mistake*. A whipsaw *mistake* arises whenever a taxpayer can change her position “mid-stream” and can benefit from that “bait and switch.”<sup>7</sup> A whipsaw *mistake* can also exist when different parties to the same transaction can take different positions.<sup>8</sup> In either situation, a whipsaw *mistake* creates a transactional inconsistency that causes the tax system to have a net revenue loss because of an inconsistency. Another common *mistake* is a double dip *mistake*. A double dip *mistake*

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4. See, e.g., Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong. (1999); Dep’t of Treasury, *The Problem of Corporate Tax Shelters: Discussed, Analysis, and Legislative Proposals* (1999). For an early work that appears to have been the genesis for the codification effort, see Calvin H. Johnson, *The Anti-Skunk Works Corporate Tax Shelter of 1999*, 84 *Tax Notes* 443 (1999).

5. Many earlier versions of the codification of economic substance doctrine, some of which were adopted by the House, also provided special rules for applying what was essentially a per se lack of economic substance in transactions with tax indifferent parties that involved financing and artificial income and basis shifting. See, e.g., H.R. 2345, 110th Cong., 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003). These rules did not make it into the enacted version.

6. It is appropriate to refer to transactional inconsistencies as a *mistake* because Congress has articulated a desire that the tax laws should accurately account for the income of the taxpayer. See IRC § 446(b) (providing that if the taxpayer’s method of accounting “does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income”). When a transactional inconsistency causes a taxpayer’s income to not be clearly and accurately reflected on a tax return, the purposes of § 446(b) have been frustrated.

7. See, e.g., F. David Lake, Jr., *The Whipsaw Problem in Federal Tax Controversies*, 34 *N.Y.U. Ann. Inst. on Fed. Tax’n* 867 (1976); Kenneth L. Harris, *Should There be a “Form Consistency” Requirement? Danielson Revisited*, 78 *Taxes* 88 (Mar. 2000).

8. See, e.g., Special Committee on Whipsaw, Section of Taxation, American Bar Association, *Final Report*, 30 *Tax Law* 127 (1976); Harvey S. Gilbert & Steve Mather, *Whipsaw Revisited*, 43 *Tax Law* 343 (1990).

occurs when multiple deductions are created for the same economic loss in multiple jurisdictions.<sup>9</sup> Because of the complexity of U.S. tax laws, cross-border transactions can often lead to inconsistent tax treatment between the U.S. tax system and another country's tax system such that a double dip benefit may arise. A third common *mistake*, a loss or tax credit generator *mistake*, is a transaction entered into primarily to permit a U.S. taxpayer to take the position that it has the right to claim a deduction, loss, or credit for tax purposes when the loss, deduction, or credit has not been incurred economically so that the tax benefit can be used to offset (i.e., "shelter") other taxable income or gain.<sup>10</sup>

Given the creativity and sophistication of the tax bar, taxpayers can affirmatively find ways to put themselves into a *mistake* situation if the tax laws were literally applied. Playing in such *mistakes* is much like "playing in the rain." We generally know when we are playing in the rain. In the end, *mistakes* should and generally do get corrected, and so a tax planning strategy that captures value from a tax *mistake* is not a "built-to-last" strategy: the rain will stop and the sun will come out again. The drama is not in terms of whether the rain will stop; the drama is in determining which branch of government will fix the *mistake* and whether a taxpayer can benefit from the *mistake* while it is raining or whether a court will thunder its disapproval. Judge Posner, speaking for the Seventh Circuit in *Yosha v. Commissioner*, made this same point in the following statement:

Well, what is wrong with all this? . . . There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes . . . . 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 . . . . If Mrs. Gregory had won, either Congress would have had to amend the statute (which it did anyway, however) or there would have been a flurry of sterile reorganizations — reorganizations not only motivated solely by a desire to

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9. See, e.g., T.D. 9315, 2007-1 C.B. 891 (noting that a "double dip" that Congress sought to prevent occurs when a dual resident corporation uses a single economic loss once to offset income that was subject to U.S. tax, but not foreign tax, and then uses the same economic loss a second time to offset income subject to foreign tax, but not U.S. tax); T.D. 8999, 2002-2 C.B. 78 (limiting the ability of a domestic reverse hybrid entity from utilizing U.S. tax treaty relief because of a concern that the use of income tax treaties to manipulate the inconsistencies between U.S. and foreign tax laws created a double dip benefit).

10. See, e.g., David Hariton, How to Define "Corporate Tax Shelter," 84 Tax Notes 883 (1999).

avoid taxes but having no consequences other than to avoid taxes.<sup>11</sup>

The question of who should win in the context of a *mistake* raises competing notions of fairness and competing notions of equity. Rewarding taxpayers for their *mistakes* motivates tax practitioners to find more and more *mistakes* to the benefit of the sophisticated taxpayer.<sup>12</sup> Such a system creates cynicism about the fairness of the nation's tax laws because it allows some taxpayers who plan for *mistakes* to receive a preference over similarly situated taxpayers who do not plan for *mistakes*.<sup>13</sup> However, a counter-equity argument can be made that taxpayers should be able to rely on the plain meaning of the tax laws. Tax laws are, by their very nature, enforced exactions.<sup>14</sup> There is something unfair about collecting an enforced exaction when the tax laws do not specifically authorize the exaction. Due to these competing notions of fairness, any tax *mistake* will create an inequity to someone, and so the question is who will suffer that inequity? It is in this context that new section 7701(o) has now entered the discussion and has sought to clarify and in many cases re-draw the line for where the taxpayer can benefit from a *mistake* and where the taxpayer cannot.<sup>15</sup>

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11. *Yosha v. Commissioner*, 861 F.2d 494, 497-98 (7th Cir. 1988).

12. See, e.g., Calvin H. Johnson & Lawrence Zelenek, Codification of General Disallowance of Artificial Losses, 122 Tax Notes 1389 (2009).

13. See Dep't of Treasury, *supra* note 4, at 3 (stating that corporate tax shelters breed disrespect for the tax system—both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a “race to the bottom.” If unabated, this could have long-term consequences to our voluntary tax system far more important than the short-term revenue loss we are experiencing).

14. See *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (“Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.”).

15. Some have argued that a positive rule of law should be adopted where the taxpayer is not allowed to benefit from a mistake regardless of the business purpose of the transaction. See, e.g., Marvin Chirelstein & Lawrence Zelenak, Essay: Tax Shelters and the Search for a Silver Bullet, 105 Colum. L. Rev. 1939 (2005).

## I. OVERVIEW OF CODIFIED ECONOMIC SUBSTANCE DOCTRINE

The modern articulation of the judicially-created economic substance doctrine traces its roots back to *Frank Lyon Co. v. United States* where the Court upheld the taxpayer's treatment of an early version of a sale-in / lease-out transaction, stating as follows:

[W]here, as here, 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, the Government should honor the allocation of rights and duties effectuated by the parties.<sup>16</sup>

From this statement in *Frank Lyons*, the courts in subsequent cases developed several different formulations of the economic substance doctrine. Under one formulation, the so-called "conjunctive test," the courts would apply the economic substance doctrine only when a transaction had both (1) economic substance and (2) a non-tax business purpose.<sup>17</sup> Under a second formulation of the economic substance doctrine, the so-called "disjunctive test," the courts would apply the economic substance doctrine only when a transaction did not have either (1) economic substance or (2) a non-tax business purpose.<sup>18</sup> Yet a third formulation of the economic substance doctrine appeared in *ACM Partnership v. Commissioner*, where the court concluded that "these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."<sup>19</sup> Thus, as a result of these various opinions, the legislative history indicates that Congress was concerned that these divergent articulations created confusion over the manner in which the economic substance doctrine should be applied.<sup>20</sup> Notwithstanding this congressional

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16. *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

17. See, e.g., *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009); *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

18. See *IES Indus. v. United States*, 253 F.3d 350, 358 (8th Cir. 2001); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

19. *ACM P'ship v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998).

20. Staff of Joint Comm. on Taxation, 111th Cong., Description of Revenue Provisions Contained in the President's Fiscal 2010 Budget Proposal Part Two:

concern, it is unclear whether these divergent formulations of the economic substance doctrine resulted in any actual conflict in the decided cases.<sup>21</sup>

The courts had also differed with respect to the nature of the non-tax economic benefit a taxpayer was required to establish in order to withstand an economic substance challenge. Some courts required merely that a potential economic profit exist in order for a transaction to withstand challenge under the economic substance doctrine.<sup>22</sup> Other courts applied the economic substance doctrine to disallow tax benefits unless the economic profit potential were more than insignificant in comparison to the tax benefits of the transaction.<sup>23</sup> Yet other courts asked whether a stated business benefit—for example, cost reduction, as opposed to profit-seeking—of a particular transaction was actually obtained through the transaction in question.<sup>24</sup> Finally, some courts have considered, but ultimately rejected, bootstrap arguments that a tax benefit can create a valid business purpose when the tax benefits increase the company's stock price.<sup>25</sup>

With this backdrop in mind, Congress decided to codify the economic substance doctrine in order to achieve a number of objectives. First, Congress was concerned that divergent articulations of the economic substance doctrine had led to an uneven application of this doctrine.<sup>26</sup>

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Business Tax Provisions, at 36-37 (2009); Joint Comm. Technical Explanation, *supra* note 3, at 143-44.

21. See, e.g., *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989) (“This court will not inquire into whether a transaction’s primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a sham.”); *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) (“Once a court determines a transaction is a sham, no further inquiry into intent is necessary.”); *Pasternak*, 990 F.2d 893, 898 (6th Cir. 1993) (“If the transaction lacks economic substance, then the deduction must be disallowed without regard to the niceties of the taxpayer’s intent.”); *Cherin v. Commissioner*, 89 T.C. 986, 993 (1987) (noting that even if a taxpayer has a profit objective, the investment is not recognized for tax purposes if the transaction lacks economic substance). Thus, considerable support exists for the proposition that a taxpayer’s subjective intent will not resurrect a deduction that has no economic substance behind it.

22. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966).

23. See, e.g., *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

24. See *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

25. See *Am. Elec. Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001), *aff’d*, 326 F.3d 737 (6th Cir. 2003); *Wells Fargo & Co. v. United States*, 91 Fed. Cl. 35, 84 (2010).

26. Staff of Joint Comm. on Taxation, 111th Cong. Description of Revenue Provisions Contained in the President’s Fiscal 2010 Budget Proposal Part Two: Business Tax Provisions, at 36 (2009); Joint Comm. Technical Explanation, *supra* note 3, at 143.



Secondly, the decision to codify the economic substance doctrine also was motivated by a congressional concern<sup>27</sup> over the decision of the Court of Federal Claims in *Coltec Industries, Inc. v. United States*.<sup>28</sup> In the *Coltec* case, the Court of Federal Claims outright questioned the legitimacy of the economic substance doctrine, stating that “the use of the ‘economic substance’ doctrine to trump ‘mere compliance with the Code’ would violate the separation of powers.”<sup>29</sup> However, in that case the trial court found that the particular transaction at issue did not lack economic substance, and thus the trial court did not actually rule on the doctrine’s validity.<sup>30</sup> Nevertheless, on appeal, the Court of Appeals for the Federal Circuit vacated the Court of Federal Claims decision and explicitly endorsed the validity of the economic substance doctrine by holding that the transaction in *Coltec* lacked economic substance and failed for that reason.<sup>31</sup> Finally, given the budget estimates associated with the codification of the economic substance doctrine, it can be inferred that Congress believed that the codification of the economic substance doctrine would further enhance the successful application of this doctrine and would curtail aggressive tax planning.<sup>32</sup>

Now that Congress has finally codified the economic substance doctrine, it is an appropriate time to consider how we think tax jurisprudence will be impacted as a result of section 7701(o)’s addition to the Internal Revenue Code. The remainder of Part I provides an overview of new section 7701(o) and the new penalties that have been enacted to enforce compliance with this new provision. Part II of this article then analyzes how several important historical court decisions may have been altered if new section 7701(o) had applied at the time those earlier court decisions were decided.

