

March 26, 2010

The Codification of “Economic Substance”

On March 25, 2010, both the U.S. House of Representatives and the U.S. Senate passed the final piece of the health care package, the Health Care and Education Reconciliation Act of 2010 (the Act). Included in the bill is a statutory codification of the “economic substance” doctrine. Various forms of codification of the doctrine have been under consideration by Congress since 1999 and have been on the verge of enactment on several occasions during the last decade, but it will now be a reality as soon as the President applies the necessary signature.

The Act adds new Internal Revenue Code § 7701(o), which provides that if the economic substance doctrine is relevant to a transaction, the transaction will be considered to have economic substance only if two tests are satisfied: (1) the transaction must change the taxpayer’s economic position in a “meaningful way” (apart from the Federal income tax effects); *and* (2) the taxpayer must have a “substantial purpose” for entering into the transaction (again, apart from the Federal income tax effects).

Under this new provision, a taxpayer may rely on the potential for profit to demonstrate that a transaction altered its economic position in a meaningful way or that it had a substantial non-Federal income tax purpose for entering into the transaction *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 is respected. For this purpose, fees and other transaction costs will be counted in determining pre-tax profit. The Treasury Department is also directed to issue regulations “requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.”

In addition, this new provision provides that state or local tax effects related to a Federal income tax effect will be treated in the same manner as a Federal income tax effect, and thus will not constitute a non-Federal tax purpose for a transaction. Similarly, a financial accounting benefit will not be taken into account under this new provision as a non-Federal tax purpose for entering into the transaction if the origin of the accounting benefit is a reduction in Federal income tax.

This new statutory definition of “economic substance” *must* be applied if it is determined that the economic substance doctrine is “relevant” to the transaction. The determination of whether the economic substance doctrine is “relevant” to a transaction is to be made in the same manner as if the doctrine had not been codified. For this purpose, the term “economic substance doctrine” is defined, in a somewhat circular manner, as the common law doctrine under which Federal income tax benefits are not allowable if the transaction does not have economic substance or lacks a business purpose. For individuals, the new provision applies only to transactions entered into in connection with a trade or business or with an activity engaged in for the production of income.

The Act also creates a new “strict liability” penalty of 20% of an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance under the newly codified definition. The penalty is increased to 40% if the taxpayer did not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return. The

© 2010 Sutherland Asbill & Brennan LLP. All Rights Reserved.

This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

CIRCULAR 230 DISCLOSURE: To comply with Treasury Department regulations, we inform you that, unless otherwise expressly indicated, any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under the Internal Revenue Code or any other applicable tax law, or (ii) promoting, marketing or recommending to another party any transaction, arrangement, or other matter.

reasonable cause and good faith exception to the accuracy related penalties does not apply to any underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance. In addition, any claim for refund that is excessive due to a claim that lacks economic substance is subject to a 20% penalty and no reasonable basis exception is available.

Although the statutory definition of economic substance doctrine is intended to impose uniformity on what had been a muddled and often conflicting body of precedent applying the common-law economic substance doctrine, the adoption of this provision raises many new questions that will need to be addressed in future regulations or litigated cases. For example, it is unclear what will constitute the “transaction” under the new provision. The Act provides that a transaction can include a series of transactions and the Joint Committee on Taxation’s explanation of the bill states that codification is not intended to affect common-law standards allowing a court to aggregate, disaggregate, or otherwise recharacterize a transaction. The uncertainty regarding what constitutes a transaction raises the daunting prospect that strict liability penalties may potentially be applied to what the taxpayer views as only a portion of a larger transaction. Other issues remain open as well, such as the appropriate discount rates to be used to compare profit potential to tax benefits and how to determine whether the economic substance doctrine is relevant to a particular transaction.

Finally, it remains to be seen whether the Internal Revenue Service will be more aggressive in asserting the economic substance in light of the new provision, or whether it will become more reluctant to assert the doctrine as a result of the new strict liability penalty that applies if a transaction lacks economic substance.

The new statutory definition of economic substance and the new penalties related thereto apply to any transactions entered into after the date of enactment.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Thomas A. Cullinan	404.853.8075	tom.cullinan@sutherland.com
Mary E. Monahan	202.383.0641	mary.monahan@sutherland.com
David A. Roby Jr.	202.383.0137	david.robby@sutherland.com