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Economic Substance Doctrine Codified in the Health Care and Education Reconciliation Act of 2010 - Business Transactions Subject to New Standards to Obtain Tax Benefits and Avoid Penalties

The Health Care and Education Reconciliation Act of 2010 (the "Act") was signed into law by the President on March 30, 2010. As part of the revenue enhancements in the legislation used to finance the major reform of the U.S. health system, the Act codifies the economic substance doctrine and introduces into the Internal Revenue Code (the "Code") penalties for taxpayers who attempt to derive tax benefits from transactions which lack economic substance.

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The economic substance doctrine is a common law doctrine used by courts under varying standards to deny tax benefits to taxpayers when the transaction generating these tax benefits lacked economic substance, business purpose, or both, even if the transaction may have satisfied the literal requirements of a specific tax provision. This Client Advisory highlights the codification of economic substance doctrine and imposition of penalties.

Codification of economic substance doctrine. The Act adds new Code Section 7701(o), entitled the "Clarification of Economic Substance." A transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Other than certain "safe harbor" transactions described below, the codified doctrine could be applied by the IRS to disallow the tax benefits of any transaction.

Under Code Section 7701(o), a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such transaction. The codification is intended to eliminate the disparity that exists among the Federal circuit courts regarding the application of the economic substance doctrine. Some courts had required either a change in economic position *or* a non-tax business purpose. Code Section 7701(o) will now require both.

In determining business purpose, achieving a financial accounting benefit is not taken into account if the origin of such financial accounting benefit is a reduction of Federal income tax. On the other hand, the potential for profit of a transaction shall be taken into account if the present value of the reasonably expected pre-tax profit from the transaction, taking into consideration foreign taxes, fees and other transaction expenses, is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. Any State or local income tax effect which is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. For individuals, the codification applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

The determination of whether or not the economic substance doctrine is relevant to a transaction is left to the courts; whether a particular transaction meets the requirements for specific treatment under any of these provisions remains a question of facts and circumstances. Also, except as noted below for "safe harbor" transactions, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of economic substance. Lastly, the codification does not alter a court's ability to bifurcate, integrate separate steps (so-called "step transaction doctrine"), or otherwise recharacterize a transaction when applying the doctrine.

No effect on tax benefits of a transaction consistent with Congressional purpose or plan. The legislative history of the Act states that tax benefits designed by Congress to effectuate a Congressional purpose or plan are not intended to be disallowed through Code Section 7701(o). It is not intended that a tax credit (for example, Code Section 42 low-income housing credit, Code Section 45 production tax credit, Code Section 45D new markets tax credit, Code Section 47 rehabilitation credit, Code Section 48 energy credit, and other such tax benefits which may be determined by the IRS) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the tax credit was intended to encourage. While the IRS has long taken the position that tax benefits from an investment in property qualifying for the low-income housing tax credit will not be disallowed for lack of economic substance, *Treas. Reg. §1.42-4*, this legislative history seems to extend this treatment to other tax credit investments which had not been treated so favorably.

Additional "Safe harbor" transactions. The legislative history of the Act also states that the codification 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. Among these basic "safe harbor" transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of Code Section 482 and other applicable concepts are satisfied. Similarly, leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances. The legislative history states that this is not an exhaustive list of "safe harbor" transactions thereby leaving open the possibility of additional transactions, e.g. choice of business entity, being included in this "safe harbor" though IRS guidance.

Imposition of penalties. The Act amends Code Section 6662(b) by adding transactions lacking economic substance (within the meaning of Code Section 7701(o)), or failing to meet the requirements of any similar rule of law, to the list of tax underpayments to which the 20% accuracy-related penalty applies. In addition, the penalty is increased to 40% of the portion of an underpayment of tax for cases of transactions without economic substance that are not disclosed. Such transactions are those where relevant facts affecting the tax treatment are not adequately disclosed in a tax return.

This penalty is a strict liability penalty, which means there is no requirement for intent to incur liability and the reasonable cause and good faith exceptions that apply to other accuracy –related penalties do not apply. A taxpayer may not amend returns to avoid the penalties described above after being contacted by the IRS regarding an examination of a return or such other date as is specified by the IRS. 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.

New Code Section 7701(o) is effective for transactions entered into after the enactment date, March 30, 2010.

Note that this Client Advisory highlights only a few of the changes made by the Act that may affect your business planning. If you have any questions regarding the tax law changes summarized in this Advisory or other provisions of the Act, and how these changes and provisions may affect your business, please contact one of the following members of our Tax Department listed below.

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