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Codification of Economic-Substance Doctrine

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Under new legislation intended to help pay for the health-care law,¹ taxpayers are now subject to a 40% penalty on underpayments of tax attributable to transactions that lack economic substance as defined under new section 7701(o) of the Internal Revenue Code or fail to meet the requirements of any similar rule of law. This penalty will be reduced to 20% if the relevant facts affecting the tax treatment are disclosed in the taxpayer's return.² Significantly—and this may be the most striking aspect of the new legislation—there is no reasonable-cause defense.³ Thus, a taxpayer who derives tax benefits from a transaction determined to lack economic substance will be subject to the 40%/20% penalty even if the taxpayer acted reasonably and in good faith. Opinions of outside counsel or in-house tax analyses will not protect a taxpayer from imposition of the penalty. These new rules apply to transactions entered into after March 30, 2010.

New section 7701(o) provides that, in the case of a transaction to which the economic-substance doctrine is relevant, the transaction will be considered to have economic substance only if both—

- it changes the taxpayer's economic position (apart from federal income tax benefits) in a meaningful way, and
- the taxpayer has a substantial purpose (apart from the federal income tax effects) for entering into the transaction.

These rules do not specify the transactions to which the economic-substance doctrine is relevant. Thus, whether the relevancy precondition is met is presumably left to the discretion of the IRS and, ultimately, the courts.

A taxpayer may rely on a transaction's profit potential to show that a transaction has economic substance only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits.⁴ The provision does not require or establish a minimum return that will satisfy the profit-potential test. Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit, and the Treasury Department has been tasked with issuing regulations treating foreign taxes as an expense in determining pre-tax profit in appropriate cases.

In the case of individuals, new section 7701(o) applies only to transactions entered into in connection with a trade or business or activities engaged in for the production of income. It therefore appears that routine charitable giving and estate planning will not be subject to the new economic-

substance test.

The new law also modifies section 6676 of the Code, relating to erroneous claims for refunds or credits. Under section 6676, a taxpayer that claims a refund or credit without a "reasonable basis" for the claim is subject to a 20% penalty on the amount by which the amount of the claim exceeds the amount of the claim allowable for the year. New section 6676(c) provides that a taxpayer will not be considered to have a reasonable basis for any claim for such excess amount if the excess amount is attributable to a transaction that lacks economic substance under new section 7701(o) or fails to meet the requirements of any similar rule of law.

The new law is not intended to disallow tax benefits that are consistent with the congressional purpose or plan that the benefits were designed to effectuate. Nor is it 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. Among these are (i) the choice between capitalizing a business enterprise with debt or equity, (ii) a U.S. person's choice between using a foreign corporation or a domestic corporation to make a foreign investment, (iii) the choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization, and (iv) the choice to use a related-party entity in a transaction, provided the parties act consistently with arm's-length standards.

Despite these assurances, however, there are a number of normal-course business transactions that could be considered to lack economic substance under new section 7701(o) if the economic-substance doctrine were considered relevant to those transactions. Thus, while the new rules clearly reach abusive tax shelters, depending on how the rules are applied, they may also extend to a wide range of business transactions that have not historically been targeted by the IRS as lacking economic substance. Given this, and the fact that the potential penalties are so harsh (*i.e.*, automatic 40%/20% penalties with no reasonable-cause exception), taxpayers should carefully evaluate the risk that contemplated transactions may be subject to these rules. We are hopeful that the IRS will move quickly to provide guidance on the many unanswered questions raised by the new law.

1. H.R. 4872, Health Care and Education Reconciliation Act of 2010.

2. See Internal Revenue Code § 6662(b)(6), (i).

3. See *id.* § 6664(c)(2).

4. See *id.* § 7701(o)(2).

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