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Fourth Circuit Economic Substance Doctrine

The Tax Court's recent opinion in *Austin v. Commissioner, TC Memo 2017-69*, claims to be following the Fourth Circuit's view of the economic substance doctrine by calling it the sham transaction doctrine, saying it is an issue of fact, and misattributing it to the usual set of cousins that are by no means its parent. The only correct conclusion is that the economic substance doctrine might have served the purpose of finding certain facts, but not on the unlimited basis that the Tax Court applies here.

The *Austin* case had been in the Tax Court for a while and came up for decision on the issue of whether an employee with deferred income on restricted stock under Section 83 could receive the stock and have it redeemed for nothing and repurchase it for a note nearly equal to its value and report as income only the sliver of net value. The court held no.

It said it was following the Fourth Circuit's version of the sham transaction doctrine established in *Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). Even though this particular opinion avoided calling the so-called Fourth Circuit doctrine the economic substance doctrine, prior Tax Court opinions have called it that. *See Bank of N.Y. Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013).

According to *Austin*, the sham transaction doctrine "may" be applied in the Fourth Circuit. If it applies and the taxpayer fails, the court will disregard the sham transaction—the taxpayer has to prove a business purpose and a profit potential, which presumably might be one and the same. The *Austin* opinion also applied the doctrine to the smallest subset of events needed to preclude the taxpayer from proving a business purpose. That was the redemption and repurchase.

Once the court had defined the issue that way, and rejected the taxpayer's tax-saving purpose, the outcome of the case was determined for the government.

The peculiar things about the opinion are that it gives no indication of concern about how the sham transaction doctrine, so-called, fits with the economic substance doctrine; it indicated no concern about the possible limits on the doctrine (does it apply only to leasing cases like *Rice's* and if not, to what else?); and it did not notice that Section 7701(o) does not authorize disregarding a transaction but denying a benefit. So how will the Tax Court's and the Fourth Circuit's sham transaction doctrine morph into the world of Section 7701(o) when it applies?

This taxpayer was bolder than most because he did not try to convince the court of a menu of hypothetical business purposes: he admitted that the corporation did not want to pay the employment taxes on the Section 83 income. A federal tax savings reason cannot satisfy the business purpose requirement of the doctrine unless the doctrine is not applicable at all because Congress intended that the taxpayer could elect into the tax reduction.

But the Tax Court did not even consider that possibility. It is unfortunate that this Tax Court opinion suggests the court has become entirely too comfortable with the economic substance/sham transaction doctrine. It did not ask whether it should apply or what it meant; it simply disregarded steps because the taxpayer could not prove out of the "prongs" of the doctrine.

Takeaway: Taxpayers like Austin should push back hard on the meaning and purpose of the economic substance doctrine.

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