Practical Implications of the Codification of the Economic Substance Doctrine

Tax Alert
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After consideration of several proposals over a number of years, Congress recently codified the economic substance doctrine as part of the Health Care and Education Reconciliation Act of 2010. This alert provides an overview of the new statute, as well as some initial observations about the practical implications for future tax planning, the relationship between taxpayers and their financial auditors, and the relationship between taxpayers and the Internal Revenue Service (the "IRS").

Overview of the Statute

New Section 7701(o) provides that "[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if— (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." Underpayments attributable to a transaction that is determined to lack economic substance under this two-prong test are subject to a 20 percent strict liability penalty, which is increased to 40 percent if the taxpayer does not disclose the transaction in its return.

 Conjunctive Two-Part Test Adopted

The statute resolves some lingering uncertainty regarding the formulation of the economic substance standard. Most notably, the statute resolves the split among the U.S Circuit Courts of Appeals by providing that the two-part economic substance standard is conjunctive (and not—as some Circuit Court decisions had suggested—disjunctive). Thus, a transaction subject to the economic substance standard must lead to a non-tax change in economic position and the taxpayer must have a non-tax business purpose for entering the transaction.

The Statute Applies Only Where Judicial Doctrines Would Have Applied

The statute provides little guidance on the threshold issue of whether the economic substance standard should apply to a transaction. Section 7701(o) states that it will apply "[i]n the case of any transaction in which the economic substance doctrine is relevant." Perhaps acknowledging that this language is not particularly helpful, the statute later explains that "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." Thus, one would look to pre-enactment case law, which tends to apply the doctrine only to transactions that create significant tax advantages that were not clearly intended by Congress. Where it appears that Congress intended tax benefits notwithstanding the lack of non-tax business purpose, such as certain credits designed to provide an incentive for otherwise non-economic investment, the doctrine tends not to apply. See D. Blair, "Are Plain Meaning Cases on a Collision Course with the Economic Substance Doctrine?" 5 J. Tax’n Fin. Prods. (CCH) 9 (2005).

The Joint Committee on Taxation explanation accompanying the statute (the "JCT Explanation") provides some general guidance on the inapplicability of Section 7701(o) to garden-variety tax planning. The JCT Explanation notes that the statute is "not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages." The JCT Explanation provides illustrative examples of such basic transactions, including (i) form of capitalization of a business enterprise (i.e., debt or equity), (ii) utilization of a domestic or foreign corporation to make a foreign investment, and (iii)
corporate organizations or reorganizations. It remains to be seen whether the IRS issues general guidance consistent with the JCT Explanation, such as providing a so-called “angel list” of transactions that are exempted from the application of the economic substance doctrine. Alternatively, the IRS could issue rulings on the legal question of whether the economic substance doctrine is relevant to a particular transaction. Without such guidance, taxpayers may be left with uncertainty as to whether garden-variety tax planning, such as a simple check-the-box election, could potentially be subject to later challenge by the IRS under the economic substance doctrine.

The Statute Does Not Define “Transaction”

Section 7701(o) does not address how the IRS or a court should apply the economic substance doctrine to the various elements of a transaction that is structured with tax efficiencies in mind. For example, in Coltec, the Federal Circuit held that the economic substance test should be applied to the element of the transaction that created the tax benefit (the tax planning “crux”), rather than to the transaction as a whole. Accordingly, the court examined the economic impact and business purpose associated with the particular transactional step that created high-basis, low-value stock in a subsidiary, which the taxpayer later sold for a large tax loss. Other courts also have focused their economic substance analyses on the element or step in an overall transaction that appeared to generate the tax benefit at issue. Although focusing the inquiry in this way makes it more difficult for inappropriate “tax shelter” transactions to pass muster, it also has the potential to make garden-variety tax planning vulnerable to the application of the economic substance doctrine.

In practice, courts rarely apply the economic substance doctrine to the tax planning crux of garden-variety tax planning, but the standards that courts use to distinguish acceptable from unacceptable tax planning remain on some level a matter of “feel.” Although the statute does little to clarify this point, the JCT Explanation provides that courts may continue to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the economic substance doctrine. Thus, consistent with Coltec, the IRS and the courts retain some ability to combine or take apart transactions in a manner such that a transaction (or a portion thereof) as recharacterized by the IRS could be found to lack economic substance.

The Statute Provides Some Guidance on the Assessment of Profit Potential, But Leaves Open the Treatment of Foreign Taxes

Section 7701(o) provides some guidance on the extent which pre-tax profit potential may be taken into account in establishing that a transaction meets the economic substance test, but leaves open the characterization of foreign taxes for such purposes. In general, pre-tax profit potential may be considered only if “the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.” Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. With respect to the treatment of foreign taxes, the statute provides that the IRS “shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.” The statute thus provides the IRS with the discretion to issue regulations contrary to the Compaq and IES decisions, which were decided in favor of the taxpayer in part based on the conclusion that foreign taxes should not be treated as expenses in applying the economic substance doctrine. It will be interesting to see whether and in what manner the IRS acts on this grant of regulatory authority given the shifts in policy direction since the issuance of Notice 98-5.

