Codification of the Economic Substance Doctrine by the Health Care and Education Affordability Reconciliation Act of 2010

by Thomas E. Taylor

I. Introduction

The economic substance doctrine is a judicially developed doctrine under which the anticipated tax benefits from a transaction may be denied notwithstanding the fact that all statutory and administrative requirements are satisfied if the transaction does not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in federal income tax. There has been a lack of uniformity among the courts regarding the proper application of the economic substance doctrine. Nevertheless, by and large the application of the doctrine by the courts has worked fairly well.

On March 30, 2010, President Obama signed the Health Care and Education Affordability Reconciliation Act of 2010 (H.R. 4872) (the “Act”), which includes a provision that codifies the economic substance doctrine. A similar provision to codify the economic substance doctrine is contained in the American Workers, State, and Business Relief Act of 2010 (H.R. 4213, S. Amendment 3336), a tax extenders bill which was passed by the Senate. Because of the inclusion of the economic substance codification provision in the Act, new offsets will have to be found for H.R. 4213. Provisions to codify the economic substance doctrine are also contained in other pending bills which have not passed either chamber of Congress or either tax legislative committee. If any of those bills advance in the legislative process, substitute revenue raising provisions will have to be found. Proposals to codify the economic substance doctrine were contained in numerous – more than two dozen –

1 See Joint Committee on Taxation Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Health Care Act”.

2 Some courts have applied a conjunctive test that requires the taxpayer to establish the presence of both economic substance and business purpose for a transaction to pass judicial muster. See, e.g., Pasternik v. Commissioner, 990 F.2d 893 (6th Cir. 1993), rehearing den. 1993 U.S. App. LEXIS 11369 (1993). (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”) Other courts have taken the approach that either economic substance or a business purpose is sufficient for the transaction to be respected. See, e.g., Rice’s Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”) A third approach has been to regard economic substance and business purpose as “simply more precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), cert. den. 526 U.S. 1017 (1999).

There also has been a lack of uniformity regarding the type of non-tax economic benefit that a taxpayer must establish in order to demonstrate that a transaction has economic substance. For example, some courts have disagreed as to whether more than a nominal pre-tax profit is required in order to determine whether a reasonable possibility of profit exists independent of tax benefits. See generally Joint Committee on Taxation Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Health Care Act”.

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will greatly complicate tax planning because of a combination of the facts that: (1) many legitimate business transactions will fail to satisfy the literal statutory requirements for economic substance; and (2) the scope of the application of the statute, i.e., the types of transactions to which it would apply, is unclear. The Act includes a strict liability penalty for transactions that fail the codified economic substance doctrine. Codification of the doctrine will require taxpayers to accept increased tax risk with respect to many transactions and, in all likelihood, will deter some taxpayers from engaging in certain transactions that they would otherwise have undertaken.

The new statutory economic substance provision applies to transactions entered into after March 30, 2010.

This discussion does not purport to be a comprehensive discussion of the economic substance doctrine, the economic substance provision contained in the Act, or issues involving or consequences of codification.

II. Provisions of the Act to Codify the Economic Substance Doctrine

A. Summary of provisions (Section 1409 of the Act)

The Act adds new Internal Revenue Code §7701(o), which 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 (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.” (The requirement of clause (A) is sometimes referred to as the “objective” test, and the requirement of clause (B) is sometimes referred to as the “subjective” test for economic substance.)

The term “economic substance doctrine” is defined as “the common law doctrine under which tax benefits under subtitle A [income taxes] with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”

If a taxpayer relies on the potential for profit of a transaction to establish economic substance, such profit potential would be taken into account in determining whether the objective or the subjective test is met with respect to a 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 were respected. In determining pre-tax profit, fees and transaction expenses, and to the extent provided in regulations, foreign taxes would be taken into account.

State and local tax effects that are related to a federal tax effect would be treated in the same manner as a federal tax effect.

In determining whether a substantial purpose (apart from Federal income tax effects) exists, achieving a financial accounting benefit would not be taken into account if the origin of the financial accounting benefit is a reduction of Federal income tax.