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27. Staff of Joint Comm. on Taxation, 111th Cong., Description of Revenue Provisions Contained in the President’s Fiscal 2010 Budget Proposal Part Two: Business Tax Provisions, at 37 (2009); Joint Comm. Technical Explanation, *supra* note 3, at 144.

28. *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716 (2004), *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007).

29. *Id.* at 756.

30. *Id.* at 754-56.

31. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1360 (Fed. Cir. 2006).

32. See Staff of Joint Comm. on Taxation, Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872, “The Reconciliation Act of 2010,” In Combination with the Revenue Effects of H.R. 3590, The “Patient Protection And Affordable Care Act (‘PPACA’),” (estimating \$4.5 billion of additional tax revenue through 2019 as a result of § 7701(o)).

A. *Substantive Rules Contained in New Section 7701(o)*

New section 7701(o)(1) sets forth the following requirement for applying the statutory economic substance doctrine to a particular transaction:

Section 7701(o) Clarification of Economic Substance Doctrine—

(1) APPLICATION OF DOCTRINE—In the case of any transaction to which the economic substance doctrine is *relevant*, such transaction shall be treated as having economic substance *only if*—

(A) the transaction *changes in a meaningful way (apart from Federal income tax effects)* the taxpayer's economic position, *and*

(B) the taxpayer has *a substantial purpose* (apart from Federal income tax effects) for entering into such transaction.<sup>33</sup>

The codification of the economic substance doctrine in new section 7701(o)(1) clarifies and standardizes the application of the economic substance doctrine, but importantly it does not establish explicit rules for determining when the doctrine should be applied. Thus, an important initial question is when will the economic substance doctrine be relevant within the meaning of section 7701(o)(1)? New section 7701(o)(5)(C) states that “[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [new section 7701(o)] had never been enacted.” According to the legislative history, “the provision [section 7701(o)(5)(C)] does not change present law standards in determining when to utilize an economic substance analysis.”<sup>34</sup> Furthermore, the legislative history goes on to state that “the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.”<sup>35</sup> Finally, the legislative history indicates that the economic substance doctrine is relevant unless the tax benefits are consistent with all applicable provisions of the code and the purpose of such provisions.<sup>36</sup> Thus, the court will need to engage in a facts and circumstances inquiry as to whether a particular result is “consistent

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33. See IRC § 7701(o)(1) (emphasis added).

34. See Joint Comm. Technical Explanation, *supra* note 3, at 152.

35. *Id.* at 153.

36. *Id.* at 152.

with” the purpose of the tax laws.<sup>37</sup> It is unclear whether the court will decide this issue as part of a de novo review or whether the court will give some level of deference to the government’s assertion that the economic substance doctrine is “relevant.”<sup>38</sup>

However, the legislative history did indicate that “[t]he 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.”<sup>39</sup> The list of transactions intended to be immunized from the application of section 7701 includes:

- (1) the choice between capitalizing a business enterprise with debt or equity;
- (2) 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.<sup>40</sup>

Given that the legislative history sets forth a limited “angel list” of approved transactions and states that this list is non-exhaustive, one would expect that the tax community will request the Treasury Department to utilize its rulemaking authority to further expand the list of safe transactions that need not have a non-tax motivation. Leasing transactions were not placed on an “angel list” and thus will continue to be scrutinized based on all of the facts and circumstances.

When the economic substance doctrine does apply, new section 7701(o) standardizes the methodology for its application. In this regard, new section 7701(o)(1) adopts a conjunctive analysis under which a transaction has economic substance only if (A) the transaction changes the taxpayer’s economic position in a meaningful way apart from federal income tax effects

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37. Id. at 153.

38. *Compare* *Conn. Gen. Life Ins. Co. v. Commissioner*, 177 F.3d 136, 143-46 (3d Cir. 1999) (giving some deference to the IRS’s interpretation of a regulation offered for the first time during that particular controversy), *with* *CSI Hydrostatic Testers v. Commissioner*, 103 T.C. 398, 408-09 (1994), *aff’d*, 62 F.3d 136 (5th Cir. 1995) (granting some deference to an IRS litigating position only when that position was based on a published IRS position or was a longstanding administrative position).

39. See Joint Comm. Technical Explanation, *supra* note 3, at 152.

40. Id. at 152-53.

and (B) the taxpayer has a substantial business purpose, apart from federal income tax effects, for entering into the transaction. In earlier versions of this legislation, section 7701(o)(1)(B) had added the following additional statement: “[A]nd the transaction is a reasonable means of accomplishing such purpose.”<sup>41</sup> It is not clear what difference in application was intended by the deletion of this qualifier language in the final statutory language. The conjunctive test set forth in section 7701(o)(1)(A) and (B) resolves the split between the circuits (and between the Tax Court and certain circuits)<sup>42</sup> by rejecting the view of those courts that held the economic substance doctrine was satisfied if there were either (1) a change in the taxpayer’s economic position or (2) a non-tax business purpose.<sup>43</sup>

Furthermore, new section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions. In this respect, new section 7701(o)(5)(D) and its associated legislative history is likely to have a significant impact on how a transaction will be framed under the economic substance doctrine. To better understand this assertion, it is appropriate to review the standards for applying business purpose and economic substance under judicial case law that predates section 7701(o)’s enactment.

In the landmark case of *Gregory v. Helvering*, Judge Learned Hand set forth the following boundaries for the business purpose doctrine:

We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.<sup>44</sup>

Commentators have forcefully argued that this statement in *Gregory* and similar statements in other cases grant the taxpayer the right to structure an overall transaction in the most tax advantageous manner as long as the

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41. See, e.g., H.R. 2345, 110th Cong., 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003).

42. See Joint Comm. Technical Explanation, *supra* note 3, at 154.

43. For cases that had articulated the “disjunctive test,” see generally *IES Indus., Inc. v. United States*, 253 F.3d 350, 353 (8th Cir. 2001); *Rice’s Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

44. *Gregory v. Helvering*, 69 F.2d 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

overall transaction has economic substance and business purpose.<sup>45</sup> In contrast, the Federal Circuit in *Coltec* stated that the taxpayer in that case failed to meet the requirements of the economic substance doctrine by focusing on the tax motivations for one particular step in an overall transaction that failed to possess economic substance and business purpose:

[T]he transaction to be analyzed is the one that gave rise to the alleged tax benefit. For example, in *Basic Inc.*, where the taxpayer underwent an inter-company transfer of stock to allow the parent to sell the stock to a third-party with little taxable gain, our predecessor court looked for the economic substance of the inter-company transfer of stock—not of the ultimate sale of stock to the third-party. The court explained that if the business purpose of the ultimate sale could be used to justify the unnecessary inter-company transfer, then “all manner of intermediate transfers could lay claim to ‘business purpose’ simply by showing some factual connection, no matter how remote, to an otherwise legitimate transaction existing at the end of the line.”<sup>46</sup>

In reaching its opinion, the Federal Circuit cited the *Gregory* decision extensively and then cited two other circuit courts for the

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45. See David Hariton, *The Frame Game: How Defining the “Transaction” Decides the Case*, 63 *Tax Law.* 1 (2009); David Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 *Tax L. Rev.* 29, 43-44 (2006) [hereinafter Hariton, *Economic Substance*] “[S]ubsequent courts adopted and applied the reasoning of *Gregory v. Helvering* to disallow tax benefits arising from a transaction that lacked business purpose and economic substance considered as a whole. And I believe that courts should continue to apply the ‘economic substance doctrine’ in this manner today rather than broaden it further, lest its coherence be undermined.”); David Hariton, *Sorting Out the Tangle of Economic Substance*, 52 *Tax Law.* 235 (1999).

46. *Coltec Indus. v. United States*, 454 F.3d 1340, 1356 (Fed. Cir. 2006) (citations omitted); see also *Black & Decker Corp. v. United States*, 436 F.3d 431, 442 (4th Cir. 2006) (“[E]ssential question posed in Taxpayer’s motion is whether the IRS adduced sufficient facts to go to trial on its argument that Taxpayer lacked ‘any reasonable expectation of a profit’ from the transaction that generated the claimed \$560 million capital loss reported on the 1998 return. We conclude that the IRS offered ample evidence to permit a reasonable trier of fact to find in the IRS’s favor.”); *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2002) (“The relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance.”); *ACM P’ship v. Commissioner*, 157 F.3d 231, 260 & n.57 (3d Cir. 1998) (stating that the Tax Court properly excluded profits from certain aspects of related transactions in order to determine profit potential for the transaction tested for economic substance).

proposition that a transaction should be disaggregated to analyze the component part that created the tax *mistake*.

With this backdrop in mind, it appears that section 7701(o)(5)(D) seeks to make clear that the government has the ability to disaggregate transactions and to test each transactional step individually. The legislative history goes further in this regard by stating that this provision “does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine,” thus by implication suggesting that a court should exercise this authority.<sup>47</sup> Furthermore, the legislative history favorably cites the *Coltec* case and then states that a court has the ability “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.”<sup>48</sup> This ability to disaggregate, isolate, or bifurcate a tax-motivated aspect of a larger transaction resolves the conflict that had developed among the courts as to whether the economic substance doctrine is applied on an overall basis or whether this doctrine applies to each separate step individually.<sup>49</sup>

New section 7701(o) does not explicitly require a taxpayer to have a pre-tax profit in order for a transaction to have a substantial business

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47. See Joint Comm. Technical Report, *supra* note 3, at 153. For cases that favorably allowed a bifurcation approach, see generally *ACM P’ship*, 157 F.3d at 256 n. 48; *James v. Commissioner*, 899 F.2d 905, 910 (10th Cir. 1990) (“The only transactions at issue in this case are the purported sales by the Communications Group to the joint ventures. These sales cannot be legitimized merely because they were on the periphery of some legitimate transactions.”); *Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991) (“The activities of the other entities involved in exploiting the Koppelman process, however, cannot necessarily be attributed to POGA [the taxpayer].”); *Long Term Capital Holdings v. United States* 330 F. Supp. 2d 122 (D. Conn. 2004); *aff’d*, 150 F. App’x 40 (2nd Cir. 2005).

48. See Joint Comm. Technical Explanation, *supra* note 3, at 153.

49. *Compare Coltec*, 454 F.3d at 1358 (“The first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale.”) *with* *Shell Petroleum, Inc. v. United States*, 102 A.F.T.R. 2d 5085, 5111 (S.D. Tex. July 3, 2008) (“[T]he Court has found no 5th Circuit cases, and the parties have cited none, similarly dissecting or, ‘slicing and dicing’ as it was referred to in oral arguments, an integrated transaction solely because the Government aggressively chooses to challenge only an isolated component of the overall transaction. Indeed, commentators have criticized *Coltec’s* disregard of the larger context in which the intended § 351 exchange occurred.”); see also Hariton, *Economic Substance*, *supra* note 45, at 40–44 (2007) (stating that *Coltec’s* narrow framing of the operative transaction represents a “fundamental misunderstanding” of the Supreme Court’s seminal decision in *Gregory v. Helvering*, 293 U.S. 465 (1935), which instead supports the notion that transactions must be viewed as a whole).

purpose.<sup>50</sup> However, if the taxpayer's substantial business purpose does rely on an argument that a transaction has a profit motivation, then new subsections 7701(o)(2) through (4) set forth the following criteria for analyzing whether this profit potential is substantial enough to satisfy economic substance concerns:

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL—

(A) IN GENERAL—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 the expected net tax benefits* that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES—Fees and other *transaction expenses shall be taken into account as expenses* in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring *foreign taxes to be treated as expenses* in determining pre-tax profit in appropriate cases.

(3) STATE AND LOCAL TAX BENEFITS—For purposes of paragraph (1), any *State or local income tax* effect which is related to a Federal income tax effect shall be treated *in the same manner* as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS—For purposes of paragraph (1)(B), achieving *a financial accounting benefit shall not be taken into account* as a purpose for entering into a transaction *if the origin of such financial accounting benefit is a reduction of Federal income tax.*<sup>51</sup>

As set forth above (emphasis added), in calculating the expected profit potential, new section 7701(o)(2)(B) requires that transaction costs be taken into account. What is more, in a departure from prior law,<sup>52</sup> new

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50. See Joint Staff Comm. Technical Explanation, *supra* note 3, at 154-55.