Impact on Future Tax Planning

The statute will have a significant impact on future tax planning as taxpayers face the potential application of a 20 percent (or 40 percent) strict liability penalty. As an initial matter, taxpayers may have an incentive to “over-disclose” transactions on their returns to avoid the 40 percent penalty. However, it should be noted that the proposal contained in Announcement 2010-9 regarding uncertain tax positions also would require disclosure of transactions with a FIN 48 reserve, and it is unclear whether or how the IRS will coordinate the two disclosure requirements.
As a result of the potential imposition of the strict liability penalty, taxpayers may request private letter rulings to provide greater assurance that particular transactions will not be subject to economic substance challenges. In the absence of additional guidance, and with a strict liability penalty on the line, it may be difficult for advisors to conclude, and for taxpayers to feel comfortable, that the economic substance doctrine is not “relevant” to a transaction. If the IRS is willing to issue a private letter ruling on a transaction, taxpayers might reasonably take comfort that the doctrine is not relevant (the so-called “halo effect” of a ruling) because the IRS would not rule on the technical merits of a transaction if it had concerns regarding economic substance. Ruling requests, however, may cause undue delay and expense. In addition, the viability of pursuing a private letter ruling may be limited in many instances given the IRS’s policy of not issuing rulings involving fact-specific issues, such as those involving business purpose determinations.

Opinions of legal counsel may become more valuable for a variety of purposes, including (i) for internal risk management and internal controls purposes, (ii) for purposes of dealing with concerns raised by financial auditors, including concerns related to the robustness of a company’s internal controls, (iii) for purposes of marshaling facts and authorities in anticipation of an argument by the IRS that the transaction lacks economic substance and is subject to the strict liability penalty, and (iv) for purposes of avoiding accuracy-related penalties for transactions that are determined to have economic substance but are challenged on other grounds. Balanced against the last consideration is the concern that disclosing an opinion could provide the IRS with a “roadmap” for challenging the transaction at issue.

Impact on the Relationship Between Taxpayers and Their Financial Auditors

The statute, particularly when coupled with the IRS’s new uncertain-tax-position proposal (see Announcement 2010-09), may also have a significant impact on the way in which companies evaluate tax positions in the context of accounting standards such as FIN 48. Historically, the analysis of whether a transaction would survive the application of the “soft doctrines” such as economic substance was an element that drove the recognition of tax benefits for financial statement purposes. But with no statutory definition and no additional penalties for failing such a doctrinal analysis, the application was, in the case of non-shelter transactions, often relegated to minor importance when compared with the analysis of whether those transactions “worked” under the technical provisions of the Internal Revenue Code. With this new statute and its accompanying strict liability penalty, financial auditors may become more focused on the potential application of the economic substance doctrine alongside the technical provisions of the Internal Revenue Code. Financial auditors may require this more holistic-type analysis of the transaction because the new statute not only underlines the importance of satisfying the economic substance standard before claiming a tax benefit, it also introduces a significant downside risk for getting the analysis wrong. Thus, taxpayers may expect a more thorough analysis of transactions before their financial auditors allow the tax benefits of such transactions to be recognized on their financial statements.

Impact on the Audit Relationship

The new statute has the potential to negatively impact the relationship between taxpayers and the IRS. Already, some IRS examiners are too quick to invoke the economic substance doctrine before considering the technical merits of a transaction. In this sense, the doctrine can become a blunt instrument that leads to proposed deficiencies and penalties that are out of proportion to the technical concerns that the IRS might have regarding a transaction. Empowering IRS examiners to assert the strict liability penalty may exacerbate this problem because (i) there will often be more revenue potential to the IRS from assertion of the new penalty than the revenue potential if an accuracy-related penalty were asserted with respect to a technical issue under a substantive provision of the Internal Revenue Code, and (ii) assertion of the traditional, accuracy-related penalty involves a time- and labor-intensive evaluation of the merits of the underlying substantive issues, which may conflict with the examiners’ incentives under the IRS “currency” initiatives. Furthermore, the IRS may view codification as a Congressional endorsement of economic substance and, therefore, feel institutional pressure to encourage the assertion the strict liability penalty.

Conclusion
The codification of the economic substance doctrine has the potential to dramatically change the tax enforcement landscape. As the Treasury Department and the IRS decide how to implement and administer the statute, taxpayers should consider how any future guidance will impact their tax planning function and their relationship with their financial auditors and the IRS. Therefore, interested taxpayers should consider engaging with the Treasury Department and the IRS as they develop this important guidance. Most importantly, taxpayers should take into account the new environment created by codification of economic substance and the strict liability penalty, including the perspective of their financial auditors and the IRS on these changes, when evaluating pending and future transactions.

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