In the case of an individual, these rules would apply only to transactions entered into in connection with a trade or business or an activity entered into for the production of income.

prior bills. The only such economic substance codification provision to have passed either chamber of Congress was the Food and Energy Security Act of 2007, which passed the Senate.
The determination of whether the economic substance doctrine is relevant to a transaction would be made in the same manner as if the subsection had not been enacted.

A new 40% strict liability penalty would be imposed on underpayments resulting from transactions found to lack economic substance or failing to meet the requirements “of any similar rule of law.” The penalty would be reduced to 20% of the underpayment if the transaction were disclosed by the taxpayer.

Interestingly, the Act does not contain a provision authorizing the Secretary of the Treasury to prescribe regulations to implement the economic substance codification provision. However, the Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Health Care Act” (the “Joint Committee Report”) states that “[a]s with other provisions in the Code, the Secretary has general authority to prescribe rule and regulations necessary for the enforcement of the provision.”

Another provision that was omitted from the Act but that is contained in substance in the Joint Committee Report is the statement that “[e]xcept as specifically provided in this subsection, the provisions of this subsection shall not be construed as altering or supplanting any other rule of law, and the requirements of this subsection shall be construed as being in addition to any other such rule of law.”

**B. When the test for economic substance is to be applied**

This would seem to be the most important issue of all. As discussed below, there are many transactions generally thought to involve legitimate tax planning that would not satisfy the Act’s literal standards for economic substance (e.g., leveraged equipment leasing transactions). There would seem to be only two possible “escape hatches”: (1) a finding that the transaction is not one to which the economic substance doctrine is relevant, and (2) possible future guidance exempting particular types of transactions from the application of the rule. In the absence of relevant future

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4 As noted, the economic substance provision in the Act would apply “[i]n the case of any transaction to which the economic substance doctrine is relevant”. By contrast, the economic substance provision contained in certain other proposals to codify the economic substance doctrine, e.g., S.3018, would apply “[i]n any case in which a court determines that the economic substance doctrine is relevant for purposes of this title to a transaction (or series of transactions)”. Each of the differing scope-of-application provisions finds precedent in numerous prior bills. There would not appear to be a great deal of practical difference between the formulations. Perhaps there may be cases in which an IRS determination that the doctrine applies is not judicially contested, but in many or most cases a court would make the final determination. Conversely, a court would not normally determine that the economic substance doctrine is relevant unless the IRS had asserted that it was. (Perhaps, generally, under one formulation the IRS could assert penalties prior to a judicial determination that the economic substance applies, but not under the other formulation. Note, however, that although the economic substance codification provision in S.3018 would have applied to a transaction only if a court determines the economic substance doctrine is relevant, it provides that the Chief Counsel may assert, compromise or collect a penalty with respect to a noneconomic substance transaction even if there has not been a court determination that the economic substance doctrine was relevant if the Chief Counsel or his delegate determines that it was relevant.)

5 Sheppard, News Analysis: Drafting Economic Substance, Part 3, 106 Tax Notes 1020 (Feb. 28, 2005) states: “Leveraged leasing, even the garden variety kind, has no economic substance in that it has no short-term nontax economic return. The present value of the residual value of the assets can’t possibly compete with the up-front tax benefits. (And no rational investor would wait around for uncertain residual value without the current tax juice.)”
guidance (the issuance of which at this point is speculative), the critical issue will be whether the economic substance doctrine is relevant to a particular transaction”.\[^{6}\]

An interesting point regarding the scope of the economic substance codification provisions of the Act and prior bills is that they would codify the definition of “economic substance” rather than codifying the doctrine. See CRS Report for Congress, *The Economic Substance Doctrine: Legal Analysis of Proposed Legislation* (March 24, 2008) (“CRS Report”), which states, “The proposals would not codify the doctrine, itself, nor provide standards for a court’s determination that the doctrine was relevant to a particular case.” The Joint Committee Report states, “The provision does not change present law standards in determining when to utilize an economic substance analysis.”

