Acquiring Economic Substance with No Rudder

By Robert W. Wood

There's been no end of concern about the economic substance doctrine. Of course, the ship has already sailed on the question whether it is a good idea to codify it. Like it or not, we all now must get used to this nonstatutory-*cum*-statutory doctrine. And of course, having a statute means we will have the kinds of overlays that statutes typically engender.

So perhaps we should not have been surprised when the IRS issued Notice 2010-62, IRB 2010-40, 1. It puts the first administrative gloss on the codified economic substance commandment. Probably most controversial was the message that the IRS will not be issuing an "angel" list of transactions that would not be subject to economic substance principles (nor, for that matter, will there be a list of "devil" transactions either).

Godot's Guidance

The Notice even confirms that the IRS will not issue private letter rulings on whether the doctrine is relevant to a particular transaction. In the face of these broad and arguably draconian pronouncements, some have not exactly been charitable in their descriptions of the IRS's missive (!). To paraphrase Gertrude Stein, there's no guidance there. Like Samuel Beckett's WAITING FOR GODOT, it never comes.

So what *do* we know? Well, we know we want (probably always?) to be able to show both of the following:

- The transaction changes in a meaningful way the taxpayer's economic position.
- The taxpayer has a substantial purpose for entering into the transaction, meaning non–federal income tax purposes for entering the transaction that are "substantial."

For those of you who are already thinking about the difference between tax and book treatment, the Code itself makes clear that the purpose of achieving favorable accounting treatment for financial reporting purposes is *not* taken into account as a non–federal income tax purpose if the origin of the financial accounting benefit is a reduction of federal income tax. [Internal Revenue Code Section ("Code Sec.") 7701(o)(4).] State or local tax savings can be OK, but not if they are mere imprints of the federal tax savings. [*See* Code Sec. 7701(o)(3).]

What is a *meaningful* change to a taxpayer's economic position might also be seen as a little puzzling. We all find meaning in different places, after all. Although it's clear that a minimum return satisfying the potential profit test is not required, it also seems clear that the present value of the reasonably expected pre-tax profit must be *substantial* in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

This not-terribly-precise notion is now referred to as the Pre-Tax Profit to Net Tax Benefit Ratio Test. [Code Sec. 7701(o)(2)(A).] So what is the IRS going to rely upon? Notice 2010-62 says the IRS will continue to rely on relevant case law under the common law economic substance doctrine in applying the two-pronged test.

Case Law?

Is there any relevant case law? Most tax advisors don't seem to think so. Still, the IRS will challenge

taxpayers, the Notice says, relying on prior case law for the proposition that a transaction will be treated as having economic substance merely because it satisfies either prong (that is, one or the other, but not both). The same is true for taxpayers who indicate that common law economic substance principles should govern and protect them. In other words, we really are in an era in which the statute controls.

Joint Committee to the Rescue

Recall that in the Joint Committee's Technical Explanation of the law, the position is enunciated that Code Sec. 7701(o) was *not* intended to disallow tax benefits if their realization is "consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate." Accordingly, we can expect to see more disputes about the "intent" or "purpose" of various provisions. Taxpayers will need to dig into the legislative history and analyze each case in light of that history.

Arguably one of the more important exceptions from the scope of the codified rule that is mentioned in the Technical Explanation is basic business deals. As the Joint Committee put it, exempted would be "certain basic business transactions that under longstanding judicial and administrative practice are respected."

Hey, It's Just Business

The Joint Committee provided the following nonexclusive list:

- The choice between capitalizing a business enterprise with debt or equity
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C
- The choice to utilize a related-party entity in a transaction, provided that the arm's-length standard of Code Sec. 482 and other applicable concepts are satisfied

Remember, this is a *nonexclusive* list. Still, some have suggested that perhaps well-established (one might even say vaunted) tax cases could be reexamined with a codified economic substance myopia. The results of these cases could at least be debated.

Take *Cottage Savings Ass'n* [SCt, 91-1 USTC ¶50,187, 499 US 554], where financial institutions exchanged mortgage portfolios and recognized tax losses in transactions that were motivated solely by tax considerations. Surely there could be no change in that result, right? After all, there and elsewhere, the tax code includes *specific* rules that surely must trump a *general* anti-abuse rule like the IRS's statutory economic substance plaything.

It sure seems logical to say that if tax benefits are limited by the Code or regulations in a *specific* way, the overarching economic substance prongs should not come in to play. The fact that the Joint Committee on Taxation included related-party transactions in its list of business transactions that should be respected surely supports this view. After all, related-party deals are closely regulated by Code Sec. 482.

Yet do you notice how much I'm saying "surely"?

And there are even more fundamental things we don't know. Although we know we need a "meaningful" change to the taxpayer's economic position, how meaningful is meaningful? Although the present value of the "reasonably expected" pre-tax profit must be "substantial" in relation to the present value of the expected net tax benefits, one wonders about the minimum ratio that would be acceptable.

Same Old, Same Old

Paradoxically, the Notice says the IRS will continue to use the same economic substance analysis it did before the vaunted Code section was enacted. The IRS is suggesting that case law on circumstances in which the economic substance doctrine is relevant will continue to develop. I don't know about you, but I don't look out that far into the future. In contrast, the IRS has quite a long view of the world.

The Treasury and the IRS have made clear that they do *not* intend to issue guidance on the types of transactions to which the economic substance doctrine will or will not apply. The IRS won't issue Letter Rulings or Determination Letters on whether economic substance is relevant to any transaction, nor on whether any transaction complies with the important two-prong test.

All of this might not be so frustrating if it weren't for the new penalty regime. A possible

40-percent penalty truly makes economic substance the lifeline of the transaction. You just have to have it. And that, we should note, leads us directly into disclosure.

One might be tempted to conclude that a lot of this is simply about disclosure. Unless a transaction is a reportable transaction, the adequate disclosure requirements of Code Sec. 6662(i) will be met if the taxpayer adequately discloses (on a timely filed original return or a qualified amended return) the relevant facts affecting the tax treatment of the transaction. What's adequate?

First, the disclosure must be made on Form 8275 or 8275-R. But exactly how much is enough to import the ticket to adequacy is simply not clear. Notice 2010-62 does not offer guidance about what is adequate. And adequacy is really important, since an adequate disclosure gets you past (well, partially past, since you still might get a 20-percent hit) the otherwise draconian 40-percent penalty.

Up in the Air?

Some say the IRS's Notice is a trial balloon. If so, it seems to be going the way of the Hindenburg. Time will tell whether more on economic substance is released. There are rumors of internal IRS penalty guidance. But until we have, er, more "substance," advisors on transactions that don't on their face look quite profit motivated might be feeling some degree of trepidation, much like Wiley Coyote walking under a very large Acme anvil.