Economic-Substance Doctrine and Subchapter C: What, Me Worry?

By Jodi J. Schwartz

Jodi Schwartz provides a framework for analyzing whether, or how, the economic-substance doctrine applies to commonplace corporate transactions.

Introduction

On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 20101 (“the Act”). Section 1409 of the Act added Code Sec. 7701(o) to the Internal Revenue Code of 1986, as amended (“the Code”),2 which codifies the economic-substance doctrine (“the ESD”). As a general matter, the ESD is a judicially developed anti-abuse doctrine used by the courts to deny the tax benefits of certain tax-motivated transactions that satisfy the literal reading of the Code, but exactly which benefits the court determines Congress did not intend to be available.3 In particular, ESD disregards tax-motivated transactions that do not result in a meaningful change in the taxpayer’s economic position other than by reason of the tax benefits they generate.4

The Act establishes the test to be applied by the courts in determining whether ESD has been satisfied, assuming the doctrine is “relevant” to the transaction in question, but does not establish the criteria for “relevance” and generally purports to leave much of the law in this area unchanged. In particular, ESD disregards tax-motivated transactions that do not result in a meaningful change in the taxpayer’s economic position other than by reason of the tax benefits they generate.4

The Act establishes the test to be applied by the courts in determining whether ESD has been satisfied, assuming the doctrine is “relevant” to the transaction in question, but does not establish the criteria for “relevance” and generally purports to leave much of the law in this area unchanged. In addition to codifying the doctrine itself, the Act also imposes significant penalties associated with engaging in transactions that do not satisfy the ESD, as well as underreporting of facts related to such transactions.

The codification of ESD, with its practical consequence in light of the penalty provisions, has engendered a flurry of commentary from practitioners, academics and government officials. The viewpoints have been varied, but the codification has generally caused significant concern among practitioners and taxpayers as to whether and to what extent it might apply to traditionally acceptable tax planning and not merely to artificial abuse transactions.

In essence, uncertainty and concern regarding the scope of the ESD as codified reflect the difficulty in capturing through statutory language a doctrine that has been judge-made and largely contextual. It was for this reason that many professional groups, including the New York State Bar Association Tax Section, opposed codification.5 As applied by judges, the ESD could take into account all the facts and aspects of a completed transaction. In the codified version, context is relevant only through the concept of “relevance”—an awkward construct. This article attempts to re-introduce context in the interpretation of the codified ESD by creating an interpretive “lens” to facilitate the determination of ESD’s relevance to particular, commonplace corporate transactions by reference to practical, real-world corporate transactions that implicitly underlay the historical application of the ESD by the courts.

Brief History of the Economic-Substance Doctrine

The ESD is one of a number of anti-abuse doctrines developed by the courts to deny tax benefits of certain tax-motivated transactions. In addition to the ESD, these doctrines include the “substance-over-form,” “sham-transaction,” “step-transaction” and “business-purpose” doctrines. The genesis of most
of these doctrines is the Supreme Court’s seminal decision in Gregory v. Helvering. Gregory, however, did not expressly establish the ESD. It was in subsequent cases that the Supreme Court began to shape the doctrine as it is understood today, and it was not until its decision in Frank Lyon that the Supreme Court articulated the origins of the modern two-prong test. Since Frank Lyon, however, the Supreme Court has not decided any significant ESD cases, leaving the continued articulation of the two-prong test and its application to the lower courts.

The lower courts, however, have struggled with the doctrine’s application, almost always in the context of artificial transactions having no relation to the taxpayer’s business. They have not been consistent in their application of the ESD, developing three different variations of the test for whether a particular transaction had economic substance. Generally, all courts concluded that ESD required them to evaluate whether the transaction had economic substance (the objective component) and whether the taxpayer had a nontax business purpose for engaging in the transaction (the subjective component). However, the courts disagreed as to whether a showing of both components was necessary. Some courts adopted a conjunctive test, requiring that a taxpayer establish the presence of both (1) economic substance and (2) business purpose in order to satisfy ESD. Other courts applied a disjunctive test, which required that the taxpayer establish either (1) economic substance or (2) business purpose, but not both. A third approach, sometimes referred to as the “unitary analysis,” used by some courts was to view economic substance and business purpose as “simply more precise factors to consider” in determining whether tax benefits of a particular transaction should be denied on ESD grounds.

The courts have also adopted varying approaches as to how a taxpayer can satisfy either prong of the test. As to the objective component, various approaches taken include the determination of whether the transaction had an expected profit without taking into consideration its tax effects, a comparison of the disputed transaction with transactions that may be expected to occur in the usual course of business, the application of a cost-benefit analysis and an opportunity cost analysis (which considers whether the taxpayer could have obtained the same economic result absent the disputed structure). As to the subjective component, courts have reached different conclusions as to whether the tax-motivated purpose must be the sole purpose, the motivating purpose or just an important purpose for the transaction.

In sum, the application of the ESD test in the courts has been fairly inconsistent, which has caused many commentators in the past to question its usefulness.

### Impetus for Codification

Concerns regarding the lack of uniformity among the courts in applying the ESD began to intensify at the end of the 1990s, due to the perceived threat from the ongoing proliferation and increased complexity of corporate tax shelters. In 1999, both the Treasury and the Joint Committee on Taxation (“Joint Committee” or “JCT”) issued comprehensive reports on tax shelters, suggesting for the first time that the ESD should be codified and used as the primary tool in denying tax benefits resulting from such tax shelters. For example, the Treasury report concluded that “a substantive change [was] necessary to address corporate tax shelters” and that any such change “should embody the adoption of coherent standards rather than narrow, mechanical rules.” According to the Treasury, “[t]he centerpiece of the substantive law change should be the codification of the economic-substance doctrine.”

Beginning in 2001, there had been numerous attempts to codify ESD, with the last significant push for its adoption prior to its recent codification occurring in 2006. Notably, these proposals were initiated at a time when the tax law was lacking in many of the current reporting rules that are designed to facilitate enforcement and deter tax shelters and other abusive transactions, including “reportable” and “listed” transactions. Circular 230 and, most recently, schedule UTP. Taken together, these reporting rules effected a drastic change in the overall compliance regime. But, even in an environment of less stringent reporting obligations, each of the proposals for codification of the ESD was met with severe criticism from many practitioners and other commentators. Practitioners were primarily concerned about the potential invalidation of, and imposition of substantial penalties on, typical business transactions in light of the uncertain scope and application of ESD. Commentators, as well as previous administrations, were also concerned that codification would limit the flexibility of the courts and weaken ESD.

As a general matter, even before codification, the IRS has had significant success in the courts when
seeking to invalidate abusive transactions on economic-substance grounds. Nevertheless, Congress sought to “clarify and enhance[] the application of the economic-substance doctrine.” Consequently, the ESD was codified in Section 1409 of the Act with the new provisions effective for transactions entered into after March 30, 2010. Thus, there will likely be some time before it becomes clear how, if at all, the codification of ESD will affect existing tax law and tax planning in conjunction with legitimate business transactions.

Overview of the Statute and the JCT and House Reports

The new ESD-related statutory provisions are generally contained in new Code Sec. 7701(o) with related penalty provisions incorporated into Code Secs. 6662, 6664 and 6676, as applicable.

Applicability of ESD

As an initial matter, the statute provides that the two-prong test for determining whether a transaction has economic substance is applicable only “in the case of any transaction to which the ESD is relevant.” The statute, however, provides little guidance as to how this determination is to be made, stating only that “the determination of whether the ESD is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.” The report of the JCT (“JCT Report”) is somewhat more informative in stating that “the provision does not change present law standards in determining when to utilize an economic substance analysis” with a footnote that states that “[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.” The report of the House of Representatives (“House Report”), in turn, notes that “[i]f the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic-substance doctrine as defined in this provision.” Without any guidance in the statutory text and limited guidance in the relevant reports, however, it remains highly unclear how a court is to make this determination, especially since, pre-codification, it was not always clear where the courts ever actually considered whether the ESD was “relevant” to a particular transaction before applying the two-prong test. Even if the courts did make such a determination in past ESD cases, they did not always do so expressly, leaving taxpayers with little guidance in this regard.

Conjunctive Two-Prong Test and Other Mechanics

As indicated by the statute with respect to the “relevance analysis,” according to the JCT and House Reports, the codification of the ESD is for the most part not intended to effect a significant change in existing law. One substantive change that is effected by the statute, however, is the imposition of uniform standards for the mechanical application of the ESD. Most notably, the statute codifies a conjunctive two-part test for determining whether a transaction has economic substance. Thus, in order for its transaction to be treated as having economic substance, a taxpayer must satisfy both the objective and subjective prongs of the ESD test by demonstrating that (1) the transaction changes the taxpayer’s economic position in a meaningful way (apart from Federal income tax effects) and (2) the taxpayer has a substantial purpose for entering into the transaction (apart from federal income tax effects). As noted by the JCT Report, “[t]his clarification eliminates the disparity that exists among the Federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits [that adopted the disjunctive or unitary test].”

The statute also imposes additional requirements relating to how courts are to determine whether each prong of the ESD test has been satisfied. One such arguably additional requirement is found in the statute’s formulation of the two-part test itself, the subjective prong of which states that the nontax business purpose for the transaction must be “substantial.” The potential impact of this addition is unclear. The courts have not clearly articulated such a requirement, and the statute provides no guidance as to what is meant by “substantial.” The JCT and House Reports similarly provide no additional guidance on this point. In addressing the business purpose requirement, however, both reports add a footnote indicating that not only must the transaction be entered into for a business purpose, but the transaction must also be “rationally related” to such purpose.
previously considered this factor, the statute itself does not specifically incorporate it, although it may be argued that “rational relationship” is inherent in the notion of true motivation. Thus, the import of the footnote contained in the JCT and House Reports—in particular, whether it indicates that the requirement that the business purpose be “substantial” somehow incorporates a requirement that the transaction be rationally related to such purpose—is left for interpretation.

Another point of clarification related to the subjective prong is that achieving financial accounting benefits is not a “good” nontax business purpose for the transaction “if the origin of such financial accounting benefit is a reduction of Federal income tax.”38 A different approach would risk eviscerating the nontax business purpose requirement of the ESD.39 For similar reasons, the statute also provides that state and local tax savings are not to be considered in determining whether a transaction has economic substance, to the extent such effects are “related” to a federal income tax effect.40 In other words, state and local taxes cannot provide economic substance to a transaction and justify its attendant federal tax benefits if the reduction in state and local taxes arises by virtue of a reduction in federal taxes. Otherwise, many abusive transactions could be justified on these grounds.

The statute also clarifies the importance of the profit potential of the transaction. First, the statute indicates that no particular level of profit is required and that taxpayers may rely on factors other than profit potential to satisfy either prong of the test.41 But, should a taxpayer choose to rely on potential profit from the transaction, such potential is relevant in determining whether either prong of the ESD test is met only to the extent that the present value of the reasonably expected pre-tax profit from the transaction is “substantial” in relation to the present value of the expected net tax benefits of the transaction.42 The statute, however, does not indicate what is meant by “substantial.” The statute does specify that transaction fees are to be treated as expenses for purposes of calculating expected pre-tax profit.43 In addition, the statute instructs the Secretary to issue regulations that would require foreign taxes to also be treated as expenses in “appropriate cases.”44

Finally, the statute provides that the ESD is applicable to personal transactions of individuals only to the extent such transactions are related to a business or income-producing activity of the taxpayer.45

Certain Definitions

The statute also contains two definitions, including the definition of ESD itself. The ESD is defined as the common-law doctrine under which tax benefits of a transaction “are not allowable if the transaction does not have economic substance or lacks a business purpose.”46 The JCT and House Reports note the definition in passing, indicating that it is consistent with the adoption of the conjunctive test.47 However, the definition—specifically, the use of the word “or” therein—raises a possible interpretative question, namely whether Congress intended that the definition encompass any transaction for which there is a business-purpose requirement. If so, even transactions that traditionally would not have been subject to the ESD analysis may now be subject to such analysis and its related penalties. This would represent a significant departure from what was generally understood to be prevailing law and would ignore the statutory requirement that the transaction in question be one to which the requirement is “relevant.”

The second definition provides that the term “transaction” includes “a series of transactions.”48 In this regard, both the JCT and House Reports state that the doctrine does not affect the ability of the courts to aggregate, disaggregate, bifurcate or otherwise recharacterize a transaction.49 The Reports cite to Coltec Industries, Inc.50 in further noting that “the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with nontax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”51 But, although the courts have not been consistent in their willingness to focus on individual steps of a transaction in applying the ESD, nor provided a framework for analysis as to when a more narrow focus may be appropriate, neither the statute nor the relevant reports provide any additional guidance. Accordingly, what constitutes the relevant transaction and how this is to be determined remains unclear after codification.

Accuracy-Related Penalties

Finally, the new law makes a number of amendments to the penalty provisions of the Code, which, taken together, impose a strict liability accuracy-related penalty for any underpayments attributable to “[a]ny
disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of § 7701(o)) or failing to meet the requirements of any similar rule of law.” The applicable penalty rate is 20 percent if the facts related to the transaction in question are adequately disclosed, but a 40-percent penalty applies if such facts are not adequately disclosed.

The statute does not specify what is meant by “similar rule of law.” The JCT and the House Reports, in turn, provide cryptic guidance. The JCT Report states in a footnote that it is intended that the penalty applies to any “transaction the tax benefits of which are disallowed as a result of the application of similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.” The House Report, in turn, states that “the penalty would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”

Thus, it is difficult to predict with any certainty how broad the application of the strict liability penalty is intended to be. The JCT explanation appears significantly broader than the House Report, as it captures any transaction the tax benefits of which are disallowed based on the application of “similar” factors as those relevant to the ESD analysis. The statute, in turn, could be read even more broadly in that it refers to any “similar rule of law,” without regard to the particular factors or analysis to be applied. Read expansively, the statute could be interpreted to apply a strict liability penalty to underpayments resulting from transactions that fail any of the judicially developed anti-abuse doctrines. Indeed, the JCT and House Reports specifically note (albeit in a different context) that doctrines that are closely related to ESD, and that are “sometimes interchangeable with the economic-substance doctrine,” include the “sham-transaction doctrine” the “business-purpose doctrine,” and the “substance-over-form doctrine.” Although not mentioned by the Reports, another arguably related doctrine is the “step-transaction doctrine.” The JCT and House Reports further note that common-law anti-abuse doctrines “are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants.” Indeed, these doctrines overlap significantly. For example, the step-transaction doctrine eliminates steps that are lacking in business purpose, or a step can be disregarded if it is a formality inconsistent with the substance of the transaction. On the other hand, the doctrine can also serve as a simple analytical tool for determining whether a legitimate, nonabusive transaction meets a technical Code definition. Given the recognition of the possible significant overlap and blurring of the lines in this area, the lack of specificity in the statute that imposes a significant strict liability penalty is likely to cause significant concerns among taxpayers and their tax advisors.

### The Impact of the New Statute on Existing Law

Despite indications in the JCT and House Reports that the codification of the ESD was generally not intended to effect a significant change in existing law, as the previous discussion indicates, this is far from clear from the statutory text and, to a large extent, the JCT and House Reports themselves. The statute clearly expands the reach of the doctrine in those circuits that applied a disjunctive version of the two-part test. It also seems arguably to broaden the doctrine more generally by imposing or clarifying certain additional requirements, such as that the business purpose for the transaction, as well as its pre-tax profit, where relevant, be “substantial.” Be that as it may, the additional statutory requirements of this nature generally do not present a significant cause for concern. The relevant statutory provisions are express and, for the most part, effect only incremental changes, if any, to existing law.

However, the statute and the JCT and House Reports also contain more cryptic references, which, depending on their correct interpretation, could result in a radical change in the existing legal landscape. In particular, the statute may have expanded the reach of the independent business purpose requirement and may have also made it much more difficult for integrated transactions to satisfy the ESD by narrowing the scope of the relevant transaction.

### Business Purpose: Statute and the JCT and House Reports

New Code Sec. 7701(o)(5)(A) defines ESD as a common-law doctrine under which tax benefits of a transaction are “not allowable if the transaction does not have economic substance” or “lacks a business purpose.” This definition raises a number of ques-
tions. Read literally, does this provision mean that every transaction which requires a business purpose under the Code is also an ESD transaction? If so, does this mean that in the case of every transaction for which a business purpose is required, the business purpose must always be “substantial”? Further, if all transactions that require a business purpose are also subject to ESD, must they now also result in an objective change in the taxpayer’s economic position? If this is the case, does the ESD subsume both statutory and common-law–based business-purpose requirements?

Some commentators have questioned if the codification of the ESD has expanded the business-purpose doctrine even further, suggesting that without the limitation provided by the “relevance” requirement, the two-prong ESD test could be interpreted to impose a “business purpose requirement on every transaction to which any Code section might otherwise apply.”

The JCT and House Reports do not completely resolve these ambiguities. According to the Reports: “The [ESD statute] defines ‘economic-substance doctrine’ as the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Thus, the definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both.” While the better reading of this sentence is that it refers to either the conjunctive or disjunctive test for ESD—i.e., situations where courts look for either economic substance, business purpose or both economic substance and business purpose, the last sentence of this paragraph literally states that the ESD includes the business-purpose doctrine.

The Reports do provide a more encouraging indication that the codification of the ESD has not heightened the requirements and expanded the applicability of the business-purpose doctrine. The JCT Report (as well as the House Report, but with slightly different language) explains that “[t]he [ESD statute] is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.” Although this language is helpful, it is unlikely to provide taxpayers with great comfort in light of the many ambiguities in the statutory language and the potentially significant penalties that may apply.

In particular, if the statutory language is properly interpreted to mean that any transaction with a business purpose requirement is now also an ESD transaction, does this also imply that the strict liability penalty may apply to any transaction with a failed business purpose?

Many of Subchapter C’s basic transactions have a business purpose requirement. For example, Code Sec. 355 applies to a transaction “only if it is carried out for one or more corporate business purposes.” Business purpose is a requirement of the Code Sec. 368 reorganization transactions. Some courts have even suggested that Code Sec. 351 incorporates require a business purpose. Traditionally, failure to satisfy the business purpose requirement in any of these contexts has not subjected the taxpayer to a strict liability penalty. Has the codification of the ESD heightened the stakes in these transactions?

It seems unlikely that Congress could have intended for ESD codification to change the law to this extent. On the other hand, Congress is generally aware of positions taken by the IRS on particular issues, and it appears that the IRS has previously applied ESD scrutiny to Code Sec. 351 transactions, albeit never expressly. The IRS seems to clearly take the position that a Code Sec. 351 contribution must have a business purpose to be respected, but some of these decisions seem to go beyond business purpose and suggest that anti-avoidance doctrines, like ESD, apply to Code Sec. 351 transactions as a general matter. In Rev. Rul. 60-331, the taxpayer’s closely held corporation was faced with an assessment for a deficiency in personal holding company tax, which the corporation could avoid by paying a deficiency dividend distribution. After receiving this assessment, the corporation’s sole shareholder contributed the stock of the corporation to a newly formed corporation. The new corporation (which, as the old corporation’s new sole shareholder, would be the entity receiving the deficiency dividend) would not be required to pay tax on most of the dividend because of the dividends received deduction available to corporate shareholders. The IRS concluded that the taxpayer’s motive for the contribution was to minimize Federal income taxes and therefore disregarded the involvement of the new corporation and treated the dividend as constructively received by the taxpayer directly.

In reaching this conclusion, the IRS relied on Gregory v. Helvering and Higgins v. Smith, noting that the underlying theme of these cases was that “only
bona fide business transactions having a legitimate business purpose in addition to the minimization of taxes will be recognized for tax purposes, and then only if the characterization the taxpayer places on the transactions is in reality what it purports to be in form. A transaction which has no purpose other than the avoidance of reduction of taxes, will be ignored for tax purposes.” This language in Rev. Rul. 60-331 [1960-2 CB 189] could arguably provide support for the view, suggested in the new ESD statute, that the ESD imposes a business-purpose requirement on most, if not all, business transactions.

The new accuracy-related penalty provision can be read to suggest that the statute may have done just that. New Code Sec. 6662(b)(6) applies to “[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of Code Sec. 7701(o)) or failing to meet the requirements of any similar rule of law.” The statute is silent on what is meant by “similar rule of law.” The JCT and House Reports note, albeit in a general context, that doctrines which are closely related to and are “sometimes interchangeable” with the economic-substance doctrine include (1) the sham-transaction doctrine, (2) the substance-over-form doctrine and (3) the business-purpose doctrine [JCT Report, at 142, note 300; House Report, at 292, note 106]. Thus, Code Sec. 6662(b)(6) may arguably encompass benefits disallowed under the business-purpose doctrine, even if the doctrine is not the same as ESD.

Although it is possible to read the statute in this fashion—that the ESD has elevated the business-purpose doctrine to the same status as the ESD itself, at least with respect to applicable penalties—this reading is inconsistent with the oft-repeated notion that the codification was primarily intended to clarify, rather than alter, existing law. But, how is a court to determine in which circumstances a taxpayer’s failure to demonstrate a nontax business purpose should subject such taxpayer to the strict liability penalty. One possible approach can be discerned from the JCT and House Reports, or in this case, the differences between the two. As noted, in addressing the accuracy related penalties, the JCT Report explains that “[i]t is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.” The House Report, on the other hand, states that “the penalty would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”

The differences in language between the two reports intimate a possible framework for differentiating between cases where failing to satisfy the business purpose requirement should subject the taxpayer to a strict liability penalty and those where it should not. Specifically, one proposed approach is that the penalty is applicable where a court uses common law doctrines to find that a part of the transaction will be disregarded entirely. So, for example, the determination that a transaction (e.g., a spin-off) is taxable for lack of business purpose would not give rise to a penalty; by contrast, a transaction would be subject to the penalty if the court finds that all or part of the transaction should be disregarded.

