The dangers of the new functional risk analysis

This new analysis can lead to the application of entirely subjective standards and create additional uncertainty for taxpayers, write Andrew W Steigleder, David F Abbott, and Brian W Kittle
Within the ever-evolving standards and judicial doctrines applied by the courts to assess the validity of tax-advantaged transactions, there has been an increasing trend to supplement, or even abandon, a traditional risk analysis in favour of an analysis that examines not only whether a risk exists, but also the probability that such risk will manifest itself. This new analysis can lead to the application of entirely subjective standards, thus creating additional uncertainty for taxpayers in structuring and defending tax-advantaged transactions.

Though death and taxes may be certainties of life, the amount of tax each taxpayer owes has been gaining uncertainty for many decades. This is due in large part to taxpayers having to comply both with technical statutory provisions in the Internal Revenue Code and interpretations of these in Treasury Regulations as well as the many judicial doctrines - substance over form, step transaction, sham transaction, and economic substance - that the Internal Revenue Service can use to scrutinize or recast a transaction.

These judicial doctrines can be traced back to the early 1900s. However, not until after the Supreme Court’s landmark decision in Frank Lyon Co. v. United States did the IRS begin to progressively challenge transactions with these judicial doctrines because it believed the transaction at issue failed to comply with the spirit of the technical rules.

In Frank Lyon, the Supreme Court held that “[w]here as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honour the allocation of rights and duties effectuated by the parties.” Frank Lyon Co. v. United States, 435 US 561, 583-84 (1978) (emphasis added). Since Frank Lyon, courts have scrutinized tax-advantaged transactions with differing frequency to determine whether a transaction creates substantive rights, obligations, and economic benefits that are not solely driven by or resulting from the tax consequences.
Legal Risk Analysis

Regardless of which judicial doctrine the IRS uses to scrutinize a transaction, the inquiry into whether a tax-advantaged transaction will be respected for Federal income tax purposes necessarily commenced with an examination of the transaction documents or other legal blueprint for the arrangement. The allocation of rights, obligations, and risks by the documents— as opposed to the labels attached to the documents - were used to determine a transaction’s true substance. We call this approach the ‘Legal Risk Analysis’ because the governing legal documents were responsible for defining and allocating the parties’ risks.

The Legal Risk Analysis was limited to examining the allocation of risks without regard to the probability that they will be invoked. A determination that a party possesses legally enforceable rights, assumes obligations, and faces risk would support a finding that a transaction has substance. The Legal Risk Analysis lent itself to examining what

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happens in a ‘worst-case’ scenario, eg, how do the documents work in the event of disaster, or default by one party to a transaction, and who is entitled to what? The presence of risk was central to this analysis and very little consideration was ever given to how likely the worst-case scenario is to occur.

The new Functional Risk Analysis
Recently the IRS and the courts have been evaluating risk based on the ‘real world’ probability of an event occurring. Not only must the transaction documents allocate a risk, but the likelihood of the event occurring must not be too remote in order for a transaction to withstand judicial scrutiny. We refer to this as the ‘Functional Risk Analysis,’ which disregards what could happen in a worst case scenario if that event is unlikely from a subjective point of view to occur. In this analysis, the substance of a transaction is assessed based on the ‘best case,’ ‘most likely,’ or ‘expected’ outcome. Risks that are less likely to occur, even though any such event may result in catastrophic consequences, are disregarded.

The Functional Risk Analysis opens the floodgates to questions over exactly what probability standards are to be applied in analyzing a transaction, which can vary from remote, to possible, to reasonable expectation, to most likely, to probable, to certain. By departing from the worst-case scenario inquiry posed by the Legal Risk Analysis, the choice of the correct probability standard becomes very unclear and extremely subjective.

Legal Risk Analysis vs. Functional Risk Analysis
Over the last several years, the new Functional Risk Analysis has been gaining significant momentum in the IRS’s litigating positions. The IRS has used this analysis to disregard the tax consequences of transactions that it perceives are abusive, such as Son of Boss transactions. For example, in Stobie Creek Invs, LLC v. United States, the court adopted the IRS’s position that the transactions at issue was done solely for tax reasons because the probability that the taxpayer would earn a profit was low, even though the amount of profit would have been very large. Stobie Creek
Invs, LLC v. United States, 608 F.3d 1366, 1378 (Fed. Cir. 2010) (evaluating substance of transaction based in part on the ‘structure of the investment,’ which eliminated any ‘reasonable possibility’ of nontax profit).

This success has resulted in the IRS wielding the Functional Risk Analysis to attack everyday business decisions such as a company’s capital structure and intercompany transactions. The rest of this discussion focuses on a how a court recently applied the Functional Risk Analysis and then concludes with an example of this impact on transfer pricing and considerations for taxpayers going forward.

Pritired 1 LLC v. United States
On September 30, 2011, the United States District Court for the Southern District of Iowa ruled in favor of the government in Pritired 1, LLC, Principal Life Ins. Co., Tax Matters Partner v. United States, 2011 US Dist. LEXIS 116366, (SD Iowa 2011), a so-called foreign tax credit generator case (‘Pritired’). The transaction details are complex, but the simplified structure involved the use of a tax partnership (‘SAS’) to co-invest with a foreign investor, with the US investor receiving the benefit of crediting the foreign taxes paid on the combined investments.

The partnership contribution was structured as an equity investment, with the taxpayer receiving hybrid securities called perpetual certificates (‘PCs’) along with ‘B Shares.’ In its decision, the court held for the IRS on three separate and independent grounds: (1) the court recast the partnership equity investment as a loan; (2) the court found that the transaction lacked economic substance and a business purpose beyond the foreign tax credits; and (3) the court found that the transaction violated the partnership ‘anti-abuse’ regulation.

