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Issues, cases, practice management tips and news for Forensic and Valuation Services Section members

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A Proactive Approach to Fraud Prevention and Detection

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Books of accounts and records have existed in some form for thousands of years, going back to ancient Egypt and other civilizations in the Middle and Near East, the Zhao Dynasty in the Far East, as well as the Greek and Roman republics in the West. Such record keeping usually was maintained to comply with government taxation requirements. Access

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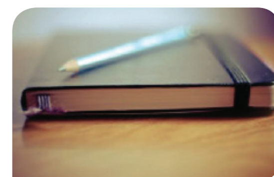

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Chair's Corner

Here in the FVS Section, we rely on high-quality professionals with the specialized skills to help accomplish everything we do. To learn more about the FVS committees and what their responsibilities are, head to the FVS Community page. If you are interested in participating, be sure to apply at volunteers.aicpa.org/ by **May 10, 2016**. Whether you're a relatively new partner or have substantial experience in the field, consider volunteering for one of the 2016–2017 FVS committees. I can tell you from personal experience that it offers excellent learning experiences and the chance to network with highly skilled professionals and develop long-lasting friendships.

It is also the time of year to encourage and retain promising professionals by recognizing their value and nominating them for the second class of the Standing Ovation Recognition Program, which spotlights young CPAs in forensic accounting and business valuation who exhibit exemplary professional achievement. Recipients will be featured in a press release on the FVS Section website, in the FVS Conference brochure, and during the town hall at our annual conference. Partners and managers are encouraged to submit nominations on behalf of your top talent.

And if you're new to valuation or forensics, you should be aware of two great programs that match you with seasoned professionals who can mentor you and help you develop your skills. If you want to advance your knowledge and your career, take the time to learn more about the ABV Mentor Program or the CFF Mentor Program.

Carol Carden, CPA/ABV, CFE, ASA

Contact Us

We welcome your comments, questions or article ideas. Please send them to fvsconsultingdigest@aicpa.org.

The CPA Valuation Analyst and the Economic Substance Doctrine

By Robert F. Reilly, CPA

INTRODUCTION

In the last few years, the IRS has stepped up its challenges of what it believes to be suspect taxpayer transactions based on the so-called "economic substance doctrine." The IRS particularly challenges transactions in which the cost of the transaction (for example, a taxpayer investment in an asset or a security) is less than the amount of the claimed tax deduction or loss generated by the transaction. The IRS often claims that such transactions lack "economic substance."

CPA valuation analysts (analysts) are often called on to perform economic substance analyses to assist corporate and individual (business owner) taxpayers in federal income tax challenges. These analyses often involve cases in which the IRS challenges a tax deduction or loss related to a taxpayer transaction by applying the economic substance doctrine. Codified in IRC Section 7701 (and in the related IRC Section 6662 tax penalty previsions) and often accepted by the courts, this doctrine allows the IRS to disallow a suspect transaction if the taxpayer (or the taxpayer's analyst) cannot prove that (1) the taxpayer expected to earn a profit (absent any income tax considerations) on the transaction,

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and (2) the taxpayer had a reasonable business purpose to enter the transaction (other than the reduction of income tax expense).

Recently, the IRS issued additional administrative and procedural guidance regarding the application of the economic substance doctrine. This discussion summarizes the guidance provided in IRS Notice 2014-58.

One basic principle of the federal tax law is that a taxpayer is permitted to structure its business transactions in a manner that produces the least amount of income tax. However, in order for the tax consequences of a business transaction to be recognized for federal income tax purposes, the transaction must have economic substance.

Under the IRS's economic substance doctrine, a taxpayer transaction is considered to have economic substance only if it has (1) a reasonable possibility of the taxpayer earning a profit and (2) an independent business purpose other than the taxpayer saving the payment of income taxes. The IRS continues to examine — and disallow — both corporate and individual taxpayer transactions that it considers to lack economic substance or to be a sham.

In particular, the IRS focuses on taxpayer debt or equity investments when the investment yields a capital loss (or other income tax benefit) in excess of the amount of the taxpayer's initial investment. Sometimes, the analyst is asked to perform an ex ante economic substance analysis of a pending taxpayer transaction as a prophylactic measure. Often, the taxpayer (and the taxpayer's legal counsel) waits until the IRS challenges the taxpayer transaction. In such instances, the analyst is asked to assess the completed taxpayer transaction ex post facto. Whether the analysis is ex ante or ex post, the analyst assesses the transaction as of the date the taxpayer entered into it and considers only information that was known or knowable as of that transaction date.

In both ex ante and ex post economic substance analyses, the analyst will perform some type of valuation analysis of the taxpayer transaction. Often, the analyst first calculates the expected net present value (or internal rate of return) of the taxpayer transaction based on after-tax net cash flow (or some similar income measure). Second, the analyst also calculates the expected net present value (or internal rate of return) of the taxpayer transaction based on pretax net cash flow) or some similar income measure. This second analysis is intended to prove that the taxpayer transaction has economic substance absent any income tax benefit considerations.