The Joint Committee Report discusses circumstances in which the provision is not intended to apply. First, it states:

> 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. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit) section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.”\[^{7}\]

\[^{6}\] Whether the IRS would ever be disposed to create an “angel list” is somewhat doubtful. See, e.g., Note, IRS Official, Practitioners Pan Economic Substance Doctrine Codification, 2007 TNT 106-1 (Doc. 2007-13194), which quoted a tax counsel to the Senate Finance Committee as stating that while “[w]e’re not trying to chill legitimate transactions. . . staff does not want to create an ‘angel list’ that allows planners to find a way around the line that was drawn in the sand”. See also Coder and Sheppard, *Congress Will Pass Economic Substance Codification in 2008, Government Officials Predict*, 2008 TNT 15-5 (Doc. 2008-1239), which quoted a Treasury tax legislative counsel as stating that he would be reluctant for Treasury to develop regulations that set out exceptions to the doctrine, because doing so would only create abusive planning opportunities. Also, in a letter by Andrew Berg on behalf of the New York State Bar Association to Pamela Olson and Mark Everson dated May 21, 2003, Mr. Berg stated, “The Proposed Legislation purportedly ‘clarifies’ the application of the economic substance doctrine. In so doing, however, it imposes certain conditions, which on their face would not be met by many transactions that all would agree are unobjectionable . . . While it is true that Treasury and IRS could ameliorate the impact of the impact of the Proposed Legislation on legitimate transactions through the issuance of rules and regulations, in our view this is a near impossible task. It is also unfair to have the legislation become effective in a form that is overbroad subject to the later adoption of remedial measures.”

\[^{7}\] The Joint Committee on Taxation report dated Sept. 2009 for the President’s Fiscal Year 2010 Budget Proposal quotes the Senate Report for S.2242 for the principle that the economic substance doctrine will not apply “if the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions”. To the apparent benefit of taxpayers, the Joint Committee Report for the Act drops the word “clearly”.

A number of other authorities provide similarly. See, e.g., *ACM Partnership v. Commissioner*, TC Memo. 1997-115, 73 T.C.M. 2189, aff’d in part and rev’d in part, 157 F.3d 231 (3rd Cir. 1998), cert. den., 526 U.S. 1017 (1999), in which the Tax Court described the economic substance doctrine as follows:
The Joint Committee Report further states:

The provision 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. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied. Leasing transactions, like all other types of transitions, will continue to be analyzed in light of all facts and circumstances. [The Joint Committee Report further states that these examples are illustrative and not exclusive.] As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.8

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim benefits, unintended by Congress, by means of transactions that serve no purpose other than tax savings. [Emphasis added]

A Senate Finance Committee report dated Oct. 25, 2007 on the Heartland, Habitat, Harvest, and Horticulture Act of 2007 (which became part of the Food and Energy Security Act of 2007) states: “If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance [is] that the transaction fails the economic substance doctrine as defined in this position.” (The same language appears in Joint Committee on Taxation report dated July 14, 2009 for H.R. 3200 (“Americas Affordable Health Choices Act of 2009”) and report dated Nov. 5, 2009 on H.R. 3962 (“The Affordable Health Care for America Act of 2009”).)

8 The Senate Finance Committee’s report on the Food and Energy Security Act of 2007 similarly stated that the economic substance codification provision “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.” Such report provided a non-exclusive list of such transactions identical to the list in the Joint Committee Report.

A corollary of the statement that the economic substance doctrine would not apply to such basic business transactions is that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.” Gregory v. Helvering, 293 U.S. 465, 469 (1935). See Ventry, Save the Economic Substance Doctrine from Congress, 118 Tax Notes 1405 (Mar. 31, 2008), who, speaking of this maxim, cites from Coltec Industries, Inc., 454 F.3d 1340, 1357 (Fed. Cir. 2006), cert. den. 549 U.S. 1206 (2007) to caution, But ‘there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is perfectly permissible) and creating a transaction, without a business purpose, in order to create a tax benefit (which is impermissible).’”
The provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits. [Citations omitted.]

