

IV.A.2. Business Purpose/Economic Substance

Introduction

This section deals with business purpose and economic substance.

Economic Substance Doctrine

The interpretation and application of the economic substance doctrine may vary depending on the applicable circuit. In general, to be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits which were not intended by Congress by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable.

Whether a transaction has economic substance is a factual determination. This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction's costs.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance apart from its tax consequences to be respected for tax purposes.'

¹Winn-Dixie Stores, Inc. v Commissioner, 254 F. 3d 1313 (11th Cir. 2001) affg 113 T.C. 254 (1999); United States v. Wexler, 31 F. 3d 117, 122, 124 (3d Cir. 1994); (*28); Yosha V. Commissioner, 861 F. 2d 494, 498-99 (7th Cir. 1988), affg; Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F. 2d 734 (2d Cir. 1966), affg 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), affg, 270 F. 2d 294 (3d Cir. 1959); Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001); ACM Partnership v. Commissioner, T.C. Memo. 1997-115 aff'd in part and rev'd in part 157 F. 3d 231 (3d Cir. 1998); IRS v. CM Holdings, Inc. No. 00-3875 (3d Cir. August 19, 2002)

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Argue the Statute First

Writing for Tax Notes Today, contributing editor Lee A. Sheppard recently opined that IRS “should argue the statute first” in tax shelter cases. Ms. Sheppard argued that often a Code section is a much more powerful tool than a judicial doctrine:

The economic substance doctrine is a doctrine of statutory interpretation that says the taxpayer is not entitled to the benefit of the statute that it seeks to abuse, even if it has a technical argument for the result. Only after the statutory analysis has been completed does the economic substance doctrine come into play, and then only if a statutory antiabuse rule does not disallow the taxpayer's desired result. If the taxpayer's transaction is not within the statute it seeks to abuse in the first place, then the court never reaches the economic substance question. If a specific antiabuse rule ... applies to prevent the taxpayer from having the benefit of the statute that it is otherwise within, then, the court never reaches the economic substance question. If the taxpayer has complied with all the applicable statutes but its lack of business purpose, expectation of profit, and risk in the deal mean that it should not have the benefit of technical compliance, then that is the point when the economic substance doctrine should be invoked.²

In some cases, however, the IRS must use the economic substance doctrine as its primary argument because there is no statutory argument to address the taxpayer's position.

What does this mean to the agent?

This means that in addition to the development of facts necessary to reach a conclusion under the statutory provisions of the tax shelter transaction, facts should also be developed to establish that the tax shelter transaction has no business purpose, economic substance, or is in essence a sham transaction. Inquiry should be made into whether the transactions or steps of transactions actually occurred (commonly referred to as factual shams. For instance, if property was transferred, determine if the property actually changed hands. If the transaction involves a loan was the loan actually processed? Was money actually transferred? This can be accomplished by reviewing the complete transaction with all of the related entities and agreements.

²Sheppard, *Why the IRS Should Argue the Statute First*, 2001 Tax Notes Today 141-3 (2001).

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Circular Cash Flows

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham as it produced no significant economic effect, and had been structured only to provide the taxpayer with interest deductions.

A good example of this can be seen in the [LILO CPE 2001 handout material](#). Excerpts from Day Three, Leasing, Lesson 2 follow:

“Through hedges, circular cash flows, defeasements and the like, LILO participants are insulated from economic risk. Exclusive of the tax benefits, LILOs will typically earn little or no economic profit on a pre-tax basis.”

From the examples given in this Lesson and the reasoning behind the adjustments made, one can see the types of documents and parts to a transaction that one needs to look at to show that there was no economic substance or business purpose to the transaction.

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LIFO Example - Basis For Adjustment

During the 20-year primary term of the Sublease, X's obligation to make the property available under the Sublease is completely **offset** by X's right to use the property under the Headlease.

X's obligation to make **debt service payments** on the loans from BK1 and BK2 is completely **offset** by X's right to receive **Sublease rentals** from FM. Moreover, X's exposure to the **risk** that FM will not make the rent payments is further **limited** by the arrangements with the affiliates of BK1 and BK2. In the case of the loan from BK1, X's **economic risk is completely eliminated through the defeasance arrangement.**

In the case of the smaller loan from BK2, X's economic risk, although not completely eliminated, is substantially reduced through **the deposit arrangement.**

As a result, neither bank requires an independent source of funds to make the loans, or bears significant risk of nonpayment. In short, during the Sublease primary term, the offsetting and circular nature of the obligations eliminates any significant economic consequences of the transaction.

IV.A.2. Business Purpose/Economic Substance Conclusion

By following the cash flow, determine whether or not the economic risks of a transaction have been offset, defeased, or severely limited. This elimination of economic risk can be done through the use of deposit accounts, financial products such as hedges or options, offsetting transactions (i.e. rental income offset by debt repayments), loans, etc. A flowchart or diagram that maps the cash flow is beneficial.

It is always a good idea to calculate the pretax profit and determine if it is substantial in relationship to the tax benefits received.

Remember that third party contacts are often necessary to gain a complete picture of the transaction.

Specialists and Technical Advisors are a good source for help in developing the facts concerning economic risk and circular cash flows. (See [Sections IV.C.1 & 2](#))
