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The "Codified" Economic Substance Doctrine

By Steven E. Hollingworth • Wood & Porter • San Francisco

No judicial doctrine generates more uncertainty in the tax field than the economic substance doctrine. So surely it must be welcome news that Congress has enacted a "clarification" of the economic substance doctrine, right? Absolutely not, according to the panelists at the American Bar Association Tax Section Corporate Tax Committee teleconference, entitled "The Economic Substance Doctrine," held on March 31, 2010.

The panelists were Jasper L. Cummings (Alston & Bird LLP), Yoram Keinan (Greenberg Traurig LLP) and Mark J. Silverman (Steptoe & Johnson), who reviewed the relevant provisions of the Health Care and Education Reconciliation Act ("the Act"), signed into law on March 30, 2010.

Economic Substance

Since the early years of the income tax, a guiding principle of the tax law is that the substance of a transaction, rather than its form, determines its tax treatment. The courts historically have shown little hesitation to disregard a taxpayer's compliance with the literal terms of the code. After all, in cases where the taxpayer is motivated by no business purpose other than obtaining tax benefits, and the transaction has no reasonable possibility of a pre-tax economic profit, something has to give.

Over time, the federal appellate courts have adopted different formulations of this doctrine. Some cases state that a transaction must lack both business purpose and profit motive to be disregarded for tax purposes. Others utilize a disjunctive test, so that the lack of either a profit motive or business purpose triggers a denial of the tax benefits.

Still other cases view the business purpose and profit motive components as mere factors in the court's overall analysis. Adding to the controversy, some commentators have criticized the doctrine

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as adding greater uncertainty and complexity to an already Byzantine tax code. But in spite of these disputes and differing formulations, the economic substance doctrine is generally considered to be firmly established.

Funny New Statute

Mark Silverman began by reviewing the newly enacted Internal Revenue Code Section ("Code Sec.") 7701(o). This section attempts to resolve the perceived conflict among the courts. Code Sec. 7701(o) provides that economic substance for income tax purposes requires both a meaningful change in the taxpayer's economic position (apart from tax benefits) *and* a substantial nonfederal income tax purpose for the transaction.

The failure to satisfy either one of these two prongs or "any similar rule of law" will trigger penalties equal to 20 percent of the disallowed tax benefits. The penalty increases to 40 percent if the relevant facts affecting the tax treatment are not disclosed on the return. *No* exceptions to the penalty are available. That should get your attention!

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Scope of New Rules

The new rules are effective immediately for transactions entered into after March 30, 2010. What Code Sec. 7701(o) does not do, however, is clearly define the scope of transactions to which it is intended to apply. That seems to be the fundamental challenge in dealing with the statute.

As Mr. Silverman was quick to point out, Code Sec. 7701(o)(1) expressly states that it applies only when the economic substance doctrine is "relevant." For this purpose, relevance is determined in the same manner "as if this subsection had never been enacted." The explanation from the Joint Committee on Taxation indicates that Code Sec. 7701(o) should be construed as an *addition* to existing law, not as altering or supplanting any other rule.

Therefore, the panelists concluded that the Act does not actually codify the economic substance doctrine itself. Rather, it codifies a precondition to a taxpayer's escaping the doctrine, once it has been determined to be applicable.

Exceptions to Economic Substance Doctrine

The statute provides only one explicit exception. For individuals, the statute applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. The legislative history suggests, however, that the statute may have a narrower application than is apparent from its literal terms.

In fact, Jasper Cummings directed our attention to the Joint Committee's Technical Explanation, which indicates that Code Sec. 7701(o) was not intended to disallow tax benefits if the realization of those benefits 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 the tax code or regulations. Taxpayers will need to dig into the legislative history and analyze each case in light of that history.

A third exception mentioned in the Technical Explanation is for "certain basic business transactions that under longstanding judicial and administrative practice are respected." The report 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

Mr. Cummings expressed some surprise at this list. Indeed, the use of debt and foreign subsidiaries can have substantial tax sheltering effects, and transactions with related parties are frequent sources of controversy. But time will tell what happens next.

Expected Effects of Codification

At the conclusion of the presentation, Mr. Silverman briefly discussed the effect of the statute on transactions that seem to fall under the literal terms of the statute. His first example referred to *Cottage Savings Ass'n* [SCt, 91-1 USTC ¶50,187, 499 US 554], a seminal Supreme Court case. There, financial institutions exchanged mortgage portfolios and recognized tax losses in transactions that were motivated solely by tax considerations.

If Code Sec. 7701(o) were to apply to these facts, what would be the result? The transactions appear to fail the economic substance test. After all, they had no profit or nontax business motive. Still, the panelists all agreed that the holding of *Cottage Savings* should remain valid after codification of the economic substance doctrine.

The reason is that the ability to claim losses is already highly restricted by numerous code and regulatory provisions. Mr. Cummings argued that any area in which tax benefits are limited by specific, constricted rules should not be subject to the economic substance doctrine. This analysis may explain why the Joint Committee on Taxation included related-party transactions in its list of business transactions that should be respected, since these transactions are closely regulated by existing anti-abuse rules set out in Code Sec. 482.

Code Sec. 7701(o) will certainly be the subject of litigation, and the scope of its application hopefully will be more precisely delineated. Mr. Cummings encouraged practitioners to help the courts fashion workable rules that would clarify the exceptions to the economic substance doctrine.

How Will the IRS Apply It?

As a practical matter, the panelists fear that an IRS auditor reviewing a transaction that appears to lack profit and business purpose will assume that Code Sec. 7701(o) and related penalties should apply. Skipping the "relevance" precondition to the application of that section would seem to be over-reaching. Yet the panelists cautioned that the strict liability penalty applies not only to transactions that fail the economic substance doctrine, but also "any similar rule of law."

Taxpayers can expect the IRS to assert a broad interpretation of what constitutes a "similar" rule, perhaps including step transaction, sham transaction and other judicial doctrines. Defending an audit may be an increasingly daunting task.

Future Guidance?

The panelists identified a number of other ambiguities in the statute that hopefully will be clarified in future regulations. First, the question may arise as to who is the relevant "taxpayer" that must satisfy the business purpose and profit motive conditions. This issue can be expected, for example, in cases involving partnerships or members of affiliated groups.

Second, the first prong of the economic substance test requires a "meaningful" change to the taxpayer's economic position. How meaningful is meaningful? Similarly, the requirement that the present value of the "reasonably expected" pre-tax profit must be "substantial" in relation the present value of the expected net tax benefits provides little guidance as to the minimum ratio that would be acceptable. However, it is clear from the Joint Committee Technical Explanation that Code Sec. 7701(o) does not require (much less establish) a minimum return that will satisfy the profit-potential test.

Conclusion

The codification of the economic substance doctrine has done little to clarify this extremely murky area of the law. At the same time, the penalties for failure to meet this standard have significantly increased and become a lot harder to avoid. Strict liability is indeed strict.

The consensus among the panelists was that, to minimize exposure to penalties, taxpayers will now be required to review each transaction with greater care than ever before. Taxpayers and their advisors should recognize that this is likely to slow down transactions significantly. Who said the tax lawyer in a deal didn't have any clout?

The ABA Tax Section's teleconference, "The Economic Substance Doctrine," is available in recorded format at http://meetings.abanet.org/meeting/tax/TX0310T2/.