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News Analysis: Early Economic Substance Signs in 2011

by Jeremiah Coder

Summary by taxanalysts

In news analysis, Jeremiah Coder looks at the current state of the economic substance doctrine, reviewing a recent judicial opinion and public requests for guidance on the issue.

Full Text Published by taxanalysts

For taxpayers and practitioners worried about the specter of economic substance hovering over nearly every tax transaction in the wake of the codified doctrine, a January 3 decision by the Tax Court upholding a taxpayer's claim for historic rehabilitation tax credits is a sign that the situation might not be as worrisome as some think.

In *Historic Boardwalk Hall LLC v. Commissioner*, the taxpayer -- a partnership (HBH) formed by a state entity, the New Jersey Sports and Exposition Authority (NJSEA), and a private corporation, Pitney Bowes (PB) -- fought to allow PB to claim section 47 historic rehabilitation tax credits for its 2000 to 2002 tax years for qualified rehabilitation expenditures that HBH incurred in rehabilitating East Hall, an Atlantic City convention center. Although NJSEA was originally the sole member of HBH, PB bought a 99.9 percent interest, contributing capital that went to pay down an acquisition loan and to pay NJSEA a developer's fee. (For the opinion, 136 T.C. No. 1 (Jan. 3, 2011), see *Doc 2011-80* or *2011 TNT 2-15*.)

In its notices of final partnership administrative adjustment for the tax years at issue, the IRS asserted that HBH was a sham because PB entered into the partnership only to obtain the rehabilitation credits and that PB was not a bona fide partner because it lacked a meaningful stake in the investment. The FPAA further stated that ownership of the property had never been properly transferred to HBH and that the IRS could disregard the partnership in accordance with the partnership antiabuse rules (reg. section 1.701-2(b)). The agency also asserted accuracy-related penalties.

Judge Joseph Robert Goeke disagreed with all of the IRS's positions. Drawing from Third Circuit precedent, the court looked at both the objective economic substance of the transaction and the subjective business motivation behind it. Rather than construing that approach as a "rigid two-step analysis," the court said the related factors must be viewed together when considering the transaction's economic substance. Moreover, Judge Goeke agreed with the Third Circuit's decision in *ACM Partnership* that appropriate judicial review did not compel the court to disregard a taxpayer's transaction "merely because it was motivated by tax considerations." (For *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), see *Doc 98-31128* or *98 TNT 202-7*.)

The IRS claimed that PB's investment in HBH showed a lower return compared with other commercially reasonable financial instruments, as well as a negative cash flow. The IRS, relying on a Tax Court opinion in *Friendship Dairies*, said that "investment tax credits are never to be taken into account in determining the economic substance of a transaction." (For *Friendship Dairies v. Commissioner*, 90 T.C. No. 1054 (1988), see *Doc 88-4855* or *88 TNT 110-7*.)

Judge Goeke was not swayed and held that consideration of the tax credits at issue was proper in an economic substance analysis. "We did not explicitly hold that investment credits are never taken into account when applying the economic substance doctrine," he wrote.

In the absence of clear Third Circuit precedent, the court found the Ninth Circuit opinion in *Sacks* (reversing the Tax Court) instructive on the issue of the interplay of tax credits and economic substance. (For *Sacks v. Commissioner*, 69 F.3d 982 (1995), see *Doc 95-10132* or *95 TNT 218-13*.)

Because many credit schemes enacted by Congress are designed to motivate investment conduct, the inclusion of credits properly forms part of the analysis, the Tax Court reasoned. If transactions that Congress intended to encourage had to be profitable on a pretax basis, "then Congress would not have needed to provide incentives to get taxpayers to invest in them," the court said. Rather, the legislative history of section 47 makes clear that the credit was meant to "encourage taxpayers to participate in what otherwise would be an unprofitable activity" so as to "spur private investment in unprofitable historic rehabilitation."