The IRS has prevailed in many of its judicial challenges regarding the economic substance of taxpayer transactions. In these challenges, the IRS often claims that the taxpayer entered into the suspect transaction solely for the purpose of generating tax deductions or capital losses. In other words, the IRS claims that the only expected economic benefit from the suspect transaction is the reduction of taxable income—and income taxes. When they are litigated, these economic substance cases often become a battle of valuation or other forensic experts.

Since 2010, the IRS has been able to advance its challenge of suspect taxpayer transactions when Congress codified the so-called "economic substance doctrine" in the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) (hereinafter, the 2010 act). Late in 2014, the IRS issued a notice to provide taxpayers and their tax advisers with updated guidance with regard to its interpretation of the economic substance doctrine.

Notice 2014-58 expands on the previous administrative and procedural guidance available from Notice 2010-62. The 2014 notice provides guidance on the definition of the term transaction in the application of the IRC Section 7701(o) economic substance doctrine. Notice 2014-58 also provides updated guidance on the meaning of the term *similar rule of law* under the IRC Section 6662(b)(6) accuracy-related penalty. The 2014 notice is effective retroactively for taxpayer transactions entered into after March 30, 2010.

Analysts who perform economic substance transactional analyses for federal income tax planning or dispute purposes should be familiar with this updated administrative and procedural guidance. In addition, corporate and individual (business owner) taxpayers — and their legal counsel — that are involved in economic substance disputes with the IRS should also be familiar with this updated guidance.

THE ECONOMIC SUBSTANCE DOCTRINE

As mentioned previously, Congress codified the economic substance doctrine as part of the 2010 act. The 2010 act added Section 7701(o) to the IRC. IRC Section 7701(o) states that a taxpayer transaction has economic substance if it meets a two-part test:

1. The transaction must change, in a meaningful way, apart from any federal income tax effects, a taxpayer's economic position.
2. The taxpayer must have a substantial business purpose, apart from any federal income tax effects, for entering into the subject transaction.

The term *economic substance* is defined in IRC Section 7701(o)(5)(A) as "the common law doctrine that disallows income tax benefits under IRC subtitle A if the transaction that produces those income tax benefits lacks either

- economic substance or
- a business purpose."

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DEFINITION OF THE TERM TRANSACTION

Notice 2014-58 applies an aggregation definition to the term transaction. According to the 2014 notice, a transaction "generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of those steps that are carried out as part of a plan."

Therefore, when a transaction that generates an income tax benefit involves a series of interconnected steps with a common objective, then that transaction is considered to include all of those steps in the aggregate. Under this 2014 notice interpretation, each interconnected step should be considered when analyzing whether the suspect taxpayer transaction as a whole lacks economic substance.

However, when a transaction includes a series of steps, including a tax-motivated step that is not necessary to achieve a nontax objective, Notice 2014-58 indicates that the IRS may apply a disaggregation approach.

This disaggregation approach determines whether any of the individual tax-motivated steps is considered a separate transaction that is subject to the economic substance doctrine. Accordingly, under the 2014 notice provisions, the IRS is free to either aggregate or disaggregate the interconnected steps of an overall taxpayer transaction. The IRS may also aggregate or disaggregate a transaction's interconnected steps when it assesses the application of the economic substance doctrine on a case-by-case basis.

This definition of the term transaction in Notice 2014-58 is consistent with the legislative history of the term in IRC Section 2701(o)(5)(D). That legislative history is provided in the House report on the 2010 act. The 2014 notice specifically refers to that House report, which explains that the legislative provision "does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction" when applying the economic substance doctrine.[1]

DEFINITION OF THE TERM *SIMILAR RULE OF LAW*

IRC Section 6662(b)(6) and 6662(i) together impose a per se 40 percent penalty for taxpayer transactions that fail the economic substance doctrine or a "similar rule of law." Notice 2014-58 provides an explanation that a *similar rule of law* is a rule or doctrine that applies the same factors or analysis as provided under IRC Section 7701(o). The 2014 notice explanation indicates that the similar rule of law provision applies even if the doctrine is called something different.

Notice 2014-58 provides an example of what it calls the "sham transaction doctrine." Specifically, the 2014 notice defines *similar rule of law* to mean a rule or doctrine that disallows the income tax benefits under IRC subtitle A related to a taxpayer transaction because

- the transaction does not change a taxpayer's economic position in a meaningful way (apart from federal income tax effects), or
- the taxpayer did not have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

Notice 2014-58 also explains that the IRS will not apply an IRC Section 6662(b)(6) tax penalty unless the IRS also applies IRC Section 7701(o) to support its underlying income adjustments.

Even with this updated administrative guidance, it remains to be seen exactly how or when the IRS will assert the codified economic substance doctrine. The Large Business and International (LB&I) guidance in LB&I-4-0711-015 provides a specific set of factors for IRS examiners and their managers in the LB&I division to consider and procedures for the LB&I division to follow when seeking approval through IRS management to apply the IRC Section 6662(o)(6) penalty.

