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Federal Tax ADVISORY ■

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Better Luck with Economic Substance Doctrine
John Hancock Life Insurance Co. v. Commissioner, 141 T.C. No. 1 (2013)

Win Fight/Lose War

John Hancock Life Insurance lost a recent decision in the U.S. Tax Court ruling on a combination of LILO and SILO transactions that were supposed to generate lease and depreciation deductions. The IRS attacked the deductions primarily under what it called the substance-over-form doctrine, and secondarily under the economic substance doctrine. John Hancock won the economic substance doctrine issue, but lost the substance-over-form issue. There are several lessons here for taxpayers.

Economic Substance Doctrine Fatigue?

There are two signs in this case that the IRS may be tiring of the economic substance doctrine. First, it did not raise the doctrine as a defense in a timely fashion and so was required to bear the burden of proof. Despite extensive expert testimony, the court ruled that the IRS failed to carry the burden of proof.

Not raising the issue in a timely fashion was surprising, and can hardly have been an oversight. Perhaps the IRS litigators were afraid of exactly what happened: a taxpayer victory on this issue. Perhaps they did not want to create bad precedent.

The reason the IRS could not carry the burden of proof is that the court believed the taxpayer was going to make a sizeable enough cash-on-cash profit from cash flows, regardless of the fact that the court then turned around and ruled that John Hancock had not bought or leased the property it said it bought and leased.

If the failure to plead the defense is evidence of IRS tiring of the economic substance doctrine, the reason may be that this decision is now the third of the six reported LILO/SILO decisions in which the taxpayer has won on that issue at the trial level. The other decisions are *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008), and *Consolidated Edison v. United States*, 90 Fed. Cl. 228 (2009), reversed, 703 F.3d 1367 (Fed. Cir. 2013).

Of course, the IRS economic substance doctrine fatigue might pass after Section 7701(o) begins to apply to post-codification transactions and the 40-percent no-fault penalty can be applied. However, on the other hand, IRS' Large Business & International Division issued a Directive in 2011 to auditors that imposes a series of hurdles before they can assert the economic substance doctrine as the basis for a deficiency. Maybe the IRS is seeing the doctrine as more trouble than it is usually worth.

Substance over Form

Like all five of the other final decisions in the government's favor in LILO/SILO cases, this one ruled against the taxpayer on what it called the substance of the transactions. Using a different sort of economic analysis from that which produced positive profit potential for economic substance doctrine purposes, the second part of the opinion found that John Hancock wasn't really going to make any money on the "rent" received, and would not wind up with the property in the end; in other words, the foreign government would buy back the rail cars, or whatever was leased in and leased out.

Although the court called this substance over form, it was really contract interpretation. The Tax Court, in effect, did the same thing that the Supreme Court did in *Frank Lyon* to decide whether the parties intended to enter into a sale leaseback, or instead contracted for a loan. In *Frank Lyon*, the taxpayer won because the trial court found that the taxpayer was quite likely to keep the property after the lease was over and the Supreme Court refused to disturb that finding. In *John Hancock*, the taxpayer lost because the Tax Court thought it was "reasonably likely" that the tenant would exercise the purchase option at the end of the lease.

"Reasonably likely" is less "more likely" than not: it is in the one-third to 40-percent range of likelihood. That is a very low standard of fact finding on which to re-characterize a contract contrary to its form.

Conclusion

This decision may be one of the last of the decisions on what the IRS called loss generator transactions of the 1990s. Most of them were shut down by changes in the code and regulations, as were the LILO/SILO deals. The concern for taxpayers is that the IRS will turn its substance-over-form weapons honed by these taxpayer wars against more standard transactions, particularly financial transactions.

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