In viewing the whole transaction, the court was satisfied that HBH had a legitimate business purpose and that PB's expected profit potential and tax credits together imbued the investment with economic substance. Moreover, PB's involvement in the rehabilitation provided NJSEA with "more money than it otherwise would have had," with the result that both parties "would receive a net economic benefit if the rehabilitation was successful," the court concluded. Consequently, Judge Goeke held that PB was indeed a partner in HBH and that NJSEA had transferred the benefits and burdens of ownership of East Hall to the partnership.

Judge Goeke also considered the IRS's claim that the transaction should be recast under its reg. section 1.701-2(b) authority to achieve tax results that are consistent with the intent of subchapter K, but he found recasting inappropriate. Drawing from Example 6 of reg. section 1.701-2(d), which approves of a partnership transaction to pass along low-income housing credits that lowers the federal tax liability of individual investors, the court held that the use of the HBH partnership was necessary to allow private investment in the rehabilitation of a government-owned structure.

Even though the transaction led to a lower tax liability for PB, "Congress intended to use the rehabilitation tax credit to draw private investments into public rehabilitation," Judge Goeke wrote. The IRS's regulations in the example "clearly contemplate a situation in which a partnership is used to transfer valuable tax attributes from an entity that cannot use them [to] individuals who can," he said.

A 'Sensible Decision'

Practitioners contacted by Tax Analysts approved of the court's approach in analyzing the economic substance doctrine.

"I think it was a very sensible decision," said Lawrence M. Hill, a partner at Dewey & LeBoeuf LLP. "While there was apparently profit potential apart from the congressionally sanctioned tax benefits, it would be quite a peculiar result from a tax policy standpoint to penalize taxpayers for making tax-favored investments that Congress clearly intended the tax-favored status to encourage."

But Hill wondered whether the IRS would have asserted a strict liability penalty under section 7701(o) if the transaction fell within the effective date of that provision. "I find the prospect disconcerting," he said.

Kevin M. Flynn of Kostelanetz & Fink LLP, who represented the taxpayer in *Historic Boardwalk*, said the Tax Court appropriately believed that Congress's legislative purpose in establishing the rehabilitation credit was to encourage renovations that on their face may not appear profitable without taking into account the credit. Thus, the court "made it pretty clear that when engaged in an economic substance analysis, a court needs to look at the congressional purpose of a tax credit provision," he said.

Although practitioners will undoubtedly try to extend the court's reasoning to other instances of economic substance being challenged in tax litigation, Flynn cautioned that courts may be unreceptive to that approach. "In this case, it all revolved around the uniqueness and congressional purpose behind the statute, and the Service's arguments did not take this into account," he said.

A practitioner who spoke on the condition of anonymity said the decision affirms that "transactions that actually occurred can take tax credits into account if that is what Congress intended, and this will give the transaction economic substance." That analysis becomes relevant in determining how section 7701(o) might apply in future transactions, the practitioner said. However, "I doubt the government will accept this loss without several appellate losses," the practitioner added.

Another feature of the decision that may hinder IRS challenges of partnerships involving tax credits is the court's blessing of very small partner interests. "A partnership can exist where one party has almost all of the economics if each party brings something of value to the table," said the practitioner. "The case rejects any concept of a small partner not being a partner. It's as simple as that."

The practitioner said the IRS made a tactical mistake in trying to recast the transaction. "The court turned the reg. section 1.701-2 regulation Example 6 against the government. This argument should not have been raised and should serve as a warning to the government not to raise the regulation when there is an example in that regulation contrary to the government's argument," the practitioner said.

Unsettling Instructions?

But what practitioners view as an encouraging sign that the judiciary might take a reasonable approach to limiting the intrusion of economic substance into tax planning areas traditionally perceived as legitimate does not necessarily carry over to the administrative side. Indeed, practitioners expect economic substance codification trouble to emanate from IRS enforcement procedures.

Informal IRS internal guidance recently made public could weaken assurances by agency officials that the new economic substance strict liability penalty will be asserted sparingly and only in merited cases. In program manager technical assistance dated August 24, 2010, the IRS addressed queries from the Office of Servicewide Penalties on treating the potential applicability of penalties enacted in the healthcare reform legislation (P.L. 111-152), including section 6662(i), the new economic substance penalty. (For PMTA 2010-055, see *Doc 2010-25254* or *2010 TNT 228-45*.)