This approach would prevent the strict liability penalty from applying to transactions that, while failing a statutory or common-law business purpose requirement, are not the types of transactions to which the ESD is “relevant.” This result seems consistent with the intent of the statute. Moreover, the approach is supported by existing law. “The economic substance doctrine denies the tax benefits of a transaction by causing the transaction to be completely ignored for tax purposes. That is, no portion of the transaction is respected—neither the beginning nor the end nor the middle.” Or, as one court has explained, “[o]ver the last seventy years, the economic-substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality.” On the other hand, a lack of business purpose generally does not mean that the transaction should be disregarded; instead the transaction obtains different tax consequences. For example, in the reorganization context, a failed business purpose will prevent a statutory merger from qualifying as a reorganization. In that case, however, the transaction will not be disregarded for tax purposes, rather it will be treated as a different but real transaction, a taxable asset sale. Similarly, a failed business purpose in the context of Code Sec. 355 tax-free spin-offs will not cause the IRS to disregard the distribution of the shares of the controlled corporation; rather, the distribution will be subject to tax on the gain inherent in the distributed stock under Code Sec. 311(b).
Transaction: Statute, JCT and House Reports

Beyond business purpose, the new statute may have also meaningfully changed existing law by expanding the reach of the ESD itself. This is likely to be the case if, as the JCT and House Reports suggest, the statutory definition of “transaction” is properly interpreted as an endorsement of the approach adopted in Coltec Industries, Inc.,77 which subjects each individual step of an integrated transaction to the ESD. If this is in fact the correct view, the ESD as codified has greatly expanded the universe of transactions that, despite clearly satisfying the literal provisions of the Code, may be subject to invalidation on ESD grounds and a significant penalty. A court’s understanding of what constitutes the relevant transaction for purposes of ESD analysis can have a significant impact on the resolution of the case, and can often be outcome determinative.78 Thus, perhaps the lynchpin question may be: what is the (scope of the) transaction to be analyzed?

Good tax planning often involves the addition of steps to the transaction that are entirely tax-driven, even where the overall transaction clearly has economic substance. More often than not, such steps also do not meaningfully change a taxpayer’s economic position other than by reason of the tax benefits achieved. For example, the formation of a transitory subsidiary in order to qualify an acquisition as a nontaxable subsidiary merger under Code Sec. 368(a)(2)(E) does not, in and of itself, have economic substance or business purpose, even though the overall transaction—the acquisition—has a meaningful economic impact and is entered into with a nontax motivation.79

Thus, whether economic substance is required with respect to the transaction as a whole or with respect to each step of the transaction is an important question with potentially significant consequences. Courts have reached different conclusions on this question, often on similar facts and without much explanation. The leading case setting forth the narrow view of “transaction” is Coltec Industries,80 which suggests that economic substance is needed for each step of an integrated transaction. Coltec is also one of the few cases to expressly focus on the framing of the transaction to be analyzed under the ESD.

Coltec Industries

Background Facts

In 1996, Coltec Industries, Inc. (“Coltec”), a publicly traded company and the common parent of an affiliated group, sold one of its subsidiaries, recognizing a significant capital gain. After this sale was completed, Coltec engaged tax advisors to devise a strategy for minimizing its tax consequences.

Transaction

Acting on the advice of its tax advisors, Coltec first reorganized one of its dormant subsidiaries into a special purpose entity (“SPE”) to which it contributed approximately $14 million in cash in exchange for SPE stock. Then, another Coltec subsidiary, Garlock, Inc. (“Garlock”), transferred to the SPE (1) stock of certain of its subsidiaries that had previously manufactured products with asbestos and (2) a promissory note with face value of $375 million issued to Garlock by one of Garlock’s other subsidiaries. The SPE also assumed Garlock’s contingent asbestos-related liabilities and assumed primary management responsibility for handling the asbestos-related claims. The expected value of the contingent liabilities was only slightly less than the value of the assets Garlock contributed—in fact, the promissory note was intended to be sufficient to allow the SPE to cover any future asbestos-related claims.

At the time, Code Sec. 358(d)(2) provided that a contributor in a Code Sec. 351 contribution did not have to reduce the basis of the stock received in exchange for its contribution by the value of any contingent liabilities assumed by the newly formed corporation. Accordingly, although contributing little net value to the ESP, Garlock did not reduce its basis in the SPE stock by the expected value of the contingent asbestos-related liabilities. As a result, Garlock’s SPE shares had little market value, but basis in excess of $350 million.

Shortly thereafter, Garlock sold its SPE stock to two participating banks in exchange for a nominal sum, recognizing a significant capital loss. Coltec, in turn, used this capital loss to offset its capital gain from the earlier subsidiary sale. And, even after Garlock sold its SPE shares, Coltec retained approximately a 93-percent interest in the SPE, and stood to benefit from future losses incurred by the SPE, which would be largely duplicative of the loss incurred in Garlock’s sale of SPE stock.
Observations/Questions
The court agreed with Coltec’s basis calculation pursuant to Code Sec. 358, concluding that its “loss from the sale of its [SPE] stock fell within the literal terms of the statute.” The court nevertheless disallowed Coltec’s loss on the grounds that the step of the transaction which created the loss lacked economic substance.

The court took a very narrow approach in framing the relevant transaction as the specific transaction that gave rise to the tax benefit in question. As a result, Coltec’s asserted business purpose—the creation of an SPE to manage the group’s asbestos-related liabilities—although accepted by the court as a legitimate business purpose for the overall transaction, was insufficient to satisfy the subjective prong of the ESD as applied to the relevant step. In the court’s view, the relevant transaction consisted solely of the SPE’s assumption of the asbestos-related contingent liabilities in exchange for the promissory note, and this particular step did not further the stated objective of allowing the SPE to manage the asbestos-related claims. That objective was accomplished by the creation of the SPE alone.

The court also flatly rejected Coltec’s assertion that the transfer of the contingent asbestos-related liabilities was driven by the need to insulate Coltec from any related veil-piercing claims. The court explained that “[t]he problem was that there was no objective basis for suggesting that the assumption of these liabilities by another subsidiary ... would in any way ameliorate this veil-piercing problem.” In reaching this conclusion, the court pointed out in particular that “[i]n this respect, Coltec relied entirely on the testimony of various Coltec executives about the veil-piercing benefits that they perceived from the ... transaction.” Ultimately, because Coltec could not satisfy the subjective prong of the ESD test as applied to the relevant transaction, the court concluded that the “transaction must be disregarded for tax purposes.”

Prior to ESD-codification at least, not all courts have adopted Coltec’s approach. For example, in Shell Petroleum, the court expressly declined to follow Coltec and bifurcate a transaction so that it could focus solely on the step that generated the tax benefit. Perhaps the existence of a disagreement among the courts is unsurprising, as it is questionable whether applying ESD to each individual step of a transaction is always appropriate. Such an approach is in tension with the generally recognized principle, articulated by the Supreme Court in Gregory v. Helvering, that some degree of tax planning is acceptable. With a narrow enough focus, it is always possible to isolate any tax-planning step and conclude that such a step did not have a nontax business purpose or economic substance other than that related to federal tax effects. But many transactions involving such steps, such as pre-transaction structuring to qualify for reorganization treatment, for example, have traditionally been understood to be acceptable tax-planning techniques that have also enjoyed long-standing approval by the courts and the service. Is the ESD now applicable to such steps?

There are many other questions. Where each step is a logical and rational means of achieving the overall business objective, can the ESD require an examination of a single step? Many individual steps of overall transactions are in and of themselves tax-motivated. What about a step that has tax benefits, which could be accomplished in another way or skipped entirely?

The new statute does little to clarify these questions. The statutory text merely provides that the term “transaction” includes a series of transactions. In and of itself, this does not indicate what is the smallest relevant “transaction” for ESD purposes.

The JCT and House Reports are more informative than the statute, but they do little to assuage shareholder concerns in this area. Indeed, both reports appear to endorse the narrow Coltec approach. According to both reports, “[t]he provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine” and “the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with nontax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.” Moreover, both reports cite to Coltec in support of this proposition.

The reference to Coltec in the JCT and House Reports is likely to further increase the import of this case. As one commentator has observed, “[w]hile [the JCT and House Reports’] endorsement does not mean that circuits that have not applied a Coltec approach to a given transaction in the past will now do so, it will likely embolden the IRS to assert Coltec in tax litigation. Indeed, the endorsement of Coltec in the legislative history appears to be the basis for the IRS’s public statements that it may challenge a future transaction having facts similar to the transaction.
addressed in *Shell Petroleum* (presumably even in the same circuit) notwithstanding its loss in the *Shell Petroleum* case, and may also challenge transactions similar to those addressed in other cases that the IRS views as having been wrongly decided. The endorsement of *Coltec* also feeds the uncertainty about whether the ESD may be ‘relevant’ to a single step of a transaction if not the transaction as a whole.96

Ultimately, it is unclear how the references to *Coltec* in the JCT and House Reports will affect the development of the law in this area. *Coltec* involved a highly uneconomic transaction in which the court essentially held that the taxpayer had not been truthful about liability shifting.97 For example, the court described one of Coltec’s asserted business purposes for the transaction as having “no basis in reality” and took issue with the fact that in establishing that business purpose Coltec relied primarily on the “subjective views of [its] executives”—testimony that the court indicated would not be credited.96 The district court in *Shell Petroleum, Inc.*99 later described *Coltec* as involving a “legal [and] logical flaw” because of the “objective impossibility of [Coltec’s] stated goals for transferring the note in exchange for assumption of contingent liabilities.”100 Query whether the *Coltec* court was not mostly result-oriented in light of concern the court had with the taxpayer’s alleged motivation.

Regardless of the underlying motivation for the court’s decision, *Coltec* illustrates how the transaction is framed can be a critical determination in any ESD case.101 If *Coltec*’s focus on each particular step of an integrated transaction were adopted universally, many legitimate business transactions would be threatened.102 But, despite the significant uncertainty and high stakes, the courts have not developed a coherent approach to the “framing” question, making it extremely difficult (if not impossible) to predict how any particular court will frame the relevant transaction for ESD purposes. Given the lack of guidance in this area and the potentially outcome-determinative nature of the question, it is imperative for the courts to develop a framework for analysis.

One possible approach would be to first consider whether each step of the transaction represents a reasonable means of accomplishing the stated business purpose. If so, and the overall transaction is driven by business considerations, then the courts should not analyze each individual step under ESD. This approach would allow courts to identify suspect transactions (like *Coltec*) that contain an unrelated, but critical step, that generates significant tax benefits, but does nothing at all to further the stated business purpose. As was the case in *Coltec*, the presence of such a step indicates the presence of a “structure in search of a transaction,”103 which is often indicative of abusive transactions. When a particular step raises a red flag to this extent, it is likely that it is precisely that step that is the driving force behind the transaction. In such circumstances, it appears appropriate for courts to apply ESD to this step alone. The conclusion should be different where a series of smaller steps, which admittedly serve no function other than to secure certain tax benefits (such as pre-reorganization structuring into qualification) are part of a broader business transaction. Such steps are consistent with the generally accepted principle that taxpayers are free to engage in some degree of tax planning.

Whichever view is ultimately adopted, until the courts articulate a framework for analysis with predictive power, significant ambiguity will remain. The endorsement of *Coltec* in the JCT and House Reports will likely only add to the uncertainty and heighten taxpayer concern in this area (especially in light of the significant potential penalties).

**Presenting the Problem: Application of ESD to Subchapter C**

The potentially expanded reach of the post-codification ESD is particularly problematic in the context of Subchapter C. Subchapter C is by its nature highly form-driven. Whether a transaction satisfies any number of highly technical, bright-line rules can more often than not have a significant impact on its tax consequences.104 There are innumerable examples—most notably, Code Sec. 368 and its seven enumerated reorganization transactions.105 This particular statute imposes highly technical and sometimes seemingly arbitrary requirements that must be satisfied before a transaction will qualify for nonrecognition treatment under a particular reorganization provision. These requirements often overlap and in some circumstances conflict, but substance is not really apparent in the differences between the various reorganization transactions themselves, nor between the reorganization transactions and ones that do not qualify for reorganization treatment.106
For example, the reorganization provisions treat a merging corporation as the entity that has undergone a reorganization, even if it is BigCo that merges with TinyCo. In such a case, it is BigCo that has undergone a reorganization, even though in substance, it is TinyCo that is more appropriately viewed as the target entity. The use of this “reverse acquisition” structure allows the merger to qualify as an A reorganization even if a substantial portion of the “target” shareholders have been cashed out, as the continuity of interest requirement applies only to the acquirer.\(^\text{107}\) This would not be the case if the merger was structured in the other direction.

Moreover, each individual reorganization provision has unique technical requirements, thus, transactions that differ significantly in substance may qualify for reorganization treatment generally, albeit under a different provision. For example, the use of too many tiers spoils only certain types of reorganizations\(^\text{108}\) and the use of voting stock as acquisition currency is mandatory in only certain reorganizations,\(^\text{109}\) while acceptable levels of boot vary significantly between different types of reorganizations.\(^\text{110}\) Given that satisfaction of various technical rules almost completely drives the tax characterization in this context, planning in and out of tax-free transactions is commonplace and characterization of and qualification as a reorganization can have significant consequences including whether gain or loss is recognized and where valuable attributes move. Although many steps taken as part of such structuring could be seen as lacking in economic substance (choosing to structure an acquisition as a merger rather than a stock-for-stock exchange is often done solely in order to achieve reorganization treatment under the less restrictive A reorganization provisions), the IRS has traditionally not sought to invalidate such steps on ESD grounds. Given the context, this is hardly surprising. Congress has expressly imposed a series of specific requirements in the statute\(^\text{111}\) and the courts, following Congressional mandate, have enforced these tests quite literally on not infrequent occasions.\(^\text{112}\) Given the highly technical nature of this area of law, courts can do little else. “When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. ‘Substance’ can only be derived from forms created by the statute itself. Here substance is form and little else; there is no natural law of reverse triangular mergers.”\(^\text{113}\)

The use of highly specific, technical requirements in Subchapter C is not limited to the reorganization context. Thus, the ESD, which stands for the proposition that the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether it will be respected by the IRS and the courts, is in some tension with the literal reading by the courts and the IRS of various provisions of Subchapter C and its many technical requirements.

The answer cannot be simply that literal compliance with Code provisions is always a necessary, but never a sufficient, condition before a transaction will be respected for tax purposes. Indeed, the tax law consists primarily of relatively clear statutory rules and technical requirements so as to provide taxpayers with some degree of certainty and predictability in structuring business transactions.\(^\text{114}\) As the JCT Report points out, “[t]axpayers generally may plan their transactions in reliance on these rules to determine the Federal income tax consequences arising from the transactions.”\(^\text{115}\) Clearly, the statute and common law recognize the ability, within a legitimate transaction, to optimize taxes. Indeed, this premise is a widely accepted truism in the area of tax law, which dates back to the seminal \textit{Gregory v. Helvering}\(^\text{116}\) case itself. In writing the Second Circuit’s opinion in that case, Judge Learned Hand made the often quoted observation that “[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”\(^\text{117}\) The sentiment was echoed by the Supreme Court in its \textit{Gregory} decision: “The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”\(^\text{118}\)

Thus, the fundamental dilemma in analyzing many transactions under Subchapter C—where particular steps in an overall business-motivated transaction are often taken to achieve a tax result—is in determining when a technically compliant transaction must pass muster under ESD. In other words, when is ESD “relevant”?

As this article will illustrate, this question is a difficult one, but it is also one of critical importance now that the ESD has been codified. Because of the statute’s failure to even address the question, let alone provide a framework that would allow taxpayers to differentiate between transactions to which ESD is and those to which ESD is not relevant, taxpayers will be forced to structure business transactions amid
significant uncertainty as to their tax consequences. Of course, all Subchapter C transactions are subject to step-transaction, substance-over-form and other common-law doctrines, and everyday practice necessarily involves judgments in these arenas. But, post-codification, the heightened concern in this arena is largely a product of ambiguities in the new statute and concern about a strict liability penalty. The significant penalty, in conjunction with the lack of meaningful guidance as to the circumstances in which such a penalty may be assessed, could chill even minimal tax planning unless the IRS demonstrates restraint in its assertion of the penalty.

Relevance: JCT and House Reports

As will be discussed in more detail in Part VI of this article, if the ESD were universally applicable (i.e., any transaction engaged in by a taxpayer is subject to the ESD analysis), the two-prong ESD test as codified could be applied to invalidate a wide range of transactions that have long been understood as legitimate, or even transactions that are structured so as to take advantage of tax benefits expressly provided for in the Code. For example, if applied to each particular step, the ESD could invalidate certain pre-transaction structuring steps undertaken solely to allow the taxpayer to qualify or fail to qualify for reorganization treatment. Similarly, nonrecognition treatment afforded to like-kind exchanges under Code Sec. 1031 could arguably be denied under ESD, as structuring a transaction as a sale versus a like-kind exchange does not in and of itself have a nontax business purpose or a nontax impact on the taxpayer’s economic position. The ESD could even jeopardize the availability of tax elections that are expressly made available by the Code or Treasury regulations, since the making of a tax election almost never has a nontax business purpose or economic impact in and of itself. Similarly, it could operate to deny any number of tax benefits expressly granted by the Code and designed to incentivize particular behavior, as long as the taxpayer in any way structures the transaction so as to qualify for such benefits (even though the very purpose of the provision is to incentivize such structuring).

This clearly could not be what Congress intended. Indeed, the JCT and House Reports indicate as much. Both reports state that the new statute is “not intended to alter the tax treatment of certain basic business transactions,” nor deny tax benefits that are “consistent with Congressional purpose.” But, as many such benefits would be denied if subjected to the ESD, it must be that in some cases the ESD simply does not apply. Indeed, the statute provides that the ESD two-prong test is applicable only to those transactions to which ESD is “relevant.” Thus, the critical question becomes how to differentiate between the two sets of cases—those that should be subject to the ESD and those that should not. Indeed, as previously noted, this threshold inquiry is not only difficult, it is in many ways the central inquiry. But, despite the importance of the question, the statute provides virtually no guidance as to how the relevancy determination is to be made. Rather, the statute assures taxpayers that the law in this area has not changed: “The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection [Code Sec. 7701(o)] had never been enacted.” The JCT Report adds that “the provision does not change present law standards in determining when to utilize an economic substance analysis.”

But, what are “present law standards in determining when to utilize an economic substance analysis”? Arguably, at least in the most egregious of tax shelter cases, ESD has been a useful tool in the courts’ arsenal to invalidate clearly abusive transactions. But, the courts’ application of the ESD is not consistent and the cases are not, as a practical matter, susceptible to a systemic finding that ESD is or is not “relevant” to a category of transactions.

Before codification, the courts have never had to decide specifically whether economic substance is “relevant,” they simply apply it or fail to apply it. A court’s failure to address ESD could indicate either that the court concluded that ESD was not relevant or that the court simply did not consider the doctrine (thus not addressing “relevance”). In fact, as federal courts may only address arguments and theories actually raised by the litigants, a court’s failure to address ESD in the vast majority of cases most likely indicates simply that the IRS chose not to assert the doctrine in that particular case.

Even where the IRS does raise ESD as an issue, a court still may not consider ESD, not because it does not find it to be relevant, but because it can decide the case on other grounds. Frequently, ESD is only one of many common-law doctrines (such as “step-transaction,” “substance-over-form,” “sham-
transcendal approach, stating that "[i]f the tax benefits are not relevant, it may just mean that the court preferred grounds instead. It is not clear that that means ESD is economic substance are challenged on technical standards in determining when to utilize an economic substance analysis," they are often difficult to find in existing case law. The JCT and House Reports are somewhat more instructive in this regard, by indicating that the question is ultimately one of Congressional purpose or intent. For example, the JCT Report states that "[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed." The House Report arguably provides a more focused approach, stating that "[i]f the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic-substance doctrine as defined in this provision." In fact, many commentators have noted that Congressional intent and purpose must be incorporated into the ESD analysis. A number of courts have expressed a similar sentiment, with one court explaining that the "economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code" and "is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute." But, while this is an important limitation on the application of ESD, discerning Congressional purpose is a difficult exercise susceptible to multiple interpretations, particularly if one takes the broad "Congressional purpose or plan" approach referred to in the JCT Report. The JCT Report provides examples of benefits that would not be subject to disallowance on ESD grounds because they are consistent with the "Congressional purpose or plan," including the Code Sec. 42 low-income housing credit, the Code Sec. 45 production-tax credit, the Code Sec. 45D new-markets–tax credit, the Code Sec. 47 rehabilitation credit and the Code Sec. 48 energy credit. However, these examples are not particularly helpful as they involve uniquely straightforward inquiries into a single statutory provision that expressly grants tax benefits to a taxpayer if such taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

In the Subchapter C context, the question is rarely this simple. The particularly hard ESD cases in the corporate context typically involve a taxpayer who, in connection with a business transaction with a good business purpose, engages in a step that allows the taxpayer to benefit either from the application of a Code section that was enacted in an entirely different context or from the mismatch of two unrelated Code provisions. In such cases, Congress probably never considered the particular situation in question when enacting the relevant statutory provisions.

In such circumstances, perhaps the best a court can do is to attempt to determine what Congress would have done had it considered the provisions and the situation in question. But, how are courts to approach this determination? As an initial matter, it is unclear what sources a court may or should consult in determining the relevant "Congressional purpose or plan." Neither the statute nor the JCT Report address this question, and while the House Report appears more focused on the relevant Code provisions, it does not provide further guidance. Must a court look solely to
the provisions applicable to the transaction at issue, or may a court apply general principles of tax law in making its determination? If the latter, how are such principles to be defined? Moreover, if Congress is not bound by general tax law principles, from which it in fact often deviates, how is a court to determine whether Congress would have chosen to follow or deviate from such principles in any given situation? Finally, it is also unclear whether and to what extent this limitation on the ESD applies with respect to the “purpose or plan” articulated in the Treasury regulations.

