

New Contours to the Internal Revenue Service's Application of the Economic Substance Doctrine

Tax Alert
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On April 10, 2015, the Internal Revenue Service (the Service) issued Chief Counsel Advice (CAA) 201515020, which applied the economic substance doctrine to disregard the taxpayers' participation in a marketed transaction comprised of a loan and a right to receive offsetting payments from the lender on a prepaid forward contract (the "Transaction"). The Transaction was designed to allow the taxpayer to deduct the interest payments on the loan as they were made, while deferring recognition and treating as long-term capital gain income from the forward contract. A prior CCA¹ applied the at-risk rules to limit the taxpayers' losses; the substance-over-form doctrine to disregard the loan and the portion of the forward contract that offset the loan; and the conversion rules of section 1258 to treat any gain from the Transaction as ordinary up to the imputed income amount. The Service's application of the economic substance doctrine to the Transaction in the recently released CCA is the "icing on the cake."

The Service applied six of the 17 factors set forth in Large Business and International (LB&I) Directive "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties," dated July 15, 2011.² Since the Transaction was marketed by a promoter, the Service asserted that the Transaction lacked economic substance because it was promoted, developed and administered by outside advisers and was highly structured. In addition, the Service asserted that the taxpayers held "offsetting positions" that reduced the risk of loss, deductions generated by the Transaction were not matched by an equivalent economic loss or expense and there was no meaningful potential for profit other than tax benefits.

Notably, the Service also argued that the Transaction lacked economic substance because it included unnecessary steps and the taxpayers' interest in the Transaction was not purchased at an arm's length price. These two factors may indicate that the Service will assert the economic substance doctrine when values in a complex transaction can be questioned.

Analysis

In determining whether the Transaction included unnecessary steps, the Service looked to the purported purpose of the Transaction. The taxpayers had opinions of counsel which asserted that the Transaction protected them from certain interest rate increases. Although the Service acknowledged that there was potential for additional payments to be made on the contracts if interest rates rose,³ it argued that the Transaction provided this protection in a "circuitous and costly" manner. Because the Service determined that the taxpayers could have accomplished this protection in a less costly manner by purchasing a derivative contract, the Service concluded that the Transaction lacked economic substance.

The Transaction was originally structured to provide interest rate protection for 21 years to a real estate developer specializing in the construction of luxury beachfront condominiums. The developer, however, ceased doing business during year 4 and sold its rights in the Transaction to the promoter and its affiliates. The taxpayers did not structure the Transaction, but rather bought an interest in the Transaction. The taxpayers, therefore, could not have structured this Transaction to be less circular. Nonetheless, the Service cited this factor as evidence of a lack of economic substance because instead of purchasing an interest in the Transaction to mitigate interest rate exposure, the taxpayers could have purchased a simpler derivative contract.

In addition, the Service argued that the Transaction lacked economic substance because the taxpayers paid too much for their interest in the Transaction. The Service did not obtain an appraisal for this determination but rather concluded that the price paid between two unrelated parties was not arm's length because the taxpayers paid 10 times more for their ratable share of the

Transaction than the amount paid by the promoter and three promoter-controlled limited liability companies for the entire Transaction. This conclusion was reached without an independent valuation and was premised on the view that because the taxpayers paid more than the arm's length value of the interest rate protection, they were therefore paying for tax benefits. It would appear, however, that the expected tax treatment of any transaction would be factored into this purchase price.

Conclusion

This most recent CCA indicates that the Service will assert the economic substance doctrine if it deems a taxpayer to be a bad negotiator in structuring a transaction either by including too many steps or paying too much for the property acquired. Thus, the limits of the economic substance doctrine remain fuzzy at best.

1. CCA 201501012 (Jan. 2, 2015)

2. LB&I-4-0711-015

3. Higher interest rates would result in a greater payout to the taxpayers on the forward contract, although from the lender's perspective this payment would be exactly offset by payments from a third party on a "swaption" contract, such that the lender was never out of pocket more or less than the amount it received in loan payments from the taxpayers.

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