51. IRC §§ 7701(o)(2)-(4), (emphasis added).

52. See *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 784 (5th Cir. 2001) (holding that “the Tax Court erred as a matter of law by disregarding the gross amount of the Royal Dutch dividend”), *rev'g* 113 T.C. 214 (1999) (treating foreign taxes as an expense for purposes of computing Compaq's profit on the ADR transaction); Notice 2004-19, 2004-1 C.B. 606, *withdrew* Notice 98-5, 1998-1 C.B.

section 7701(o)(2)(B) also requires the Treasury Department to issue regulations to treat foreign taxes as expenses for purposes of calculating the reasonably expected pre-tax profit potential of a transaction. In addition, new section 7701(o)(3) provides that the state or local income tax effect of a transaction that is related to a federal income tax effect is treated in the same manner as a federal income tax effect.<sup>53</sup> Thus, state tax savings that piggy-back on federal income tax savings cannot provide either a profit potential or a business purpose. Similarly, new section 7701(o)(4) provides that a financial accounting benefit cannot satisfy the business purpose requirement if the financial accounting benefit originates in a reduction of federal income tax.<sup>54</sup> Finally, once the reasonably expected pre-tax profit potential is determined, new section 7701(o)(2)(A) requires the taxpayer to then apply present value concepts before determining whether the reasonably expected profit is substantial. The requirement to utilize net present value concepts directly overturns the holding of *Consolidated Edison Co. of New York v. United States*.<sup>55</sup> In the *Consolidated Edison* case, the court rejected the use of any net present value analysis in determining the application of the judicially developed economic substance doctrine.<sup>56</sup> Thus, taken in their totality, these statutorily prescribed adjustments represent a significant alteration in how the reasonably expected pre-tax profit potential will be calculated when compared with the diversity of methods that is contained in existing case law.

It is also important to note that section 7701(o)(2) does not provide an explicit return threshold, and in this respect the enacted version differs from earlier proposals that would have only required the reasonably expected pre-tax profit from the transaction to exceed a risk-free rate of return.<sup>57</sup> Instead of providing for a safe-harbor profit threshold, new section 7701(o)(2)(A) requires that the expected pre-tax profit potential must be substantial in comparison to the expected tax benefits. Thus, section 7701(o) does not simply allow a transaction to withstand attack even though it has business purpose or some positive profit level. Instead, the economic consequences must be substantial in comparison to the tax benefits being created. This standard requires a weighing of the relative benefits of a transaction, and as such this comparative approach causes the court to make

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334 (stating that foreign taxes should be treated as an expense for purposes of determining economic profit).

53. See Joint Comm. Technical Explanation, *supra* note 3, at 154.

54. *Id.*

55. *Consol. Edison Co. of N.Y. v. United States*, 90 Fed. Cl. 228 (2009).

56. *Id.* at 328-29.

57. See, e.g., H.R. 2345, 110th Cong, 1st Sess. (2007); H.R. 2, 108th Cong., 1st Sess. (2003); see also Joseph Bankman, *Articles and Essays: The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 23-26 (2000) (discussing various alternative approaches that could have been adopted).



an analysis of the relative tax versus non-tax motivations. This comparative analysis appears to increase the required showing on the part of the taxpayer of the level of non-tax benefits beyond what has generally been required under existing case law.<sup>58</sup>

Although it is clear that new section 7701(o) requires taxpayers to demonstrate a substantial economic consequence for a transaction, the standard set forth in section 7701(o) does leave several unresolved questions. In this regard, would the net present value of the reasonably expected potential profit be “substantial” if it were at least equal to 33% of the net present value of the expected tax benefits? What would be the result if the reasonably expected net present value of the potential pre-tax profit were less than 33% of the expected tax benefits but more than 20% of the net present value of the expected tax benefits? Would an economic consequence of this amount be “substantial” within the meaning of new section 7701(o)(2)? Suppose a transaction showed minimal non-tax profitability but did create several subjective economic consequences to the taxpayer. Would the non-tax economic consequences in this situation be “substantial”? These questions are left unresolved, but the burden is clearly on the taxpayer to demonstrate the substantial nature of the non-tax benefits for engaging in a tax preference transaction.

As two concluding points, it is important to note that new section 7701(o)(5)(B) specifically provides that the statutory modifications and clarifications apply to an individual only with respect to “transactions entered into in connection with a trade or business or an activity engaged in for the production of income.” Finally, the legislative history also states that the codification of the economic substance doctrine supplements existing judicial doctrines but does not alter or supplant any other judicial interpretive doctrines such as the business purpose, substance over form, and step

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58. See *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94, 111 (D. Conn. 2004) (stating that “[i]n evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self-serving testimony,” and holding for the government, but the analysis involved a transaction that possessed extremely minor economic consequences), *rev’d and remanded*, 459 F.3d 220 (2nd Cir. 2006); Dep’t of Treasury, *supra* note 4, at 97 (stating that the Administration’s proposal for codifying the economic substance doctrine “does not look to motive or business purpose, as these concepts are viewed as subjective and potentially subject to taxpayer manipulation.”); Bankman, *supra* note 56, at 27-28 (“[A] primary criticism of the business purpose test is that it leads to the creation of false or misleading documents that evidence nontax motives.”); Hariton, *Economic Substance*, *supra* note 45, at 53-54; Yoram Keinan, *The Many Faces of the Economic Substance’s Two-Prong Test: Time for Reconciliation?* 1 N.Y.U. J.L. & Bus. 371, 400 (2005) (discussing the overly subjective nature of business purpose and the resulting uncertainty and uncertain for tax shelter analysis).

transaction doctrines.<sup>59</sup> Thus, one would expect that the step transaction doctrine's various "formulations,"<sup>60</sup> including the end result test,<sup>61</sup> remain as an independent inquiry for the courts. Furthermore, the expressed endorsement of these judicial doctrines in the legislative history to section 7701(o) is likely to further embolden the courts to further develop these judicial doctrines given that the courts now have expressed congressional endorsement of these judicial doctrines.

*B. New Penalty Regime Under Section 6662(b)(6) and Section 6664(c)(2)*

New section 6662(b)(6), in conjunction with new section 6664(c)(2), imposes a strict liability 20 percent penalty for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance. The penalty is increased to 40 percent if the taxpayer did not adequately disclose the relevant facts on the original return or an amended return filed before the taxpayer was contacted for audit.<sup>62</sup> One would expect that the enhanced penalty provided in section 6662(i) for undisclosed positions will be the subject of significant future discussion among tax professionals and taxpayers because there is an inherent tension between the need to "disclose just enough" about a transaction in order to meet the requirements of section 6662(i) while at the same time taxpayers will be motivated to "not disclose too much." As this gets sorted out in practice, one would expect that the courts will look to the underlying policy behind section 6662(i) and will accept a taxpayer's disclosure as being sufficient only when the disclosure in fact reasonably provides sufficient information to the IRS to identify the specific aspects of the transaction that give rise to section 7701(o) concerns.

Because a "reasonable cause" exception to section 6664(c) is unavailable, outside (or in-house) analysis and opinions of counsel or other tax advisors will not insulate a taxpayer from the penalty if a transaction is found to lack economic substance. Likewise, new section 6664(d)(2) precludes a reasonable cause defense to imposition of the section 6662A reportable transaction understatement penalty for a transaction that lacks

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59. Joint Comm. Technical Explanation, *supra* note 3, at 155.

60. See *Penrod v. Commissioner*, 88 T.C. 1415, 1433 (1987).

61. The most expansive formulation of the step transaction doctrine has been called the "end result test." Under the end result test, steps will be collapsed if they are "component parts of an overall plan." See *Crenshaw v. United States*, 450 F.2d 472, 475 (5th Cir. 1971), (citations omitted); see also *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983); *King Enters. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). For a further discussion of the end result test, see Stephen S. Bowen, *The End Result Test*, 72 *Taxes* 722, 722–24 (Dec. 1994) ("[T]he end result test is very much the order of the day.").

62. See IRC § 6664(i).

economic substance. What is more, section 6662A(e)(2) has been amended to provide that the section 6662A penalty imposed with respect to a reportable transaction understatement does not apply to a transaction that lacks economic substance if a 40 percent penalty is imposed under section 6662(i). A similar no-fault penalty regime applies to excessive erroneous refund claims that are denied on the ground that the transaction on which the refund claim was based was a transaction that lacked economic substance.<sup>63</sup> However, under the “every dark cloud has a silver lining” maxim, the section 6662(b)(6) and section 6664(c)(2) penalty regime does not apply to any portion of an underpayment on which the section 6663 fraud penalty is imposed.

## II. REVIEW OF DECIDED CASES ILLUMINATES WHERE SECTION 7701(O) CHANGES JUDICIAL HOLDINGS

The cases that are set forth in the following sections present careful tax planning strategies that created a *mistake* and allowed the taxpayer to benefit from this *mistake*. For the most part, these transactions have not been considered as tax shelter cases. Other cases could have been chosen, but these were chosen because they raise fundamental interpretive questions with respect to new section 7701(o)'s application to complex business transactions. By analyzing the application of new section 7701(o) in light of the facts set forth in these historic cases, Part II draws some important conclusions about how tax planning and tax jurisprudence outside of the tax shelter context is likely to be impacted as a result of section 7701(o)'s addition to the U.S. tax laws.

### A. *Woods Investment Co. v. Commissioner*<sup>64</sup>

The decision in *Woods Investment Co.* is thought-provoking because it helps to frame the issue of whether new section 7701(o) changes the landscape for the government to argue against the application of its own regulations.

#### 1. *The Historical Basis for the Opinion*

In *Woods Investment Co.*, the taxpayer's consolidated group computed consolidated net income with reference to accelerated depreciation claimed by its operating subsidiary. However, for purposes of making investment basis adjustments in the stock of the operating subsidiary under former Regulations section 1.1502-32(a), the parent reduced its basis in the

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63. See § 6676(c).

64. *Woods Inv. Co. v. Commissioner*, 85 T.C. 274 (1985).

subsidiary stock using straight-line depreciation. The taxpayer relied on Treasury regulations that existed at the time that required taxpayers to make investment basis adjustments using straight-line depreciation. The parent company sold its investment in its subsidiary and reported a gain of \$1,472,378. If the taxpayer had used a consistent method of depreciation for purposes of computing its consolidated taxable income and for purposes of making its investment basis adjustments, its gain on the disposal of the subsidiary would have been \$12,252,266. The IRS issued a deficiency notice stating that the parent should have reduced its subsidiary stock basis for the excess amount of accelerated over straight-line depreciation in order to avoid a “double deduction.”<sup>65</sup> Thus, there was a *mistake*, and this *mistake* represented a *mistake* based on a transactional inconsistency in that the taxpayer was stating that its depreciation was one amount for one part of its tax return and then was claiming that its depreciation was a lower amount for a different part of the same tax return. But, in the taxpayer’s defense, this inconsistent assertion was literally required as a technical matter under the consolidated return regulations that existed at the time.

The court in *Woods Investment Co.* refused to fix the whipsaw *mistake* that was created by the consolidated return regulations. In fact, the court said that the *mistake* was one of the Commissioner’s own doing and if he wanted to have a different result then the government should change its own regulations. The following statement was particularly poignant:

In 1982, although respondent changed his position to the one he advances herein, he failed to amend his regulations to reflect his new position.

