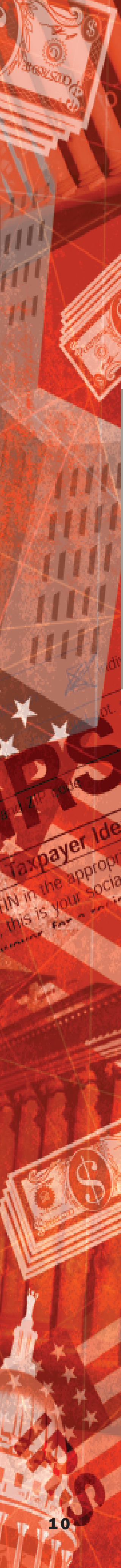

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Economic Substance Codification

Due to the implications from the codification of the economic substance doctrine, companies need to ensure that they can demonstrate the pretax benefits of any transaction that might have potential economic substance issues and should consider disclosing it to avoid harsher penalties.

The economic substance doctrine has long been a key in determining whether or not the tax result of a transaction or series of transactions has legitimate economic purpose other than the avoidance of tax. If it does, the transaction merits acceptance. As with many doctrines, however, the courts haven't been entirely consistent in applying it.

While not designed to alter the proper application of the doctrine, codification is being implemented by the Internal Revenue Service (IRS) in order to bring about a more consistent application of the doctrine. This change has some implications for businesses.

The Doctrine

Internal Revenue Code §7701(o) was added by the Health Care and Education Act of 2010 (P.L. 111-152) and specifies that a transaction (to which the economic substance doctrine is relevant) has economic substance only if two requirements are met. First, the transaction must change the taxpayer's economic position in a meaningful way (apart from federal income tax effects). Second, the taxpayer must have a substantial purpose (apart from federal income tax effects) for entering into the transaction. A recent example involves the use of this doctrine in the case of Jade Trading (2010-1 U.S.T.C. ¶50,304, Court of Appeals Federal Circuit). This case involved a transfer of Euro call options to a partnership. The transaction ultimately involved a scheme to produce a tax benefit by claiming a high basis on assets received but with low values, resulting in tax losses on disposition. (At the time of the facts of this case, the taxpayer didn't reduce basis for the contingent liability that was also part of the transaction.) The Court found that this type of transaction doesn't have economic substance because it creates a tax loss but doesn't otherwise affect the economic position of the taxpayer. The bottom line is that the scheme produced a tax benefit but no other real economic chance of obtaining a profit and thus represents the type of transaction the economic substance doctrine was designed to prevent. Note that the statutory imposition of IRC §7701(o) wasn't applied in this case. That's because the years at issue occurred before the enactment of this provision. We include the case here as an example of the type of transaction that will be subject to the new provision.

The Joint Committee on Taxation Report, JCX-18-10, makes it clear this change doesn't include disallowing transactions intended by Congress to create tax benefits. For example, Congress has enacted a rehabilitation credit in IRC §47 to encourage rehabilitation activities. Where a taxpayer incurs expenditures in qualifying rehabilitation activities, it isn't intended that the taxpayer would now be denied a credit—that's the type of action Congress wanted to encourage on the part of a taxpayer.

There are other specific examples in the report that aren't intended targets of this change, including capitalizing a business enterprise with debt or equity, whether an individual in the U.S. utilizes a foreign corporation or a domestic corporation to make a foreign investment, or entering a transaction or series of transactions that constitute a corporate organization or reorganization.

The penalty provision of IRC §6662 has also been modified with this codification. The accuracy-related penalty on underpayments may be imposed when tax benefits are disallowed because it's found that the transaction lacks economic substance. Also, the penalty is increased in the case of a nondisclosed transaction that doesn't have economic substance. Nondisclosure may result in a penalty of 40% rather than the usual 20%.

In relation to this, IRC §6676 now provides that transactions that lack economic substance don't have a reasonable basis. This effectively means that outside opinions or in-house analysis won't protect a taxpayer from the penalty if a transaction was found to lack economic substance.

Implications

While the intent of this change is clear, there's still reason for concern. It's possible that the IRS may attempt to employ this provision where taxpayers have complied with the statute but don't receive satisfactory economic benefits (absent taxes).

While the rules don't specifically require that a profitability test be used in order to demonstrate that a given transaction has economic substance, if this is the test used, then the present value of the reasonably expected pretax profit from the transaction needs to be substantial in relation to the present value of the expected net tax benefits of the transaction.

Taxpayers will also need to be concerned that IRS personnel may view themselves as having more leverage in negotiating with taxpayers through use of the higher penalties associated with the nondisclosure provisions.

Suggestions

It seems that companies planning transactions that have a potential economic substance issue should employ their usual capital budgeting techniques (NPV, IRR) to demonstrate the existence of expected pretax profits. If such profits can't be demonstrated, then the companies should consider disclosing the transactions to the IRS in order to avoid the 40% nondisclosure penalty. The issue of disclosure is a very important consideration and should be the decision of management in consultation with house tax counsel and auditor.

Documentation of the economic benefits—not simply current dollar benefits, but also long-term benefits such as company goodwill—would seem to be key to fending off an attack based on this doctrine. Remember that the intent of this is to stop taxpayers from entering transactions for which the only real economic purpose is a tax benefit. **SF**

Note: The authors are not attorneys and in no way should be deemed to be offering legal advice or a legal interpretation. The authors are providing an overview of changes in federal tax rules, which is within the realm of the authorized practice of tax by accountants.

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