SUMMARY OF RECENT JUDICIAL DECISIONS

As mentioned previously, the IRS historically has experienced a fair amount of success when it applies the economic substance doctrine to suspect taxpayer transactions in the courts. The last year or two continued this trend of judicial success related to the IRS's economic substance challenges of taxpayer transactions. The following discussion summarizes several recent judicial decisions (all pre-2014 notice) in which the IRS challenged a suspect taxpayer transaction under the economic substance doctrine. The following judicial discussions illustrate the type of suspect transaction that the IRS will pursue.

Kenna Trading, LLC

In 2014, in *Kenna Trading, LLC*,[2] certain Brazilian retailers contributed distressed consumer account receivables to a limited liability company (LLC). The LLC claimed a carryover tax basis in the accounts receivables under IRC Section 723. Later, the LLC contributed some of the account receivables to trading companies and then contributed the LLC's interest in each trading company to a holding company.

The LLC claimed a cost-of-goods-sold deduction for each holding company

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1. See House Report No. 111-443, 111th Cong., 2d Session 296.
2. *Kenna Trading, LLC*, 143 T.C. 18 (2014).
3. *Humboldt Shelby Holding Corp.*, T.C. Memo. 2014-47.

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equal to the tax basis of the contributed account receivables. The LLC then sold an interest in each holding company to an investor. The trading companies claimed bad debt deductions for the account receivables.

The next year, the LLC contributed more of the Brazilian account receivables to main trusts. Each main trust then assigned the account receivables to a newly created subtrust. Other investors contributed cash to the main trust in exchange for a beneficial interest in the subtrust. The subtrusts then claimed bad debt deductions for the account receivables.

Claiming that the subtrusts were grantor trusts for federal income tax purposes, the investors claimed deductions on their income tax returns. The IRS disallowed these bad debt deductions under the economic substance doctrine.

In addition, the IRS levied (1) the IRC Section 6662(h) gross valuation misstatement penalties, (2) the IRC Section 6662(a) accuracy-related penalties on the amounts receivable of the LLC's underpayments of tax, and (3) an IRC Section 6662A listed transaction understatement penalty.

In *Kenna Trading, LLC*, the Tax Court received expert testimony from both sides in the case. In its decision in *Kenna Trading, LLC*, the Tax Court held that the Brazilian retailers did not intend to enter into a partnership for federal income tax purposes. In addition, the Tax Court concluded that the LLC had a cost basis in the account receivables and not a carryover tax basis.

Also, the Tax Court found that the entire transaction lacked economic substance. Lastly, because the IRS provided that the LLC had understated its income, the Tax Court concluded that the LLC was subject to all three IRC Section 6662 tax penalties.

Humboldt Shelby Holding Corp.

Humboldt Shelby Holding Corp.[3] provides another recent example of an economic substance judicial victory for the IRS. In *Humboldt Shelby Holding Corp.*, the taxpayer, a holding company, bought two corporations that had recently realized large capital gains.

To avoid paying taxes on the capital gains, the taxpayer executed a common tax-avoidance procedure to generate capital losses. Under that procedure, the taxpayer contributed offsetting short-term options to two LLCs that it had formed. The taxpayer increased its tax basis in the recently formed LLCs by the cost of the purchased options. However, the taxpayer did not reduce its tax basis by the cost of the sold options. This accounting treatment allowed Humboldt Shelby Holding Corp. to increase its tax basis in the partnerships by approximately $75 million — while only spending $320,000.

After the options had expired, the taxpayer resigned from the LLCs and received corporate stock with a very low fair market value — and a very high tax basis. The taxpayer then sold the corporate stock and recognized capital losses of almost $75 million. These capital losses completely offset the capital gains that the Humboldt Shelby Holding Corp. had inherited from the two corporations.

Under the economic substance doctrine, the IRS issued a deficiency notice disallowing the taxpayer's claimed deductions from the stock sales. In addition, the IRS assessed the accuracy-related tax penalty under IRC Section 6662.

Again, the Tax Court received expert testimony from both sides in the case. In *Humboldt Shelby Holding Corp.*, the Tax Court concluded that the taxpayer improperly deducted capital losses on stock with a tax basis that was artificially inflated in a transaction that lacked economic substance. In addition, the Tax Court concluded that Humboldt Shelby Holding Corp. was liable for the IRC Section 6662 accuracy-related tax penalty.

SUMMARY AND CONCLUSION

The IRS continues to challenge suspect taxpayer transactions based on the so-called "economic substance doctrine" both at the examination level and in the courts. Also, at least at the judicial level, the IRS continues to be successful in many of these transaction challenges. The IRS seems to be successful when the taxpayer's analyst cannot convince the court regarding the two questions to the economic substance test.

Notice 2014-58 provides IRS-friendly administrative and procedural guidance with respect to the application of the economic substance doctrine. However, at least this 2014 notice provides expanded guidance that taxpayers (and their legal counsel) should consider in their tax planning related to proposed transactions. CPA valuation analysts who provide these so-called "economic substance analyses" (either for tax-planning or tax-controversy purposes) should be familiar with this most recent guidance provided by the IRS.