Of concern is that the program manager technical assistance approved of asserting section 6662(i) "as an alternative position." That written guidance contradicts statements from IRS officials following codification that the penalty would not be aggressively used as a fallback approach when issuing notices of deficiency.

Michael J. Desmond of Bingham McCutchen LLP said the program manager technical assistance "highlights the one-off, case-specific nature of guidance we can expect to see on interpretation of the codified economic substance doctrine and related penalty provisions." That result is unfortunate, because a "better and more uniform approach would be to address these issues, including such important questions as effective date, in published guidance with an opportunity for notice and comment," he said.

The position on assertions of the economic substance penalty taken by the IRS in issue 4 of the guidance "isn't necessarily a change," said Desmond, who served as Treasury tax legislative counsel from 2005 to 2008. "The IRS's discretion to assert or not assert the penalty is very constrained once the economic substance doctrine is in play, but the [program manager technical assistance] does highlight the critical need for guidance -- some of which has been supplied by Notice 2010-62 -- on the issue of what it means to disclose a non-economic substance transaction," he said. (For Notice 2010-62, 2010-40 IRB 411, see *Doc 2010-20020* or *2010 TNT 177-14*.)

Perhaps more illustrative of the predicament that taxpayers face in light of recently enacted penalty provisions is that issue 3 of the guidance, regarding the new section 6662(j) undisclosed foreign financial asset penalty, "highlights another situation where penalties can be stacked, leading to some exceedingly punitive results," Desmond said. The problem is that "as experience in the offshore disclosure initiative illustrates, even before enactment of section 6662(j), [foreign bank account report] and other penalties can in theory be stacked to add up to far more than the actual account value," he said.

Calls for Guidance

Since enactment of section 7701(o), public demands for IRS clarification have quieted somewhat after having largely been ignored. Notice 2010-62 gave limited guidance but avoided anything substantive that could clarify doubts on the scope of applying the codified doctrine. So in the past few months, taxpayers have been relegated to waiting. But in the new year, practitioners have begun taking steps to publicly reaffirm their unease with the lack of clarity in the absence of guidance. As one practitioner said, "Taxpayers are not going to let this go" given the severity of the penalty if applied.

In January 5 comments, the New York State Bar Association Tax Section (NYSBA) called for more guidance. Prompting its request was concern over "the potential for honest misuse of section 7701(o) by the IRS," the report said. (For the report, see *Doc 2011-314* or *2011 TNT 5-14*.)

In a summary of recommendations, the NYSBA said that any coming guidance should clarify rules governing the terms "any similar rule of law" and "relevant," as well as the profit potential test. The report asked that the government clarify that the codified doctrine applies only to judicial rules invoking the two-part test and excludes other doctrines such as substance over form and the step transaction doctrine.

Regarding application of the penalty, the NYSBA urged IRS and Treasury to require chief counsel review of section 6662(i) before it is asserted in the field and said the disclosure requirements should be aligned with those of section 6662(b)(6) for the substantial understatement penalty.

While not directly asking for an "angel list," the report requested guidance "that certain existing legal doctrines do not fall under the statutory definition" of the economic substance doctrine.

The American Bar Association Section of Taxation and the American Institute of Certified Public Accountants are expected to release their own comments later this month asking for additional economic substance guidance and clarification.

And taxpayers are still waiting for the IRS Small Business/Self-Employed Division to issue its own internal guidance on coordinating the penalty, following the issuance of the Large Business and International Division's field direction last fall. (For LMSB-04-0910-024, see *Doc 2010-20089* or *2010 TNT 178-47*.)

Tax Analysts Information

Code Sections: Section 7701(o) -- Economic Substance Codification
Section 6662 -- Accuracy-Related Penalty
Section 47 -- Rehabilitation Credit
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Subject Areas: Practice and procedure
Penalties
Credits
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