Apropos of the four examples of transactions of “basic business transactions” to which the economic substance doctrine would not apply, note that Tax Executives Institute, in Tax Executives Institute Says Economic Substance Provisions Should Be Removed from AMT Bill, 2007 TNT 243-25, comments that although the purpose of an “angel” list of transactions is to be helpful to taxpayers, the mere existence of such a list implies that the transactions omitted from the list would be subject to challenge.) Silverman, in Steptoe & Johnson Requests Reconsideration of Economic Substance Doctrine Codification, 2007 TNT 231-20 (Nov. 30, 2007), observes that the list “is far from exhaustive of all the common ordinary transactions that have been respected pursuant to well established authority.”

Under a proposal that was contained in the report by the staff of the Joint Committee on Taxation titled “Options to Improve Tax Compliance and Reform Tax Expenditures,” JSC-02-05 (Jan. 27, 2005) (“JCT Proposal”), statutory economic substance would have applied only to a specified list of transactions.9 The Act does not contain any similar provisions. (Nor does there appear to have been any other bill that contained a provision to codify the economic substance in which the provision would apply only in specified circumstances (except that the Abusive Tax Shelter Shutdown Act of 1999 contained findings regarding abusive transactions and listed factors that gave rise to a presumption of noneconomic tax attributes)).

Nor, generally, have there been bills with economic substance codification provisions that identified particular transactions to which the statutory economic substance rule would not apply or that identified credits or other tax attributes that would be considered economic returns and not tax benefits (except that the Abusive Tax Shelter Shutdown Act of 1999 provided that credits under §§29, 42, 45 and 1397E would be treated as economic returns and not tax benefits). However, a number of bills have provided that with respect to lessors of tangible personal property, the expected net tax benefits would not include the benefits of depreciation or any tax credit with respect to the leased property. The Act contains no such provision relating to lessors.

(Note that Tax Executives Institute, in Tax Executives Institute Says Economic Substance Provisions Should Be Removed from AMT Bill, 2007 TNT 243-25, comments that although the purpose of an “angel” list of transactions is to be helpful to taxpayers, the mere existence of such a list implies that the transactions omitted from the list would be subject to challenge.) Silverman, in Steptoe &

9 Such transactions, called “applicable transactions”, were defined “a transaction – (A) in which (i) the taxpayer holds offsetting positions which substantially reduce the risk of loss, and (ii) tax benefits would result from differing tax treatment of the positions, (B) which is structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain, (C) which is structured to create or increase a gain in an asset any portion of which would not be recognized for Federal income tax purposes if the asset were sold at fair market value by the taxpayer (or a related person), (D) which is structured to result in income for Federal income tax purposes to a tax-indifferent party for any period which is materially in excess of any economic income to such party with respect to the transaction for such period, (E) in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities regularly traded on an established securities market) which the taxpayer held for a period of less than 45 days. . . (F) which is structured to result in a deduction or loss which is otherwise allowable under this title and which is not allowed for financial reporting purposes, or (G) which is specified in regulations prescribed by the Secretary.
Johnson Requests Reconsideration of Economic Substance Doctrine Codification, 2007 TNT 231-20 (Nov. 30, 2007), observes that the list “is far from exhaustive of all the common ordinary transactions that have been respected pursuant to well established authority.”

Donald Korb, in Codification of the Judicial Economic Substance Doctrine, 852 PLI/TAX 377, states: “The author also stated that the doctrine should be considered where the transaction ‘does not appear to be in accord with Congressional intent and common sense’. . . . The doctrine should not be codified without an exception for results that are ‘reasonably intended to be available under the circumstances in which they arose (based on a reasonable reading of the relevant statutes and regulations, considered in the light of the purposes for which they were promulgated).’”

