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Codification of the Economic Substance Doctrine: Bright Lines May Create New Uncertainties for Tax-Sensitive Transactions

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The common law "economic substance doctrine" would be codified as a mandatory two-prong test should the reconciliation bill to the new health care legislation be enacted. In general, the 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 Internal Revenue Code (the "Code") and its interpretations. The reconciliation bill would also impose a strict liability penalty standard, and possibly also increase penalties, for federal income tax benefits disallowed because a transaction flunks the new test.

H.R. 4872, "The Health Care and Education Affordability Reconciliation Act of 2010" (the "Bill"), passed by the House on March 21 and consideration of which began in the Senate on March 23, contains the economic substance provision and would amend H.R. 3590, the "Patient Protection and Affordable Care Act," signed into law by President Obama on March 23. The provision would add Section 7701(o) to the Code to provide that a transaction will only have economic substance if (1) the transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects) and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction. These new provisions (often referred to as a "conjunctive test") would apply to transactions entered into after enactment and, according to the Joint Committee on Taxation (the "JCT"), would raise $4.5 billion through 2019.

Case law interpreting the economic substance doctrine has been far from uniform in its application. While the conjunctive test on its face appears to provide a clearly articulated standard, we expect that the application of certain fundamental concepts contained in the Bill would result in fresh interpretive difficulties. The effect of the codification would no doubt be debated and litigated, and its effect on taxpayers and their

advisors would vary widely based on the types of transactions that they engage in and advise on, respectively.

Profit Potential

The Bill would clarify that a taxpayer seeking to enlist "profit potential" to satisfy either prong of the conjunctive test for a transaction will prevail only if the present value of the reasonably expected pre-tax profit is "substantial" in comparison to the present value of the expected net tax benefit, in each case resulting from the transaction (were it to be respected). 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. The JCT explanation of the Bill clarified that a taxpayer is not required to use the profit potential test and, if it did so, there is no mandatory minimum return required. See Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,' as Amended, in Combination with the 'Patient Protection and Affordable Care Act,'" JCX-18-10, p. 155 (Mar. 21, 2010).

The proportionality implicit in the "profit potential" provision between a "substantial" pre-tax profit and expected tax benefits arguably introduces a fixed legal requirement that did not exist under pre-Bill case law. Despite the JCT explanation's assertion that "substantial" does not mean some preset minimum return, the introduction of the proportionality concept is one of the more mischievous aspects of the Bill. The profit potential rebuttal grew out of a body of cases that, to a large extent, could fairly be characterized as abusive tax shelter cases. Accordingly, the ability to demonstrate even a modest (but reasonably expected) pre-tax economic profit gave practitioners comfort that a given transaction could be distinguished from those economic substance cases which held adversely to the taxpayer. With this new "profit potential" formulation, and no guidance as to what "substantial" may mean (other than that it does not mean a minimum return), taxpayers and tax advisors would have to consider the possibility that ordinary commercial or investment transactions could fall within the scope of the economic substance codification if such transactions result in a meaningful federal income tax benefit. In fact, although the Bill purports not to change the circumstances under which the doctrine would be applied, it is difficult to reconcile this statement with the introduction of a proportionality concept that could significantly increase the scope of transactions which would potentially fail the economic substance test. Given that this provision was scored as raising approximately $4.5 billion in revenues, it is not clear whether the increased revenue would be due to an increase in penalties or a potentially broader application of the doctrine.

State and Local Tax Benefits; Financial Accounting

For purposes of the two-prong test, any state and local income tax effect which is related to a federal income tax effect will be treated in the same manner as any federal income tax effect. It is not entirely clear what this means. Further, the treatment of state tax benefits is arguably a significant change from current law, which may have supported a transaction that generated a significant state income tax benefit (and a modest federal income tax benefit) for a taxpayer but generates little or no pre-tax profit. Additionally, a financial accounting benefit will not be considered a substantial, non-federal income tax purpose under the second prong of the test if the origin of the financial accounting benefit is a reduction in federal income tax.

Individuals

The Act would clarify that the codification would only be applied to transactions engaged in by individuals to the extent that such transaction is entered into in connection with a trade or business or is engaged in for the production of income.

What is the "Transaction"?

One of the serious uncertainties under current law is how to define a "transaction." The JCT explanation states that a transaction can include a series of transactions and that the Bill would not alter the current law standard that allows a court to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine, including bifurcating a transaction in which non-tax avoidance activities are combined with unrelated tax-avoidance activities in order to disallow the latter. With strict liability for penalties poised to be applied to "portions" of a transaction, this becomes a very difficult interpretive issue.

What the Bill Is Not Intended to Do

The Bill specifically states that the codification of the economic substance doctrine is not intended to affect the determination as to *whether* the doctrine is relevant to a transaction, and instead the determination would be made in the same manner as if Section 7701(o) had never been enacted. The JCT explanation asserts that the Bill would not change present law standards as to when the economic substance analysis is invoked. Nor is it intended that the codification prejudice the application of the doctrine under current law or supplant any other rule of law; it is meant to be additive.

The JCT explanation, however, does provide some comfort to taxpayers that the Bill would not change current judicial and administrative practice regarding the following non-exclusive list of transactions: capitalizing a business with debt or equity, using a domestic or foreign entity to make a foreign investment, using a single or multiple steps in a corporate organization or reorganization, entering into a related-party transaction and leasing.

The JCT explanation also emphasizes that, as under current law standards, it is not intended that tax benefits arising from a transaction would be disallowed if the realization of those tax benefits is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate. In particular, the explanation views favorably transactions pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the targeted tax credits are intended to encourage, including, by way of example, investments generating tax credits under the following Code provisions: Section 42 (low-income housing credit), Section 45 (production tax credit), Section 45D (new markets tax credit), Section 47 (rehabilitation credit) and Section 48 (energy credit).

Increased Penalties

Practitioners are concerned about the Bill's strict liability penalty standard and possibly increased penalties that would be imposed should a transaction fail the new economic substance test. The Bill amends section 6664(c) of the Code to prohibit application of the "reasonable cause exception" to a substantial understatement penalty attributable to any transaction that fails the economic substance test. Thus, not even a "more likely than not" or better tax opinion will shield a taxpayer from penalties. Further, in an amendment to Section 6662 of the Code, the understatement penalty increases from 20% to 40% to the extent the understatement is attributable to any portion of a transaction that lacks economic substance and is not adequately disclosed in a return or statement attached to the return. For this purpose, non-disclosure can-

not be cured by amendment or supplemental disclosure after notice of IRS examination of the relevant return (or other date as specified by the IRS). Finally, Section 6676 of the Code is amended to affirm that a claim for refund for an amount attributable to a transaction lacking economic substance will not be treated as having a reasonable basis and will therefore be subject to a 20% penalty on such amount.

The codification of the common law economic substance doctrine would have a disparate impact on taxpayers and their advisors. If enacted, the Bill may change the playing field in certain areas of federal income tax practice, particularly tax-advantaged transaction planning, by stating rules of uniform application with specific criteria that must be taken into account in evaluating a transaction and which, in certain cases, may differ from current law. Otherwise, ordinary tax planning for business transactions that did not heretofore bump into the economic substance doctrine arguably is unlikely to do so after enactment. A measure of uncertainty likely would be introduced, however, to any commercial or investment transaction which generates material federal (and possibly state) income tax benefits, even if such benefits are not a significant motivating factor in the transaction. The further imposition of a strict liability penalty standard would force taxpayers and their advisors to pay attention to the doctrine even for ordinary-course commercial and investment transactions, although the extent to which this attention would have a chilling effect remains to be seen.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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