Even if some of these questions were resolved however, the determination of a “Congressional purpose or plan,” in a context that Congress could not have predicted and never expressly addressed, is a highly open-ended inquiry and reasonable people can disagree as to its correct conclusion. Inherently a lot of judgment must be applied to analyzing these types of questions. As a result, this approach provides taxpayers with little comfort in their ability to predict with any certainty whether a particular transaction would be subject to the ESD analysis.

Relevance: Case Law

As discussed above, existing case law does not always expressly consider whether the ESD is “relevant” to a particular transaction. Moreover, there appears to be no coherent implicit approach to the “relevancy” question in the existing cases that could help frame the inquiry. This is partially due to the fact that the applicability of the ESD to the majority of cases in this area is relatively uncontroversial. The ESD case law has largely developed out of marketed, structured tax-motivated transactions. In large part, these transactions arose solely in order to mitigate tax consequences or to generate tax benefits and lead, in many cases, to noneconomic losses or benefits.

For example, one subset of these transactions are the “sale-in/lease-out” (SILO) and “lease-in/lease-out” (LIGO) transactions, one typical variant of which involves the taxpayer purchasing a depreciable asset from a tax indifferent party (such an entity exempt from U.S. tax or a foreign corporation) and subsequently leasing the asset back to the tax indifferent party with a lessor-funded option to purchase the asset at the end of the lease term. Thus, such transactions generally provided for the shifting of depreciation deductions to parties to which such deductions would be most valuable, without really changing the ownership of the underlying assets. Inherent in these transactions were circular cash flows, with little involvement required from either party after the closing. Typically, the buyer/lessee would borrow most of the purchase price, which the seller/lessor would then immediately deposit with an affiliate of the lender. The lease/sublease payments would in turn be structured so as to equal the service payments due on the debt, with the relevant fund “transfers” often effected solely between the lender and its affiliate as servicers of the lease/debt.

Another popular shelter transaction prior to its elimination by changes to Code Secs. 743 and 704(c) involved the duplication of losses effected by the transfer of built-in loss assets to a partnership without a Code Sec. 754 election in effect. The contributor of the asset would sell its partnership interest after the contribution, recognizing the loss. Because the partnership would not have a Code Sec. 754 election in effect, the purchaser would then step into the shoes of the seller and be allocated the loss realized by the partnership upon its sale of the contributed asset.

Another class of cases involved the simultaneous transfer of assets and contingent liabilities of nearly identical value to the taxpayer’s wholly owned corporation in exchange for the corporation’s stock. The taxpayer would take basis in the stock equivalent to the fair market value of the asset, but unreduced by the value of the contingent liability. Then, the taxpayer would sell the shares to a third party for a nominal sum (the fair market value of the assets reduced by the value of the contingent liabilities), recognizing a significant noneconomic loss.

Another similar example is loss-generating transactions, commonly known as “Son-of-Boss” transactions. These transactions typically involved the contribution of a long position to a partnership coupled with the partnership’s assumption of an economically offsetting short position from the contributing taxpayer. The taxpayer would increase the basis of the partnership interest received in exchange by the value of the long position, but without reduction for the value of the short position. The taxpayer would then sell the partnership interest for a nominal sum, recognizing a noneconomic loss.

Despite the fact that most of these cases involved marketed tax shelter transactions that were often clearly abusive and generally suitable candidates for ESD, the courts have applied the law very differently even to cases involving nearly identical facts. One of the seminal decisions in this area, ACM Partnership, involved a structured transaction marketed by Mer-
rill Lynch ("ML") to Colgate-Palmolive Corporation ("Colgate") that was designed to generate capital losses and allow Colgate to offset a previously recognized, unrelated capital gain. Colgate formed a partnership with a U.S. tax–indifferent foreign entity, with both parties contributing cash at formation. Most of the cash was contributed by the foreign entity; accordingly, this entity was allocated most of the partnership’s profits and losses (over 80 percent). The partnership used the contributed cash to purchase short-term securities. These securities were sold shortly thereafter at fair market value for consideration consisting primarily of cash, payable immediately, and an installment note tied to LIBOR payable over several periods.

The inclusion of the installment note allowed the partnership to account for the transaction as a contingent installment sale. The rules applicable to such sales at the time, provided for equal basis recovery with each payment received. Thus, if the first payment represented a significant proportion of the total consideration, its receipt would trigger a gain to the seller even where the asset was sold at no gain, because such payment would be applied against a lesser proportion of the basis of the asset sold. The remaining payments, in turn, would result in a loss and eventually offset the initial gain.

After the partnership received the first cash payment and recognized a significant gain, which was mostly allocated to the foreign entity, this entity’s interest in the partnership was redeemed by Colgate. Thus, when the partnership recognized the back-end losses associated with the installment sale, the loss was allocated entirely to Colgate, which used these losses to offset prior, unrelated gains.

The **ACM Partnership** court denied Colgate’s losses, applying the ESD to conclude that “ACM’s transactions did not have sufficient economic substance to be respected for tax purposes.” In particular, the court found that the transactions lacked real economic consequences as they were structured to be mutually offsetting, and that ACM lacked a nontax purpose for entering the transactions, in part because the partnership’s investment activities actually impeded ACM’s stated purposes and ACM had no reasonable expectation of profit.

In **ACM Partnership**, the Third Circuit largely affirmed the conclusions of the Tax Court, which decided the case in 1997. Barely a year later, the Tax Court addressed a nearly identical factual situation, but this time decided the case on entirely different grounds. **ASA Investerings Partnership**, involved a transaction highly similar to that in **ACM Partnership**, again marketed by ML to a taxpayer who sought to offset an unrelated capital gain. Although the court reached the same result, it did so based on its conclusion that the parties never formed a valid partnership under the statutory definition or relevant case law. The court mentioned ESD in a single footnote, and then, only to note that it need not consider the issue as it agreed with the IRS’s primary argument.

The D.C. Circuit later affirmed the Tax Court on the same basis.

As the decisions in **ACM Partnership** and **ASA Investerings** illustrate, the courts have been very inconsistent in applying the law in this area even when faced with similar fact patterns, making it extremely difficult to discern a coherent framework for legal analysis from the cases. Consequently, it is virtually impossible to predict the result in any given factual situation, even in the context of the relatively “easy ESD cases” that more closely resemble traditional “tax shelter” arrangements.

These cases, which all involve noneconomic losses or deductions, are a far cry from the “typical” two-party Subchapter C transactions, which largely involve the acquisition or disposition of a business.
or a recapitalization and are therefore, at least in an overall sense, imbued with far more business motivation and substance than the post-ACM Partnership tax shelter cases. The cases that do involve more typical Subchapter C transactions, however, are even less helpful in determining when ESD is relevant. Three of these cases, Gregory v. Helvering,161 Esmark, Inc.155 and Tribune Company,156 are considered in detail.

**Gregory v. Helvering**

The first case is the Supreme Court’s seminal decision in Gregory v. Helvering.157 Although often cited as support for the ESD, it is not clear that Gregory was an ESD case. One can take the view that the case was fundamentally a business purpose case (assuming that business purpose is not, in and of itself, an ESD).158 The Supreme Court expressly focused on the lack of business purpose in invalidating the transaction, noting that “[t]he transaction was [s]imply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.”159 Moreover, the business purpose requirement imposed in Gregory was not borne out of a common law, anti-abuse doctrine, but was largely a matter of statutory interpretation.160 Thus, Gregory can also be interpreted simply as a statutory construction case based on an inquiry into Congressional intent.161

**Background Facts**

The taxpayer in Gregory v. Helvering,162 Mrs. Gregory, was the sole shareholder of United Mortgage Corp. (“UMC”), which in turn owned 100 percent of Monitor Securities Corp. (“MSC”). Mrs. Gregory sought to sell the MSC shares to a third party. One way in which this transaction could have been effected was for MSC to sell its UMC shares to the third party and distribute the proceeds to Mrs. Gregory as a dividend. If structured in this manner, MSC would have recognized gain on the sale of the UMC shares, while Mrs. Gregory would have ordinary income in the amount of the sales proceeds distributed. A better tax alternative was for UMC to instead distribute its MSC shares to Mrs. Gregory as a dividend first, which she could then sell to the third party. Because the law at the time did not require a corporation to recognize gain on appreciated assets distributed to its shareholders, this structure would have resulted in only one level of tax on the dividend income to Mrs. Gregory equivalent to the fair market value of the MSC shares distributed.163 Mrs. Gregory, however, sought to obtain the MSC shares subject to tax at the capital gain rate.

**Transaction**

In order to attempt to convert what otherwise would have been a dividend into capital gain, Mrs. Gregory first created a new corporation, Averill Corp. (“Averill”). In accordance with a tax-free reorganization provision in effect at the time, Ms. Gregory caused UMC to transfer its MSC shares to Averill and pursuant to the plan of reorganization, Averill issued 100 percent of its shares directly to Mrs. Gregory. Soon after the transaction, Averill was liquidated and it distributed to Mrs. Gregory the MSC shares in complete liquidation. Averill recognized no gain on the liquidation under prevailing law. Moreover, as Mrs. Gregory received the MSC shares in connection with a complete liquidation of Averill, this receipt qualified for exchange treatment, resulting only in tax on any gain inherent in the MSC shares at capital gain rates.

**Observations/Questions**

Although the Gregory transaction complied with the letter of the relevant reorganization statute, the Supreme Court disallowed capital gain treatment on the grounds that literal compliance with the statute was not sufficient to secure the desired tax treatment if the transaction was otherwise indistinguishable from an ordinary dividend.164 As noted above, the Gregory case is often cited as the origin of the ESD, but it is not clear that Gregory actually was an ESD case. Gregory contains language that resembles a number of the common-law anti-abuse doctrines, including business-purpose,165 sham-transaction166 or step-transaction167 doctrines or the principle that a transitory entity is disregarded for tax purposes.168 As noted, however, perhaps Gregory is best interpreted as a case that imposed a business purpose requirement in the reorganization context as a matter of statutory construction.169 In summarizing the problem presented by the case, the Court succinctly stated that “the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.”170 The Court
In fact, the Second Circuit expressly declined the IRS’s invitation to entirely disregard the existence of Averill and the related share transfers. Instead, the Second Circuit recognized every aspect of Mrs. Gregory’s transaction in its particular order. As the court explained, “[The transactions’] only defect was that they were not what the statute mean[t] by a ‘reorganization.’”176 Accordingly, the only consequence of the court’s holding was that nonrecognition treatment was not available to the distribution of MSC shares by Averill, a result that is arguably inconsistent with the ESD, which seems to require that a transaction be disregarded if the ESD test is failed.177

But, if ESD were applicable to the entire Gregory transaction, the declaration of the dividend of MSC stock could arguably fail to satisfy the conjunctive two-prong ESD test. The declaration of the dividend (or at least the order in which it was declared) was clearly tax-motivated and arguably had no economic substance separate from its tax benefits (since Mrs. Gregory continued to own directly the exact same assets as she previously owned indirectly). Yet, nowhere is it even suggested in the Gregory opinion that this part of the transaction could be disregarded.178

Does this indicate that Gregory is not an ESD case? The Supreme Court subsequently considered the propriety of a similar structure in Court Holding Co.179 In Court Holding, a corporation that had essentially completed negotiations with a third party for the sale of its primary asset, postponed the sale at the last minute, having realized that it would have to pay a significant tax on the sale. The law in effect at the time provided that a corporation does not recognize gain in any appreciated assets distributed to its shareholders in partial or complete liquidation. Accordingly, the corporation liquidated, distributing the asset to its shareholders, who then sold the asset to the third party, incurring only one level of tax. In holding that the corporation must recognize the gain, the Court echoed substance over form considerations, noting that “[t]he incidence of taxation depends upon the substance of a transaction.”180

The Supreme Court revisited the question five years later in Cumberland Public Service Co.,181 and

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**Figure 2.**

![Diagram of the transaction process](image)

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**Step 1**
- Taxpayer
- UMC transfers its MSC shares to Averill in a purported tax-free reorganization
- Averill
- MSC shares

**Step 2**
- Averill
- Liquidates distributing its MSC shares to Taxpayer at capital gain rates
- MSC
- UMC

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But, if ESD were applicable to the entire Gregory transaction, the declaration of the dividend of MSC stock could arguably fail to satisfy the conjunctive two-prong ESD test. The declaration of the dividend (or at least the order in which it was declared) was clearly tax-motivated and arguably had no economic substance separate from its tax benefits (since Mrs. Gregory continued to own directly the exact same assets as she previously owned indirectly). Yet, nowhere is it even suggested in the Gregory opinion that this part of the transaction could be disregarded.

Does this indicate that Gregory is not an ESD case? The Supreme Court subsequently considered the propriety of a similar structure in Court Holding Co.

In Court Holding, a corporation that had essentially completed negotiations with a third party for the sale of its primary asset, postponed the sale at the last minute, having realized that it would have to pay a significant tax on the sale. The law in effect at the time provided that a corporation does not recognize gain in any appreciated assets distributed to its shareholders in partial or complete liquidation. Accordingly, the corporation liquidated, distributing the asset to its shareholders, who then sold the asset to the third party, incurring only one level of tax. In holding that the corporation must recognize the gain, the Court echoed substance over form considerations, noting that “[t]he incidence of taxation depends upon the substance of a transaction.”

The Supreme Court revisited the question five years later in Cumberland Public Service Co., and
reached the opposite conclusion. In *Cumberland*, a third-party purchaser sought to acquire the assets of a corporation, but the corporation rejected the offer outright because of the significant capital gains taxes that would be imposed on the sale. Instead, the purchaser agreed with the corporation’s shareholders to acquire the assets directly from them after the corporation was liquidated. The Court rejected the IRS’s attempt to recharacterize the transaction as a sale of assets by the corporation, essentially limiting *Court Holding* to its facts. Recognizing that the “distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held,” the court pointed out that “Congress has chosen to recognize such a distinction for tax purposes.” Thus, far from invoking ESD in this context, *Cumberland* seems to elevate form over substance, at least where the importance of form is mandated by Congress.

Despite *Gregory*, *Court Holding* and *Cumberland*, it remains unclear if ESD is “relevant” to these types of transactions. Instead of illuminating the proper application of ESD to tax-optimized Subchapter C transactions that have an overall business purpose, *Gregory* largely serves to illustrate the difficulties in applying ESD in this context.

**Esmark, Inc.**

Another case involving a more typical Subchapter C transaction is *Esmark, Inc.* In *Esmark*, the Tax Court refused to collapse or reorder the steps of the transaction, relying on *P. Grove* for the proposition that courts are not to ignore the form of the transaction where anti-abuse doctrines provide no good reason for doing so beyond the fact that the taxpayer would have paid more tax had the transaction been structured differently. In reaching this conclusion, it appears that the *Esmark* court was particularly influenced by the fact that the transaction occurred in the public context and involved independent sales of stock by large numbers of public shareholders.

**Background Facts**

The taxpayer in the *Esmark* case, Esmark, Inc. (“Esmark”), was the common parent of an affiliated group of corporations. In the early 1980s, Esmark experienced a “liquidity crisis” due to rising oil prices, poor business performance, increased interest rates and a recent acquisition. Nevertheless, management believed that Esmark’s stock was undervalued. In an attempt to solve both problems, Esmark began exploring the sale of its energy business, which it conducted through its subsidiary (“Vickers”), and the use of any proceeds to repurchase up to 50 percent of its stock in the open market. Such a significant capital reduction following the potential sale would be undertaken for a number of business reasons, including reduced capital requirements, protection from a hostile acquisition and allowing shareholders who invested into Esmark solely because of its energy business to cash out. Esmark sought to achieve these goals without incurring a significant tax liability and believed this could be achieved through a tender offer/redemption transaction—a structure it made a requirement in connection with the Vickers auction. Mobil Oil Corporation (“Mobil”) emerged as the winning bidder.

**Transaction**

Pursuant to a prearranged and binding agreement, Esmark and Mobil structured the transaction in the following manner. Mobil first initiated a best-efforts tender offer for up to the number of shares of Esmark common stock the value of which would equal the sale price for Vickers. Esmark had agreed to redeem any of its stock purchased by Mobil pursuant to this exchange offer for a 97.5-percent interest in Vickers. In the event Mobil could not purchase the required amount of Esmark shares in the open market, the agreement provided Mobil with an option to purchase any excess Vickers shares for cash. The transaction would result in no tax liability for either corporation. Mobil, having a cost basis in the acquired Esmark stock, would recognize no gain on the redemption of such shares in exchange for Vickers stock of the same value. The redemption would also be tax-free to Esmark because Code Sec. 311 provided at the time that a corporation recognizes no gain on a redemption of its stock if such stock was redeemed in exchange for stock of a subsidiary corporation.

**Observations/Questions**

The *Esmark* opinion is a good illustration of the difficulties associated with the application of ESD and other judicial anti-abuse doctrines to legitimate business transactions that contain an element of tax planning. The *Esmark* court itself noted that the case was particularly challenging as there was no dispute that the transaction fell squarely within the language of then Code Sec. 311(d)(2)(B) and the
purpose of the transaction was “as much to redeem more than 50 percent of petitioner’s stock as it was to transfer Vickers to Mobil.”

The court ultimately rejected the IRS’s recharacterization of the transaction as a sale of Vickers to Mobil for cash, followed by a redemption of Esmark shares. Distinguishing the case from Gregory v. Helvering, the court noted that all steps of the transaction had an independent business purpose and economic effect—including Mobil’s purchase of Esmark’s stock.

The court’s substance-over-form analysis ultimately came down to whether the result was intended by Code Sec. 311. Examining the statute, legislative history and stated purpose of the provision, the court concluded that the focus of Code Sec. 311 is on the position of the corporation before and after the relevant transaction, and not on the identity of the shareholder involved, thus, the court could not “say that petitioner’s transaction was not ‘the thing that the statute intended.’” Finding that in Code Sec. 311(a) “Congress enacted a statute under which tax consequences are dictated by form” and discerning no other Congressional policy underlying Code Sec. 311 in this context, the court held that form dictated the tax treatment in this case.

The court opined that express Congressional statutory directives must be accepted by courts, particularly in the public context: “The oddities in tax consequences that emerge from tax provisions here controlling appear to be inherent in the present tax pattern ... Congress having determined that different tax consequences shall flow from different methods ... we accept this mandate.” Accordingly, “[p]etitioner was entitled to rely on the literal language of § 311, and the judicially recognized doctrines [g]ave [the court] no satisfactory basis for taxing the transaction as if something else had occurred.” The court concluded by noting its belief that an “ad hoc extension of doctrine to achieve a result on any of the difficult issues in this case [was] unwarranted and unwise.”

Although it never expressly addressed the ESD, the Emark case intimates some useful factors which may be relevant in determining whether the ESD should be applied to a particular transaction. First, Emark explains that Congress sometimes deliberately enacts highly technical statutes that are meant to be applied literally. In such a case, all that matters is that a taxpayer satisfies the specific requirements of the statute and the ESD should not apply to trump Congressional design—i.e., the ESD is not relevant. Second, the focus on the presence of a number of independent third parties, such as public shareholders, suggests that disallowance of a transaction based on ESD may be inappropriate where such parties are involved. Although these indications are helpful, as Emark does not actually address ESD, the case still does not provide taxpayers with significant comfort.

Tribune Co.

A third illustration is found in Tribune Co. The Tribune court denied reorganization treatment to a transaction that it concluded was in reality a taxable sale. Parts of the court’s opinion indicate that heightened scrutiny applies to transactions involving related or cooperative parties, perhaps suggesting that the ESD is more likely to be relevant to such cases. The court, however, did not reach ESD (although the doctrine was discussed), but a future court might in this situation with the new penalty at stake.


**Background Facts**

The taxpayer in *Tribune Co.* was a news and information company, Times Mirror (“TM”). In light of the consolidation in the legal publishing industry, TM decided to exit the legal publishing business by selling the subsidiary through which it conducted those operations, Matthew Bender (“Bender”). Reed Elsevier (“Reed”), another publishing and information company, emerged as the buyer. However, as TM had built-in gain in Bender stock of approximately $1 billion, it sought to structure the sale as a tax-free reorganization.

**Transaction**

To achieve nonrecognition treatment for TM, the parties entered into the following transaction. Reed (through other subsidiaries) formed a new subsidiary, MB Parent. MB Parent in turn, formed Merger Sub. Merger Sub then merged with and into Bender and pursuant to the merger, TM exchanged all of its Bender stock for MB Parent stock representing 20 percent of voting control of MB Parent. Reed retained preferred shares of MB parent with 80 percent of voting control; thus, Reed obtained control of Bender.

The reverse subsidiary merger of Merger Sub with and into Bender was intended to qualify as a reorganization pursuant to either Code Secs. 368(a)(1)(B) or 368(a)(2)(E). Both of these provisions require that control of the target corporation (within the meaning of Code Sec. 368(c)) is acquired in exchange for the voting stock of the acquiring corporation. Thus, the merger satisfied the requirements of the statute.

But, the merger was only one step in the overall transaction. In connection with the transaction, MB Parent also formed a limited liability company (“LLC”), wholly owned by MB Parent and capitalized with $1.35 billion in cash, an amount representing the bulk of the consideration for which Reed agreed to acquire Bender. Reed then appointed TM as the sole manager of the LLC, with complete control over the LLC’s assets (including the $1.35 billion in cash). TM ultimately caused the LLC to use that cash to repurchase TM stock in the open market.

