

## So, Your Client Is Thinking Of That Aggressive Transaction

Your client, with the assistance of other professionals, devised an “aggressive” transaction that allegedly will attain the desired tax treatment under the Internal Revenue Code. Will such results in fact hold up? Just a few years ago, the answer would have been “probably yes.” However, there is a different paradigm today. The Internal Revenue Service (IRS) has had an unparalleled and unbroken string of victories in the United States Tax Court and every court of appeals that has considered tax shelters and certain other transactions under the Economic Substance Doctrine. In the seminal 1997 decision in *ACM Partnership v Commissioner*, the Tax Court held that despite literal compliance with the Internal Revenue Code and regulations at every step of complicated transactions, the deal was devoid of economic substance.<sup>1</sup>

Thus, the desired tax treatment would not be sustained. Congress is very seriously considering enshrining an aggressive and penalty laden punitive version of the Economic Substance Doctrine into the Internal Revenue Code. The U.S. Treasury opposes the move as it prefers the present uncertainty for planners. In even relatively common transactional settings, IRS agents, group managers, and counsel attorneys are invoking the doctrine. The reach of the doctrine has been the subject of considerable debate, as well as the subject of presentations at the national tax institutes.

What is the Economic Substance Doctrine? Is it synonymous with business purpose? Are they merely related factors? Various courts of appeal have had different answers. The Third Circuit says that both economic substance and business purpose must be satisfied.<sup>2</sup>

Does the taxpayer’s non-tax profit motive control rather than the underlying non-tax economics of the underlying transactions? The Sixth Circuit in *Dow Chemical v United States* first

reviewed the district court’s factually intense, hundred-plus pages of findings focusing on underlying economics. It then reaffirmed this circuit’s holdings that objective economics will control rather than the proffered intent of the taxpayer, and the government prevailed.<sup>3</sup>

*Dow* involved the tax treatment of corporate owned life insurance, commonly known as COLI. For example, in COLI cases, courts examine positive cash flow, inside build-up, mortality gain on the life insurance and delve into considerable detail on the underlying assumptions.

Opinions of over one-hundred pages with detailed analyses of assumptions and economics are common. Counsel must understand that an expert’s opinion on the economics that cannot withstand rigorous cross-examination by a well-prepared and knowledgeable party is of little value. That is because a taxpayer that “bought an opinion” proceeds under the delusional assumption that that is all that is required. Well-advised taxpayers are appropriately and contemporaneously documenting significant non-tax reasons for a deal. Doing so during negotiations and consummation of the transaction is far more probative than if done years later in an IRS audit.

The courts have also disallowed claimed tax benefits from transactions under the Step Transaction Doctrine. For example, in *Long-Term Capital Holdings v United States*, the Second Circuit defined it as “a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no purpose than to avoid U.S. taxes.”<sup>4</sup> A long-term capital partner, a Nobel Prize winner, and a taxation textbook author who devised the transactions were simply shredded in cross-examination on the underlying non-tax economics.

Typically, there are two or more transactions that if viewed in isolation work from a tax perspective. Usually, there is a purported tax-free transfer from A to B, and then B in turn transfers the underlying asset. If each step is viewed separately, there is either no taxable gain or minimal gain, often accompanied by a claimed step up in basis. However, if the various steps are collapsed into one transaction, then the desired tax results do not follow. Application of the Step Transaction Doctrine must routinely be evaluated in corporate transactions.

Where does that leave practitioners? In any remotely “aggressive” transaction, counsel must make and appropriately document evaluations under the Economic Substance Doctrine as well as under the Step Transaction Doctrine. This may entail contemporaneous documentation of legitimate business purposes that, as stated, will have considerably more weight in an audit setting several years later than something done at the time of the examination. This is certainly not tax simplification and places an added burden on taxpayers and their advisors. However, this is the state of the transactional tax world today.

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### NOTES

1. TC Memo 1997-115, 157 F3d 231 (3rd Cir 1998), *cert denied*, (Mar 22, 1999).
2. *Rice’s Toyota World v Comm’r*, 752 F2d 89 (4th Cir 1985).
3. 435 F3d 594 (6th Cir 2006).
4. 2005 US App LEXIS 20988, 2005-2 US Tax Cas (CCH) P 50575.



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