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Sham Wow: Economic Substance and a New Sunrise

By Robert W. Wood • Wood & Porter • San Francisco

In a new political administration and a new (but not so happy) economic climate, there is much talk these days of new beginnings. There is also an enormous uptick in the nature and scope of tax legislation. We are probably only seeing the tip of the iceberg. One of the perennial old saws is the codification of economic substance.

Sure, there is gloomy commentary from practitioners about the disadvantages of attempting to codify the age-old economic substance doctrine. Nevertheless, Congress continues to want to tinker with it. The debate is far from over.

No Substance

Recently, the Tax Court in *New Phoenix Sunrise Corp. and Subsidiaries*, 132 TC No. 9, Dec. 57,785 (2009), tested a transaction for economic substance, concluding that it did not measure up. Codified or not, transactions that have clever acronyms—and that seem entirely tax-motivated—will not cut the proverbial mustard. The transaction at issue in *New Phoenix Sunrise* was a Basis Leveraged Investment Swap Spread (which bore the dubious acronym "BLISS"). And it bore the Hester Prynne–like stamp of Jenkins & Gilchrest.

New Phoenix was the parent of a consolidated group. Capital Polybag Inc. was a wholly owned subsidiary of New Phoenix. In 2001, Capital sold substantially all of its assets, realizing a $10.3 million gain. During the same tax year, however, Capital entered into certain options transactions that can be summarized as follows:

1. Capital purchased from and sold to Deutsche Bank long and short options in foreign currency, paying only the net premium to Deutsche Bank.
2. Capital and one of the owners of New Phoenix (Mr. Ray) formed Olentangy Partners, with Capital contributing the long and short options to this partnership.

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3. Capital increased its basis in Olentangy Partners by one side of the transaction (that is, by the amount of the premium on the purchased long option), but did not reduce its basis by the amount of the premium on the sold short option.
4. Olentangy Partners purchased for cash $149,958 worth of Cisco stock.

Both the long and the short options expired as worthless. A few days later, Olentangy Partners dissolved, distributing its shares of stock in Cisco to Capital in redemption of its partnership interest. Capital sold the Cisco stock for $148,467, generating a loss of $1,491.

Odiferous Deal

On its consolidated return, New Phoenix claimed a loss of approximately $10 million, which it claimed was realized on the Capital stock sale. New Phoenix calculated this loss by claiming a basis of approximately $10 million in the Cisco stock distributed by Olentangy Partners. Not surprisingly, the claimed $10 million loss was used to offset the $10.3 million gain New Phoenix had on the sale of the Capital assets.

Olentangy Partners filed a partnership return showing the loss on the expiration of the long and short options, and allocated the loss to Capital and Ray. The IRS issued a notice of deficiency to Capital, disallowing the claimed flow-through loss from Olentangy Partners. The IRS even disallowed claimed deductions for legal fees. The taxpayer had paid Jenkins & Gilchrest $500,000 to set this all up.

The IRS notice took the position that the transaction entered into by New Phoenix lacked economic substance and should be disregarded for federal tax purposes. The notice of deficiency also sought Code Sec. 6662 penalties. New Phoenix filed a Tax Court petition, and proceeded on its consolidated return, which included Capital.

Actions vs. Words

New Phoenix essentially argued that this was a legitimate deal, with a proper step-up in the basis of the Cisco stock. The Tax Court thought differently. The Tax Court noted that Capital had purchased and sold the long option to Deutsche Bank for a premium. Nevertheless, it paid only the difference between the long and short options.

The Tax Court disallowed the overstated loss claimed as a result of the sale of the Cisco stock and the flow-through loss from Olentangy Partners. The Tax Court found that this was simply not an economic loss. The Tax Court also disallowed legal fees, not allowing them to be deducted by New Phoenix.

Turning to penalties, the Tax Court found New Phoenix was liable for Code Sec. 6662 accuracy-related penalties. That meant a hefty 40 percent on the portion of the underpayment stemming from New Phoenix's overvaluation of Cisco stock, and a 20-percent accuracy-related penalty on the remainder of the underpayment stemming from the disallowed flow-through loss from Olentangy Partners and the disallowed legal fee deduction.

Surprise, Surprise

There are plenty of surprises left in the tax law, but the result in this case is not one of them. Option mechanics can be Byzantine, and one

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must acknowledge (as the Tax Court seemed to) that it was theoretically possible to hit a "sweet spot" where this deal could have made money. The taxpayer put on the expert testimony of a math whiz and an options trading guru. There's no doubt that their combined testimony gave some sea legs to an otherwise wobbly deal.

But was this Dramamine enough? It wasn't for the Tax Court. The case is worth reading for its how-much-is-enough analysis.

There is a good deal of confusion between the sham transaction and economic substance doctrines. Both are discussed in *New Phoenix*. The sham transaction doctrine stands for the proposition that even if something complies formally with the tax law, it will not be respected if it is an economic sham. The transaction must be *bona fide* before its tax implications can be vetted. As explained by the court in *New Phoenix*, to determine if a transaction is a sham, one must first ask if it has economic effect (as opposed to economic substance). Yet economic effect and economic substance are closely allied.