The New York State Bar Association Tax Section Summary Report on the Provisions of Recent Senate Bills that Would Codify the Economic Substance Doctrine (May 21, 2003) contains a good explanation of the proper use of the doctrine:

The economic substance doctrine currently does not deny taxpayers every tax benefit arising from a tax-motivated transaction that lacks business purpose and does not meaningfully change a taxpayer’s economic position. Given its role as a doctrine of statutory interpretation, it denies tax benefits only if under the circumstances allowing the benefits would be contrary to the intent of the drafters. Thus, in Cottage Saving Ass’n v. Commissioner, a taxpayer entered into a tax-motivated transaction (an exchange of economically similar mortgage portfolios) solely to accelerate the deduction of an otherwise unrealized economic loss. Notwithstanding that the transaction had no non-tax business purpose and did not meaningfully change the taxpayer’s economic position, the Supreme Court refused to disallow the deduction because the drafters of the relevant provision of the Code (section 1001 of the Code and the regulations thereunder) might reasonably have envisioned a taxpayer deducting its loss under those circumstances. The taxpayer’s intentional realization of gains or losses from strictly tax-motivated transactions was therefore within the relevant statutory and regulatory intent. Similarly, in Horn v. Commissioner, the court refused to disallow deductions arising from abusive commodity straddles, even though the straddles obviously lacked both business purpose and economic substance (in that they were “devoid of any prospect of true gain or loss”), because Congress arguably had condoned such deductions for straddles undertaken by commodities dealers under Section 108(c) of the Deficit Reduction Act of 1984.

Although a finding that allowing a claimed tax benefit was not contemplated by the applicable provisions is a precondition for disallowance, that finding, standing alone, is not sufficient. The economic substance doctrine is not a “general anti-abuse rule” that denies any tax benefit that was not intended to be available under the relevant circumstances. The economic substance doctrine has most commonly been applied to transactions that do not change economic consequences and thus “do not appreciably change the taxpayer’s financial positions. . . .

. . . .

To summarize . . . a court normally makes two findings before it disallows a tax benefit under the doctrine. First, the Court finds that the taxpayer is seeking to obtain tax benefits under circumstances where Congress and/or the Treasury did not intend the benefits to be available. In other words, the tax benefits are ones that were not reasonably contemplated by the drafter of the relevant statute or regulation, but instead frustrate the relevant statutory or regulatory intent. Second, the court normally finds that the transaction both lacked
business purpose and economic substance, based on a finding that the transaction could have accomplished little more economically than the taxpayer’s reported tax provision.

[S]trict liability penalties are legitimate only if taxpayers have fair warning of what is prohibited. As proposed, the codification of economic substance leaves so much uncertainty for taxpayers that we believe it would be unfair to impose strict liability penalties . . .

Tax Executives Institute, in Tax Executives Institute Says Economic Substance Provisions Should Be Removed from AMT Bill, supra, states:

Regrettably, the statutory terms relevant, meaningful, and substantial do not provide any objective standard to clarify when the economic substance doctrine should apply.

TEI submits that statutorily “clarifying” the economic substance doctrine would do nothing to curb illegitimate transactions because there are no illegitimate transactions currently beyond the doctrine’s reach and scope. In other words, since the doctrine requires judges to apply their best judgment to the facts and circumstances, there is no statutory embellishment that will result in a mechanistic formula for its automatic and – equally important – correct application.

Codifying the economic substance doctrine would further complicate the system, confuse taxpayers and revenue agents, raise significant issues of statutory construction, impede the courts’ ability to rely on existing precedent, and interfere with legitimate commercial transactions.

See also ABA Tax Section Comments on Codification of Economic Substance Doctrine, 2007 TNT 72-22 (April 13, 2007).