Based upon the foregoing, we conclude that petitioner reached the result mandated by respondent’s consolidated return regulations and section 312(k) in computing its basis in the subsidiaries’ stock. We believe that judicial interference sought by respondent is not warranted to alter this result. This Court will apply these regulations and the statute as written. If we were to make a judicial exception with respect to the adjustment for depreciation, *we would be opening our doors for respondent every time he was dissatisfied with a certain earnings and profits adjustment.*

If respondent believes that his regulations and section 312(k) together cause petitioner to receive a “double deduction,” then respondent should use his broad power to amend his regulations. See *Henry C. Beck Builders, Inc. v. Commissioner*, 41 T.C. 616, 628 (1964). Since respondent

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65. See *id.* at 279.

has not taken steps to amend his regulations, we believe his apparent reluctance to use his broad power in this area *does not justify judicial interference in what is essentially a legislative and administrative matter.*<sup>66</sup>

Thus, *Woods Investment Co.* presented the court with a *mistake* in how the law was being applied, and the court stated that this *mistake* needed to be fixed by another branch of government. The Service announced that it would not appeal the decision in *Woods Investment Co.*<sup>67</sup> Congress eventually fixed the *mistake* highlighted by *Woods Investment Co.* for dispositions occurring after December 15, 1987, by adding section 1503(e) to the Code.

## 2. *How New Section 7701(o) Would Change Things*

In a world where new section 7701(o) now applies, the opinion in *Woods Investment Co.* would need to be substantially rewritten. The court would not be able to simply dismiss the government's statements that a double deduction created under the consolidated return regulations should be fixed by the administrative branch. The IRS made a showing in *Woods Investment Co.* that the result achieved under the consolidated return regulations by the taxpayer in that case was unintended, and the government also demonstrated that several interpretive administration rulings had been issued that confirmed the government's assertion. Thus, it would appear that sufficient grounds would exist for the court to find that the *mistake* created by the consolidated return regulations in *Woods Investment Co.* represents a situation in which the economic substance doctrine is "relevant."<sup>68</sup> Thus, it would appear that new section 7701(o) opens the door for the Commissioner to argue against the plain meaning of its own regulations when those regulations lead to an unintended result.

Assuming, as is likely to be the case, that the government would be able to convince the Tax Court that the economic substance doctrine is "relevant" to the consolidated return *mistake* because a double deduction is not consistent with the purpose of the tax laws, the burden would be on the taxpayer to demonstrate that the transaction that had given rise to this tax *mistake* changed the taxpayer's position in a meaningful way and had a substantial non-tax purpose.<sup>69</sup> If the taxpayer could meet its burden of proof with respect to the requirements contained in section 7701(o)(1)(A) and (B),

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66. *Id.* at 281-82 (emphasis added).

67. Announcement 86-32, 1986-12 I.R.B. 26, 1986 I.R.B. LEXIS 264 (Mar. 24, 1986).

68. § 7701(o)(1).

69. IRC §§ 7701(o)(1)(A), (B).

then it could capture an unintended benefit from this *mistake*. Although not free from doubt, it would appear that the taxpayer would likely be able to meet its burden of proof in the fact pattern presented in *Woods Investment Co.* because (1) the taxpayer's effort to sell a real operating subsidiary changed the taxpayer's economic position in a meaningful way, and (2) the taxpayer should be able to demonstrate that the disposal of a real operating subsidiary has a substantial business purpose apart from the tax benefits of such a sale. So, as to the disposal transaction, this transaction would likely satisfy the economic substance doctrine. Likewise, as to the transactions that gave rise to the right to claim accelerated depreciation deductions at the operating subsidiary level, the taxpayer would likely satisfy economic substance concerns if it could show that the assets subject to accelerated depreciation were used in a meaningful way in the business of its subsidiary and if it could show that those assets were acquired for a substantial business reason apart from their tax depreciation.

Thus, new section 7701(o) opens the door for the IRS to argue against the plain meaning of its own regulations in cases such as *Woods Investment Co.* but the actual holding in that particular case probably would not change because the transactions used to create the *mistake* had substantial economic consequences to the taxpayer. However, having said this, it is important to note that the court would be required to go through a fact finding exercise before reaching this conclusion and that a failure by the taxpayer to meet its factual burden of proof under section 7701(o)(1) with respect to the acquisition of depreciable assets and the disposal of its subsidiary would be fatal. Thus, this analysis indicates that new section 7701(o) appears to eliminate the taxpayer's ability to assert arguments of government estoppel or detrimental reliance when the regulations that are being relied upon create a tax *mistake* to which section 7701(o) is relevant. If subsequent judicial cases concur in this assessment, then section 7701(o) will have an important impact on the course of future tax jurisprudence.

#### B. *Textron, Inc. v. United States*<sup>70</sup>

The facts in the *Textron* case are fascinating because they present the issue of how the government will be able to bifurcate a transaction to isolate one narrow aspect of an overall transaction for purposes of applying the economic substance doctrine.

##### 1. *The Historical Basis for the Opinion*

Textron took tax deductions in the amount of \$1,259,714.67 for worthless securities and \$4,670,520.02 for bad debts for the taxable year

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70. *Textron, Inc. v. United States*, 561 F.2d 1023 (1st Cir. 1977).

ended January 2, 1960 with respect to its wholly owned subsidiary, Hawaiian Textron, Inc. (“Hawaiian”). In April, 1960, Textron acquired the assets of the Bell Defense Group from Bell Aircraft Corporation using Hawaiian as the receptacle. Textron transferred approximately \$16,500,000 to Hawaiian to purchase Bell’s assets, and Hawaiian’s name was changed to Bell Aerospace Corporation (“Bell”). Bell, in contrast with Hawaiian, made money. Hawaiian’s operating loss carryover of \$6,745,025.35 was fully utilized by Bell (pursuant to section 172 of the Internal Revenue Code). The net result was that Bell, a subsidiary of Textron, offset its profits by using a loss carryover that its predecessor, Hawaiian, had accumulated, and Textron claimed an additional tax deduction for its investment in Hawaiian. Thus, for one economic loss, Textron claimed a double deduction. This represents a loss-generator *mistake* or perhaps a whipsaw *mistake*. The deductions for the worthless stock and bad debts of Hawaiian under section 165 and section 166 were disallowed on audit and refund litigation ensued. The District Court of Rhode Island ruled in favor of the taxpayer,<sup>71</sup> and the case was subsequently appealed to the First Circuit.

The First Circuit recognized that a *mistake* had been made, but the court believed that the *mistake* should be corrected by Congress, not the courts, and so the court explicitly refused to apply judicial equity considerations in its decision.<sup>72</sup> Judge Coffin, writing for the majority of the First Circuit, reasoned as follows:

Admittedly, Textron has turned its Hawaiian sow’s ear into a silk purse—and filled it at Treasury expense. But this is a matter that should be cured by statute or regulation, not by a far reaching retroactive court decision.

The dissent, agreeing that the Service’s approach must fail, introduces a theory that the Service has advanced diffidently at best. The dissent would brand as a “double deduction” Textron’s worthless stock and debt claim and Bell Aerospace’s carry-over loss deductions. We have grave doubts about the dissent’s casual eliding of the distinction between parent and subsidiary. They are separate taxpayers. In the absence of a consolidated return, cf. *Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), treating the two corporations as one may not be justified. But cf. *Marwais Steel Co. v. Commissioner*, 354 F.2d 997 (Ninth Cir. 1965). It is no answer to invoke the maxim that substance must prevail over form. Textron’s subsidiary was never a sham

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71. *Textron, Inc. v. United States*, 418 F. Supp. 39 (D.R.I. 1976), *aff’d*, 561 F.2d 1023 (1st Cir. 1977).

72. *Textron*, 561 F.2d at 1026-27.

corporation lacking any substantial business purpose. In the first place, we are not inclined to adopt a policy of ignoring the distinction between parent and subsidiary in all tax cases. In the second place, corporate taxation is an area of careful planning, planning that will be seriously disrupted if courts simply ignore separate entities whenever it seems “fairer” to do so. We decline to inject so massive and unsettling a dose of “equity” into the tax laws without a clear invitation from the Service and a careful exploration of the issue by both sides.<sup>73</sup>

In contrast to the majority opinion, Judge Bownes stated in dissent that the court should apply substance over form principles and not allow a parent-subsidiary arrangement to create a double deduction. In fact, the dissenting opinion written by Judge Bownes is remarkably consistent with the economic substance doctrine as codified by section 7701(o).

In any event, as a matter of tax history, neither the Tax Court nor the First Circuit fixed the *Textron* mistake.<sup>74</sup> In the end, Congress eventually fixed this *mistake* statutorily by adding current section 382(g)(4)(D) to the Code. Under section 382(g)(4)(D), a worthless stock deduction claimed by a more than 50% shareholder creates an ownership change for the subsidiary. Given that a subsidiary in the *Textron* fact pattern would be considered worthless at the time of this fictional ownership change, the section 382 limitation would be zero. Thus, in the words of the court, the taxpayer in *Textron* was able to turn a *mistake* (a “sow’s ear,” in the court’s own words) into a “silk purse” and “filled it at Treasury expense.”<sup>75</sup>

## 2. How New Section 7701(o) Would Change Things

New section 7701(o) arguably would have changed the holding in *Textron* if it had existed at the time that the *Textron* case was decided. In this regard, the court would be required to employ equitable doctrines to determine whether the taxpayer’s “careful planning”<sup>76</sup> in the *Textron* transaction would withstand attack under the economic substance doctrine.

The IRS made a showing in *Textron* that the result achieved by the taxpayer in that case was unintended because the taxpayer received the economic benefit of a double deduction. But, under new section 7701(o), a

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73. *Id.* (footnotes omitted).

74. For a thoughtful review of the judicial options to handle the *Textron* mistake, see William Natbony, *Twice Burned or Twice Blessed—Double Deductions in the Affiliated Corporation Context*, 6 J. Corp. Tax’n 3 (1979).

75. *Textron*, 561 F.2d at 1026.

76. *Id.*



court can no longer simply “decline to inject so massive and unsettling dose of ‘equity’ into the tax laws”<sup>77</sup> because that is exactly what new section 7701(o) explicitly requires a court to do. Furthermore, if the *Textron* case were analyzed in the context of new section 7701(o), it seems fairly clear that there are ample grounds to find that the double deduction *mistake* in *Textron* is not consistent with the underlying purpose of the tax laws. If the court made this finding as part of a de novo review of the court record or if the court gave some deference to the government’s assertion about the underlying purpose of the tax laws, then in either case the result would be that the economic substance doctrine would likely be considered relevant to the tax planning transaction implemented in the *Textron* case.

Once the economic substance doctrine were found to be relevant to the *Textron mistake*, the burden would be on the taxpayer to demonstrate that the transaction, or series of transactions, changed the taxpayer’s position in a meaningful way and had a substantial non-tax purpose.<sup>78</sup> If the taxpayer could meet its burden of proof with respect to these requirements that are contained in sections 7701(o)(1)(A) and (B), then it could still benefit from this *mistake* even though a double deduction was created.

Certainly, the acquisition of an aerospace business represented a meaningful change in the economic position of Textron’s investments, and the acquisition of this profitable business clearly had a substantial non-tax business purpose. However, the IRS would likely argue that the acquisition of a new business is not the key aspect of the transaction that needs to be tested. Instead, the IRS would focus its concern on the question of whether the use of Hawaiian was an extraneous and unnecessary part of the transaction that does not satisfy economic substance doctrine concerns. In this regard, new section 7701(o)(5)(D) allows the economic substance doctrine to be applied to a single transaction or to a series of transactions. The Staff of the Joint Committee report indicates that the provision gives a court the ability “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.”<sup>79</sup>

Based upon new section 7701(o)(5)(D) and the legislative history of this provision, the IRS would seek to bifurcate the use of Hawaiian from the rest of the series of transactions and then argue that the use of Hawaiian had no economic substance except for tax avoidance purposes. In this analysis, the IRS could show that the taxpayer’s claim of a worthless stock deduction with respect to the Hawaiian stock indicates that the taxpayer admits that Hawaiian had no continued business significance or business purpose. The IRS would therefore claim that the taxpayer’s own representation about the

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77. Id.

78. IRC §§ 7701(o)(1)(A), (B).

79. See Joint Comm. Technical Explanation, *supra* note 3, at 153.

total lack of a business prospect or any future business use for the Hawaiian subsidiary shows that its use in the acquisition of a new business was solely tax motivated. By this line of argument, the IRS would then argue that the use of Hawaiian in any transaction after it became worthless would have been solely motivated by tax reasons. By disaggregating the transaction into this separate step inquiry and then bifurcating the use of Hawaiian away from the overall transaction, the IRS would have strong arguments to disallow the use of any of Hawaiian's net operating loss carryforwards.