The primary argument voiced by the taxpayer in *New Phoenix* was, with the aid of expert testimony, that one really could make a profit in this transaction, even if *this* taxpayer failed to. Complex transactions and complex economics make for complex explanations, and the opinion does not disappoint. But the Tax Court could not seem to get over the hurdle about how just reasonable it was to think there might be a profit here.

If the stars had to align in an almost unheralded formation to produce a profit, does that shard of a possibility mean that this taxpayer really could have made a profit? Ultimately, the court could find neither economic substance nor business purpose here. Despite the testimony of the experts and the arguments voiced by the taxpayer, the Tax Court viewed this as a tax shelter, pure and simple.

Even the $500,000 fee paid to Jenkins & Gilchrest was done on a "for legal services rendered" invoice. There was no detail of exactly what Jenkins & Gilchrest did, the way most legal bills are detailed.

Take the Fifth

More important than *New Phoenix* is the recent decision in *Klamath Strategic Investment Fund*, CA-5, 2009-1 USTC ¶50,395 (2009). The Fifth Circuit in that case adopted the majority view of other circuits concerning economic substance. Essentially, the Fifth Circuit adopted a three-part conjunctive test in determining if a transaction has economic substance, rather than the two-prong test used by other courts.

The three factors apply in the conjunctive, meaning that the absence of any one of them will render a transaction void for tax purposes. According to the Fifth Circuit, a transaction will have economic substance if it is:

1. compelled by business or regulatory realities;
2. imbued with tax-independent considerations; and
3. not totally shaped by tax-avoidance features.

The interrelationship between these important triple litmus tests deserves underscoring. The court made clear that if a transaction lacks economic substance compelled by business or regulatory realities, for example, the transaction must be disregarded. That is so even if the taxpayer professes a genuine business purpose without tax-avoidance motivations. *Klamath* thus sets a high bar for economic substance qualification.

BLIP on the Radar Screen

Klamath Strategic Investment Fund involved a shelter known as BLIPS, the Bond Linked Issue Premium Structure that is a son of BOSS transaction. In essence, two lawyers placed funds with investment advisory firm Presidio Advisory Services in a structure that used foreign currency forward contract trades. After the initial contributions to the partnerships along with additional loan proceeds, the taxpayers liquidated their holdings, claiming losses on their 2000, 2001 and 2002 tax returns. These losses arose from inflated tax basis calculations that were not offset by considering loan premiums as liabilities under Code Sec. 752.

The taxpayers did not contemplate having the transaction last longer than a 60-day period, notwithstanding the presence of a purported seven-year term. Moreover, the court found the economics behind the arranged loans meant that monies could not actually go toward the investment strategy. The District Court (with which the Fifth Circuit agreed) had held that the loan transactions lacked economic substance.

Turning to profit motive, the *Klamath* court found that there was no reasonable possibility of profit. The Fifth Circuit echoed the District Court to the effect that it was not enough to show that there was some *conceivable* profit motive.

What was important was whether there was a *reasonable* possibility of profit. Taxpayers, said the Fifth Circuit, should not be rewarded for having a "head in the sand" attitude. The Fifth Circuit in *Klamath* concluded that there was no underlying economic substance to the transaction.

That meant the partnerships could not deduct claimed interest expenses. Interestingly, the Fifth Circuit reversed the District Court on this point. Indeed, the District Court in *Klamath* had held that the loan premiums were not liabilities, and that operational expenses were deductible. Even with this, the District Court had held the transactions lacked economic substance, so should be disregarded for tax purposes. The District Court also found that the asserted penalties did not apply.

Economic Imperative

The Fifth Circuit was considerably more harsh, concluding that without economic substance, the partnerships could not deduct claimed interest expenses. Making clear what a lack of economic substance does to a transaction, the Fifth Circuit said that the effect of disregarding a transaction for lack of economic substance was simple: for taxation purposes, the transaction is viewed as never having occurred at all. The Fifth Circuit cited favorably the Tax Court decision in *Winn-Dixie Stores*, 113 TC 254, Dec. 53,589 (1999).

After all of this, though, the Fifth Circuit sided with the District Court on the question of penalties. The court ruled that the taxpayers had satisfied the Code Sec. 6664(c)(1) reasonable cause and good faith standard, but the court did not address the individual penalties. The District Court below had ruled that the 40-percent gross valuation misstatement did not apply when the IRS disregards a transaction as lacking economic substance. That leaves the gross valuation misstatement penalty question somewhat up in the air, with different views in different circuits.

Last Legislative Word

All of this brings us back to economic substance and the need (or lack thereof) for legislation. The Obama administration's fiscal 2010 budget proposal includes a proposed codification of the economic substance doctrine. Surely there are more important things to address, but this canard continues to be discussed.

We may not see a statutory economic substance requirement during this administration or maybe even during the next. But one could certainly argue that there is a *realistic possibility* that the economic substance doctrine will be codified!