There can be no doubt many common transactions would lie beyond the pale of the Act’s economic substance codification provision. In certain tax-advantaged transactions, we would as a practical matter be confident that such provision would not be relevant. A clear example would be a simple like-kind exchange under Code §1031.10 There could be many other situations, however, in which we would expect the doctrine not to be found relevant but could not be certain. Examples might be leveraged leasing transactions and (notwithstanding the reference to Code §48 in the Joint Committee Report) many structured energy credits transactions. After all, “there are no limits on the types of transactions in which the IRS can assert economic substance.” Korb, Codification of the Judicial Economic Substance Doctrine, supra at 392. Particularly because of the penalty provisions relating to noneconomic substance transactions, legitimate tax planning could be seriously impeded. According to the CRS Report:

10 It would seem that the more tightly restricted the attainment of a tax benefit is under the Code or other relevant authority, the less likely that the economic substance doctrine should be found relevant. Examples might be a sale of stock at a loss and a purchase of substantially identical property just outside of the period in which the wash sale rule would apply, or a deliberate effort to “break” what would otherwise be a Section 351 exchange.
Taxpayers, tax professionals, and the courts will still be in the position of trying to determine Congress’s purpose for various provisions of the tax code. In some cases, there is sufficient legislative history to determine the purpose, but in other cases there is not. As a result, taxpayers might avoid legitimate business transactions out of fear and a potential penalty.

See also Jackel, For Better or For Worse: Codification of Economic Substance, 2004 TNT 96-33 (Doc. 2004-9475), which states:

Even though the proposed [provision] requires that a court first determine that the economic substance doctrine applies to a transaction or series of transactions before the codification becomes effective, there is simply no way of knowing in advance of a court determination whether a court will apply the economic substance doctrine for the first time to a transaction. Given the current strict liability nature of the economic substance penalty of [the] proposed [provision], this state of affairs seems unfair to taxpayers and imposes significant burdens upon the taxpayer’s professional advisors. For example, if a court case or an IRS revenue ruling reaches a result on a given set of facts without addressing the economic substance doctrine, does this mean anything as to whether the issue under consideration is subject to being tested for validity under [the proposed provision] when and if the issue reaches the courts? And when are tax benefits “clearly contemplated and expected by the language and purposes of the relevant authority”? When the taxpayer wants it to be? Does an Internal Revenue Code provision have to explicitly state that it applies without regard to [the proposed provision] and the common law economic substance doctrine in order for the “clearly contemplated” exception to apply? If this is the governing test, no present law statute will meet the test.

See also Hariton, Economic Substance Complaint No. 1: “Too Vague and Too Broad”, 96 Tax Notes 1893 (Sept. 30, 2002), which states:

What shall we conclude, as a legal matter, if legislation containing this definition of the economic substance doctrine [the same definition that appears in the Act] is nevertheless adopted? I assume we will conclude, as a matter of law, that the disallowance doctrine described in this definition now governs the tax treatment of all transactions. The disallowance doctrine described in this definition, however, is much broader than any conceivable “antiabuse” rule. For the disallowance doctrine described in this definition serves to disallow tax benefits arising from transactions that are not even abusive. Maybe this wouldn’t be so troubling if the provision applied to a relatively narrow group of transactions. But the provision has been drafted as broadly as possible, in a familiar effort to pick up any transaction that could conceivably turn out to be a tax shelter, and it therefore literally applies to most transactions. A definition that is drafted this broadly is necessarily a grant of executive discretion, like the 55-mile-per-hour speed limit posted on a superhighway. You rely on the cops to selectively ticket the people who are going 90 miles per hour, because as a technical matter, everyone is speeding. But what do you do when the police lack the manpower to figure out who is going too fast? You hope to keep drivers in line by imposing a stiff penalty on the ones who get caught, but you can’t do that if everyone is in technical violation.

It appears somewhat hyperbolic to say that we will conclude, as a practical matter, that the codified economic substance doctrine now governs the tax treatment of all transactions. Nevertheless, the quoted language does underscore the in terrorem effect that codification would have.
C. The test for economic substance

Comparatively little has been written on the specific tests for economic substance contained Act or in various prior bills, other than explain that many legitimate transactions would fail those tests (which leads back to a discussion of the proper scope of the application of the test). This is hardly surprising, because the tests involve vague, undefined terms with, as of yet, no real-world application.