**Observations/Questions**

After conducting an extensive and detailed review of the relevant deal documents, the Tax Court concluded that the overall transaction was in reality a sale of Bender to Reed in exchange for stock in MB parent and control over the LLC cash. The court first cited *Esmark* for the proposition that a court will not give “conclusive effect to a single part of a complex integrated transaction.” Because effective control of the cash in the LLC was found to be part of the merger consideration, the result was that too much boot was used in the transaction for it to qualify under any of the reorganization provisions.

The court never reached ESD, but embraced many theories underlying the doctrine. Although the IRS agreed that the overall transaction had a business purpose—for TM to exit the legal publishing business—the court effectively disregarded MB Parent and its ownership of the LLC, which, according to the court, “clearly serve[d] no purpose and perform[ed] no function apart from Times Mirror’s attempt to secure desired tax consequences.”

Distinguishing the case from *Esmark,* the court explained that MB Parent served only an intermediary function and that “[b]y contrast to the facts in *Esmark, Inc.*, here there [was] no uncontrolled participation by persons who [were] not
parties to the contractual arrangement, such as the public shareholders in Esmark, Inc., to give substantive economic effect to the existence of MB Parent. To disregard the existence of MB Parent [was] not to ignore any meaningful step in the transfer of Bender from Times Mirror to Reed.\textsuperscript{206}

In rejecting TM’s argument that the valuation placed by the parties on the MB parent stock should be respected as a product of arm’s-length negotiations, the court noted that Reed had an incentive to agree to documentation containing language that would support TM’s desired tax treatment, as “Reed concluded that it could not acquire the Bender stock without agreeing to those terms.”\textsuperscript{207} Thus, the \textit{Tribune} case may suggest that the ESD may be more likely to be found relevant to transactions that involve related parties or parties that have an interest in cooperating to secure the tax treatment sought by one of the parties, even to the extent of cloaking reality in illusion.

**The Future of Tax Planning**

Where does ESD leave the future of tax planning? The ESD has always been in tension with the \textit{Gregory} principle that a taxpayer may structure its affairs so as to minimize its tax liability. The codification of the ESD and the imposition of the strict liability penalty may have increased that tension.

But even the JCT and House Reports explaining the new ESD provisions recognize this principle. “Taxpayers generally may plan their transactions in reliance on [Code] rules to determine the Federal income tax consequences arising from the transactions.”\textsuperscript{208} The JCT and House Reports also explain that “[t]he [ESD statute] is not intended to alter the tax treatment of certain basic business transactions that, under long-standing judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”\textsuperscript{209} According to these reports, such “basic transactions” include (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter into a transaction or a series of transactions that constitute a corporate organization or reorganization under Subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm’s-length standard of Code Sec. 482 and other applicable concepts are satisfied.\textsuperscript{210} This list is “illustrative and not exclusive.”\textsuperscript{211}

It will be some time before the courts begin to weigh in on how the ESD, as codified, should be applied. This wait-and-see situation has further increased concerns in this arena. The uncertainty regarding how the ESD will affect existing law, coupled with the increased stakes associated with the strict liability penalty, have prompted numerous appeals on the part of corporate taxpayers and their tax advisors to the IRS for additional guidance.\textsuperscript{212} In particular, there have been numerous appeals for the IRS to issue an “angel list” of transactions that satisfy ESD requirements.

The IRS issued interim guidance on the codified ESD in Notice 2010-62,\textsuperscript{213} but the Notice left many practitioners unsatisfied. In particular, the Notice was criticized for doing little more than repeat the statutory text and proclaim that no further guidance would be forthcoming from the IRS.\textsuperscript{214}

Notice 2010-62 states that codification will not change the IRS’s approach to ESD analysis. In this regard, the Notice informs taxpayers that the IRS (1) anticipates that case law on whether ESD is relevant will “continue to develop,” (2) will not issue an “angel list” or a list of transactions to which ESD is relevant and (3) will not rule on whether ESD is relevant to a transaction. Noting that codification confirms that both prongs of the ESD test must be satisfied, but does not change the analysis under either prong, the IRS assured taxpayers that it would continue to rely on existing case law in applying either prong of the ESD test.\textsuperscript{215} The IRS will also continue to respect authorities that have previously held that ESD was not relevant to whether certain tax benefits were allowable. But, as noted, prior authorities are often conflicting and ambiguous or even nonexistent—existing case law does not adequately address when ESD is “relevant.”\textsuperscript{216}

Thus, much will be left to the courts. But, at least up till now, case law has not been susceptible to systemic analysis—although the outcome of many of the abusive tax shelter cases was in the view of many correct. More often than not, however, doctrinal development in the ESD context has been imprecise and the legal landscape increasingly confusing, because in this context, “bad facts” often make “bad law.” Ultimately, of course, the IRS’s assertion of the penalty is only the beginning; the courts must agree. However, given the amount at stake, taxpayer anxiety over the IRS’s enforcement of the ESD penalty is unlikely to abate significantly.
Framework for Analysis: Proposed Lens for Application of ESD Penalty

Most basic two-party business transactions would appear to pass muster under the ESD, at least in their entirety. Difficult issues will therefore most likely arise in determining whether each individual step must be analyzed under ESD, or whether the transaction may be considered as a whole. Internal transactions, without the rigor of arm’s-length dealing, will always pose more difficult questions. Though it may be that the most challenging issues will arise only in a small subset of transactions, given the size of the penalty if Code Sec. 7701(o) applies, taxpayers and their advisors are justifiably operating with a heightened sense of concern.

In considering the issues that may arise in this context, it is useful to analyze some “typical” Subchapter C transactions through the lens of the codified ESD. The remainder of this article will proceed in three parts. First, realization transactions will be considered, then corporate formation and reorganization transactions, and finally, corporate distributions. Before turning to this analysis, however, this article will first articulate a proposed framework for determining whether the ESD and the related penalty should apply in any given case. Because of the high stakes involved, the development of an approach with some predictive power is of critical importance. Given that ESD will in the first instance be administrated by agents in the field, the ideal test would be objective. However, ESD is fundamentally about a determination that objective analysis does not lead to the correct result. Thus, any lens in which we view ESD will be subjective, thereby increasing the stakes on a determination of “relevance.” To the extent there are categories of transactions to which ESD is not relevant, subjectivity is reduced. The remainder of this section attempts to develop an approach to the threshold “relevance” inquiry (“Proposed Lens”).

The Proposed Lens

The tax law is, by its nature, characterized by highly technical, bright-line rules, designed to provide a degree of predictability to business transactions. This predictability comes at a price, however, as bright-line rules can be easily manipulated. Anti-abuse doctrines like the ESD are an important tool in the arsenal of the courts and the IRS in preventing taxpayers from abusing these rules.

But in a highly technical area like the tax law, it is extremely difficult to differentiate between abusive and legitimate transactions where both types comply with the applicable rules. Answers to tax problems in large part cannot be reached independently of statutory text and regulatory guidance. Rather, the statutory form is often all there is. And while general principles of tax law certainly exist, Congress is not bound by these rules. The Code is replete with provisions that are a deliberate departure from general tax law principles. They do so for a variety of reasons, including administrative convenience and the desire to incentivize particular behaviors. To accomplish these goals, Congress must often draw arbitrary lines. And certain Code provisions are designed to bestow tax benefits on transactions that in and of themselves lack a nontax business purpose and a nontax economic effect.

Thus, the development of a framework for differentiating between such transactions and then determining whether any given transaction should be subject to the ESD is of critical importance. Absent a threshold determination of “relevance” of the ESD, the modern two-part ESD test is not well-suited for the task. As courts struggled to differentiate between “good” and “bad” transactions, the ESD test evolved into a search for two elements that, while generally absent in abusive transactions, may often be absent from legitimate transactions as well. Thus, in many situations, the ESD two-part test is not particularly useful to the inquiry in purports to address.

The Proposed Lens is a suggested framework that the courts could apply to determine whether the ESD should be applicable to a particular transaction.

First Question: Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code? Judgments about the proper tax treatment of a transaction properly depend, in the first instance, on the application of statutes and fundamental principles of tax law.

The first part of the Proposed Lens acknowledges that, when discernible, the text of the Code and Congressional intent control. If the Code clearly grants certain tax benefits, whether the relevant transaction effects a change in the taxpayer’s economic position apart from its tax effects should for the most part be irrelevant. Obvious examples are tax credits and tax elections. Another example are Code provisions that grant tax benefits to transactions that satisfy a detailed and technical set of specific requirements,
such as those needed for reorganization qualification under Code Sec. 368(a).

Situations in which the tax benefits of a transaction are not clearly contemplated by the Code present a more difficult question. An inquiry into Congressional intent appears attractive, but this is a challenging exercise in the context of Subchapter C. The most difficult cases often involve statutory provisions that were enacted to deal with an entirely different set of circumstances, and Congress likely never considered how such provisions should apply to the set of facts in question. Thus, an analysis of Congressional intent often necessarily involves counterfactual analyses and is inherently a matter of judgment. Resort to general principles of tax law or overall tax policy may also appear attractive, but is not ultimately helpful. As Congress is generally free to depart from general tax law principles, how is a court to determine whether or not Congress would have chosen to make such a departure had it been faced with the particular situation at hand?

Thus, the better approach may be to ask whether the result of the transaction is reasonable or whether it generates losses or benefits that are clearly not contemplated by the Code. This formulation avoids the difficult inquiry into Congress’s hypothetical intent and in many cases it should be possible to arrive at an answer solely by parsing the statutory text. A focus on the Code, combined with a requirement that the benefits be clearly unavailable before they may be denied, would add needed certainty in this area by preventing the application of the ESD to debatable situations.

This approach effectively shifts some of the costs of legal uncertainty away from the taxpayer, imposing it on the government instead. This may very well be the more efficient allocation of burdens in the post-ESD codification world in which significant uncertainty combined with a costly strict liability penalty may result in overdeterrence of tax planning. It seems unlikely that Congress intended ESD codification to cause taxpayers to structure every transaction so as to maximize their tax liability in order to avoid the potential penalties. The JCT and House Reports do not indicate that this was Congress’s intent and it generally does not appear that it was ever envisioned that the ESD should invalidate on an ad hoc basis any tax planning result that the IRS finds to be too aggressive. Further, such a result would be contrary to the Gregory principle that taxpayers are generally allowed to engage in some degree of tax planning.

An approach that permits tax benefits that are not unreasonable or clearly disallowed under the Code, on the other hand, would be consistent with that principle and the related view that the applicability of the ESD should be limited.

Some degree of “[u]ncertainty [to the taxpayer] is inevitable because the Code (and regulations) cannot begin to anticipate every conceivable transaction or every conceivable factual variation of relatively common transactions.” Taxpayers can structure around bright-line rules with relative ease. Thus, being an anti-abuse doctrine, the entire point of the ESD is to blur clear lines. But the question is one of degree. In light of the significant new penalty, striking the right balance is important. The first test of the Proposed Lens shifts the costs of ambiguity away from the taxpayer in an attempt to prevent the application of the harsh penalty in inappropriate cases and to lessen the deterrent effect of the new statute.

Second Question: Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning (i.e., how did the transaction arise and who was involved)? Was this consistent with the business of the taxpayer or outside of the ordinary course? This test looks to the factual circumstances surrounding the transaction in question in order to distinguish marketed or highly structured tax shelter transactions from bona fide business transactions that incorporate an element of tax planning. The basic inquiry asks: “[w]as there a structure in search of a transaction, or a transaction in search of a structure?” The ESD and its related penalties should apply to the former, but not the latter situation. This notion finds support in case law, as “[other ESD] cases recognize that there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate).”

This overall inquiry should isolate the majority of transactions that should be analyzed on ESD grounds. Many abusive arrangements involve one-off transactions that are unconnected to the taxpayer’s primary business and which are entered into in order to generate tax losses or deductions specifically designed to offset wholly unrelated income. Generally, transactions that are isolated from the taxpayer’s business and other activities, and are generally unusual in the industry, indicate that the transaction may be driven by a tax-avoidance
motive.\textsuperscript{228} The parties involved are also relevant, and closer scrutiny may be warranted where a transaction under review involves only related parties.\textsuperscript{229} The involvement of tax shelter promoters is also a clear sign that the transaction is abusive.

The second test of the Proposed Lens plays an important limiting role. As the reader may recall, the first test denies taxpayers only those benefits that are unreasonable and clearly not contemplated by the Code. But, the benefits of such ambiguities (or even loopholes) in the tax law should not be afforded to all transactions. Rather, taxpayers should be allowed to take advantage of such ambiguities only in cases involving one-off tax benefits generated as an incident to a bona fide business transaction.

Under this view, similar transactions may or may not be subjected to the ESD analysis and penalty, depending on the context. Thus, an aggressive interpretation of applicable statutory or regulatory rules would be tolerated if the structure and the benefits generated thereby were discovered “accidentally,” as part of a larger business transaction. The same structure, however, may be disallowed if it is a part of a structured plan that is unrelated to the taxpayer’s business, and often involves tax indifferent or other facilitating parties.\textsuperscript{230}

Although seemingly arbitrary, this approach serves the important function of protecting the fisc. By virtue of the context, tax benefits that are realized as a result of tax planning in connection with an overall business transaction are generally one-off occurrences. In these circumstances, it is the business transaction that drives structuring. As business transactions that lend themselves to significant tax planning opportunities occur relatively infrequently, there are limited opportunities for these structures to arise. Thus, the aggregate cost to the government coffers resulting from allowing such tax benefits is relatively low. On the other hand, marketed tax shelters are predetermined structures that are implemented through fabricated transactions. They are designed for repeated use and are aggressively promoted. Thus, the allowance of tax benefits in that context has a potentially far more significant negative impact on the government’s ability to collect revenue.\textsuperscript{231}

Moreover, the intent of the first test—which is largely to provide taxpayers with certainty in structuring their business affairs and preserve the long-standing ability to optimize one’s taxes—is furthered by the application of the second test. Together, they act to provide certainty only to legitimate business transactions, while subjecting tax shelters to ESD review.

Consequences of the Application of the Proposed Lens

If these two tests are not passed, then ESD should be tested and where failed, the penalty should apply.

If these two tests are passed, the transaction still needs to meet technical Code requirements and satisfy other judicial doctrines.

The Proposed Lens thus shields legitimate tax planning activities in connection with a business transaction from the vagaries of the two-part ESD test. On the other hand, transactions that generate questionable tax benefits outside of the ordinary course of business are subject to the traditional two-step analysis. Limited to the situations in which it is primarily meant to apply, the ESD two-part test will be the appropriate tool for further inquiry.

Application of ESD to Representative Transactions

Part VI of this article analyzes various representative Subchapter C transactions under the new statute. Generally, the direct application of the statutory two-part ESD test to these transactions produces surprising results, possibly invalidating transaction structures with a long-standing pedigree. This illustrates that the adoption and development of the Proposed Lens (or another test like it) is of critical importance as the courts begin to fill in the contours of ESD.

Realization Transactions

The U.S. tax system is largely realization-based. Significant tax consequences flow from the timing of a realization event, which is for the most part entirely within the taxpayer’s control.

Questions surrounding the application of ESD potentially arise even in the context of the most basic realization transaction entered into without a concern for timing. It is conceivable that a sale of an asset for cash that is driven solely by business considerations could fail the ESD test. Although such a transaction would clearly have a business purpose, it would arguably lack economic substance. Specifically, in selling the asset for its fair market value in cash, the taxpayer has done nothing other than convert the form of the held asset—the taxpayer’s economic position is exactly the same before and after the transaction. Yet, it
is clear that it was not intended that a business-driven sale of a built-in gain asset would be vulnerable to an ESD challenge.

But what if the timing makes a difference from a tax perspective? Is the answer different if the taxpayer, who was planning to sell an asset to a third party at a gain, accelerates the sale in order to secure lower tax rates, which are about to increase? What if the asset has a built-in loss? Can the IRS now challenge the recognition of a loss in an arm’s-length transaction on ESD grounds? What if the taxpayer has a significant tax gain in the relevant year from a separate transaction and could use the loss to offset such gain?

**Loss Realization: Cottage Savings**

**Background Facts**

In *Cottage Savings*, the taxpayer, Cottage Savings Association ("Cottage Savings"), was an S&L that, like most S&Ls during this time period, held numerous long-term, low-interest mortgages that had declined in value after interest rates surged in the late 1970s. In order to enable the S&Ls to recognize losses on these mortgages for tax purposes while avoiding negative accounting treatment, the relevant regulatory body implemented a rule under which banks, for accounting purposes, would not need to report losses on mortgages exchanged for "substantially identical" mortgages for tax purposes while avoiding negative accounting treatment, the relevant regulatory body implemented a rule under which banks, for accounting purposes, would not need to report losses on mortgages exchanged for "substantially identical" mortgages held by other lenders.

**Transaction**

Accordingly, Cottage Savings exchanged mortgage portfolios with another similarly situated S&L. The underlying mortgages were taken out on similar homes in a similar area, but with different mortgagees. Thus, although the S&Ls exchanged securities that had different issuers, in the aggregate, their economic terms were substantially identical. Treating the exchange as a realization event for tax purposes, the S&Ls recognized a significant tax loss on the exchange, all without changing their economic position.

**Observations/Application of Proposed Lens**

The Supreme Court rejected the IRS’s attempt to disallow Cottage Savings’ loss, holding that the realization requirement of Code Sec. 1001 is satisfied whenever the taxpayer exchanges property for other property that is “materially different,” including because it embodies “legally distinct entitlements.”

Does the result in *Cottage Savings* obtain under ESD? The answer likely depends on what is deemed to be the relevant transaction. If the relevant transaction is Cottage Savings’ investment and eventual disposition of mortgage securities, then both the subjective and objective prong of the ESD should be satisfied. But, if the focus is solely on the exchange under a Coltec-type analysis, the ESD test is likely failed. The sole motivation for the S&Ls entering into the exchange was to trigger the recognition of the loss in the underlying mortgage securities. Thus, there was no nontax business purpose for the transaction. *Cottage Savings* also fails the objective prong of ESD as there was essentially no possibility for economic profit, at least in the aggregate.

In sum, to the extent ESD is relevant here and the transaction to be considered is the ultimate exchange, *Cottage Savings* appears to fail the ESD test. Would the Proposed Lens subject this transaction to the ESD?

1. **Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code?** As an initial matter, Cottage Savings recognized an economic loss. Moreover, denying the loss in this case would be arguably at odds with the Code and its ubiquitous realization requirement. Indeed, an ESD-based argument against a realization transaction seems out of place given that the realization rule itself is largely arbitrary, technical and devoid of economic substance. Where the Code prescribes specific, formalistic rules, acts of compliance with such rules are likely to have those same characteristics. ESD should have no role in this context.

The *Cottage Savings* court understood the realization requirement as a fundamental
principle of the tax law, driven entirely by administrative considerations. In light of this purpose, the Court found that little difference in the assets exchanged is required for a realization event to be triggered,237 “[f]or, as long as the property entitlements are not identical, their exchange will allow both the Commissioner and the transacting taxpayer easily to fix the appreciated or depreciated values of the property relative to their tax bases.” 238 Accordingly, the Court rejected the IRS’s argument that the properties must not be “economic substitutes,” in order to be materially different, noting that the complexity of the IRS’s approach—which would have required a subjective inquiry into the intent of the parties, and an analysis of the economic similarity of the properties in question—undermined the very purpose underlying the realization requirement—administrative convenience.239 In other words, as the realization requirement itself does away with economic considerations in the name of administrative convenience, it would be at odds with this requirement to demand that a taxpayer demonstrate that a realization event that lends itself to clear delineation and measurement had economic substance.

Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? Cottage Savings satisfies the second test as well. Although the disposition of the mortgages was executed in order to recognize a loss, the exchange grew directly out of the taxpayer’s S&L business.240 The old mortgage portfolio represented securities held by the S&Ls in the ordinary course of business, and after the transaction, each S&L would continue to service the mortgages received in the exchange. The opportunity for the tax-structured exchange arose as a direct result of the taxpayer’s business.

Thus, under the Proposed Lens, ESD is not relevant to the Cottage Savings transaction. Commentators seem to generally believe that the Cottage Savings decision stands for the principle that ESD is not relevant to any transaction designed to trigger an economic gain or loss.241 This seems like the correct result and the most likely litigation outcome. However, query if in the absence of the Cottage Savings decision and further ESD guidance every court (the Coltec court?) would reach the same result.242

Internal Gain Recognition Transaction

Background Facts

In some circumstances, a taxpayer may choose to trigger a gain rather than a loss. For example, assume that a corporation (“Taxpayer”) owns appreciated assets directly, and that the Taxpayer expects either (1) to soon recognize a significant capital loss or (2) that the tax rates are about to increase. In each case, Taxpayer would prefer to trigger the built-in gain in the appreciated assets. However, the Taxpayer also does not want to dispose of these assets.

Transaction

The Taxpayer can achieve the above result by first transferring the appreciated assets to its wholly owned corporate subsidiary (either existing or newly formed) in a Code Sec. 351 transaction in which the Taxpayer takes back “nonqualified preferred stock.” Structuring the relevant security so that it constitutes “nonqualified preferred stock” requires only that one of four technical require-
mments is met. If the taxpayer then transfers the appreciated assets to the subsidiary solely in exchange for such “nonqualified preferred stock,” Code Sec. 351(a) will not apply and the taxpayer will recognize gain on the contribution.

**Observations/Application of Proposed Lens**

May Taxpayer recognize the gain? *Cottage Savings* indicates that ESD is not relevant. But, if ESD were relevant, a literal application of the test could cause the transaction to be disregarded. Taxpayer’s motivation for the contribution is purely tax-driven. Moreover, can Taxpayer demonstrate that the incorporation has effected a change in Taxpayer’s economic position? Is there ever a meaningful change in economic position resulting from the incorporation of and transfer of assets to a wholly owned subsidiary? There is also the question of what the proper focus of the ESD inquiry should be—is it the contribution, or is it the deliberate use of “nonqualified preferred stock” in order to avoid nonrecognition treatment? If the latter, the transaction seems unlikely to pass ESD muster unless there is a nontax business purpose for the use of “nonqualified preferred stock” (rather than common stock).