Pritired has extremely unfavourable facts and circumstances specific to that case and was strategically selected by the IRS for this exact reason. As the saying goes, bad facts make bad law and, in examining the facts at issue, the court in Pritired utilized a Functional Risk Analysis that applied several different risk standards when analyzing the
In its debt-versus-equity analysis, the court first articulated ‘black letter’ law using Legal Risk Analysis: “A debtor may not miss a required interest payment without suffering consequences, such as default. If a debtor fails to make a required payment on a debt, the holder of that debt has legal recourse against the debtor. A receiver of equity capital, on the other hand, may decide not to pay dividends without suffering any similar contractual limitations. Equity holders generally cannot legally force the liquidation of an issuing entity based on a failure to pay.” Id. at *80-*81 (emphasis added).

But then the court disregarded the Legal Risk Analysis in the next breath by looking at surrounding circumstances to determine that, based on the analysis of the IRS’s expert, the PCs had “ongoing payment attributes more similar to debt.” Specifically, the court found that the “SAS had no contractual requirement to make ongoing payments on the PCs... the transaction was designed in a manner to ensure that payments would be made, based on [the IRS's expert’s] analysis.” Id. at *81 (emphasis added).

Similarly, with regard to whether the returns were more debt or equity-like, the court first stated the traditional Legal Risk Analysis by examining the trade off between risk and return for equity and debt. But then, once again, the court went on to disregard that analysis based on surrounding circumstances: “Although the B Shares appeared to have a more equity-like return, the actual return had debt-like features. For example, the B Shares had a right to 1% of the SAS income, which was potentially uncapped. But the strict investment guidelines on the SAS bond portfolio effectively capped the return the B Shares could receive...” Id. at *79 (emphasis added).
The court also discussed the Legal Risk Analysis of the duration of the transaction, specifically noting that a change in voting rights could allow a liquidation of the transaction by a simple majority vote of shares. But the court again relied on surrounding circumstances to disregard that Legal Risk Analysis: “[t]he Court finds that the provisions for change in voting rights reveals that the parties planned and expected the duration of the... transaction to be five years. The internal approvals by [the parties involved] all suggested that the [foreign parties] would unwind the transaction by the end of 2005. The change in voting rights... also provided a measure for [Principal Life] to force the transaction to unwind.” Id. at *31 (emphasis added).

The Functional Risk Analysis going forward
As shown in Pritired, the Functional Risk Analysis is quickly becoming a favourite government argument. Often this analysis is the result of a cursory view of a transaction’s structure and so-called ‘business realities,’ which leads directly to consideration of facts and circumstances outside the four corners of the governing deal documents. These arguments have superficial appeal because the arguments are presented in an easily distilled form and, accordingly, a court does not have to understand complex transactions and allocations of risk if it simply accepts an expert’s testimony that only the ‘most likely’ scenario need be considered. Thus, the IRS can put forward simple arguments based on expert testimony that cuts through the intricacies of otherwise complex transactions. By focusing on the ‘most likely’ outcomes rather than worst-case scenarios, the IRS can argue that a taxpayer should not be allowed to create tax benefits by advancing an artificial and unrealistic analysis. This puts the taxpayer on the defensive right from the start.

As stated previously, this analysis has far-reaching effects and may capture everyday transactions, such as typical transfer pricing allocations. In transfer pricing, the traditional risk analysis is made in accordance with Treas. Reg. §1.482-1(d)(3)(iii), which provides that the allocations of risk specified or implied by the taxpayer’s contractual terms will generally be respected if it is consistent with the economic substance of the transaction.
None of the factors for assessing risk for transfer pricing purposes look to the probability of the legal risks becoming real events, which is entirely consistent with the Legal Risk Analysis. However, consider the not-so-abstract example of what happens if the IRS applies a Functional Risk Analysis in its determination of the proper pricing of an intercompany arrangement. By moving away from the allocation of risks in the legal documents, the IRS might instead focus on whether this risk has ever occurred.

For example, legal documentation may allocate product liability risk or manufacturing risk to one affiliate, but if there has never been a product recall the IRS could attack the transaction because this risk may not be considered probable (in light of historic events). Thus, the IRS could disregard or ignore any risk allocated in transfer pricing documentation if the taxpayer does not have a ‘real life’ example of when such risk actually happened. Not only is such an analysis flatly inconsistent with the Treasury Regulations, it could become nearly impossible under this standard for a taxpayer to find a comparable that has the same real-world risk experiences. In the sway of the Functional Risk Analysis, the transfer pricing regulations cannot be administered.

In the end, any analysis focusing on probabilities can be distorted or limited by the imagination of the person conducting the analysis. For example, if someone cannot imagine that a major financial crisis could occur, they will not think there is any risk in a transaction backed by a bank guarantee or AAA securities. The layman does not often appreciate or comprehend the real risks allocated by the transaction documents. As the risk analysis becomes more focused on probabilities or business realities outside of the transaction documents, courts and the IRS will continue to turn to experts to explain those risks.

It is always hard to predict the winner in an after-the-fact battle of experts and taxpayers need to understand that the IRS experts may not be addressing the same legal risk analysis that the taxpayer may be putting forward. In fact, you may be talking past one another. Therefore, taxpayers should expect that experts will become involved earlier
in the audit process and should be prepared to defend against the ever-increasing use of the Functional Risk Analysis.

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