According to the CRS Report, “[c]odifying the economic substance doctrine arguably could provide a ‘clear and understandable rule.’” That may or not be true, but again to quote the CRS Report:

There are . . . phrases and concepts in the proposed definition that may be less than clear. If so, they may cause uncertainty rather than providing clarification. Some of these are “changes in a meaningful way”, “substantial purpose” and substantial profit (in comparison to tax benefit). Additionally, since the courts are left to determine when the economic substance doctrine is relevant, there may still be room to apply the codified definition “in an unpredictable and arbitrary manner.” [Citations omitted.]

Silverman, West and Nocjar, The Case Against Economic Substance Codification, 104 Tax Notes 314 (July 19, 2004), state:

Although there are several technical elements of the proposal that would bring certainty to the economic substance analysis where the authority is currently ambiguous (conjunctive vs. disjunctive test, impact of foreign tax payments, financial statement tax asset as a business purpose, etc.), it is clear that numerous questions will continue to require judicial resolution (e.g., whether the doctrine should apply to a transaction), and numerous other new issues will be created by the proposal that will require judicial or administrative resolution. As such, it is unclear that the proposal will yield a net reduction in uncertainty. Put another way, the proposal will likely add complexity than reduce it.

1. “Objective” test. According to Korb, Codification of the Judicial Economic Substance Doctrine, supra at 389, the JCT Proposal expresses objective economic substance as a meaningful change in the taxpayer’s economic position:

1) An example provided in the proposal as “suspect” is “if money (or any other asset or liability) moves in a circular manner, such that the taxpayer’s or another party’s apparent fiscal outlay is largely protected from risk and is reasonably expected to be returned to that party or a related party when the transaction is complete.”

2) The Economic Substance Speech indicates that one measure of objective economic substance is a legitimate potential for pre-tax profit. Evidence that this potential exists is that the transaction is “carefully conceived and planned in accordance with standards applicable to a particular industry, so that judged by those standards the hypothetical reasonable businessman would participate in the investment.”

2. “Subjective” test. It is noteworthy that the Act, in contrast to certain prior bills, does not require (in addition to requiring that the taxpayer have a substantial nontax purpose for entering into the transaction) that the transaction be a reasonable means of accomplishing such purpose.
The Joint Committee Report’s discussion of the need for a substantial non-federal-income-tax purpose cites Treas. Reg. §1.269-2(b), which states that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that “the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer.” It also cites ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1987), in which the court stated:

Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and useful in light of the taxpayer’s economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with the commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with transaction costs.

3. Both objective and subjective tests. It is noteworthy that the Act, in contrast to certain prior bills, does not require for purposes of the rule regarding a potential for profit (in addition to requiring that the present value of the reasonably expected pre-tax profit from the transaction be substantial in relation to the expected present value of the net tax benefits) that the reasonably expected pre-tax profit exceed a risk-free rate of return.

Silverman, in Steptoe & Johnson Requests Reconsideration of Economic Substance Doctrine Codification, supra, commenting on the economic substance codification proposal in the Tax Reduction and Reform Act of 2007, states:

The additional requirement included in past bills that the transaction be a “reasonable means of accomplishing” the “substantial” non-federal tax purpose has been eliminated. In addition, the special rule in past bills requiring a transaction motivated by profit in excess of a risk-free rate of return has also been eliminated. These modifications improve the proposal somewhat by removing additional requirements, but they do nothing to address the fundamental problem that when and how the economic substance doctrine would apply is still uncertain. “Relevant”, “meaningful,” and “substantial” are not clear and objective standards.

Commenting on similar language in The Heartland, Habitat, and Harvest, Horticulture Act of 2007), the authors state, “These vague standards [i.e., “relevant,” “meaningful,” and “substantial”] will have to be applied by numerous lower level IRS agents, IRS appeals officers, and ultimately, different courts, and will likely produce different results, eliminating the clarity and uniformity intended by the bill.”

The Senate Finance Committee report on the Food and Energy Security Act of 2007 states:

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer’s economic position or that the taxpayer has a substantial non-Federal-tax purpose for entering into such transaction. The provision does not require or establish a specified minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected
pre-Federal-tax profit must be substantial in relation to the present value of the expected net Federal tax benefits that would be allowed if the transaction were respected.