It seems clear that both the decision to transfer assets to a subsidiary and the decision about how to capitalize such subsidiary must be the type of “basic business transactions” intended to be unaffected by ESD. Ultimately, moreover, this transaction does not seem to involve any real abuse. All Taxpayer did was accelerate the recognition of a gain. And, as discussed above, ESD is not relevant to recognition.

1. **Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code?** The acceleration of gain is hardly a suspect transaction. The tax treatment of the transaction is clearly governed by Code Sec. 351, which is a fairly technical provision. Specifically, Code Sec. 351(g)(2) delineates four specific structural features of “nonqualified preferred stock,” while Code Sec. 351(g)(1) expressly denies nonrecognition treatment to a Code Sec. 351 transfer in exchange for such stock. The result of the transaction is reasonable—it is mandated by these statutory rules.

2. **Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course?** Internal restructuring transactions (including the drop-down of business assets into a corporate subsidiary) are more likely to fail the second prong of the Proposed Lens, but generally, ESD would not be relevant here.

**Structuring to Avoid Code Sec. 332 Liquidation Treatment**

**Background Facts**

A corporation (“Taxpayer”) owns 100 percent of the stock of its corporate subsidiary (“Sub”), which has a significant built-in loss. Because Taxpayer owns more than 80 percent of Sub, it meets the stock ownership requirements of Code Sec. 1504(a)(2) and a complete liquidation of the Sub would qualify for nonrecognition treatment under Code Sec. 332. Taxpayers may not elect out of Code Sec. 332 treatment. But, Taxpayer desires to liquidate Sub in a taxable transaction so that it may recognize the loss inherent in the Sub stock.

**Transaction**

In order for the liquidation of Sub to be a taxable transaction (thus allowing Taxpayer to recognize the loss inherent in the Sub stock), the liquidation must qualify under Code Sec. 331 rather than Code Sec. 332. If Code Sec. 331 applies, amounts received in complete liquidation of a corporation are treated as payments in exchange for the corporation’s stock. However, Code Sec. 331 applies only if the owner of the liquidating corporation owns less than 80 percent of its stock. Thus, before causing Sub to liquidate, Taxpayer sells more than 20 percent of its Sub stock to a “friendly” third party (“Third Party”). Having less than 80 percent ownership, after the sale, Taxpayer liquidates Sub in a transaction that qualifies under Code Sec. 331. The liquidation is taxable to Taxpayer who realizes the loss inherent in its Sub stock.

**Observations/Application of Proposed Lens**

Does the ESD preclude the liquidation of Sub from qualifying under Code Sec. 331? The sale of more than 20 percent of Sub stock by Taxpayer is undertaken solely in order to secure the preferred tax treatment on liquidation—thus, absent additional facts, it might lack business purpose. The transaction also may not be able to satisfy the subjective prong, particularly if the relevant “transaction” for this purpose is the involvement of Third Party. Third Party’s overall economic position is likely unaffected by the transaction (other than by reason of any compensation received in exchange for its participation.
Economic-Substance Doctrine and Subchapter C: What, Me Worry?

in the transaction). This will be particularly obvious if Third Party used cash to purchase the Sub stock and then received the cash back in Sub’s liquidating distribution. Similarly, apart from income tax effects, Taxpayer’s economic position post-liquidation is likely the same with or without the involvement of Third Party.244 Thus, it is likely that the two-part ESD test, if applied, would disregard the pre-liquidation sale for tax purposes—and thus prevent qualification under Code Sec. 331.

This result contradicts a long-standing proposition, established in Granite Trust Co.245 and other cases, 246 that a taxpayer is generally given latitude to structure into Code Sec. 331 or Code Sec. 332 treatment if effected entirely within an internal group. Various types of transactions between members of the same consolidated group have historically been subject to heightened scrutiny. Can the ESD become relevant to a transaction solely because it involves related members? The IRS has approved such transactions in prior rulings, even where they did not involve an actual, but only a “deemed” liquidation resulting from a change in the legal form of the relevant entity.251 Are these rulings still valid post-ESD? These questions do not have an obvious answer. Moreover, at present it is not clear how a taxpayer should even begin to analyze the question. The development of a framework for the “relevance” analysis should be an imperative for the courts.

(1) Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not
_contemplated by the Code?_ Although Code Sec. 332 is not expressly elective, it either applies or it does not apply, depending solely on whether the specific requirements of the statute are satisfied. The provision does not focus on the end-result, but rather provides specific conditions for the nonrecognition of realized gains or losses.\(^{252}\) Because the statutory requirements are relatively easy to satisfy or avoid, Code Sec. 332 has long been understood as effectively elective.\(^{253}\) By making it easy for taxpayers to either qualify or not qualify under the terms of a literal statute, either result is clearly a possibility contemplated by the Code. And, as *Granite Trust* points out, the legislative history of Code Sec. 332 also indicates that taxpayers may structure in and out of the statute. In enacting the provision, for example, the Senate Finance Committee expressly referred to the “elective features of the section.”\(^{254}\)

**(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course?**

While as noted above analyzing the second prong of the Proposed Lens is more challenging in wholly or largely internal restructuring transactions, it is nonetheless true that where a subsidiary of a corporation operates or contributes to the operations of a business, and its activities are related to the business activities of the taxpayer-owner, the liquidation of such a subsidiary is inherently incidental to the business of the taxpayer. The ownership and the operation of the subsidiary is the relevant business transaction—when as here, nothing unreasonable is occurring, ESD should not be relevant and should not prevent taxpayers from realizing true economic losses or gains accrued in connection with legitimate business operations.

**Formation/Reorganization Transactions**

This part of the article considers certain corporate formation and reorganization transactions. Many business transactions in this category routinely contain an element of tax planning. Accordingly, the ESD codification has introduced significant uncertainty in this area.

**Incorporation Transactions**

As discussed previously, at least three judicial decisions, including *Caruth Corp.*, arguably hold that a business purpose requirement is applicable to Code Sec. 351 contributions, albeit with a lower threshold than in the reorganization context.\(^{255}\) The IRS has also ruled that a Code Sec. 351 contribution must have a business purpose to be respected.\(^{256}\) But despite these authorities, it is not entirely clear that there actually is a business purpose requirement for Code Sec. 351 contributions. The statute does not impose such requirement, and, unlike the Code Sec. 368 regulations, there is no mention of a business purpose requirement in the Code Sec. 351 regulations.\(^{257}\)

Assuming that Code Sec. 351 is subject to a business purpose requirement, does Code Sec. 7701(o)(5)(D) indicate that the ESD also applies? As discussed above, rev. Rul. 60-331 and *Coltec* suggest this may be the case. If ESD applies, does this mean that transactions that have traditionally qualified for Code Sec. 351 treatment continue to qualify, or must they now pass the ESD test? And if they do, will they?

First, does the incorporation of a business, in and of itself, result in a meaningful change in the taxpayer’s economic position? Does the proper inquiry compare the taxpayer’s economic position immediately before and after the incorporation? Incorporation alone does not alter the underlying business in any way other than to change the legal form in which the business is conducted. Indeed, this is the underlying theory for nonrecognition treatment of Code Sec. 351 incorporations. As the First Circuit has explained, Code Sec. 351 applies when “[in the popular and economic sense there has been a mere change in form of ownership and the taxpayer has not really ‘cashed in’ on the theoretical gain, or closed out a losing venture.”\(^{258}\)

It may be that incorporation does have a potential economic impact due to the limited liability nature of the corporate form, but can limited liability serve as the basis for establishing both economic effect and business purpose for incorporation? Is the fact that the taxpayer is effectively electing into a double taxation regime relevant or sufficient? In establishing the objective prong of the ESD test, Code Sec. 7701(o)(1)(A) excludes federal income tax effects from consideration. But why should a taxpayer’s willingness to pay more rather than less tax not be considered as a factor in its favor?

Second, what is a nontax business purpose for incorporation? Is the mere desire to conduct a business in corporate form, without an articulated or particularly compelling rationale sufficient? Or, if a Code Sec. 351 incorporation is subject to the ESD by virtue of having a business purpose requirement, does this mean that
the business purpose now must be “substantial” as required by Code Sec. 7701(o)? If the business purpose must be “substantial,” does this mean that the taxpayer must articulate rationales for seeking to conduct the business in corporate form? The case law does not always refer to the terms “substantial” or “meaningful.” Has Code Sec. 7701(o) changed the law (beyond requiring a conjunctive test) despite the contrary pronouncement in Code Sec. 7701(o)(5)(C)?

An absolute requirement that a taxpayer have a business purpose for forming a corporation and qualifying for Code Sec. 351 treatment is arguably inconsistent with the ability of taxpayers to make a check-the-box election to treat a disregarded entity as an association taxable as a corporation. By definition, a taxpayer cannot demonstrate a business purpose for, or an economic effect from, the making of a check-the-box election. In fact, tax elections are inherently tax-motivated and exclusively provide tax benefits. Thus, some have argued that the existence of the check-the-box election is evidence that there is not a business-purpose requirement for a Code Sec. 351 transaction (and certainly, the argument would continue, no requirement that any necessary business purpose be significant). On the other hand, if as noted above, there is at least a threshold business purpose requirement for a Code Sec. 351 transaction, then arguably it is met in the check-the-box election context by the business reasons for establishing the legal entity in the first place, even if the entity is “old and cold” at the time of the election.

How does any of this square with the JCT and House Report’s statement that “[ESD] is not intended to alter tax treatment of certain basic business transactions ... including ... the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C.” The answer must be that the ESD is not per se relevant to all Code Sec. 351 transactions by reason of the business purpose requirement. Rather, it would be more appropriate to consider the particular transaction at issue under the Proposed Lens. Then, as with any other transaction, a Code Sec. 351 transaction would be subject to the ESD only if the tax benefits it generates are clearly not contemplated by the Code. This approach has the benefit of preserving the treatment of many routine transactions that have been approved by the IRS on numerous occasions, such as the formation of corporate entities solely to facilitate a corporate reorganization under Code Sec. 368.

Loss Duplication: Shell Petroleum

Background Facts

Shell Petroleum involved a transaction that was incidental to the taxpayer’s business, but was structured to realize significant tax benefits in the form of duplication of economic loss. The taxpayer, Shell Petroleum (“Shell”) was the common parent of an affiliated group. Following substantial declines in the price of oil in the mid-1980s and early 1990s, Shell was experiencing significant financial difficulties and accordingly was undergoing various restructuring activities. One of these activities involved the consolidation of “exploration and production property” into a single subsidiary. Such property included assets, owned by another Shell subsidiary, Shell Western (“Western”), that were not currently commercially competitive, but which had significant productive potential should certain events occur (“Frontier Assets”). These assets were associated with significant start-up costs and investment; accordingly, the Frontier Assets had a high basis, but very low market value.

Transaction

Shell incorporated a new corporate entity, Shell Frontier (“Frontier”). In an intended Code Sec. 351 contribution (1) various Shell subsidiaries transferred exploration and production assets and cash to Frontier in exchange for Frontier common stock and nonvoting preferred stock; (2) Western transferred its Frontier Assets to Frontier in exchange for 900 of the 2,000 authorized shares of Frontier auction rate voting preferred stock; and (3) various investors unrelated to the Shell group purchased the remaining 1,100 of Frontier auction rate voting preferred stock for cash. After this purchase, the unrelated investors held approximately 26 percent of the voting power of Frontier. Accordingly, Frontier ceased to be a member of the Shell consolidated group.

As in effect at the time, Code Sec. 351 provided that the contributor’s basis in its stock received would be equal to the basis of the property contributed. Accordingly, Western obtained high-basis, low-value stock in exchange for its contribution. Several months later, pursuant to a predetermined plan, Western sold 800 of its 900 Shell Frontier shares, realizing a significant loss on the sale.

At the time, Code Sec. 351 also allowed the transferee to take a carryover basis in the contributed assets, even if the basis of such assets exceeded their
fair market value. Thus, Frontier was able to also retain the high-basis in the contributed Frontier Assets. Frontier would not have been able to realize a loss on the sale of such assets as a member of the Shell consolidated group. Frontier, however, had already ceased to be a member of the Shell group by virtue of the sale of more than 20 percent voting control to outside investors through the sale of the auction rate voting preferred stock (Frontier ultimately rejoined the Shell consolidated group).

**Observations/Application of Proposed Lens**

Does *Shell Petroleum* survive Code Sec. 7701(o)? The result of the two-part ESD test in *Shell Petroleum* is likely to depend on how the relevant transaction is framed. If framed narrowly, the transaction in *Shell Petroleum* may very well fail the test. But, is ESD even relevant?

1) **Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code?** For one, the transaction allowed Shell to accelerate the realization of the built-in loss it had in the Frontier Assets through Western’s sale of its high-basis stock, low-value stock. This loss was a true economic loss and, as discussed, taxpayers have a fair amount of control over when they realize economic losses. Accordingly, this aspect of the transaction is not inconsistent with the Code or particularly troubling.

The troubling aspect of the Shell transaction was the potential it created for loss duplication upon a direct sale of Frontier Assets. The loss was incurred in a single-tax consolidated return environment and was duplicated after it accrued, with the independent counterparty supplying cash rather than business operations.

The ability to duplicate losses is not generally understood as a benefit that is contemplated by the Code. Indeed, this particular result in *Shell Petroleum* was subsequently precluded by statute. But, the law in effect at the time of the *Shell Petroleum* transaction quite clearly did not require Western to reduce the basis in the Frontier Assets upon their contribution. The potential for the double loss in *Shell Petroleum* was created as a result of Shell’s compliance with the Code rules that were directly applicable to the transaction in question. Shell did not try to game the rules of Code Sec. 351 in a context for which they were not intended, it did not try to benefit from a mismatch in unrelated provisions of the Code nor did it engineer a transaction to which it could apply a Code provision that was only peripherally relevant. As the *Shell Petroleum* court observed, the version of Code Sec. 351 in effect at the time clearly “contemplated the possibility of a double tax loss—one on the part of the transferee upon disposition of the transferred property, and another, by the transferor upon disposition of the stock received.”

Thus, although Shell was unquestionably able to generate an unusual tax benefit in connection with this transaction, this was not a benefit that was clearly contemplated by the Code at the time. Congress subsequently precluded this result. But, insofar as Shell’s transaction was a legitimate business transaction, it is not apparent that it should have been incumbent upon Shell to maximize its taxes and protect the government’s coffers until Congress decides to act.
(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? Shell Petroleum appears to pass muster under the second test of the Proposed Lens. The transaction was connected to Shell’s overall business and involved a necessary response to existing economic conditions. Shell had already been engaged in various attempts to stabilize and turn its business around. As the Shell Petroleum court noted, the company was experiencing significant financial difficulties and was engaged in a number of restructuring efforts (including a significant workforce reduction) beyond this particular transaction. Moreover, Shell did put forth two substantial business purposes for the specific transaction in question. First, Shell sought to raise cash without increasing the debt levels of the parent company or the consolidated group, which would further weaken its credit rating. This purpose justified the sale of the preferred stock to outside investors. Second, Shell sought to consolidate its exploration and production assets within a single entity with the goals of improving management focus and reducing operating costs. This purpose justified the transfer of the Frontier Assets.

Thus, under the Proposed Lens, the ESD is not properly applied to deny the tax benefits of the Shell Petroleum transaction. The transaction in Shell Petroleum is distinguishable from the more “traditional tax” shelter cases involving contingent liabilities, such as Coltec. Indeed, the Shell Petroleum court cogently distinguished Coltec, noting that the overall transaction in Coltec lacked a real connection to the taxpayer’s business. The court explained that Coltec involved “a highly unusual set of facts,” because Coltec transferred contingent liabilities that represented only potential losses, and did so “outside of its routine business activities,” in exchange for a note in an amount equal to the taxpayer’s rough estimate of those contingent liabilities. The assets involved in Shell Petroleum, on the other hand, were directly connected and used in the taxpayer’s business and were moreover “classes of producing and non-producing properties typically owned by major oil companies such as Shell.”

“Shell’s conception and execution of the Shell Frontier transaction, and the objectives to be achieved, were wholly consistent with urgent measures undertaken company-wide to cope with an unprecedented and immediate financial crisis.” The Coltec transaction, on the other hand, could not have actually achieved any of the business goals it purportedly tried to address.

Using a Corporate Purchaser to Make a Code Sec. 338(h)(10) Election

Many corporate formations, including the Code Sec. 351 transaction in Shell Petroleum, involve one-party transactions undertaken so that the taxpayer may continue to operate a particular business in corporate form and isolate the activities and liabilities of that business in a separate entity. At other times, however, corporations are formed solely in order to facilitate a form of a business transaction that has more beneficial tax consequences. For example, the tax consequences of an acquisition of a corporate target are often more favorable with a Code Sec. 338(h)(10) election. The election, however, is only available to corporate purchasers. Is the formation of a corporate entity to facilitate the making of a Code Sec. 338(h)(10) election subject to ESD?

Background Facts

Assume that a corporation (“Parent”) desires to sell the stock of a corporate subsidiary (“Target”) to a purchaser that is a partnership for tax purposes (“Purchaser”). Assume further that the Purchaser will not agree to purchase the assets of Target because of transfer consent issues. An asset sale, however, would be a better result for Parent. For instance, if the Parent’s outside basis in Target stock is lower than the Target’s basis in its assets, an asset sale would trigger less gain to Parent. Or, even if Parent’s outside basis in the Target stock is higher than the inside basis in Target assets, an asset sale may be a better alternative if the value of the basis step-up (i.e., the present value of the tax shield resulting from the additional depreciation deductions associated with the difference between the fair market value and the existing tax basis of the asset) to Purchaser is greater than the relative tax detriment to the Parent. In that case, Purchaser would be willing to pay Parent a higher purchase price if the deal was structured as an asset sale. If the buyer were a corporation, the parties could reach either result easily by jointly making a Code Sec. 338(h)(10) election, which converts a stock sale into an asset sale for tax purposes. However, this option is not available in this case because Purchaser is a partnership.

Transaction

In order to make the Code Sec. 338(h)(10) election, the parties add an additional step to the transaction.
First, Purchaser forms a corporate subsidiary ("Sub") in a tax-free Code Sec. 351 transaction by contributing to Sub cash in the amount equal to the purchase price. Then, Sub purchases from Parent the stock of Target for the cash received from Purchaser in the Code Sec. 351 contribution. Following the transaction, Sub and Parent make a joint Code Sec. 338(h)(10) election.

**Observations/Application of Proposed Lens**

Is ESD relevant to this transaction? Can the formation of Sub be disallowed or disregarded if it fails the two-part ESD test? If this is what Congress intended, a number of questions are raised. The Supreme Court’s decision in *Moline Properties, Inc.* is generally understood to establish the test for determining whether the separate existence of a corporate entity should be respected. *Moline Properties* stands for the proposition that a corporation is to be respected (and not disregarded) as a separate taxable entity, as long as the corporation is not “merely fictitious” or a “sham”: “Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator’s personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.”

Is the *Moline Properties* test still relevant or has it been replaced by ESD? If so, has Congress, in enacting Code Sec. 7701(o), overruled *Moline Properties*? Neither the statutory text nor the JCT and House Reports mention *Moline*. If ESD is relevant to the formation of Sub, this transaction is unlikely to satisfy the two-prong test. There seems to be no plausible nontax business purpose for the transaction. As the Target’s business was already incorporated, the desire to obtain limited liability and other benefits of operating a business in corporate form is not a good business purpose in this case. A direct purchase of Target stock by the partnership would have sufficed to secure these benefits. Similarly, the formation of Sub does not have an economic effect.

How can this result be squared with the availability of the Code Sec. 338 election or any other tax election for that matter? Is there any nontax economic impact or business purpose to making a Code Sec. 338(h)(10) election (or any other election) when available?

The making of a tax election and its economic effect is entirely tax-driven. In fact, tax elections are for the most part designed to allow taxpayers to obtain certain tax consequences without making any changes to the underlying transaction or business structure. For example, entity classification elections allow taxpayers to freely elect into certain tax regimes by simply checking a box on a form. The only difference between two businesses organized as a single-member LLC, one of which is treated as a sole proprietorship and the other as an association, is that the latter business is subject to corporate tax because its owner chose such treatment. If this owner later decides to revoke the election, is this decision now subject to invalidation on ESD grounds? The check-the-box regulations nowhere suggest that a showing of business purpose or economic impact is required for making the election.

**Figure 9.**

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Step 1

1. **Purchaser forms Sub**
   - **Parent**
   - **Target**
   - **Purchaser**
   - **Stock**
   - **Sub**
   - **Cash**

Step 2

1. **Parent sells Target stock to Sub for cash**
2. **Sub and Parent make a §338(h)(10) election**

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Is the answer simply that ESD is not relevant to tax elections because they are consistent with Congressional purpose? Is the answer different if the availability of the tax election is not a matter of coincidence, but instead the taxpayer had to take active steps to make itself eligible for the election? Does the ESD become relevant to the election itself because of the existence of such steps, or are only those preparatory steps themselves subject to the ESD analysis? If the latter, does this mean that Coltec’s focus on each particular step of a transaction is always appropriate?

The new statute raises numerous questions, even in the context of tax elections, which, absent ESD, are otherwise fairly straightforward. A framework for analysis of such questions, such as the Proposed Lens, is urgently needed to allow taxpayers to predict the consequences of their business transactions. Under the Proposed Lens, this transaction is not an ESD candidate.

**“Busting” a Code Sec. 351 Transaction in Order to Make a Code Sec. 338(h)(10) Election**

Is the answer affected by the identity of the ultimate purchaser or the number and complexity of the steps taken in preparation for making the desired election?

