



North Carolina Law Life

Health Reform: Codifying Economic Substance Doctrine

By: Donna Ray Chmura. *This was posted Tuesday, August 24th, 2010*

[John Vandenhoff](#) continues his exploration of the tax implications of the new health care law. There's also more in a series of [informational podcasts](#) on the Web site of the Law Firm Alliance, of which we are a member.

In our previous posts ([here](#) and [here](#)), we talked about the new healthcare legislation which was signed into law ([H.R. 4872, the Healthcare and Education Reconciliation Act of 2010 \(Reconciliation Act P.L. 101-152\)](#)) (the "Healthcare Act") and described a couple of the major mandates contained within that Act.

In these, we present a brief overview of some of the key tax changes affecting individuals and businesses. Please call our [Virginia and North Carolina business lawyers](#) for details of how the new changes may affect your specific situation.

Amongst other provisions, the Healthcare Act codified the common law [Economic Substance Doctrine](#) which had been developed by the [Internal Revenue Service](#) ("IRS") and the courts. Essentially, the courts have denied claimed tax benefits if the transaction that gave rise to those benefits lacked economic substance independent of tax considerations, even though the purported activity actually occurred. In other words, the IRS was empowered to set aside a transaction that, although technically in compliance with all tax statutes and regulations, lacked true economic substance and was entered into almost entirely for the purported tax benefit.

New in IRS Code

The Healthcare Act enacted new Section 7701(o) of the Internal Revenue Code, which provides that a transaction will be treated as having economic substance only if the transaction changed in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and, the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction. The transaction must satisfy both tests in order for it to be deemed as having economic substance.

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There has been speculation as to the extent the new codified doctrine will be applied. The statute states that the determination of whether the Economic Substance Doctrine is relevant shall be made as if the statute were never enacted. See Section 7701(o)(5)(C) of the Internal Revenue Code. The Joint Committee Report further states that “if the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.” However, it still remains that both prongs of the two-part test must be met in order for the transaction to be deemed to have economic substance.

Codification Imposes Penalties

The teeth for the codification of the Economic Substance Doctrine is that a new penalty applies for an underpayment attributable to a transaction lacking economic substance. The penalty rate is 20% of the amount of the underpayment, but is increased to 40% if the taxpayer does not adequately disclose the transaction on the taxpayer’s return or on a statement attached to the return. It is also important to note that the reasonable cause and good faith exception (which have generally been held to be exceptions to paying penalties for underpayment of tax) do not apply to any portion of an underpayment which is attributable to a transaction lacking economic substance.

The codification of the Economic Substance Doctrine (and the penalties on resulting underpayments) are effective for all transactions entered into after March 30, 2010.

Please see future posts for information regarding other tax affects of the Healthcare Act which take effect in years beginning after 2010. As business and [tax attorneys](#), we invite you comments below about the new healthcare law and its effects on your and your business.

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