Thus, the bifurcation authority set forth in section 7701(o)(5)(D) along with the legislative history to this provision now calls into question the ability of a taxpayer to bootstrap a tax motivated step into an overall transaction that has economic consequences unless the tax motivated step has a "substantial" economic consequence when judged on a stand-alone basis. In *Textron*, the taxpayer inserted an unnecessary tax motivated step (the use of Hawaiian) that created a tax *mistake* when it was included in a larger transaction that had overall economic consequences that were substantial. Under new section 7701(o)(5)(D), it would appear that the government would be able to isolate the use of Hawaiian to contest its addition to the overall transaction. This ability to narrowly target its attack on one aspect of an overall transaction promises to have a significant impact on the course of future litigation with respect to the application of the economic substance doctrine.

### C. *Cottage Savings Association v. Commissioner*<sup>80</sup>

New section 7701(o) only applies the economic substance doctrine when that doctrine is "relevant" under existing law. The *Cottage Savings* fact pattern is interesting because it raises the issue of the scope of what is a "relevant transaction" to which the economic substance doctrine may apply.

#### 1. *The Historical Basis for the Opinion*

In *Cottage Savings*, the taxpayer exchanged mortgage pool interests that it owned for other mortgage pool interests. The practice of generating losses by means of "reciprocal sales" resulted from a change in accounting requirements promulgated in 1980 by the Federal Home Loan Bank Board (FHLBB) as "Memorandum R-49." By observing R-49's criteria, savings associations attempted to generate income tax refunds by entering into "reciprocal sales" transactions that produced deductible losses but could avoid booking a loss for financial statement purposes on its mortgage pools. Based on "reciprocal sales" transactions with four other Ohio savings institutions, Cottage Savings claimed losses on its 1980 corporate income tax

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80. *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991).

return from sales of mortgage loans at less than book value. The resulting income tax refunds claimed for 1980 and carry-back years exceeded \$677,000. The Tax Court found that the mortgage pool swaps had no independent business purpose and were solely motivated by a desire to claim tax benefits, but ruled in favor of the taxpayer and allowed a valid tax deduction.<sup>81</sup> The Sixth Circuit reversed, holding that the taxpayer had not experienced a deductible loss under section 165.<sup>82</sup> The Supreme Court reversed the Sixth Circuit decision and held that the taxpayer's loss was in fact deductible.<sup>83</sup>

## 2. *How New Section 7701(o) Would Change Things*

The facts in *Cottage Savings* are interesting because these facts raise the issue of when the economic substance doctrine is relevant to a transaction. Given the findings of the Tax Court that the transaction had no business purpose and did not change the taxpayer's economic position in any meaningful way, it is clear that the taxpayer would not be able to meet its burden of proof under section 7701(o)(1), so if the economic substance doctrine were relevant then the taxpayer would lose in this fact pattern.

However, strong arguments can be made that the economic substance doctrine is not relevant to this transaction. The taxpayer in *Cottage Savings* was not claiming a double deduction, nor was it utilizing a loss-generating *mistake*. In point of fact, the taxpayer had already suffered an economic loss that had not been recognized for financial or tax reporting purposes. The fact that the taxpayer used a tax planning technique in order to recognize a loss that already represented an economic loss is not a transactional inconsistency.<sup>84</sup> Furthermore, taxpayers that originate mortgage loans can now elect to mark-to-market their financial positions for tax purposes,<sup>85</sup> and so a taxpayer like the one in *Cottage Savings* now can realize its losses even without the need to create an actual sale or exchange

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81. *Cottage Savings Ass'n v. Commissioner*, 90 T.C. 372 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *aff'd in part, rev'd in part and remanded*, 499 U.S. 554 (1991).

82. *Cottage Savings Ass'n v. Commissioner*, 890 F.2d 848 (6th Cir. 1989), *aff's in part, rev'd in part and remanded*, 499 U.S. 554 (1991).

83. *Cottage Savings*, 499 U.S. 544.

84. See *Doyle v. Commissioner*, 286 F.2d 654, 659-60 (7th Cir. 1961) ("The cases cited by the Commissioner in which loss deductions were disallowed because of lack of *economic substance* have this consistent element: taxpayers, by manipulation or chicanery, were attempting to create a loss deduction. However, here taxpayer has suffered a capital loss because of the depreciation in value of her stocks at the time of sale. The only question is whether taxpayer realized her loss at the proper time." (emphasis added)).

85. IRC § 475(b)(2).

transaction under current law if it made a section 475(b) election.<sup>86</sup> Thus, given this situation, this transaction is not the type of tax planning strategy for which the economic substance doctrine should be relevant because the tax result creates a tax benefit that is not premised on a transactional inconsistency and has not created a fundamental tax *mistake*.<sup>87</sup>

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86. Many banks are dealers for purposes of § 475 because they regularly originate and sell loans. See Rev. Rul. 97-39, Holding 2, 1997-2 C.B. 62. By enacting § 475, Congress effectively gave taxpayers an election for loans that are made to customer that are not intended to be resold, and so under current law a taxpayer like Cottage Savings can choose whether they want to have mark-to-market treatment since avoidance of mark-to-market treatment requires an affirmative identification under § 475(b)(2). See Reg. § 1.475(c)-1(c)(1)(i) (“A taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer in securities within the meaning of § 475(c)(1) unless the taxpayer elects to be so treated or, for purposes of § 471, the taxpayer accounts for any security (as defined in § 475(c)(2)) as inventory.”); Reg. § 1.475(c)-1(c)(1)(ii) (A taxpayer . . . elects to be treated as a dealer in securities by filing a federal income tax return reflecting the application of § 475(a) in computing its taxable income.); Chief Couns. Adv. 200731029 (Aug. 3, 2007) (discussing substantive requirement to make election to avoid mark-to-market treatment and discussing that loan participations are securities within the meaning of § 475). See also Tech. Adv. Mem. 200120001 (May 5, 2001) (“Consequently, Taxpayer would not be a dealer in securities subject to § 475 unless Taxpayer waived the exemption afforded by § 1.475(c)-1(c) by filing a federal tax return reflecting the application of § 475 and meeting any other requirements imposed by Rev. Proc. 97-43.”); Rev. Rul. 97-39, Holdings 8, 17, 1997-2 C.B. 62, 64, 65 (identification must be made within 30 days of loan origination for loans that are not intended to be sold to make a valid election out of mark-to-market treatment); Field Serv. Adv. 199909005 (Nov. 20, 1998) (deals with taxpayer that waives exemptions from § 475). The determination of whether a taxpayer is a dealer in securities is done on an entity-by-entity basis, so a controlled group can have some of their subsidiaries subject to § 475(a)’s mark-to-market treatment while another subsidiary is not subject to mark-to-market treatment. See FSA 200047012 (Nov. 27, 2000). Once a taxpayer identifies an asset as “held for investment” and chooses to not apply the mark-to-market principles of § 475(a), the IRS may not allow them to change that designation absent a strong showing of a factual change in purpose. See Chief Couns. Adv. 200817035 (Apr. 25, 2008).

87. But see *Cottage Savings*, 890 F.2d 848.

D. *Guardian Industries Corp. v. United States*<sup>88</sup>

The facts in *Guardian Industries* are interesting because it uses a common tax planning technique to create a foreign tax credit *mistake* that created significant benefits for the taxpayer.

1. *The Historical Basis for the Opinion*

In *Guardian Industries*, the taxpayer owned its Luxembourg operations through Guardian Industries Europe, S.a.r.l. (“GIE”). GIE, in turn, held controlling interests in several other Luxembourg companies that engaged in actual manufacturing operations in Luxembourg. The Luxembourg tax authorities taxed the income from Guardian’s affiliates in Luxembourg on a “fiscal unity” basis. Under the Luxembourg laws, the ultimate parent company, namely GIE, was the company that was responsible for paying taxes for the fiscal unity group. For U.S. tax purposes, GIE was classified as a “disregarded entity” of the U.S. company that owned GIE.<sup>89</sup> However, all of the Luxembourg operating companies were treated as separate controlled foreign corporations for U.S. tax purposes. The taxpayer claimed that all of the Luxembourg taxes represented direct taxes paid by the U.S. parent of GIE since GIE was a “disregarded entity” and since GIE was the technical “taxpayer”<sup>90</sup> of the Luxembourg taxes. However, none of the Luxembourg income was taxable in the U.S. since that income was earned by controlled foreign corporations and was not otherwise subject to immediate taxation under the U.S. Subpart F tax rules. The above tax planning technique allowed the taxpayer to “split” the foreign tax credits away from the foreign income to which those foreign taxes related. Due to this “splitter” technique, the U.S. foreign tax credits were claimed and used on the U.S. tax return of Guardian Industries while the associated Luxembourg-sourced income was not currently subject to U.S. taxation.

The Court of Federal Claims and the Federal Circuit ruled in favor of the taxpayer. First, the court stated that there was no indication that Regulations section 1.901-2(f)(1) contemplated any inquiry into which party earned the income under foreign law and found that GIE was the technical taxpayer under Luxembourg law. The court recognized that the government believed that the purpose of the foreign tax credit would be frustrated by allowing Guardian to claim a credit for taxes paid on income earned by foreign subsidiaries when the income of those subsidiaries has never been taxed in the United States. However, the court refused to fix this *mistake*, stating that the Treasury Department has the ability to draft a regulation that

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88. *Guardian Indus. Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007).

89. See Reg. § 301.7701-3(b).

90. See Reg. § 1.901-2(f)(1).

would not allow foreign taxes to be split from the associated foreign income, and it has not done so. Thus, the court applied a literal reading of the regulations and found that GIE was the party liable for the tax under Luxembourg law within the meaning of Regulations section 1.901-2(f)(1) and that the government should fix its regulations if it wanted a different result.

The Treasury Department has responded in an ad hoc manner to foreign tax credit generator transactions. Originally, the Treasury Department articulated that abusive foreign tax credit transactions would be addressed by the economic substance doctrine, with any foreign taxes being treated as an expense for purposes of determining whether a substantial pre-tax profit potential existed for the tax strategy.<sup>91</sup> However, after losing the *Compaq* case,<sup>92</sup> the government repealed Notice 98-5 in a subsequent notice.<sup>93</sup> Congress responded by enacting new section 901(k), which in turn requires the taxpayer to have a minimum holding period in the foreign stock in order to claim U.S. foreign tax credits for dividend withholding taxes.<sup>94</sup> The Treasury Department then embarked on several regulatory and administrative actions to deal with foreign tax credit generator transactions. To begin with, on October 19, 2006, the Treasury Department amended the regulations under section 704 to require foreign tax credits to be allocated among the partners in accordance with their “interests in the partnership.”<sup>95</sup> Thus, partners no longer can agree to make special allocations of a partnership’s foreign tax credits that “split” the taxes away from the associated foreign income to which they relate.<sup>96</sup> On July 16, 2008, the Treasury Department issued temporary and proposed regulations that provide that a foreign tax payment is not a compulsory tax payment and thus is not a creditable tax under section 901 if the foreign tax payment were attributable to a structured passive investment arrangement.<sup>97</sup> For this purpose, Temporary Regulations section 1.901-2T(e)(5)(iv)(B) defines a structured passive investment arrangement as an arrangement that satisfies six mechanical tests.

Several commentators argued that the mechanical “six factor test” set forth in these regulations represent a static rule that is not capable of

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91. Notice 98-5, 1998-1 C.B. 334-36.

92. *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) (holding that the Tax Court erred as a matter of law by disregarding the gross amount of the Royal Dutch dividend), *rev'g* 113 T.C. 214 (1999) (treating foreign taxes as an expense for purposes of computing Compaq’s profit on the ADR transaction).

