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CODIFICATION OF THE COMMON LAW “ECONOMIC SUBSTANCE DOCTRINE”: TAXPAYERS SUBJECT TO NEW STANDARDS TO OBTAIN TAX BENEFITS AND AVOID PENALTIES

On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010 (the “Act”). In an effort to offset some of the anticipated costs of the President’s healthcare reform measures, the Act also contains amendments to the Internal Revenue Code (the “Code”). Included among these amendments is a provision that codifies the common law “economic substance doctrine.” Evaluating the potential impact of this new provision is critical because it has the potential to deny expected tax benefits and impose a strict liability penalty on transactions that fail to meet its requirements. The new provision is effective for transactions entered into on or after March 31, 2010.

Background

In general, the common law economic substance doctrine denies federal income tax benefits to a transaction that does not have “economic substance” or lacks a “business purpose,” even though the transaction may literally comply with the applicable provisions of the Code. Prior to the Act, there was a lack of uniformity among courts as to the proper interpretation and application of the economic substance doctrine. Some courts applied a conjunctive test under which a taxpayer had to establish the presence of both economic substance and business purpose for a transaction to be respected. However, other courts applied a disjunctive test that respected transactions if a taxpayer could establish the presence of either economic substance or business purpose. For the most part, the economic substance prong of the test was a largely objective “risk-based” inquiry, while the business purpose prong of the test was a largely subjective “intent-based” inquiry. The Act now provides statutory rules to clarify and enhance the application of the economic substance doctrine. These new rules apply to transactions entered into after March 30, 2010.

Economic Substance Doctrine Codified – Two-Prong Test

The Act adds new Section 7701(o) to the Code, which provides that in the case of any transaction to which the economic substance doctrine is relevant, the transaction is treated as having economic substance only if (i) it changes in a meaningful way (apart from federal income tax effects) the taxpayer’s economic position, and (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction. A taxpayer may rely on a transaction’s profit potential to demonstrate that a transaction has economic substance only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits. The provision does not set a minimum return that will satisfy the profit-potential test. In determining pre-tax profit, fees, and other transaction expenses (and foreign taxes to the extent provided in future Treasury Regulations) will be taken into account as expenses. For purposes of the two-prong test, any state or local income tax effect which is related to a federal income tax effect will be treated in the same manner as a federal income tax effect. In determining business purpose, achieving a financial accounting benefit is not taken into account if the origin of such a financial accounting benefit is a reduction of federal income tax.

As noted above, the two-prong test only applies to any transaction to which the economic substance doctrine is “relevant.” The determination of whether the economic substance doctrine is relevant to a transaction is to be made in the same manner as if the doctrine had not been codified. Therefore, the new provision does not change current law standards in determining when to utilize an economic substance analysis, an issue that ultimately is left to the courts. In the case of individuals, the two-prong test applies only to transactions entered into in connection with a trade or business or with an activity engaged in for the production of income.

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According to a report by the Joint Committee on Taxation (JCT), it is not intended that tax benefits arising from a transaction should be disallowed if the realization of such tax benefits is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate. The JCT report also indicates that the provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. The JCT report provides the following illustrative examples of such basic transactions: (i) the choice between capitalizing a business enterprise with debt or equity; (ii) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (iii) the choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization; and (iv) the choice to utilize a related-party entity in a transaction, provided that an arm's-length standard is satisfied.

The New Penalty Regime

The Act imposes a new strict liability penalty of 20 percent for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance under the newly codified definition (or for failing to meet the requirements of any similar rule of law). The penalty is increased from 20 percent to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return. An amended return or supplement to a return cannot cure non-disclosure after the taxpayer has been contacted for audit or such other date as specified by the Internal Revenue Service (IRS). There are no exceptions to the penalty, including the reasonable cause and good faith exception. Therefore, tax counsel opinions or in-house analysis will not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance. The Act also amends Section 6676 of the Code to provide that any claim for refund or credit that is excessive due to a claim that lacks economic substance is subject to a 20 percent penalty and no reasonable basis exception is available.

Conclusion

The codification of the common law economic substance doctrine is intended to clarify and enhance the application of the doctrine in a more uniform manner. While this may provide some predictability to taxpayers, it also raises many new questions and uncertainties. For example, the Act does not define what constitutes a "transaction." Further, in determining the profit potential of a transaction, there is no indication of what discount rate should be used to compare the present value of pre-tax profits to the present value of net tax benefits of a transaction.

Based on a report by the JCT, it appears that the codification of the economic substance doctrine is intended to have minimal impact on ordinary, day-to-day transactional planning. However, it is unclear how the codified doctrine will now be applied in relation to historic norms. According to the JCT, it is expected that the new provision will generate \$4.5 billion in revenue through 2019. This estimate seems to assume that the doctrine will be aggressively utilized by the IRS, potentially causing examiners to invoke the doctrine before considering the technical merits of a transaction.

In the end, given the Act's potential for the imposition of either a 20 percent or 40 percent strict liability penalty and in light of the applicable requirements under FIN 48 and new IRS disclosure requirements relating to "uncertain tax positions," it is imperative that taxpayers and their advisors work to establish internal best practices designed to evaluate transactions under the standards set forth in the newly codified economic substance doctrine.

Please feel free to contact any of the HRO attorneys listed in the margin of this Alert to discuss the new provisions of the Act and how they might potentially apply to your particular situation.

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