**Background Facts**

Assume that, instead of selling a business to an unrelated third party, Parent desires to dispose of a business that it conducts through two operating subsidiaries (“Sub 1” and “Sub 2”) in a public offering of Target stock. For obvious reasons, Parent cannot sell the relevant assets to the public. But, as in the previous example, the Parent would recognize less gain or receive a higher purchase price if the disposition was effected as an asset sale to another corporation with whom Parent could make a joint Code Sec. 338(h)(10) election.

**Transaction**

Parent forms a new corporation (“Newco”), and contributes to Newco the stock of Sub 1 and Sub 2 in exchange for Newco common stock. This transaction would typically qualify for nonrecognition treatment under Code Sec. 351. But, Parent wants to step up the basis of the underlying assets. Thus, prior to the contribution, Parent enters into a binding commitment to sell more than 20 percent of its Newco stock to an unrelated third party (one option could involve a “firm commitment underwriting agreement” with an investment bank) (the “Prearranged Sale”). Following the contribution, the Parent sells the relevant portion of its Newco stock pursuant to the Prearranged Sale and then sells the remainder of its Newco stock to the public.

The Prearranged Sale allows Parent to avoid Code Sec. 351 treatment on the contribution to Newco. Rev. Rul. 79-70279 holds that where a transferor to a corporation in a purported Code Sec. 351 contribution sells the stock received in such contribution to a third party that did not transfer any assets to the new corporation pursuant to a prearranged binding agreement that was an integral part of the incorporation, whether the “control” requirement of Code Sec. 351 is satisfied is determined after such prearranged sale.280 Thus, if the transferor owns less than 80 percent of the new corporation following the prearranged sale, the “control immediately after” requirement of Code Sec. 351 is not satisfied.281

Thus, Parent’s contribution of Sub 1 and Sub 2 stock to Newco is a “busted Code Sec. 351 contribution” treated as a taxable sale of Sub 1 and Sub 2 stock by Parent to Newco.282 As recharacterized, the transaction satisfies the definition of a “qualified stock purchase” (QSP), a pre-requisite for a Code Sec. 338 election.283 Accordingly, Newco is eligible to make a joint Code Sec. 338(h)(10) election with Parent with respect to Sub 1 and Sub 2 stock. As a result, Parent is either able to recognize less gain that it would have on a direct sale of Sub 1 and Sub 2 stock or realize a “higher purchase price” by entering into a post-IPO agreement with Newco, pursuant to which Newco will make ongoing payments to Parent equivalent to the value of the additional tax shield resulting from the basis step-up.284

**Observations/Application of Proposed Lens**

Is ESD the proper test? The question of ESD’s relevance in this case has arguably been hinted at by the Treasury regulations. Example 24 of Reg. §1.197-2(k) considers this particular transaction to conclude that the anti-churning rules of Code Sec. 197 will not apply to prevent the new corporation from depreciating a nonamortizable Code Sec. 197(f)(9) intangible.285 Thus, the regulations implicitly sanction this transaction. Does this conclusively resolve the question of ESD’s relevance? The ICT Report provides that ESD is not relevant to a transaction that results in tax benefits that
are consistent with Congressional “purpose or plan.”286 The statute does not expressly address whether such Congressional “purpose or plan” also includes the Treasury regulations, but valid Treasury regulations must be consistent with Congressional intent and therefore ESD should not be relevant here.287

**Double Dummy Merger Structure**

**Where (1) Too Much Boot or (2) Noncorporate Target**

What if Code Sec. 351 is used in conjunction with a disposition of a business to obtain nonrecognition treatment that would otherwise not be available under the Code Sec. 368 reorganization or any other provision of the Code?

**Background Facts**

Assume that a corporate purchaser (“Purchaser”) desires to acquire another corporation (“Target”). The Target shareholders are willing to sell; however, they have different preferences as to the tax treatment of the transaction. A faction of Target shareholders would like to avoid triggering a taxable gain and wants to exchange Target shares for Purchaser shares. Other Target shareholders want to cash out, and since Target has important contracts which make it impossible to merge Target into Purchaser or its subsidiary, this faction is of sufficient size to prevent reorganization treatment if the Purchaser pays such shareholders in cash.288 Thus, Purchaser and Target cannot accomplish the objectives of both sets of Target shareholders by availing themselves of the reorganization provisions.

Alternatively, assume that Target is a limited liability company (“LLC”) taxed as a partnership for federal tax purposes. In this case, all members seek to avoid recognition of gain and are open to continuing their investment in the Purchaser. The problem here is that the reorganization transactions described in Code Sec. 368 involve only corporations. As the Target is a partnership for federal tax purposes, the transaction cannot qualify under Code Sec. 368.

In short, the sale of Target cannot qualify under the reorganization rules in either of these cases.

**Transaction**

The parties who desire it can nevertheless obtain nonrecognition treatment by using a variant of a structure commonly referred to as a “double-dummy” merger. In both cases, a new holding corporation (“Holdco”) is formed by Purchaser. Holdco forms a transitory wholly owned subsidiary (“Merger Sub”). Merger Sub then merges into Purchaser, with Purchaser shareholders exchanging their Purchaser shares for Holdco shares in the merger. The merger qualifies as a reorganization under Code Sec. 368(a)(1)(A) and (a)(2)(E). Under Rev. Rul. 67-448, the transaction also qualifies as a reorganization under Code Sec. 368(a)(1)(B) because the transitory existence of Merger Sub is disregarded.289

In the too-much-boot scenario, the Purchaser would also contribute cash to Holdco in an amount equal to the consideration to be received by the Target shareholders who desire cash. Holdco, in turn, forms a second transitory wholly owned sub-

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**Figure 10.**

[Diagram showing the double dummy merger structure]
subsidiary (“Merger Sub 2”), to which it contributes the cash it received from Purchaser. Substantially at the same time as Merger Sub merges with and into Purchaser, Merger Sub 2 merges with and into Target, with Target surviving. In connection with this merger, the shareholders of the Target who desire nonrecognition treatment exchange their Target shares for Holdco shares, while the Target shareholders who seek to cash out exchange their Target shares for cash.

The two mergers are recharacterized as contributions to Holdco by the continuing Target shareholders of their Target stock and the Purchaser shareholders of their Purchaser stock. Such Target shareholders and the Purchaser shareholders together “control” Holdco after the deemed contributions. The overall transaction is treated as a nontaxable Code Sec. 351 contribution as to those shareholders. The continuing Target shareholders thus receive nonrecognition treatment in their reverse triangular merger, despite the fact that more cash is used than is permitted in a Code Sec. 368(a)(1)(A) and (a)(2)(E) or Code Sec. 368(a)(1)(B) transaction.

In the noncorporate-target scenario, the members of LLC actually contribute their LLC interests to Holdco in exchange for Holdco stock simultaneously with the Merger Sub merger. As noted above, Merger Sub is disregarded. Thus, both the Purchaser shareholders and the LLC members are deemed to have contributed property to Holdco solely in exchange for Holdco stock for tax purposes. Immediately after these “contributions,” the Purchaser shareholders and the LLC members together own 100 percent of Holdco stock, satisfying the requirements of Code Sec. 351. The overall transaction is therefore a good Code Sec. 351(a) contribution, providing both groups with nonrecognition treatment. In effect, Purchaser and LLC have combined, albeit in a holding structure, and the members have avoided any taxable gain despite the unavailability of Code Sec. 368 reorganization treatment.

**Observations/Application of Proposed Lens**

After initially declaring double-dummy structures to be taxable, the IRS subsequently reversed course and concluded that Code Sec. 351 applies in this context. Does codification of ESD change this result? The formations of Holdco and any Merger Subs arguably have no economic effect or no nontax business purpose. The same economic result could be accomplished without these entities either by (1) a transfer of LLC interests to Purchaser or (2) the merger of Target with a subsidiary of Purchaser for cash and stock. On the other hand, to the extent a holding structure is desired for nontax reasons, this should be a sufficient business purpose for the transaction.

Rev. Rul. 68-349 involved a corporation that wanted to purchase the appreciated assets held by an unrelated individual who sought to avoid recognizing gain on the sale. A new Holdco was formed, with the corporation transferring all of its assets subject to its liabilities to Holdco and then liquidating and the individual transferring the appreciated assets to Holdco in exchange for its stock. The IRS held that Code Sec. 351 could not apply to the transfer because Holdco was organized solely...
to facilitate the tax-free transfer of the individual’s assets. On the other hand, in Rev. Rul. 76-123,292 the IRS concluded that Code Sec. 351 would apply in a similar situation because Holdco was incorporated in another state providing a nontax reason for its existence. These rulings imply that there is a need for the formation of Holdco and Merger Subs to have a nontax purpose. Does the need for business purpose further imply that the ESD is applicable? How does this square with Rev. Rul. 84-71?

(1) Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code? Though it may appear to be some tension with Code Sec. 368, a Code Sec. 351 transaction is clearly contemplated by the Code. The results of the double-dummy structure are consistent with the purposes of Code Sec. 351. Only those investors who do not cash out, but continue to hold their investment in a different form, obtain nonrecognition treatment. On the other hand, any investors who do cash out are appropriately taxed on any gain. Thus, these results cannot be said to be unreasonable or clearly inconsistent with the Code.

(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? The transaction is incidental to the Purchaser’s business decision to expand its operations by acquiring an unrelated Target. In such circumstances, the second test will generally be satisfied. Accordingly, a double-dummy transaction should not be subject to ESD.

**Distributions**

The final category of representative Subchapter C transactions to be analyzed are corporate distributions.

**Shareholder Distributions in Connection with New Investment**

**Facts**

A corporation has attracted a new investor willing to invest an amount of capital in the corporation. Due to the investment, the corporation is able to provide its existing shareholders with an additional return on capital and desires to do so by distributing some of the new investment proceeds to the shareholders.

**Transaction**

The corporation has various options how to structure this transaction. Many of these options are expressly addressed by the Code. In this basic area, as in the reorganization context, tax treatment is highly form driven. Moreover, different structures generally result in significantly different tax consequences.

One option is for the corporation to declare a dividend and pay it to the shareholders directly and in cash. In this case Code Sec. 301 will apply, and the shareholders will be taxed on the full value of the dividend received at ordinary income rates.

Alternatively, the investment could be effected by merger. To achieve this structure, the new investor would form a transitory subsidiary (“Merger Sub”) by contributing to it the cash for investment in the corporation. Merger Sub then merges with and into the corporation. In connection with the merger, the existing shareholders exchange their corporation stock for the stock in the surviving entity plus the investment cash. In this structure, as the shareholders will have cashed out a fraction of each share, exchange treatment as a Code Sec. 302 redemption applies. Thus, shareholders will be taxed on only the gain inherent in the portion of the shares exchanged and at capital gain rates.

As a third alternative, the corporation could structure the investment as a recapitalization in which the shareholders surrender for cancellation their existing shares in exchange for new shares with a changed par value and cash.293 That transaction will be subject to the rules of Code Sec. 354 and Code Sec. 356.

**Observations/Application of Proposed Lens**

As this example illustrates, even a basic distribution transaction can be structured in a number of ways having a range of tax consequences under the Code. Subject only to J.R. Bazley294 and Reg. §1.301-1(l),295 tax treatment is largely form-driven. This importance placed by the Code on the form of the transaction in this area suggests that corporate distributions should generally not raise an ESD issue. On the other hand, at least one case has held, albeit in the partnership context, that a liquidating distribution was subject to ESD.296 Although that case involved a clearly “structured” transaction where loans and note purchases were made to permit deferral of tax on the sale of an unrelated business, it indicates that the ESD analysis may be applicable. Should ESD apply in this context?
(1) Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code? A distribution to the shareholders of a widely held corporation should generally not be subject to invalidation on ESD grounds. Just as with contributions, the appropriate tax treatment largely depends on compliance with technical rules. The applicable provisions of the Code largely mandate some degree of structuring; thus, any achieved result is generally not unreasonable under the Code.

(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? Distributions to a corporation's shareholders are generally routinely made in order to provide such shareholders with a return on their investment. They are an integral part of the corporation's business and a component of the shareholder's overall investment. As such, they should generally satisfy the second test of the Proposed Lens. Nevertheless, situations involving distributions to controlling shareholders may require heightened scrutiny. Generally, however, ESD should not be relevant to these types of transactions.

Cross-Border Code Sec. 304 Transactions Used to Move Earnings and Profits

Difficult questions involving corporate distributions are likely to arise in the context of distributions from foreign subsidiaries of U.S. parent corporations.

Facts

A U.S. corporation that is the common parent of an affiliated group ("U.S. Parent") owns two sister controlled foreign corporations ("CFC 1" and "CFC 2") and seeks to repatriate cash from the CFCs in a tax-efficient manner.

Transaction

U.S. Parent sells a portion of its CFC 1 stock to CFC 2. The transaction implicates Code Sec. 304(a)(1), which governs stock sales between related parties. Under Code Sec. 304(a)(1), the sale is treated as a contribution by U.S. Parent of the sold CFC 1 stock to CFC 2 in exchange for CFC 2 stock, followed immediately by a redemption by CFC 2 of such CFC 2 stock back from U.S. Parent. The determination whether such redemption is afforded dividend treatment or exchange treatment is made with reference to CFC 1 stock.297 Because the U.S. Parent owns 100 percent of CFC 1 before the transaction directly and 100 percent after the transaction constructively,298 CFC 2's deemed redemption of its stock is treated as a deemed dividend under Code Sec. 302. The deemed dividend, in turn, is first applied to reduce the earnings and profits (E&P) of CFC 2 and then of CFC 1.

The deemed dividend is treated as foreign source income, and thus generates a deemed Code Sec. 902 foreign tax credit in the amount that represents the same proportion to the total foreign taxes paid by CFC 1 and CFC 2 as the deemed dividends represent to their respective E&P.299 If Code Sec. 304 were not applicable, however, the sale of CFC 1 stock would be treated as an exchange and would not
generate the same Code Sec. 902 benefits. Moreover, although treated as a dividend for U.S. tax purposes, in most foreign jurisdictions, the intercompany stock sales are still viewed as such. Accordingly, there is no withholding tax on the proceeds from the sale (i.e., the U.S. dividend), allowing the U.S. Parent to apply the Code Sec. 902 foreign tax credit directly to the full amount of the deemed dividend generated by the transaction.

Observations/Application of Proposed Lens

The IRS approved this result in Rev. Rul. 92-86.300 The ruling holds that the cash received from the sale of the stock of one foreign subsidiary to another foreign subsidiary would be treated as a dividend under Code Sec. 302, reducing the E&P of both foreign subsidiaries in turn. The IRS expressly approved the Code Sec. 902 foreign tax credit calculation described above. Does the holding in Rev. Rul. 92-86 survive under ESD as codified?

If ESD applies, the transaction may not satisfy the two-part test. Absent an actual need for internal restructuring, there is likely no nontax business purpose for the transaction. In addition, as the U.S. Parent’s indirect ownership of either CFC has not been affected, there is likely no meaningful change in economic position resulting from the transaction.

Thus, the determinative question is again whether ESD is relevant to this transaction. The rules of Code Sec. 304 are highly specific and their application is mechanical. As discussed in a variety of similarly technical contexts (e.g., Code Sec. 331 and Code Sec. 332 liquidations), literal compliance with the Code should arguably be sufficient where the relevant provisions are themselves highly literal. But, is the answer different where mechanical compliance with a particular provision (Code Sec. 304) allows the taxpayer to generate unanticipated tax benefits under a separate, unrelated, provision (Code Sec. 902)? Congress has generally sought to limit the ability of U.S. companies to repatriate previously untaxed foreign earnings. Should the specific rules of Code Sec. 304 or some understanding of the general purpose of Subpart F prevail? Is it sufficient that the technical terms of another Subpart F provision, Code Sec. 902, were also satisfied?

This transaction illustrates the difficulties associated with the application of ESD with a view to Congressional purpose. In enacting Code Sec. 304, Congress was exclusively focused on curbing the ability of affiliated corporations and shareholders to withdraw earnings from the corporate solution at capital gain rates. To stem the potential for abuse, Congress clearly described the types of transactions that are subject to Code Sec. 304 and provided for a mechanical recast of such transactions. The application of this recast is not subject to exceptions depending on the context or the ultimate tax results of the transaction, rather, Code Sec. 304 either applies or does not apply based on the transaction in question. But, while Code Sec. 304 is typically an anti-abuse provision, in the international context, Code Sec. 304 has been used successfully to reduce the amount of foreign earnings of foreign subsidiaries of U.S. companies at lower rates of tax. Congress did not contemplate the use of Code Sec. 304 in this manner and likely did not anticipate the potential opportunities that Code Sec. 304 would provide in the international context. In such cases, how does one determine what Congress intended for purposes of the ESD analysis?

(1) Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code? The requirements of

Figure 13.
both Code Sec. 304 and Code Sec. 902 are clearly satisfied in this case. In the Code Sec. 304 context, where tax consequences are entirely driven by highly mechanical rules, literal satisfaction of the Code’s provision is for the most part all that can be relevant. Thus, the result is not “unreasonable” and it cannot be said that it was “clearly not contemplated by the Code.”

Although it may be that the ultimate result is not what the government would prefer, as Congress likely never considered the impact of Code Sec. 304 in the international context, its intent as to the transaction at issue is largely a matter of guesswork. Accordingly, applying ESD to trump another highly technical and clearly applicable anti-abuse provision would create an unacceptable level of uncertainty for taxpayers. Are taxpayers always expected to ignore the provisions of Code Sec. 304 in the international context? Whenever the application of the provision would generate a beneficial result for the taxpayer? Does the magnitude of the tax benefit make a difference? The possible permutations of such questions are numerous.

In enacting Code Sec. 304, Congress enacted technical rules that all parties (including the IRS) must follow regardless of the result. As one court noted in a different context, “Treasury cannot with one hand promulgate ... regulations that have the force and effect of statutory law, and with the other, require a taxpayer under the guise of [an anti-abuse] doctrine to proceed contrary to the regulations but only when to the government’s benefit. That is the practical effect of what the government purports to do here.” Accordingly, absent legislative action in this area, ESD is not appropriately used as a trump card whenever the IRS is unhappy with the ultimate result.

(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? Internal corporate distributions should generally satisfy the second test of the Proposed Lens. The movement of cash between members of a corporate group is commonplace and typically driven by business needs—cash generated by the group’s business operations is generally being distributed because required for the business operations of another member. Assuming these facts, such distributions will generally be incidental to an ordinary course business transaction. Accordingly, such transactions should generally satisfy the Proposed Lens and the ESD should not be relevant.

Loss Creation: H.J. Heinz Co.

Background Facts

The taxpayer in H.J. Heinz Co., H.J. Heinz Company (“Heinz”), had a sizeable stock buyback program in place. The repurchased shares were generally kept in Heinz’s treasury and primarily used for employee stock-compensation plans. The decision was made that one of Heinz’s existing subsidiaries, Heinz Credit Company (“HCC”), should also repurchase Heinz stock directly in the open market.

Transaction

First, HCC purchased 3.5 million Heinz shares in the open market for cash, sourced in part from new borrowings. Heinz subsequently redeemed most of these shares (3,325,000) from HCC in exchange for a zero coupon subordinated convertible note. Heinz and HCC treated the repurchase as a redemption under Code Sec. 317(b), which was in turn treated as a dividend under Code Sec. 301 and Code Sec. 302(d). The dividend was fully deductible by HCC due to its membership in the Heinz consolidated group. Finally, under Reg. §1.302-2(c), HCC reallocated the entire basis it previously had in the redeemed 3,325,000 Heinz shares to its remaining 125,000 Heinz shares. HCC then sold these shares to an unrelated party recognizing a significant capital loss, which was absorbed in the Heinz group consolidated return. Three years later, HCC converted its convertible note back into Heinz stock.

Observations/Application of Proposed Lens

After concluding that Heinz’s treatment of the transaction accorded with the literal provisions of the Code, the Heinz court nevertheless denied the capital loss recognized by HCC on a number of grounds, including that the transaction lacked economic substance.

The Heinz opinion is notable for suggesting that redemptions must have a business purpose to be respected and its Coltec-like approach to defining the relevant transaction. The court did not consider the overall redemption as a whole, which clearly had a business purpose. Rather, it disallowed HCC’s capital loss on ESD grounds because it found no business purpose for HCC’s involvement in the transaction. The court only briefly acknowledged Moline Properties and provided no discussion with respect to why the general rule that a corporation is respected as a separate taxpayer was not applicable in this case.
Do these conclusions in Heinz have implications for strictly affiliate transactions? If it rationale is followed, Heinz could be interpreted to place a number of typical transactions involving wholly owned subsidiaries in jeopardy on ESD grounds, including the imposition of a business purpose requirement for the existence of the subsidiary.

(1) Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code? The rules applicable at the time of the Heinz transaction arguably provided for this very situation. The dividend in Heinz satisfied the “extraordinary dividend” definition of Code Sec. 1059(e)(1), which would require a taxpayer to reduce its basis in the underlying stock by the value of the extraordinary dividend. However, before regulations under Code Sec. 1059(e)(2)(A) were issued (which was one year after the tax year in question in Heinz), Code Sec. 1059(e)(2)(A) provided that the general rule that a taxpayer must reduce its basis in the stock pursuant to a receipt of an extraordinary dividend did not apply to dividends between members of an affiliated group. Thus, a member-taxpayer could receive the dividend tax-free, and then later, solely due to the receipt of such dividend, sell the stock ex dividend, realizing a loss in the same amount—thus, the statutory provisions directly applicable to this situation themselves arguably made loss creation possible.