93. See Notice 2004-19, 2004-1 C.B. 606.

94. See IRC § 901(k).

95. T.D. 9292, 2006-2 C.B. 914-915.

96. See Reg. § 1.704-1(b)(4)(viii).

97. Temp. Reg. § 1.901-2T(e)(5)(iv)(A).

meeting evolving business conditions, and as a result the government would have been better served to have adopted a principle-based approach similar to the one that it originally had announced in Notice 98-5.<sup>98</sup> In the preamble to its temporary regulations, the government explicitly rejected a principle-based rule similar to the one that had been articulated in Notice 98-5 because the IRS and Treasury Department were concerned that such a rule would create uncertainty for both taxpayers and the IRS.<sup>99</sup> Yet, less than two years later, Congress enacted new section 7701(o) which sets forth the same principle-based approach that the government criticized as creating “too much uncertainty” in the preamble to T.D. 9416.<sup>100</sup> The IRS also has issued an audit directive that designates foreign tax credit generator transactions as a “Tier I Issue,” and as such all large case examination teams must issue pre-written information disclosure requests to inquire about foreign tax credit generator transactions and any audit investigation of these issues must be coordinated with a designated national technical advisor.<sup>101</sup> Finally, Congress has now addressed this issue by enacting new section 909(a), which provides that the foreign tax associated with a foreign tax credit splitting event is not to be taken into account by the taxpayer until the taxable year in which the related income is taken into account by the taxpayer.<sup>102</sup>

## 2. *How New Section 7701(o) Would Change Things*

The facts in *Guardian Industries* are interesting because it presents a situation in which a taxpayer created a foreign corporation that was treated as a disregarded entity in order to create a transactional inconsistency.<sup>103</sup> The transactional inconsistency was that the taxpayer could treat the U.S. owner

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98. Kevin Dolan, *Foreign Tax Credit Generator Regs: The Purple People Eater Returns*, 2007 TNT 118-33, (June 19, 2007); Bret Wells, *Comment Letter on Proposed Treas. Reg. 1.901-2(e)(5)*, 2007 TNT 160-10 (Aug. 6, 2007).

99. T.D. 9416, 2008-2 C.B. 1142, 1147.

100. *Id.*

101. Internal Revenue Service, *LMSB Tier I Issue Foreign Tax Credit Generator Directive*, (Feb. 19, 2009), <http://www.irs.gov/businesses/article/0,,id=204526,00.html>.

102. See IRC § 909(a), as added by section 211 of the Education Jobs and Medicaid Assistance Act, Pub. L. No. 111-126, 124 Stat. 2389, 6-8 (2010); Staff of Joint Comm. on Taxation, 111th Cong., *Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586*, Scheduled for Consideration by the House of Representatives on August 10, 2010, 2-7 (2010).

103. An entity that is treated as an entity for tax purposes in a foreign jurisdiction but is disregarded as a separate taxpayer for U.S. tax purposes is referred to in the tax literature as a “hybrid entity.” The use of hybrid entities provides opportunities to create differences in how foreign jurisdictions and the U.S. tax laws will treat transactions that are conducted by the hybrid entity. See IRC § 894(c).

of GIE as the taxpayer for purposes of claiming U.S. tax credits but did not treat the U.S. owner as the taxpayer that earned the associated foreign income. It is unclear what business purposes GIE may have served under Luxembourg law, but it is doubtful that the business need for that particular entity would be substantial in comparison with the tax benefits that were being created. Thus, as a preliminary matter, this situation would present a situation to which section 7701(o)(1) would appear to be directly applicable.

However, the legislative history indicates that a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment represents a transaction that is intended to be immunized from the application of the economic substance doctrine.<sup>104</sup> Thus, the use of a hybrid entity in *Guardian Industries* would appear to be a tax motivated decision that the legislative history indicates is not a "relevant transaction" that is subject to challenge under section 7701(o)(1). Furthermore, the legislative history also makes clear that the choice of capitalizing a business enterprise with debt or with equity is another tax motivated transaction that is not a "relevant transaction" within the meaning of section 7701(o)(1).<sup>105</sup> Thus, double dip *mistakes* premised on the use of hybrid entities or hybrid instruments appear to be outside the scope of inquiry under section 7701(o). Because the double dip *mistake* created in *Guardian Industries* is premised on the use of a hybrid entity, the legislative history to new section 7701(o) insulates this transaction from challenge by reason of new section 7701(o).

Nevertheless, the Commissioner of the Internal Revenue Service has recently stated that the current administration remains concerned about double dip structures.<sup>106</sup> If that is so, then the government will need to address those concerns through additional regulations since the legislative history to new section 7701(o) condones the use of hybrid entities and hybrid instruments as "basic business transactions that under longstanding judicial and administrative practice are respected."<sup>107</sup> Thus, new section 7701(o) may address double dip transactions like those presented in the *Compaq* case, but it is unlikely to address double dip planning benefits generated through the use of hybrid entities (as in *Guardian Industries*) or hybrid instruments.

*E. The Limited, Inc. v. Commissioner*<sup>108</sup>

The facts in *The Limited* provide an interesting case to consider the potential impact of new section 7701(o) on tax planning strategies that

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104. See Joint Comm. Technical Explanation, *supra* note 3, at 152–53.

105. *Id.* at 152.

106. News Release IR-2008-137 (Dec. 8, 2008).

107. See Joint Comm. Technical Explanation, *supra* note 3, at 152–153.

108. *The Limited, Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002).



attempt to repatriate untaxed foreign earnings in a manner that circumvents section 956.

*1. The Historical Basis for the Opinion*

The taxpayer in *The Limited* sold its merchandise in its own retail stores and by catalog. The taxpayer accepted payment for its merchandise by either cash, check, or credit card. With respect to credit card transactions, the taxpayer accepted its own private-label credit card and also accepted credit cards issued by a third-party bank or other financial institution. On March 15, 1989, the taxpayer formed a wholly-owned subsidiary, World Financial Network National Bank (“WFNNB”), and organized this subsidiary under the National Bank Act.<sup>109</sup> On May 1, 1989, the Comptroller of the Currency issued a charter certificate to WFNNB authorizing it to commence the business of banking as a National Banking Association. The business of WFNNB was to provide private-label credit cards to the taxpayer’s retail customers.

The taxpayer also conducted extensive operations outside the United States through various controlled foreign corporations. One such controlled foreign corporation was Mast Industries (Far East) Ltd. (“MFE”). MFE was a contract manufacturer for the taxpayer. MFE declared no significant dividends from the early 1980s through 1993, resulting in untaxed accumulated earnings and profits in excess of \$330 million at the end of 1993.

On January 12, 1993, the directors of MFE resolved to organize and capitalize MFE N.V. to engage in group financing activities and to provide a means of investing and reinvesting liquid assets and funds. MFE N.V. had no employees. On January 28, 1993, MFE transferred \$175 million to MFE N.V. as a capital contribution. On this same date, MFE N.V. purchased eight certificates of deposit from WFNNB for \$174.9 million. On January 28, 1993, WFNNB transferred the \$174.9 million to another U.S. affiliate in order to reduce its intercompany line of credit that had been extended to it by that other U.S. affiliate.

The Tax Court held that MFE N.V.’s investment in CDs issued by WFNNB represented an investment in U.S. property that was taxable under section 956. In this regard, the Tax Court noted that section 956 was enacted to tax as dividends the repatriated earnings of controlled foreign corporations.<sup>110</sup> An exception to section 956 was made for deposits with persons carrying on the banking business. However, given the limited purpose of WFNNB (to issue credit cards to customers) and given that the

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109. See 12 U.S.C. § 24 (1994).

110. *The Limited, Inc. v. Commissioner*, 113 T.C. 169, 183-85 (1999), *rev’d*, 286 F.3d 324 (6th Cir. 2002).

purchase of the CDs by MFE N.V. made the untaxed earnings of MFE available for use by its only U.S. shareholder, the Tax Court found that the repatriation that occurred in this particular case was the type of repatriation transaction that section 956 intended to subject to immediate taxation.<sup>111</sup> In so holding, the Tax Court believed that MFE N.V.'s investments in CDs were not the type of "deposits with persons carrying on the banking business" that Congress intended to carve-out from the scope of section 956 when it crafted an exception in section 956(b)(2)(A) for certain banking deposits.<sup>112</sup>

The Sixth Circuit reversed the decision of the Tax Court, and in its opinion the Sixth Circuit criticized the Tax Court for not resolving the case through an ordinary and natural reading of section 956(c)(2)(A) but instead "raced to the legislative history of [section] 956."<sup>113</sup> The Sixth Circuit argued that Congress could have easily written the banking exception in section 956(b)(2)(A) to have read in a different or more narrow manner if it had so desired, but it did not do so. The Sixth Circuit then stated that regardless of the reasons that may or may not have been motivating Congress when it crafted the banking exception set forth in section 956(b)(2)(A), the plain language of the banking exception contained in section 956(b)(2)(A) provides for no related-party prohibition, and thus there is no need to examine the legislative history to decide whether one should exist.

## 2. *How New Section 7701(o) Would Change Things*

The decision in *The Limited* presents an interesting case where the taxpayer complied with every stated requirement in the statutory provisions, but arguably new section 7701(o) would not allow the taxpayer to prevail. As the Tax Court stated, section 956 was enacted to subject undistributed foreign earnings of a controlled foreign corporation to immediate taxation when those earnings have been repatriated. The statutory language uses a broad definition of an investment in "United States property," and the exceptions to that definition were ones that fundamentally were intended to represent transactions that were not repatriation transactions. Making a deposit with a bank was not viewed as a repatriation transaction, but there is no indication that Congress intended this exception to section 956 to swallow up the general rule that a repatriation of foreign earnings in the form of a loan to the U.S. affiliate is subject to taxation under section 956. Certainly, if the taxpayer made an investment in a bank account and that investment collateralized a loan to a U.S. affiliate, then that would represent an

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111. *Id.* at 189-91.

112. *Id.* at 190-91.

113. *The Limited, Inc. v. Commissioner*, 286 F.3d 324, 335 (6th Cir. 2002).

investment in U.S. property.<sup>114</sup> The taxpayer in *The Limited* created an internal bank that had a significant business purpose. But, this one transaction (the issuance of CDs to WFNNB) created a significant tax benefit that far exceeded the non-tax benefits for having issued those particular CDs. Thus, the Tax Court's decision would likely now have been upheld, not reversed, if section 7701(o) had existed at the time this case was decided. The Sixth Circuit refused to look at the underlying purpose of section 956, but now section 7701(o)(1) requires that this be done. The facts in *The Limited* case support the argument that the taxpayer's planning strategy had a legitimate business purpose, but at the same time this tax planning strategy created a significant tax benefit in that it allowed a substantial repatriation of foreign earnings that circumvented the application of section 956. In this fact pattern, it would appear that the tax benefits far exceeded the non-tax benefits of issuing a CD in an intercompany transaction with a related party. As a result, the government would appear to have the better argument for applying section 7701(o) because the non-tax motives do not appear to be substantial enough in relation to the expected tax benefits as prescribed by section 7701(o)(2)(A). Thus, this analysis indicates that new section 7701(o) will serve to significantly reduce the taxpayer's ability to rely on the plain meaning of a statutory provision when the plain meaning of that statutory provision creates a tax *mistake* to which section 7701(o) is relevant. If subsequent judicial cases concur in this assessment, then section 7701(o) should decrease the number of cases in which the courts will pass the buck back to Congress to legislatively correct tax *mistakes* like the one in *The Limited*.

Although the government may have a good opportunity to address repatriation strategies that circumvent section 956 in ways that resemble the fact pattern set forth in *The Limited*, the government is likely to not be able to use section 7701(o) against repatriation strategies that utilize the reorganization provisions. For example, in one common transaction called a "Killer B" reorganization, a subsidiary would acquire parent stock from the parent directly or on the open market. The acquisition of the parent stock was funded in part by the issuance of debt by the acquiring subsidiary. The acquiring subsidiary would then use the parent stock to acquire a target corporation in a transaction intended to qualify as a reorganization under section 368(a)(1)(B) or as a triangular reorganization under section 368(a)(1)(C).<sup>115</sup> After the acquisition, funds from the target subsidiary would then be used to repay the acquisition debt in a manner that would not create dividend income to the parent company or implicate section 956. Thus, the

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114. See IRC § 7701(l), (permitting re-characterization of "multiple-party financing transactions").

