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Federal Tax ADVISORY ■

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Economic Substance Doctrine Confusion

Notice 2014-58

On October 9, 2014, the IRS issued Notice 2014-58, attempting to provide some further clarification around the partially "codified" economic substance doctrine. The notice makes the following points:

- Generally, the "transaction" to which the doctrine might be applied is the aggregate of steps involved in an integrated transaction. However, "when a series of steps includes a tax-motivated step that is not necessary to achieve a nontax objective, an aggregation approach may not be appropriate."
- The "sham transaction doctrine" is a "similar rule of law" to which the 40 percent penalty can be applied.

That is pretty much the guts of the notice. As such, it does not much advance the ball beyond what we already knew. It contains nothing helpful for taxpayers.

Scope of the Transaction

One of the main things taxpayers have worried about is the scope of the transaction to which the IRS may attempt to apply the economic substance doctrine. Sometimes it suits the IRS to look at the integrated transaction and assert that there was no money to be made from the offsetting options or whatever the transaction might have been.

But the notice focuses on the other possibility: there is some larger transaction with a nontax objective for which a specific step was not necessary. That is an exception large enough to swallow the entire rule that the whole transaction counts.

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For example, a hospital chain decides to open a branch in the Middle East. It incorporates a foreign subsidiary to negotiate the rights and open the hospital. Running the hospital is a business choice, but putting it into a foreign corporation was probably not necessary to achieve the foreign operation. *See Hospital Corp. of Am.*, 81 T.C. 520, 589-590 (1983) (nonacq.) Fortunately, the IRS usually respects the choice to insert a corporation in a chain of ownership; if it did not, the entire Subpart F regime would fall. However, choosing to do a step in a larger transaction in a certain way to reduce taxes is precisely what the *Gregory* decision decreed in 1935 was perfectly okay. *Gregory v. Helvering*, 293 U.S. 465 (1935).

Similar Rule of Law

The notice sticks to what has been the IRS's position up until now that a similar rule of law that also can attract a 40 percent penalty must be one that applies the two-prong test of the economic substance doctrine, but under another name. The problem is that the notice now says that means the "sham transaction doctrine."

It is true that some courts have used that terminology. But it has been used in all sorts of ways. One of the earliest usages said this: "The leading case supporting the existence of a 'sham transaction doctrine' is *Gregory v. Helvering*, 293 U.S. 465 (1935)." Jan T. Williams, T.C. Memo 1984-11.

Of course *Gregory* did no such thing. It interpreted a business purpose requirement into the reorganization statute. More commonly, the sham transaction refers to a transaction that did not happen for legal purposes; common law courts have always known how to sham a transaction.

The problem with the notice is that it gives aid and comfort to misuse of terminology rather than attempting to clarify what is a sham case and what is an economic substance doctrine case. More and more, the courts are applying the economic substance doctrine not to say a transaction did not occur as a matter of fact, but simply that the taxpayer loses because it could not prove out of a two-prong test. This is effectively a general anti-abuse rule that, in most other countries, is enacted by statute in a very detailed and affirmative way, in contrast to the partial codification in Section 7701(o).

Legislative History

The final interesting feature of the notice is that it promotes to the status of "legislative history" the incorporation of a 2009 Ways and Means Committee report into the Report on the Budget Reconciliation Act. But there was no House Committee report, and the enacted Section 7701(o) is not exactly as considered by the House Committee. No prior government pronouncement has stated that this is the authoritative legislative history. It is unfortunate that it is promoted in this way.

Conclusion

We are in a lull period for the economic substance doctrine. As of yet, no cases have been decided on the new statute. But many taxpayers are seeking Supreme Court review of prior cases. So far it has not taken any of them, but eventually it will. Only then will we really know what the economic substance doctrine means.

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