The statute further provided that the exception in Code Sec. 1059(e)(2)(A) was to apply unless provided otherwise by Treasury regulations. At the time of the Heinz transaction, the Secretary had not yet enacted such regulations. In Heinz, the IRS effectively made up for its oversight, by imposing the requirement it had not yet itself enacted through the application of the ESD doctrine in the courts. As one commentator observed, in Heinz “[t]he Claims Court exercised authority purportedly granted only to the Treasury secretary.”

Although the Heinz result was arguably contemplated by the directly applicable provision of the Code, Heinz is a particularly difficult case because it allowed the taxpayer to recognize a noneconomic loss. This result is highly unusual under the Code and always warrants particularly close scrutiny. Nevertheless, in a situation such as this, where the recognition of a noneconomic loss cannot be said to be clearly precluded by the directly applicable provision of the Code, the benefit should arguably be allowed, but strictly limited to those situations where the benefit was clearly incidental to a legitimate business transaction.

(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? The second question of the Proposed Lens is also particularly difficult in the Heinz case. The overall redemption of Heinz’s stock held by its public shareholders, pursuant to an overall redemption program and effected in the open market, was consistent with the company’s overall business and in the ordinary course. Heinz’s had a long-standing redemption program that facilitated compensation of its employees. But, the repurchase of stock through HCC was a highly structured transaction involving related taxpayers. Still, HCC was a pre-existing bona fide subsidiary of the taxpayer that had conducted separate business operations. Thus, its existence was in some sense “accidental.”
Finally, the transaction did affect the position of a large number of public shareholders, and is for that reason reminiscent of *Esmark*. Overall, the result is far from obvious. Under any analytical approach, *Heinz* is a particularly hard case.

**Code Sec. 355 Transaction with Loss Realization**

**Background Facts**
Taxpayer, the common parent of a consolidated group, made the decision to separate one of its businesses that it operated through one of its Subsidiaries ("Sub"), and sought to effect this separation in a Code Sec. 355 tax-free spin-off. However, Taxpayer also had a significant built-in loss in the Sub stock and sought to recognize that loss before the distribution.

**Transaction**
In order to accomplish this goal, the Taxpayer formed a new corporation ("Newco") by contributing to Newco its Sub stock in exchange for Newco non-voting preferred and common stock. Prior to the contribution, the Taxpayer had entered into an agreement with an unrelated third party ("Third Party") to sell to such Third Party the Newco nonvoting preferred stock it would receive in the contribution. The parties carried out the prearranged sale in accordance with the agreed upon terms.

The effect of the prearranged sale of more than 20 percent of any class of Newco stock was to preclude the Newco contribution from qualifying for nonrecognition treatment under Code Sec. 351. Specifically, because of the prearranged sale, Taxpayer was not in "control" of Newco immediately after the contribution. As the Taxpayer "busted" the Code Sec. 351 transaction, the contribution was treated as a Code Sec. 1001 taxable exchange, allowing Taxpayer to realize its built-in loss in Sub stock.

Next, the Taxpayer formed another corporation ("Controlled") by contributing its Newco shares in exchange for a 100-percent interest in Controlled and the assets of an active trade or business within the meaning of Code Sec. 355(b). Accordingly, although the Taxpayer did not have control of Newco (since lack of control was needed to bust the Code Sec. 351 transaction), the Taxpayer would still be able to spin off the Newco business in a Code Sec. 355 tax-free transaction, a requirement of which is that the distributing corporation distribute shares representing control in the spun off corporation.

**Observations/Application of Proposed Lens**
The IRS approved a transaction of this type in a private letter ruling. Is a different result is obtained post-ESD codification? Does the use of both Controlled and Newco need to be justified? Does the ability to defer gains and recognize losses as part of the same transaction in and of itself implicate the doctrine? These questions have no clear answer under the current statute.

(1) Is the result of the transaction reasonable or does it give rise to a loss or benefit that is clearly not contemplated by the Code? Although generating a significant timing benefit, the Taxpayer for the most part achieved results that could have been realized in a number of more direct ways. The Taxpayer...
did not fabricate a noneconomic loss nor avoid gain in a situation where gain deferral is clearly inappropriate. As to the loss recognition aspect of the transaction, as the Taxpayer represented to the IRS, it “would [have been] entitled to recognize the [loss inherent in Sub stock] upon a taxable sale of [such stock] to an unrelated third party.” Ultimately, the Taxpayer recognized a loss by structuring in a way to avoid the highly technical, bright-line rule, requirements of Code Sec. 351. But, as discussed previously, given the bright-line nature of the Code Sec. 351 prerequisites, this result is arguably reasonable under the Code. As to the deferral of gain to the Taxpayer and its stockholders, the Taxpayer achieved this result as part of a Code Sec. 355 transaction that expressly provides for nonrecognition treatment assuming its specific requirements are satisfied. The Taxpayer did not rely on Code Sec. 355 in an unusual context; rather the spin-off was a relatively typical Code Sec. 355 transaction. Ultimately, the transaction appears unusual because it combines the results of two separate transactions into one, through the addition of a number of steps. Generally, where the overall result can be achieved in a relatively straightforward manner—and thus, the transaction is not abusive overall—a mere insertion of a few additional steps should not taint such an otherwise allowable transaction. The fact that the Taxpayer achieved a particularly favorable result (by recognizing loss and deferring gain at the same time), should not, in and of itself, invalidate the transaction on ESD grounds, nor subject the Taxpayer to a high strict liability penalty, as neither result is clearly not contemplated by the Code.

(2) Is the tax effect merely incidental to a business transaction or the result of tax-motivated planning? Was this consistent with the business of the taxpayer or outside of the ordinary course? The Taxpayer separated one of its business lines in the ordinary course and for a legitimate business purpose. As the Taxpayer represented to the IRS in its ruling request the “[spin-off] would be pursued by [Taxpayer] regardless of whether the [Sub] loss would be recognized by virtue of the [spin-off] and the related transactions.” Accordingly, the second test of the Proposed Lens is also satisfied in this case. Thus, this transaction, while highly favorable to the taxpayer, should not be subject to ESD.

**Conclusion**

The codification of the ESD will necessarily involve difficult judgment calls on the part of taxpayers and the IRS in attempting to apply a judge-made, flexible, anti-abuse doctrine to everyday corporate transactions in both the planning context and under audit review. While the doctrine is not susceptible to bright line tests, the use of practical real world factors to analyze the relevance of the doctrine may be a useful funnel to narrow the scope of potential transactions which need to pass ESD muster.

**ENDNOTES**

1. The author gratefully acknowledges the able assistance of Tijana J. Dvornic, Associate with Wachtell, Lipton, Rosen & Katz.
2. Unless specified otherwise, all section references are to the Internal Revenue Code of 1986, as amended.
3. See Jasper L. Cummings, Jr., *The New Normal: Economic Substance Doctrine First*, Tax Notes, Jan. 25, 2010, at 521, Doc. 2010-597: “The ESD is a positive rule of law that says the taxpayer loses even if it otherwise would win; this much is agreed.”
4. See, e.g., *Rice's Toyota World*, CA-4, 85-1 USTC ¶9123, 752 F2d 89, 94 (1985) (stating that a transaction will be found to lack economic substance if “the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists”).
7. *See, e.g., K.F. Knetch*, SCt, 60-2 USTC ¶9785, 364 US 361, 366 (1960) (invalidating a taxpayer’s claimed interest deductions because the transaction in question had no “substance or purpose aside from the taxpayer’s desire to obtain a tax benefit”).
8. *Frank Lyon Co.*, SCt, 78-1 USTC ¶9870, 435 US 561, 583–84 (1978): “In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.”
but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.”


13 Id., at 390–92, 397–400.

14 See, e.g., ACM Partnersh, supra note 11 (McKee, J., dissenting): “The majority’s conclusion to the contrary is, in essence, something akin to a ‘smell test.’”

15 U.S. DEP’T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROBLEMS (1999), available at www.ustreas.gov/offices/tax-policy/library/cfswht.pdf; hereinafter, “1999 Treasury Report”: “The proliferation of corporate tax shelters presents an unacceptable and growing level of tax avoidance behavior. Over the past several years, Congress and the Administration repeatedly have provided targeted responses to specific shelters as they have come to light. The Administration believes that a generic solution to curb the growth of corporate tax shelters must be fashioned, as opposed to the current after-the-fact, ad hoc approach. This, admittedly, is not an easy task. Unlike the individual tax shelters of the 1970s and 80s, corporate tax shelters may take several forms and do not rely on any single Code section or regulation. For this reason, they are hard to define.”


17 Treasury Report, at xviii.

18 Id.


20 Treasury regulations have required taxpayers to disclose their involvement in “reportable” and “listed” transactions since 2000, and disclosure targeting specific “listed” transactions has largely been effective in deterring those particular abusive transactions. The history of disclosure requirements regarding “reportable” transactions is more mixed. See generally Richard M. Lipton, Final Corporate Tax Shelter Disclosure and List Maintenance Regulations Impose Burdens on Everyone, 98 J. TAX’N 133, 134 (2003): “The IRS had attempted, in drafting these rules, to avoid needless disclosure with respect to non-abusive transactions, but the exceptions were so broad that they virtually swallowed the disclosure requirement. To put this failure into perspective, during the first year of the new disclosure regime (tax returns filed in 2001), fewer than 100 corporations made any disclosure under §6011, and many of the disclosures that were made related to routine leveraged lease transactions.” The IRS enacted more stringent requirements in 2003. T.D. 9046, 2003-1 CB 614. See also Lipton, supra, at 134: “The new disclosure regulations under §6011 take a completely different approach than the old ones. Instead of seeking to identify transactions that are likely abusive, the new regulations require disclosure of broad classes of transactions that might be abusive, and there are no exceptions from disclosure for reportable transactions.” In 2004, Congress imposed penalties for failure to disclose reportable transactions under Code Sec. 6011 (Code Sec. 6707A) and for understatements resulting from a reportable transaction (Code Sec. 6662A), as well as disclosure requirements on “material advisors.” American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (Oct. 22, 2004). See generally Richard M. Lipton et al., THE WORLD CHANGES: BROAD SWEEP OF NEW TAX SHELTER RULES IN AJCA AND CIRCULAR 230 AFFECT EVERYONE, 102 J. TAX’N 134 (2005).

21 T.D. 9165, 2005-1 CB 357 (imposing a number of new disclosure and practice requirements on tax advisors, intended to combat tax shelters); See generally, Lipton, 102 J. TAX’N 134, supra note 20.

22 See Announcement 2010-75, IRC 2010-41, Sept. 24, 2010 (announcing that certain corporate taxpayers will be required to file disclosure schedules reporting uncertain positions on their corporate tax returns).


24 See Martin J. McMahon, Jr., Living with the Codified Economic Substance Doctrine, TAX NOTES, Aug. 16, 2010, at 735–36, Doc. 2010-14844 (noting that over the last 15 years, the ESD has been applied in more than two dozen cases to deny benefits claimed by the taxpayer, while the taxpayers had won only a few “outlier cases”).


26 The Act, supra note 1, §1409, “Codification of Economic Substance Doctrine and Penalties.”

27 Code Sec. 7701(o)(1).

28 Code Sec. 7701(o)(4)(C).

29 JCT REPORT, at 152 and, note 344.


31 See JCT REPORT, at 152–53; HOUSE REPORT, at 295–96.

32 Code Sec. 7701(o)(1).

33 Id.

34 JCT REPORT, at 134.

35 Code Sec. 7701(o)(1)(B).

36 JCT REPORT, at 154, note 354 (citing ACM Partnership, 73 T.C.M.2189, Dec. 521,922(M), TC Memo. 1997-115): “Both the utility of the stated purpose and the 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 costs." *House Report*, at 297, note 135 (same).

38 *Code Sec. 7701(o)(4).*


40 *Code Sec. 7701(o)(3).*


42 *Code Sec. 7701(o)(2).*

43 *Id.*

44 *Id.*

45 *Code Sec. 7701(o)(5)(B).*

46 *Code Sec. 7701(o)(5)(A).*


48 *Code Sec. 7701(o)(5)(D).*


52 *Code Sec. 6662(b)(6) (imposing an accuracy-related penalty with respect to transactions failing to meet the requirements of ESD); Code Secs. 6664(c)(2) and (d)(2), and 6676(c) (providing that the "reasonable cause exception" does not apply with respect to underpayments, understatements or erroneous claims for refund or credit with respect to a transaction that does not satisfy the requirements of ESD).*

53 *JCT Report*, at 155, note 359.


55 *JCT Report*, at 142, note 300; *House Report*, at 292, note 106. For an example of (1) the "sham-transaction doctrine," see *Rice’s Toyota World*, supra note 4; (2) the "business-purpose doctrine," see *Helvering v. Gregory*, CA–2, 1934–CCH ¶9180, 69 F2d 809 (1934), aff’d by *Gregory v. Helvering*, supra note 4; and (3) the "substance-over-form doctrine," see *Phellis*, SCI, 1 USTC ¶554, 257 US 156, 168 (1921).

56 *See Minnesota Tea Co., 38–1 USTC ¶9050, 302 US 609, 613 (1938): “A given result at the end of a straightforward path is not made a different result because reached by following a devious path.” Am. Bantam Car Co., 11 TC 397, Dec. 16,601 (1948).*

57 *JCT Report*, at 142; *House Report*, at 292.

58 *See Code Sec. 7701(o)(1)(B).*

59 *See McMahon, supra note 25.*


62 *Reg. §1.368-1(b).*

63 *See Reg. §1.368-1(b).*

64 *See Caruth Corp., DC–TX, 88–2 USTC ¶9514, 688 FSupp 1129, 1138–41 (1987). (The court expressly held that *Code Sec. 351 has a business purpose requirement, based on a close connection and overlap between *Code Sec. 351 and the reorganization provisions in *Code Sec. 368. The court then went on to conclude that the business-purpose require-ment was satisfied in this case because the contribution provided additional capital to the business, which the taxpayer continued to conduct for another six years after the transfer. Thus, the threshold for the *Code Sec. 351 business purpose requirement appears to be relatively low.* S.D. Stewart, CA–9, 83–2 USTC ¶9573, 714 F2d 977, 992 (1983). (The court held that the taxpayer’s transfer of appreciated securities to a controlled corporation, which shortly thereafter sold the securities and used the proceeds to repay the loans made by the taxpayer to the corporation, would not be granted *Code Sec. 351 nonrecognition treatment. The court based this conclusion on its view that the transferee corporation was merely a conduit in this circumstance, in part because the transfer and subsequent loan repayments lacked a business purpose.) *Heimpel Bros., Inc.*, CA–3, 74–1 USTC ¶9188, 490 F2d 1172, 1178 (1974). (The Third Circuit held that the Congressional purpose underlying *Code Sec. 351—facilitating the incorporation of ongoing businesses—requires that the assignment of income doctrine yield to the *Code Sec. 351 non-recognition result. In reaching this conclusion, the Third Circuit was “influenced by [11] the fact that the subject of the assignment were accounts receivable for a partnership’s goods and services sold in the regular course of business, [2] the change of business form from partnership to corporation had a basic business purpose and was not designed for the purpose of deliberate tax avoidance, and [3] the conviction that the totality of circumstances here presented fit the mold of the Congressional intent to give nonrecognition to a transfer of a total business from a non-corporate to a corporate form.”) *Compare Rev. Rul. 68–349, 1968–2 CB 143 (holding that a transaction did not qualify as a *Code Sec. 351 contribution because the establishment of the new corporation had no purpose other than provide nonrecognition treatment to the contributing taxpayer) with Rev. Rul. 76–123, 1976–1 CB 94 (holding that a transaction did qualify under *Code Sec. 351 on nearly identical facts because the structure was not designed solely to provide for nonrecognition treatment but also to allow for incorporation in a different state).* Rev. Rul. 60–331, 1960–2 CB 189.

65 *Gregory v. Helvering, supra note 6.*

66 *Higgins v. Smith, SCI, 40–1 USTC ¶9160, 308 US 473 (1940).*

67 *JCT Report*, at 155, note 359.


69 *Compare ASA *Investership Partnership*, CA–DC, 2000–1 USTC ¶50,185, 201 F3d 505, 510–11, 516 (2000) (with *ACM Partnership, supra note 11. These cases involved highly similar tax shelters and both courts held against the taxpayer. The ASA court decided the case on business purpose grounds, concluding that a valid partnership was never formed because the parties involved never had the *bona fide* intent to form such partnership. The consequence of the decision was the reallocation of gain initially allocated to another party back to the taxpayer. The ACM court, on the other hand, decided the case on ESD grounds. As a result, the capital gain and loss at issue were not recognized at all."


71 *Coltec Indus., Inc.*, supra note 50, 454 F3d 1340, 1352; see also *ACM Partnership, supra note 11: “[A] transaction that lacks economic substance simply is not recognized for federal taxation purposes, for better or for worse, and we are not aware of any cases applying the economic-substance doctrine selectively to recognize the consequences of a taxpayer’s actions for some tax purposes, but not others. Rather, the courts have applied economic substance principles to give effect either to both the cost and the income functions of a transaction, or to neither.” (Internal citations and quotation marks omitted.) *Arrowhead Mountain Getaway, Ltd.*, 69 TC Memo 1805, 1822, Dec. 50,461(M), 1995–54 (1995) (holding that because the transactions in question were economic shams that could not give rise to deductions, income received in connection with such transactions could not be characterized as taxable income)."

72 *See Reg. Code Secs. 1.368–1(b), (c), (g).*

73 *See Rev. Rul. 69–6, 1969–1 CB 104 (a transaction that fails to qualify as an *A* reorganization is treated as a taxable sale of assets).*


75 *Coltec Indus., supra note 50.*

76 *See generally David P. Hariton, *The Frame Game: How Defining the ‘Transaction’ Decides the Case, 63 Tax Law.* 1 (2009)."

77 Interestingly, a transitory subsidiary may be disregarded where the result is to cause the transaction to qualify as a desired “B” reorganization. See Rev. Rul. 67–414, 1967–2 CB 382.

78 *Coltec Indus., supra note 50.*

79 *Coltec Indus., supra note 50, 454 F3d 1340, 1351.*

80 *Id.*

81 *Coltec Indus., supra note 50, 454 F3d 1340, 1358: “The first asserted business purpose focuses on the wrong transaction, the creation of [SPE] as a separate subsidiary to manage asbestos liabilities.”*
Economic-Substance Doctrine and Subchapter C: What, Me Worry?

1359-60.

See, e.g., Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.01[2] (7th ed. 2010), hereinafter Bittker & Eustice: "The statutory definition [of the term ‘reorganization’] looks primarily to the form rather than to the substance of these transactions... The statutory definition of ‘reorganization’ thus hauls in a most variegated catch but does almost nothing to segregate the transactions according to their economic consequences." ¶ 12.01[4]: "It cannot be overemphasized that the statutory definition of ‘reorganization’ in Code Sec. 368(a)(1) is entirely formal; that is, seven defined categories [plus two special alternatives for subsidiary-merger transactions] are available. If the transaction is unable to fit within one of these categories, it will not be treated as a reorganization, no matter how much the substance of the transaction fulfills the policies of the reorganization regime." Id.: "There is a good deal of interplay, overlap, and conflict between the reorganization provisions and such other statutory provisions as Code Secs. 301 (distributions of cash and other property), 302 (redemptions of stock and partial liquidations), 305 (stock dividends), 306 (preferred stock bailouts), 331 (complete liquidations), 351 (incorporations), and 355 (corporate divisions), since any of these events may accompany, be part of, or serve as a substitute for a reorganization. There is a similar conflict of jurisdiction within the reorganization provisions themselves, since, to take but one example, a statutory merger may be indistinguishable in results from an exchange by one corporation of its voting stock for all of the assets of another corporation; however, different statutory rules are prescribed for these functionally equivalent types of reorganization."


103 Use of parent stock does not affect the reorganization treatment of mergers under Code Sec. 368(a)(2)(A), as long as the requirements of Code Sec. 368(a)(2)(D) or (E) are met, but is not permitted in D or F reorganizations.

104 Compare Code Sec. 368(a)(1)(B) and (C) (requiring use of voting stock) with Code Sec. 368(a)(1)(A) (no voting stock requirement).

105 Compare Code Sec. 368(a)(1)(A), where up to 60 percent of the consideration may be boot, with Code Sec. 368(a)(1)(B), which requires the use of voting stock alone.

106 See, e.g., Code Sec. 368(c) (defining “control” for purposes of the reorganization provisions).

107 See Southwest Consolidated Corp., S.CI, 42-1 ustc ¶ 9248, 315 US 194, 198 (1942): “Congress has provided that the assets of the transferor corporation must be acquired in exchange ‘solely’ for ‘voting stock of the transferee.’ ‘Solely’ leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement.” See also Beverly, 621 F2d 1277 (3rd Cir. 1980) (no consideration other than voting stock may be used to effect a B reorganization, even if solely voting stock is used to acquire “control”); E.S. CHAPMAN, CA-1, 80-1 ustc ¶ 9330, 618 F2d 856, 862–63 (1980): “We believe the presence of nonstock consideration in such an acquisition, regardless of whether such consideration is necessary to the gaining of control, is inconsistent with treatment of the acquisition as a nontaxable reorganization... The reorganization definitions contained in §368(a)(11) are precise, technical, and comprehensive.”

108 See, e.g., Mahon, supra note 25.


110 Compare Coltec Indus., supra note 50, 454 F3d 1340, 1359, with Coltec Indus., supra note 50, 454 F3d 1340, 1359.


112 See Bittker, supra note 17.

113 Many commentators have criticized Coltec for its narrow view of the relevant transaction.


115 See, e.g., Robert Wilens, Unnatural Selection in Subchapter C: Why Form Controls When a Minority Interest is Eliminated, J. TAX’N, Feb. 1998: “Subchapter C is full of situations where although the substance of two transactions may be the same, the format used to attain a particular objective may have profound implications.”