115. See Notice 2006-85, 2006-2 C.B. 677; Notice 2007-48, 2007-1 C.B. 1428.

effect of the overall transaction was to allow cash from foreign subsidiaries to be repatriated to the U.S. parent company without a tax cost on the repatriation. Another foreign repatriation technique that has been popularized in recent years is known as the “all-cash D reorganization.” In this transaction, one corporation transfers substantially all of its properties to a controlled foreign corporation in exchange for cash. The transferor corporation then immediately liquidates. The transaction is intended to qualify as a reorganization under section 368(a)(1)(D) and the cash distributed in the liquidation of the transferor corporation is treated as boot in the reorganization.<sup>116</sup> However, pursuant to section 356(a)(2), the boot is taxable as a dividend only to the extent of the gain in the stock.<sup>117</sup>

The Killer B reorganization and the all-cash D reorganization represent repatriation strategies that circumvent the application of section 956. However, the legislative history to section 7701(o) lists reorganization transactions as 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.”<sup>118</sup> Thus, assuming that adequate business purpose exists for the reorganization under existing case law, these transactions would not be assailable by reason of section 7701(o) even if the tax benefits from these reorganizations far exceeded in value the non-tax benefits.

In response to these repatriation techniques that were designed to circumvent the application of section 956, the government has responded on several fronts. In this regard, in order to address the Killer B reorganization, the Treasury Department has issued temporary regulations to treat as a distribution under section 301 the amount of money plus the fair market value of other property that the subsidiary used to acquire the parent stock in the Killer B transaction.<sup>119</sup> Further, these temporary regulations provide that to the extent the subsidiary buys the parent stock from a person other than the parent, then the transaction is recast to be treated as if the subsidiary made a distribution of cash to the parent company, and the parent company stock is then deemed to have been contributed to the subsidiary from the parent company.<sup>120</sup> In response to the all-cash D reorganization, the Treasury Department has issued proposed regulations that would subject the full amount of the boot to taxation under its authority under section 367(b).<sup>121</sup> At the same time, the administration has also proposed to amend section

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116. Reg. § 1.368-2(l); Rev. Rul. 2004-83, 2004-2 C.B. 157; Rev. Rul. 70-240, 1970-1 C.B. 81.

117. Notice 2008-10, 2008-1 C.B. 277.

118. See Joint Comm. Technical Explanation, *supra* note 3, at 153.

119. Temp. Reg. § 1.367(b)-14T(b)(1).

120. Temp. Reg. § 1.367(b)-14T(b)(3).

121. Notice of Proposed Rulemaking, 2008-2 C.B. 867; Prop. Reg. § 1.367(a)-3(d)(2)(vi)(B).

356(a)(2) so that the boot in a reorganization is not limited to the amount of the gain.<sup>122</sup>

F. *Shell Petroleum v. United States*<sup>123</sup>

The facts of *Shell Petroleum* present an interesting case in which the taxpayer created a potential double deduction through a business restructuring. Internal restructurings are common and tax planners will often attempt to capture tax savings as part of a restructuring transaction. The IRS announced that it would challenge<sup>124</sup> and in fact has successfully challenged internal restructurings and related party transactions that captured tax benefits similar to those obtained in *Shell Petroleum*, but in these other cases the courts found that the business purpose and non-tax economic consequences were insignificant.<sup>125</sup> In *Shell Petroleum*, the court accepted that the taxpayer had a legitimate business purpose for its restructuring transaction, and so the facts provide an interesting situation to consider the contours of internal tax planning now that new section 7701(o) is in place.

1. *The Historical Basis for the Opinion*

In *Shell Petroleum*,<sup>126</sup> the taxpayer transferred non-producing oil and gas properties that had depreciated in value, along with some income-producing properties, to a special purpose subsidiary in exchange for common stock and preferred stock in the new subsidiary. The preferred stock had a high “carryover” basis but a low fair market value. The transferor corporation then sold the preferred stock to investors in order to raise capital and recognized approximately \$354 million of loss on this sale. The income

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122. U.S. Treasury Dep’t, General Explanation of the Administration’s Fiscal Year 2011 Revenue Proposals 38 (Feb. 1, 2009), available at <http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf>.

123. *Shell Petroleum, Inc. v. United States*, 2008-02 U.S.T.C. ¶ 50,422 (S.D. Tex 2008).

124. See, e.g., Notice 2002-21, 2002-1 C.B. 730 (inflated basis); Notice 2001-17, 2001-1 C.B. 730 (contingent liability); Notice 2000-44, 2000-2 C.B. 255 (son of boss); Notice 99-59, 1999-2 C.B. 761 (boss); Notice 2001-45, 2001-2 C.B. 129 (basis shifts).

125. See, e.g., *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2007); *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004) (contribution of built-in loss stock to partnership lacked economic substance), *aff’d*, 150 f. App’x 40 (2d Cir 2005); *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *rev’d in part*, 598 F.3d 1372 (Fed. Cir. 2010) (reversing and remanding on a separate issue, but affirming the Court of Federal Claims decision that the transaction lacked economic substance).

126. *Shell Petroleum*, 2008-02 U.S.T.C. ¶ 50,422.

producing properties produced sufficient cash flow to fund the dividends on the preferred stock. Because the underlying subsidiary took property with a built-in loss, it was left for another day to determine whether the subsidiary would be entitled to recognize ordinary losses if and when it sold the built-in loss properties in the future.<sup>127</sup> Thus, this transaction created a duplication of losses—one for Shell by selling the preferred stock in the new subsidiary and another loss for the new subsidiary if and when it disposed of the built-in loss properties.<sup>128</sup>

The taxpayer was able to demonstrate that the incorporation of the subsidiary along with the issuance of preferred stock was done in order to generate additional capital for the corporation and also in order to provide better focus over the non-producing assets. The taxpayer also stated that the tax department did not explain the tax benefits of the transaction to the corporate officers responsible for making the decision to engage in this transaction so that the taxpayer could clearly demonstrate that the transaction was motivated by non-tax business considerations. The district court held in favor of the taxpayer, reasoning that the record demonstrated sufficient non-tax business purposes because the internal restructuring allowed the corporation to provide better fit-and-focus to distressed properties and also provided a means to raise capital. Thus, the court found that the taxpayer in *Shell Petroleum* accomplished legitimate, non-tax objectives in a manner that maximized the attendant tax benefits under then-existing law. *Shell* could have employed different means to achieve its objectives, but the means it took were ones that accomplished legitimate business purposes and also captured significant tax benefits.

Congress responded to correct this mistake by enacting section 362(e)(2) as part of the American Jobs Creation Act of 2004. Pursuant to section 362(e)(2), the transferee's aggregate adjusted basis of the property transferred in a section 351 transfer shall not exceed the aggregate fair market value of such property immediately after the transfer. The aggregate reduction in basis shall be allocated among the properties transferred in proportion to the relative built-in loss that the properties exhibit. Moreover, if the transferor and transferee both elect, the transferor's basis in the stock received in exchange for property can be reduced to its fair market value in lieu of reducing the basis in the property transferred. Thus, section 362(e)(2) is directly aimed at the sort of double dipping that *Shell* was able to

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127. The properties were § 1231 properties, the loss on which could be ordinary.

128. For a further discussion of this loss duplication, see Robert Willens, *Shell Oil's Double-Dipping Strategy Pays Off*, 120 Tax Notes 687 (Aug. 18, 2008).

accomplish and thus represents a legislative solution to the *mistake* that Shell was able to benefit from.<sup>129</sup>

## 2. *How New Section 7701(o) Would Change Things*

The decision in *Shell Petroleum* is interesting because it presents a carefully planned transaction that had a legitimate business purpose but at the same time captured enormous tax savings. Under new section 7701(o), a court presented with these same facts would be required to compare the relative value of the potential non-tax benefits to the potential tax benefits from the transaction. From a comparison standpoint, the legitimate business objectives, although significant enough to justify the transaction from a business perspective, nevertheless appear to pale in comparison to the more than \$100 million of immediate tax savings created by the internal restructuring. Thus, the government could well argue on the factual record presented in *Shell Petroleum* that the legitimate business objectives that were accomplished in *Shell Petroleum* are not substantial enough when viewed in relation to the net present value of the transaction's expected tax benefits (i.e., \$350 million of losses of which \$320 million were usable immediately).

So, how large must the non-tax benefits be in a transaction to be “substantial *in relation to* the . . . tax benefits”<sup>130</sup> of the transaction? This line of inquiry represents uncharted territory and holds open the possibility that a taxpayer could have a meaningful business purpose for an internal restructuring that is not “substantial enough” when viewed in relation to the expected tax benefits that were created in the transaction.

After positing this fact pattern, Professor Bankman commented on this aspect of an earlier version of section 7701(o)(2) as follows:

One suspects that any intelligent application of the economic substance test requires some consideration of the relationship between tax benefits and nontax benefits. But basing a test primarily on the relationship between the benefits raises problems of its own. Suppose, for example, that a transaction offers a healthy pretax rate of return but even greater tax benefits. Ought the transaction to be at risk under the economic substance test? The better view is that a

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129. Section 362(e)(2) does not apply if a transferor corporation and the transferee corporation file a consolidated return, Reg. § 1.1502-80(h) (*as amended* in 2008), but Reg. § 1.1502-36 (2008) operates to prevent double deductions in consolidated return situations.

130. See IRC § 7701(o)(2)(A) (emphasis added).

transaction that produces a substantial pretax return is immune from challenge on economic substance grounds.<sup>131</sup>

However, the final language that was adopted in section 7701(o)(2) did not address the problems highlighted by Professor Bankman almost a decade earlier. Thus, it can be expected that the government will interpret section 7701(o)(2)(A) as requiring a straight comparison of the taxpayer's expected tax benefits to the non-tax benefits of a transaction. Under this comparative methodology, the taxpayer in *Shell Petroleum* would appear to have generated tax benefits that far exceed the non-tax benefits of the restructuring transaction that occurred in that case. This conclusion would be made even stronger if the IRS could isolate on the economic benefits of transferring the non-producing properties to a new subsidiary. The district court in *Shell Petroleum* refused to "slice and dice" the transaction narrowly as had the court in *Coltec*, but under section 7701(o)(5)(D) it would appear that such bifurcation now should be done. As a result, the combination of the bifurcation rule of section 7701(o)(5)(D) along with the comparative benefit analysis contained in section 7701(o)(2) work to place a significantly higher burden on the taxpayer to substantiate the non-tax economic consequences for its internal restructuring transaction. This comparative benefit approach creates a sliding scale and as such represents a slippery slope for future litigants. The need to demonstrate an increasingly higher level of economic substance when the associated tax benefits are high represents a marked departure from prior law. One can anticipate that this aspect of new section 7701(o) will be the subject of considerable future debate among commentators and the subject of future litigation.

### G. Son-of-Mirror and the General Utilities Repeal

The son-of-mirror transaction is interesting because it raises the question of whether new section 7701(o) would be relevant to arguably the highest profile tax *mistake* in a generation.

#### 1. The Historical Basis for the Opinion

Shortly after the 1986 Act, techniques were developed to circumvent the repeal of the *General Utilities* doctrine.<sup>132</sup> One such technique, the son-of-mirror transaction, involved a situation in which an acquiring company would acquire the stock of a target company at fair market value. -After the

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131. Bankman, *supra* note 57, at 26.

