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M&A Business Purpose Cannot Be A Sham

Abstracted from: *Business Purpose And Economic Substance: Catch Me If You Can*
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Section 269 gives the IRS a grand slam. In a 2002 Field Service Advice, the IRS tells agents that they can use IRC Section 269 to deny deductions to a consolidated group for costs associated with forming new subsidiaries. The FSA says agents can take such action based on a lack of economic substance in the transactions. This code section gives the IRS the authority to deny, deny, deny, if there is a preponderance of evidence that a deal's primary purpose is tax evasion. Invoking Section 269 seems an extreme measure for the Service. It has had minimal success applying this provision in the past; nevertheless, the FSA serves as a warning to taxpayers that any reorganization must have a solid business purpose and, whatever the form, the deal must have substance as well.

Business purpose a court-imposed doctrine. According to IRS regulations, a reorganization–to be tax-free–must be a strategy to improve business and not a device to avoid taxes. The courts have occasionally accepted the enhancement of shareholder value as the purpose (instead of business improvement), but doing so is the exception. The business-purpose requirement came from the 1935 *Gregory* case and is still a major theme in corporate reorganizations today, even though the tenet has never formally made it into the Internal Revenue Code. IRS regulations make clear that a company may not use a fictitious business purpose to hide its real objective of saving taxes. Despite the presence of a valid business purpose, courts often apply the *net-effect test* (which is a simulated "smell test") to establish that the deal was not equivalent to a dividend.

Economic substance a key for Second Circuit. Closely allied to the business purpose test is the *substance-over-form doctrine*. M&A professionals are waiting for the outcome of an appeal of a Tax Court decision on a 1993 deal between Loral Aerospace and Quintron Corp. In the transaction, Quintron deducted $21 million in business expenses as part of a stock transfer, asset sale, and bank loan agreement, using a reorganization through a subsidiary company. Quintron argued that the payment was in exchange for a lease obligation and therefore deductible. The IRS argued that the deal had no substance and that its only *raison d'être* was the deduction; the court agreed. Although the case is not significant in terms of M&A precedents, the critical question remains how the Second Circuit will interpret the Service's economic substance argument and the taxpayer's defense.

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