116 Code Sec. 368 specifies the corporate reorganization transactions that are eligible for nonrecognition treatment, generally based on the theory that such transactions are mere changes in form and are therefore not appropriate occasions for the imposition of tax.
abounds with provisions that not only influence economic behavior, but that also are intended to influence economic behavior.

... How are the IRS and the courts to sort the sheep from the goats and decide which combination of mismatched rules produces an intended tax benefit, thereby exempting the transactions from the business purpose test and economic substance test ...


ACM Partnership, supra note 11.

Id., at 233–36.

For example, assume taxpayer purchased short-term securities with a value of $100 and sold these securities the next day for $70 in cash and $30 in contingent installment notes payable over three years. The taxpayer’s basis in the notes is $100, and under the contingent installment sale rules in effect at the time, the taxpayer would be required to recover one-fourth of its basis over the four-year sale period ($25/year). Thus, upon receipt of the $70 in cash, the taxpayer would recognize gain of $45 ($70 – $25), while recognizing a loss of $15 ($10 – $25) in each of the following three years. Thus, although the gain is front-loaded, overall, the taxpayer recognizes no gain or loss on the sale.

ACM Partnership, supra note 11, 157 F3d, at 247–78.

Id., at 249–60.

ACM Partnership, supra note 37.

ASA Investorings Partnership, 76 TCM 325, Dec. 52,845(M), TC Memo. 1998-305.

Id., at 1–4.

Id., at 12.

Id., at note 5.

ASA Investorings Partnership, supra note 71.


Trubine Co., supra note 131.


See Jasper L. Cummings, Jr., The New Normal: Economic Substance Doctrine First, TAX NOTES, Jan. 25, 2010, at 521, Doc 2010-597: “[A]ll Gregory did was construe into the reorganization statute a requirement that the reorganization have a purpose to actually reorganize a business, based on common understanding of what a corporate reorganization was. Admittedly, that requirement properly became a sort of anti-abuse rule in the reorganization area, but it was improperly elided into an all-purpose business purpose requirement and now into a prong of the ESD.”

Gregory v. Helvering, supra note 6, 293 US 465, 469–70 (1935). Judge Learned Hand, the author of the Second Circuit’s opinion in the Gregory case, which was affirmed by the Supreme Court on largely the same grounds, subsequently explained that the doctrine announced in Gregory establishes that tax statutes are to be understood as referring to “transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.” Transport Trading & Terminal Corp., CA-2, 49-2 ustc ¶9337, 176 F2d 570, 572 (1949).


Gregory v. Helvering, supra note 6: “But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.” Helvering v. Gregory, supra note 55; “Therefore, if what was done here, was what was intended by the relevant reorganization provision, it is of no consequence that it was an elaborate scheme to get rid of income taxes, as it certainly was.”


See General Utilities & Operating Co, S.Ct, 36-1 ustc ¶9012, 296 US 200, 206 (1935) (concluding that a corporation did not recognize gain as a result of an in-kind distribution of appreciated assets to its shareholders).


Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose, ...” Gregory v. Helvering, supra note 6, 293 US 465, 469–70.

... and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.”
Gregory v. Helvering, supra note 6, 293 US 465, 469–70.

No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.” Gregory v. Helvering, supra note 6, 293 US 465, 469–70.

The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.” Gregory v. Helvering, supra note 6, 293 US 465, 469–70.

Gregory v. Helvering, supra note 6, 293 US 465, 469.

Gregory v. Helvering, supra note 6, 293 US 465, 469–70.

See NYSBA Tax Section, “Report on the Treasury’s Proposal to Codify the Economic Substance Doctrine,” July 24, 2000, available at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/9777Report.pdf: “In Gregory, the taxpayer was the sole shareholder of a corporation that had agreed to a nontax-motivated sale of one of its subsidiaries. The taxpayer’s lawyers structured the transaction as a tax-free spinoff followed by a sale of the distributed corporation at the individual level, so as to avoid (a) the corporate-level gain on the appreciated subsidiary, under the so-called ‘General Utilities doctrine,’ and (b) part of the individual-level gain by shifting some of the taxpayer’s outside stock basis to the stock of the distributed corporation prior to disposition. The IRS challenged the benefit of (b) above, but not of (a) above (it later challenged the benefit of (a) above in Commissioner v. Court Holding, and the courts upheld the Commissioner based on statutory interpretation—Congress apparently did not intend to allow tax-free treatment of a restructuring to accommodate a sale of assets.”

The courts summarized the IRS’s argument as seeking to tax Mrs. Gregory as if she received a dividend equal to the proceeds she received in the ultimate sale of her MSC stock. This argument is consistent with a recharacterization of the transaction as (1) a dividend of MSC stock to Mrs. Gregory, followed by her selling the received shares to a third party, or (2) a sale of MSC stock by UMC, followed by a dividend distribution of the proceeds to Mrs. Gregory.

Gregory v. Helvering, supra note 6, 293 US 465 (1935); E.F. Gregory, 27 BTA 223, 225, Dec. 7841 (1932); but see Martin D. Ginsburg and Jack S. Levin. 2 Mergers, Acquisitions and Buyouts ¶ 609.1, note 7: “Corporate-level tax planning was not implicated in Gregory, which was decided while the General Utilities doctrine was in full flower. Thus, under the General Utilities doctrine, had [UMC] simply distributed to Ms. G the appreciated [MSC] stock, [UMC] would not have recognized as gain the amount of that appreciation. Hence, it is not surprising that in Gregory IRS did not attempt to assert gain recognition either by [UMC] (on [UMC’s purported spin-off distribution of [Averill]] stock to Ms. G) or by [Averill] (on [Averill’s] liquidating distribution of [MSC] shares to Ms. G).”

Helvering v. Gregory, supra note 55, 69 F2d 809, 811.

Id.: “We do not indeed agree fully with the way in which the Commissioner treated the transaction; we cannot treat as inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill Corporation of its own shares to the taxpayer, and her acquisition of the Monitor shares by winding up that company. The Averill Corporation had a juristic personality, whatever the purpose of its organization; the transfer passed title to the Monitor shares and the taxpayer became a shareholder in the transferee. All these steps were real, and their only defect was that they were not what the statute means by a ‘reorganization,’ because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect. But the result is the same whether the tax be calculated as the Commissioner calculated it, or upon the value of the Averill shares as a dividend.”

See Hariton, supra note 92.

“The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. For a corporation is taxed if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet is not taxed if that property is distributed in kind and is then sold by the shareholders. In both instances the interest of the shareholders in the business has been transferred to the purchaser. Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate.”

Esmark, Inc., supra note 155, 186.


Esmark, Inc., supra note 155, 90 TC 171, 200.

Esmark, Inc., supra note 155, 90 TC 171, 183.

Esmark, Inc., supra note 155, 90 TC 171, 187.

Esmark, Inc., supra note 155, 90 TC 171, 198: ‘In this case, in contrast to Gregory v. Helvering, there were no steps without independent function. Each of the steps—the purchase of petitioner’s stock by Mobil and the redemption of that stock by petitioner—had permanent economic consequences. Mobil’s tender offer was not a ‘mere device’ having no business purpose; the tender offer was an essential element of petitioner’s plan to redeem over 50 percent of its stock. Mobil’s ownership, however, transitory, must thus be respected, and if Mobil’s ownership of petitioner’s shares is respected, a “distribution with respect to... stock” in fact occurred.’

Id.

Esmark, Inc., supra note 155, 90 TC 171, 199.

Esmark, Inc., supra note 155, 90 TC 171, 199.

Esmark, Inc., supra note 155, 90 TC 171, 199.


Esmark, Inc., supra note 155, 90 TC 171, 200 (citing Grove, supra note 186).


Tribune Co., supra note 131.


Tribune Co., supra note 131, 125 TC 8, 118.

Tribune Co., supra note 131, 125 TC 8, 127.
optative but good technical support because the doctrine can be molded to the facts of a case. That is, if a transaction ‘looks bad’ but meets all statutory requirements, it can be defeated by examining the transaction’s economic substance.”


220. See Hariton, supra note 92, at 31: “I also argue that a court’s inquiry is not finished when it concludes that a transaction lacks business purpose and economic substance. The tax benefits arising from such a transaction should not be disallowed unless they are clearly inconsistent with tax policy and congressional intent ... Was it, for example, loss acceleration—a mere timing benefit—or loss duplication, which is arguably much more egregious? ... how reasonable [was it] for the taxpayer to apply technical rules to obtain the relevant tax benefit, given the relevant statutory and regulatory regimes.”

221. See Hariton, supra note 92, at 34–35 (explaining that it has never been the case that any transaction that results in lower taxes is abusive; under that view, any transaction is abusive, other than one where the “taxpayer intentionally structures the transaction to pay as much tax as can possibly be paid to the Commissioner”).

222. See generally, Bankman, id.

223. Cottage Savings, supra note 72.

224. Another Spin on Economic Substance, 74 S. CAL. L. REV. 5, 18 (2000): “An aggressive play on the contingent sales regulations, for example, works if it is discovered ‘accidentally’ in the course of ordinary business operations but does not work if it is part of a prearranged plan that unreasonably correlate itself with business operations.”

225. See generally, Bankman, id.


229. Under Coltec, the relevant transaction would be the exchange alone. This illustrates a difficulty with framing the relevant transaction too narrowly. If only the realization event is relevant, then any disposition of any asset for a loss, no matter how long it is held as part of the taxpayer’s business, could fail ESD on the grounds that the transaction does not affect the economic position of the taxpayer.

230. See Hariton, supra note 92: “The timing of the resulting loss deduction [in Cottage Savings], was determined under arbitrary technical rules laid down by the Secretary, and it was therefore arguably unreasonable for the taxpayer to employ a technical transaction to affect that timing.”

231. In reaching its conclusion that in order to be “materially different” the relevant properties need only embody legally distinct entitlements rather than satisfy some higher economic substance threshold, the Cottage Savings Court relied heavily on the old reorganization cases—Phellis, supra note 55, Weiss v. Stearn, SCR, 1 USTC ¶50,187, 499 US 554, 556–57 (1991); and it was therefore arguably reasonable for the taxpayer to employ a technical transaction to affect that timing.”

Economic-Substance Doctrine and Subchapter C: What, Me Worry?


240 ACM Partnership, supra note 11, 157 F3d 231, 251-52; see also Jennings, supra note 228: “Our reading of Cottage Savings and ACM Partnership explains the conventional wisdom that stock acquired as part of an investment program may be sold at a time determined to allow the recognition of any tax loss on that position in a year when it would be useful. Such a sale would be the last of several steps for which there was a nontax objective.” McMahon, supra note 25: “[T]he ‘transaction’ in question is not solely the sale itself, but rather the overall acquisition, holding, and disposition of the property.”

241 See Hariton, supra note 92: “[M]ost people believe that in our system, a taxpayer is entitled to employ ... a transaction to trigger an unrealized gain at the appropriate moment. In fact, a taxpayer is equally entitled to trigger an otherwise unrealized loss ... .”

242 Of course, tax benefits of a realization transaction could be invalidated on different grounds. See Cottage Savings, supra note 232, 499 US 554, 568 (1991) (addressing the IRS’s argument that Cottage Savings should be denied its losses on the ground that such losses lacked “economic substance,” and taking this to mean that the losses were somehow not bona fide, the court observed that there was “no contention that the transactions in this case were not conducted at arm’s-length, or that Cottage Savings retained de facto ownership of the participation interests it traded ...”).

243 Preferred stock will be “nonqualified” if (1) the holder has the right to require the issuer to redeem the stock; (2) the issuer is required to redeem the stock; (3) the issuer or a related person has the right to redeem the stock and, as of the issue date, it is more likely than not to exercise such right; or (4) the dividend rate on such stock varies in whole or in part with reference to interest rates, commodity prices or similar indices. Code Sec. 351(g)(2).

244 If ESD applies, the objective prong of the test raises particularly difficult questions in the context of a purely internal transaction. It is unclear how this question should be analyzed, and from which entity’s perspective. In internal reorganization transactions, the economic position of the ultimate parent (and the group overall) may often remain unchanged. How are the direct owners of a liquidated entity impacted? Has there merely been a change in the form of their underlying investment (e.g., stock to assets)? Do such changes in the form of the investment also result in a substantial change in the owning entity’s economic position? Is the answer different when a liquidation is only “deemed” to occur as a result of a changed entity classification?

245 Granite Trust Co., CA-1, 57-1 USCT ¶ 9201, 238 F2d 670 (1956).


247 See LTR 201014002 (Nov. 16, 2009).

248 Granite Trust Co., supra note 245, 238 F2d 670, 674 (1956).


251 In LTR 201014002, supra note 247, a U.S. member of an international corporate group (“U.S. Sub”) sold more than 20 percent of its shares in its wholly owned foreign subsidiary in which it had a built-in loss (“Loss Foreign Sub”) to another foreign member of the group (“Foreign Sub”). The Loss Foreign Sub was then converted into an unlimited liability company, triggering a deemed liquidation of Loss Foreign Sub for U.S. tax purposes. Citing Granite Trust, the IRS held that Code Sec. 332 did not apply to the deemed liquidation. It appears that the IRS would also allow internal structuring into Code Sec. 332 or Code Sec. 331 treatment in conjunction with a deemed liquidation triggered by a check-the-box election. In such a case, the economic position of the liquidating entity does not change. In Rev. Rul. 2003-125, the IRS held that a parent creditor was entitled to a worthless stock deduction upon the liquidation of an insolvent subsidiary pursuant to a check-the-box election. The filing of the check-the-box election did not have a nontax purpose and had no impact on the parent’s economic position. After the election was made, the “liquidated” subsidiary retained its separate existence and continued to conduct the same business operations. But, note that Rev. Rul. 2003-125, 2003-2 CB 1243 (as well as Rev. Rul. 70-489, 1070-2 CB 53, and Rev. Rul. 59-269, 1959-2 CB 87, on which Rev. Rul. 2003-125 is based) do not cite D S. McClain, SCI, 41-1 USCT ¶ 9168, 311 US 527 (1941), which is arguably inapplicable.


253 See id.


255 See Caruth Corp., supra note 64; Stewart, supra note 64; Hempf Bros., Inc., supra note 64.

256 Compare Rev. Rul. 68-349, 1968-2 CB 143 (holding that a transaction did not qualify as a Code Sec. 351 contribution because the establishment of the new corporation had no purpose other than to provide Code Sec. 351 nonrecognition treatment to the contributing taxpayer) with Rev. Rul. 76-123, 1976-1 CB 94 (holding that a transaction did qualify under Code Sec. 351 on nearly identical facts because the structure was not designed solely to provide for Code Sec. 351 treatment but also to allow for incorporation in a different state); See also Rev. Rul. 60-331, 1960-2 CB 189.

257 At least one judicial decision has rejected the notion that qualification under Code Sec. 351 is dependent on a valid business purpose, but this case is relatively old and its continued authority somewhat questionable. See V&K Holding Corp., 38 BTA 830, Dec. 10,460 (1938) (non-acc.).

258 Portland Oil Co., CA-1, 40-1 USCT ¶ 9234, 109 F2d 479, 488 (1940).

259 See Robert Cassanos, Economic Substance, Business Purpose, and Tax Elections, Tax Forum Paper No. 578, at 5 (Nov. 1, 2004), on file with author: “By definition, tax elections are tax-motivated. They have no business purpose. They have no economic substance. Therefore, a tax election should never be tested against a ‘purpose’ or ‘substance’ standard. The existence of a tax election is, in practice, a declaration by the taxing authority that it has little or no stake in the tax characterization of the transaction or entity in question, so it is in effect formally or informally delegating the choice of that characterization to the taxpayer.” If business purpose and ESD apply to Code Sec. 351, do they also apply to the formation of a single member LLC, which is a “tax nothing” as it is? If not, can a taxpayer avoid these requirements in the context of Code Sec. 351 by first forming a single-member LLC and then checking the box? In such a case, would a taxpayer have to demonstrate a business purpose for the election? See generally, id. Arguably, if, as noted above, there is a threshold business purpose requirement for a Code Sec. 351 transaction effected by checking the box is satisfied by the business reasons for establishing the LLC, even if old and cold, id.


264 See Jennings, supra note 228: “The sale [of Shell Western’s shares] was a partial disposition of [Shell’s oil and gas] properties, which had been acquired to make a profit, and therefore was part of a transaction for which there was a nontax objective.”

265 See Chas. Ilfeld Co., SCI, 4 § 1261, 292 US 62, 68 (1934): “The allowance claimed would be denied its losses on the ground that a transaction did qualify under Code Sec. 351 because the structure was not designed solely to provide for Code Sec. 351 treatment but also to allow for incorporation in a different state; See also Rev. Rul. 60-331, 1960-2 CB 189.

266 At least one judicial decision has rejected the notion that qualification under Code Sec. 351 is dependent on a valid business purpose, but this case is relatively old and its continued authority somewhat questionable. See V&K Holding Corp., 38 BTA 830, Dec. 10,460 (1938) (non-acc.).
of treatment of taxpayers will not be attributed to taxpayers.”

280 Code Sec. 362(a)(2).


282 Id.

283 Id.

284 As the circumstances of the overall transaction in both Shell Petroleum and Coltec are sufficient to justify a different result in each case, the Shell Petroleum court did not have to rest its decision on how broadly or narrowly the relevant transaction is framed—which is often an arbitrary decision. The Shell Petroleum court expressly refused to follow Coltec by “dissecting or ‘slicing and dicing’” an integrated transaction into steps” solely because the Government aggressively chooses to challenge only an isolated component of the overall transaction.” Shell Petroleum, 2008 WL 2714252, at * 36 (S.D. Tex. 2008).


286 Id.


288 Id.

289 At least one other court has disregarded the involvement of a separate corporate entity in a transaction on ESD grounds. See H.J. Heinz Co., FedCl, 2007-1 USTC ¶50,517, 76 FedCl 570, 577–78 (2007). Heinz may support the notion that Congress meant to undermine Moline Properties in codifying ESD.

290 See Reg. §301.7701-1.

291 Id.


293 See also Rev. Rul. 79-194, 1979-1 CB 145. The step-transaction doctrine applies to combine the steps, and the intermediate period during which the transferor holds control is disregarded as “transitory and without real substance.” See Rev. Rul. 70-552, 1970-2 CB 141.

294 Rev. Rul. 79-70, 1979-1 CB 144; Code Sec. 351(a).

295 Parent recognizes any gain or loss under Code Sec. 1001.

296 Code Sec. 338(d)(3).

297 This arrangement is sometimes referred to as a “supercharged IPO.”

298 A full consideration of the anti-churning rules is beyond the scope of this article. In short, the conclusion in Example 24 obtains because the “new target” deemed created in connection with a Code Sec. 338(h)(10) election is not considered the person who held or used the assets during any period in which the assets were held or used by the corporation treated as the seller, and further, the new corporation is not related to the “old target” either before or after the entire series of relevant transactions. See Reg. §1.197-2(k), Example 24.

299 But see ACM Partnership, supra note 11 (rejecting the taxpayer’s argument that losses resulting from taxpayer’s use of the accounting method prescribed by the Treasury regulations must be bona fide on the grounds that the “argument confounds a tax accounting regulation which merely prescribes a method for reporting otherwise existing deductible losses that are realized over several years with a substantive deductibility provision authorizing the deduction of certain losses”).

300 Code Sec. 368(a)(1)(A) and (a)(2)(E); Code Sec. 368(a)(1)(B).


302 Rev. Rul. 84-71, 1984-1 CB 106.


304 Rev. Rul. 76-123, 1976-1 CB 94.

305 See Reg. §1.368-2(e).

306 R.J. Bazley, SC, 47-1 USTC ¶9288, 331 US 737 (1947) (pro rata distributions of readily marketable securities or cash in connection with a recapitalization are taxable as dividends).

307 Reg. §1.301-1(d) (largely adopting the Bazley result, in stating that a pro rata exchange of common stock for common stock and bonds is a dividend with respect to the bonds, even if the stock-for-stock portion of the exchange qualifies for nonrecognition treatment).


309 Code Sec. 304(b)(1).

310 Pursuant to the attribution rules of Code Sec. 318(a).


313 See Hariton, supra note 92.


315 See Phil Stroffene and Lynne Edelstein, An Analysis of Schering-Plough v. United States, TAX NOTES, Mar. 29, 2010, at 1599, Doc. 2010-4487 (arguing that, contrary to the court’s conclusion in Schering-Plough Corp., DC-NJ, 2009-2 USTC ¶50,614, 651 FSupp2d 219 (2009), a U.S. corporation’s repatriation of cash from its foreign subsidiaries will generally always have a business purpose, namely allowing the U.S. corporation to use the cash in its U.S. operations or to return cash to its investors); Cf. Schering-Plough, supra (Schering-Plough obtained approximately $700 million in cash that it used in its U.S. operations).


317 Id.

318 Under Code Sec. 318(4)(a), an option to repurchase shares (including an interest convertible into such shares) is treated as if those shares are already owned by the relevant taxpayer. Accordingly, the redemption did not effect a substantial reduction in HHC’s interest in Heinz, securing dividend treatment under Code Sec. 302.


323 See Rev. Rul. 79-70, 1979-1 CB 144 (where rearranged sale is integral part of incorporation, control requirement is not satisfied if the buyer acquires more than 20 percent of any class of stock and does not contribute any property to the new corporation).

324 Because the transaction was between related persons and members of the same consolidated group, the loss was deferred under Code Sec. 267(f), but only until the relevant corporation (in this case Newco) leaves the consolidated group. This, of course, was to occur in the spin-off. Accordingly, immediately before the spin off, Taxpayer would be able to recognize the loss realized on the exchange. See Code Sec. 267(f)(2)(B) and §1.267(f)-1(c); LTR 200611003 (Mar. 17, 2006).

325 Code Sec. 355(a)(1)(A).

326 LTR 200611003, supra note 312.

327 Id.

328 Id.