Health Care Reform and Economic Substance

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The economic substance doctrine is one of a cadre of nonstatutory doctrines. Like its cousins the business purpose, form over substance and sham transaction doctrines, advisors have long struggled to explain economic substance to clients. Just how does one evaluate it? Whether you call it an eye-of-the-beholder test or something else, it is about to get significantly more complicated.

The public may think the largest impact of the health care reform bill will occur in the field of health care and medical insurance. That may be, but at least some tax lawyers may be most impressed by changes to the economic substance doctrine. At its most basic, we must now get used to the idea that a nonstatutory doctrine has just become, well, statutory.

For transactions entered into after March 30, 2010, and for underpayments, understatements, refunds and credits attributable to transactions entered into after that date, economic substance is now applied by way of a new definition.

Defining Moment

A transaction will be treated as having economic substance only if, apart from federal income tax effects, two things are present:

- The transaction must change in a meaningful way the taxpayer's economic position.
- The taxpayer must have a substantial purpose for entering into the transaction.

Make no mistake, this is not an either/or test. You must satisfy *both* requirements in order for your transaction to have the requisite economic substance. [Internal Revenue Code Section ("Code Sec.") 7701(o)(1).] This new definition does not apply to personal transactions of individuals. Conversely, it does apply to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

Asking Why

Why do you enter into a transaction anyway? The taxpayer needs to have a nonfederal income tax purpose for entering into the transaction, and that purpose must be "substantial." Presumably a nontax business reason for a deal is best. Yet some tax reasons are okay.

In fact, a tax reason may be okay as long as it is a *state* or *local* tax issue, not a federal income tax one. On the other hand, you cannot say that a state or local income tax reason qualifies if the state or local income tax impact is *related* to the federal. It needs to be unrelated.

What about accounting reasons? Yes, a financial accounting benefit may be a nontax reason. However, such a reason won't qualify if the origin of the financial accounting benefit is a reduction of federal income tax. [Code Sec. 7701(o)(4).]

Profiting Nominally?

Making a profit is certainly a good purpose and one that may be substantial on a given set of facts. Unfortunately, however, it appears that this one is going to have to be worked out in the future. Taxpayers should not rely on a for-profit business purpose if it looks to a casual observer as if that profit would be purely nominal.

A nominal profit is surely one that does not result in a meaningful change in the taxpayer's economic position. Not all business or investment plans go as expected, of course. You may find yourself arguing that even though in hindsight you didn't make a profit, it was reasonable to think that you would (or at least that you *might*).

If a taxpayer relies on a potential profit, 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. [Code Sec. 7701(o)(2)(A).] This quantifiable profit is now embodied in the Code, and will likely be (catchily) known as the pre-tax profit-to-tax-benefit-ratio test.

Number-Crunching

How does one compute this pre-tax profit? Carefully. Fees and other transaction expenses are to be taken into account as expenses in determining the pre-tax profit. The IRS is expected to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. [Code Sec. 7701(o)(2)(B).]

Determining whether the economic substance doctrine is relevant to a transaction is supposed to be accomplished as if the Code section had never been enacted. This statement in Code Sec. 7701(o)(5)(C) is supposed to mean that the new section does not change present law. Of course, it is difficult to see how a sea change like the codification of this amorphous doctrine won't change something.

Still, the legislative history suggests that in Congress' quest to be more specific and to give better guidance about precisely what this non–statutory-*cum*-statutory doctrine requires, a facts-and-circumstances analysis is still needed. The committee report to the provision, for example, notes that leasing transactions will still require an analysis of all of the facts and circumstances. That seems to be true with *any* transaction.

And as if to remind us all that these nonstatutory (but now sort of statutory) doctrines trump other Code provisions, Congress points out that the mere fact that you meet a particular Code provision doesn't mean that you *in fact* qualify for something. Economic substance is a general overlay to the Code and must be so regarded. And that extends to the courts. The committee report makes it crystal clear that courts still have the ability to aggregate, disaggregate or otherwise recharacterize a transaction under the economic substance doctrine.

Safe Harbor

It may be a misnomer to suggest there is anything safe about this new economic substance provision. Yet it is clear that many transactions we see almost daily in the business world are not meant to be thrown under the bus. In essence, Congress seems to suggest that these are by definition economic transactions that are really business driven. These basic transactions are not meant to be attacked, and include such items as the following:

- 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
- Choosing to enter a transaction that constitutes a corporate organization or reorganization under Subchapter C
- A choice to utilize a related-party entity in a transaction if the standard of Code Sec. 482 and other applicable concepts are satisfied

It's All About the Penalty

So far, you may be thinking that the hype you've heard about economic substance was just that. After all, this doesn't sound too onerous. Moreover, you may even say that it doesn't sound all that different from the kind of economic substance analysis with which tax advisors have long needed to engage.

But there's a catch. And that relates to penalties, a topic that is often on the lips of tax advisors. What about the penalties?

For underpayments attributable to transactions entered into after March 30, 2010, a new strict liability penalty applies for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law. [Code Sec. 6662(b).] Yes, you read that right: a *strict liability penalty*.

Most tax advisors are wont to think that most penalties can be removed if you have a good reason and have disclosed the transaction in question. Most penalties turn out to be at least somewhat malleable in that way in the nitty gritty of practice. The concept of a strict liability penalty no doubt seems foreign.

However, this new penalty is different. The reasonable cause and good-faith exception simply does not apply to any portion of an underpayment which is attributable to a transaction lacking economic substance or failing to meet the requirements of any similar rule of law. [Code Sec. 6664(c)(2).]

What about a tax opinion from someone really, really reputable? Nope. Outside opinions would not protect the taxpayer from the imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law.

Disclosure is not a get-out-of-jail-free card, but it is certainly relevant. The penalty rate is 20 percent, but it can be increased to 40 percent if the taxpayer has not adequately disclosed the relevant facts affecting the tax treatment in the return or on a statement attached to the return. [Code Sec. 6662(i)(1).]

Note that an amended return or supplement to a return is not taken into account if it is filed after the taxpayer has been contacted for audit or such other date as the IRS specifies. [Code Sec. 6662(i)(3).] Obviously, this last rule means that you can't try to rush to disclose something after the fact as a way of trying to bootstrap yourself into disclosure that might have reduced your penalty from 40 percent to 20 percent. It won't work.

More Nuances

As this mere scratching of the surface should indicate, there's much to learn about the new lore of economic substance and its birth as a statutory behemoth. Be careful out there.

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