132. For the *General Utilities* doctrine, see Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 8.20 (7th ed. 2002).



acquisition, the acquiring company would cause the target company to distribute its wanted assets to the acquirer, thus generating gain within the acquirer's consolidated group and thereby increasing the acquirer's basis in the stock of the target by the amount of that gain. The acquirer then could sell the target's stock at a time when only unwanted assets were held by the target company. As a result, an artificial loss was created that approximated the amount of the previously recognized gain that occurred upon the distribution of the wanted assets out of the target subsidiary. This technique, if successful, permitted portions of a target company to be disposed of without the payment of tax on the target's built-in gain, thus using the consolidated return regulations to thwart *General Utilities* repeal.<sup>133</sup>

The Service immediately responded to the son-of-mirror technique by issuing Notice 87-14.<sup>134</sup> In Notice 87-14, the Service announced that it would deny the intended tax benefits of a son-of-mirror type transaction by regulations to be issued in the future that would have retroactive effect. What transpired thereafter involved the Treasury Department issuing multiple revisions to the consolidated return loss disallowance rules, and in the process having one version of the regulations held to be invalid.<sup>135</sup> The

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133. For a further analysis of the son-of-mirror technique and other techniques that were in vogue at the time, see Eric M. Zolt, *The General Utilities Doctrine: Examining the Scope of the Repeal*, 65 *Taxes* 819 (1987).

134. 1987-1 C.B. 445.

135. On Sept. 19, 1991, the IRS and Treasury Department published Reg. § 1.1502-20 (the loss disallowance rule). See T.D. 8364, 1991-2 C.B. 43. On July 6, 2001, in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the Court of Appeals for the Federal Circuit held that the duplicated loss provisions of the loss disallowance rules were an invalid exercise of regulatory authority. Because only the loss duplication factor of Reg. § 1.1502-20 was at issue in *Rite Aid*, the IRS believes that the finding of invalidity applied only to that factor and not to the factors dealing with the son-of-mirror problem. See Notice 2002-11, 2002-1 C.B. 526 ("It is the Service's position that the *Rite Aid* opinion implicates only the loss duplication aspect of the loss disallowance regulation. . . ."). In response to the *Rite Aid* decision, the IRS and Treasury Department promulgated two regulations to replace the loss disallowance rules. The first, Temp. Reg. § 1.337(d)-2T (temporary *General Utilities* regulation), was published on Mar. 12, 2002, to address the circumvention of *General Utilities* repeal. See T.D. 8984, 2002-1 C.B. 668. The second, Temp. Reg. § 1.1502-35T, was published on Mar. 14, 2003, to address the inappropriate duplication of loss. See T.D. 9048, 2003-1 C.B. 645. T.D. 9048 also included certain related provisions promulgated under Temp. Reg. § 1.1502-21T and Temp. Reg. § 1.1502-32T. On Mar. 3, 2005, the temporary regulation was adopted without substantive change as final Reg. § 1.337(d)-2. See T.D. 9187, 2005-1 C.B. 778. On Sept. 17, 2008, the IRS and Treasury Department issued final unified rules for loss on subsidiary stock through Reg. § 1.1502-36. See T.D. 9424, 2008-2 C.B. 1012. For a discussion of the final unified loss disallowance regulations that now represents the end of this sordid tale, see David Friedel, *Final Loss Disallowance Rules: A New*

current response to the efforts to circumvent the *General Utilities* repeal, including the son-of-mirror technique, is contained in Treasury Regulations section 1.1502-36.

## 2. *How New Section 7701(o) Would Change Things*

Ironically, although the son-of-mirror technique and similar techniques created major *mistakes* that potentially thwarted Congress' desire to repeal the *General Utilities* doctrine, it would appear that new section 7701(o) would have no impact on these transactions. The decision to dispose of a business segment or unwanted assets has a significant economic consequence to the selling entity. Thus, the act of disposing of a subsidiary would appear to have a substantial economic purpose apart from tax benefits. Furthermore, the desire to distribute wanted assets out of a subsidiary before selling the subsidiary would also appear to have a substantial purpose because these assets arguably need to be segregated away from the unwanted assets in order for the unwanted assets to be sold. The IRS might argue that a choice to sell the stock of a subsidiary instead of selling the underlying assets represents a tax motivated decision, but it seems undebatable that the ability to choose either to sell assets or to sell the stock of a subsidiary represents the type of business transaction that, under longstanding judicial and administrative practice, is respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.<sup>136</sup> Thus, although the son-of-mirror technique represented a serious threat to the repeal of the *General Utilities* doctrine, it appears that new section 7701(o) would not have been able to attack this technique. Thus, the solution to the tax *mistake* that was brought to light by this technique requires a legislative or regulatory response, and again the regulatory response to fix that mistake has spanned almost twenty years.

Thus, the key take-away from this particular transaction is that tax benefits derived that are directly linked with acquiring or disposing of businesses are unlikely to implicate new section 7701(o) unless some extraneous step is added to the transaction that creates a tax benefit that substantially exceeds the non-tax benefits arising from adding this tax-favored step to the overall transaction. In the fact pattern set forth in the son-of-mirror transaction, this does not appear to have been the case.

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World Order, 35 J. Corp. Tax'n 33 (2008) ("To call these final rules complicated would be a great understatement.").

136. See Joint Comm. Technical Explanation, *supra* note 3, at 152–53.

### III. CONCLUSION

The codification of the economic substance doctrine begins an important new chapter for tax jurisprudence. The analysis in this article leads to the conclusion that section 7701(o) does not stop taxpayers from reaping the benefit of all tax *mistakes*. Thus, in the future, as has been the case in the past, there will still be instances in which a taxpayer will be able to “play in the rain” without a court thundering its disapproval. This will be the case when a tax *mistake* is premised on transactions that have significant non-tax benefits that can satisfy the standards of new section 7701(o)(1) or where a tax *mistake* relies on transactions that are considered “accepted business transactions,” such as reorganizations or the use of hybrid entities and hybrid securities. Thus, sophisticated taxpayers still have important tools at their disposal to create opportunities to benefit from a tax *mistake*.

However, that is not to say that section 7701(o) does not represent an important change in the landscape. Although section 7701(o) certainly does not protect the fisc against all tax *mistakes*, it does significantly alter the landscape with respect to the taxpayer’s ability to benefit from many of the types of *mistakes* that were available in the past. New section 7701(o) provides the government with more latitude to argue against the plain meaning of its own regulations and the plain meaning of statutory provisions when the plain meaning of the statute or regulation, whichever the case may be, creates an unintended consequence. The courts will need to address what level of deference to give to the government when it asserts that its own regulations or the plain meaning of a statute creates an inappropriate result, but it now appears that a court cannot summarily refuse to act when the government’s own regulation or a statutory provision leads to a *mistake*, as has often been the case in the past. Furthermore, section 7701(o) clarifies that the government has authority to require each step in an overall transaction to independently possess substantial economic consequences. Consequently, section 7701(o)(5)(A) appears to give the government much greater leeway to bifurcate and disaggregate an overall transaction than under prior law. A key question, however, will be when the economic substance doctrine is relevant to a particular transaction. In *Cottage Savings*, a transaction that had no non-tax economic consequences created a substantial tax benefit to the taxpayer, but this tax benefit was not inconsistent with the policies of current law.

Although section 7701(o) applies generally to all transactions that are “relevant” transactions, many of the double dip *mistakes* and the foreign tax credit generator *mistakes* are likely to be largely unaffected by section 7701(o), since the legislative history makes it clear that hybrid entities and hybrid instruments (the sources of much of the tax arbitrage opportunities) are accepted techniques under current law. However, repatriation tax planning that avoids the contours of section 956 or the contours of the

subpart F tax regime may well be subject to much more scrutiny as a result of section 7701(o)'s addition to the Code, particularly when those repatriation strategies do not rely on a reorganization or the step that creates the tax *mistake* is not based on a hybrid entity or hybrid security.

Internal restructuring projects that create significant tax savings, such as the one in *Shell Petroleum*, are likely to have more difficulty in the future because the taxpayer will need to show that the non-tax economic benefits from these internal restructurings are substantial when viewed in relation to the tax benefits derived from the internal restructuring exercise. This comparative benefit analysis is likely to create a difficult factual proof problem for the taxpayer.

Thus, although new section 7701(o) does not fix all *mistakes*, new section 7701(o) taken as a whole enhances the government's arguments with respect to the application of the economic substance doctrine. As a result, it is likely that taxpayers will find that a court is going to be more likely to thunder its disapproval when there is a rainstorm of mistakes. Thus, playing in the rain may not be as profitable for taxpayers as it has been in the past, and so new section 7701(o) may serve to further dampen aggressive tax planning. If that is the legacy of new section 7701(o), then the enactment of this new regime will indeed represent an important new chapter in the nation's tax jurisprudence.

**Appendix I: H.R. 4872: Health Care and Education Reconciliation Act of 2010.****Sec. 1409. Codification of ECONOMIC SUBSTANCE DOCTRINE AND PENALTIES.**

(a) In General—Section 7701 of the Internal Revenue Code of 1986 is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

“(o) Clarification of Economic Substance Doctrine—

“(1) APPLICATION OF DOCTRINE—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

“(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and

“(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

“(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL—

“(A) IN GENERAL—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 the expected net tax benefits that would be allowed if the transaction were respected.

“(B) TREATMENT OF FEES AND FOREIGN TAXES—Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

“(3) STATE AND LOCAL TAX BENEFITS—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

“(4) FINANCIAL ACCOUNTING BENEFITS—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

“(5) DEFINITIONS AND SPECIAL RULES—For purposes of this subsection—

“(A) ECONOMIC SUBSTANCE DOCTRINE—

The term “economic substance doctrine” means 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.

“(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

“(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

“(D) TRANSACTION—The term “transaction” includes a series of transactions.”

(b) Penalty for Underpayments Attributable to Transactions Lacking Economic Substance—

(1) IN GENERAL—Subsection (b) of section 6662 is amended by inserting after paragraph (5) the following new paragraph:

“(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.”

(2) INCREASED PENALTY FOR NONDISCLOSED TRANSACTIONS—Section 6662 is amended by adding at the end the following new subsection:

“(i) Increase in Penalty in Case of Nondisclosed Noneconomic Substance Transactions—

“(1) IN GENERAL—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting “40%” for “20%.”

“(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS—For purposes of this subsection, the term “nondisclosed noneconomic substance transaction” means any portion of a transaction described in subsection (b)(6) 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.

“(3) SPECIAL RULE FOR AMENDED RETURNS—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.”

(3) CONFORMING AMENDMENT—Subparagraph (B) of section 6662A(e)(2) is amended—

(A) by striking “section 6662(h)” and inserting “subsections (h) or (i) of section 6662;” and

(B) by striking “GROSS VALUATION MISSTATEMENT PENALTY” in the heading and inserting “CERTAIN INCREASED UNDERPAYMENT PENALTIES.”

(c) Reasonable Cause Exception Not Applicable to Noneconomic Substance Transactions—

(1) REASONABLE CAUSE EXCEPTION FOR UNDERPAYMENTS—Subsection (c) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking “paragraph (2)” in paragraph (4)(A), as so redesignated, and inserting “paragraph (3);” and

(C) by inserting after paragraph (1) the following new paragraph:

“(2) EXCEPTION—Paragraph (1) shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).”

(2) REASONABLE CAUSE EXCEPTION FOR REPORTABLE TRANSACTION UNDERSTATEMENTS—Subsection (d) of section 6664 is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively;

(B) by striking “paragraph (2)(C)” in paragraph (4), as so redesignated, and inserting “paragraph (3)(C);” and

(C) by inserting after paragraph (1) the following new paragraph:

“(2) EXCEPTION—Paragraph (1) shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6).”

(d) Application of Penalty for Erroneous Claim for Refund or Credit to Noneconomic Substance Transactions—Section 6676 is amended by redesignating subsection (c) as subsection (d) and inserting after subsection (b) the following new subsection:

“(c) Noneconomic Substance Transactions Treated as Lacking Reasonable Basis—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.”

(e) Effective Date—

(1) IN GENERAL—Except as otherwise provided in this subsection, the amendments made by this section shall apply to transactions entered into after the date of the enactment of this Act.

(2) UNDERPAYMENTS—The amendments made by subsections (b) and (c)(1) shall apply to underpayments attributable to transactions entered into after the date of the enactment of this Act.

(3) UNDERSTATEMENTS—The amendments made by subsection (c)(2) shall apply to understatements attributable to transactions entered into after the date of the enactment of this Act.

(4) REFUNDS AND CREDITS—The amendment made by subsection (d) shall apply to refunds and credits attributable to transactions entered into after the date of the enactment of this Act.