An analysis of cases in which transactions were found to possess or not to possess economic substance is generally beyond the scope of this discussion. It is worth noting, however, that several recent cases show that an important factor in determining whether a transaction has economic substance is whether the transaction was entered into in the taxpayer’s own industry and in furtherance of its existing business objectives. See Consolidated Edison Company of New York, Inc. & Subs. v. United States, 104 AFTR 2d 2009-6966 (Oct. 21, 2009), which involved a ‘lease in/lease out” transaction, and Shell Petroleum Inc. v. United States, 102 AFTR 2d 2008-5085 (July 3, 2008), which involved a transfer of non-producing properties to a new corporation followed by loss-generating dispositions. See generally Bowen, “Wells Fargo” and Economic Substance, BNA Daily Tax Report, Feb. 18, 2010, J-1, which lists the following additional factors as reasons why the taxpayers in those cases were successful in establishing that the transactions had economic substance: that the taxpayers had performed pre-transaction due diligence; that the transactions had non-tax business purposes that were contemporaneously documented; and that the taxpayers did not overly emphasize the tax benefits produced by the transactions.

With respect to a codified economic substance provision, whether or not a transaction were entered into in the taxpayer’s own industry, and the other factors mentioned, would most directly be relevant to the subjective test, but they could also bear on the pre-tax profit to be realized from the transaction, which is germane to both the objective and subjective tests.

D. Penalty provisions.

Joint Committee on Taxation Description of Revenue Provisions Contained in the President’s Fiscal Year 2010 Budget Proposals (Sept. 2009), states:

It is understood that the penalty regime is intended to give economic substance greater weight in taxpayers’ decision-making prior to entering into transactions and prior to reporting transactions for tax purposes. By increasing the cost to taxpayers when a transaction is determined to lack economic substance, the codification and penalty regime intends to change the taxpayer’s cost-benefit analysis and deter some aggressive behavior.

According to the CRS Report, Donald Korb has questioned whether the strict liability penalty would ever be asserted by the IRS. He also observed that “Courts may be reluctant to find lack of economic substance when it will result in an automatic strict-liability penalty.” Korb, Codification of the Judicial Economic Substance Doctrine, supra at 394.

E. Revenue projections

Revenue projections for proposed economic substance codification provisions have varied substantially. Projections for the Act is that it will raise $4.5 billion over 10 years. Projections for the almost identical provision in H.R. 4213 were that it would raise $5.5 billion over 10 years. BNA Daily Tax Report, March 11, 2010, GG-1. Projections for the Food and Energy Security Act of 2007 were more than $10 billion over 10 years; for the Tax Reduction and Reform Act of 2007 they were
slightly over $4 billion over the same period. According the CRS Report, “there is disagreement as to both the amount that would be raised and the way in which codification would increase revenue.”

Some revenue might be raised by making uniform the conjunctive (i.e., objective and subjective) tests for economic substance, because while that is the majority approach among the Circuits, there are exceptions.11 Donald Korb has stated that “[a]ll the money is in the penalties”. Young, Korb Slams Textron Ruling, Wall Street Rule, 117 Tax Notes 204 (Oct. 15, 2007). As indicated above, however, he has stated that “[c]ourts may be reluctant to find lack of economic substance because of the automatic strict-liability penalty.” It seems likely that part of the revenue that would be raised would derive from the in terrorem effect of the provision.

F. Possible new planning opportunities
One of the stated objections to codification of the economic substance doctrine is that codification would provide a roadmap for taxpayers to plan around the doctrine and enable practitioners to devise a transaction that a court might, in the past, have found to lack economic substance but which meets the criteria for economic substance under a statutory codification. It is rather difficult to believe this, since the test is so vague. (See item 2 above.)

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11 However, the New York State Bar Association Tax Section Summary Report on the Provisions of Recent Senate Bills that Would Codify the Economic Substance Doctrine (May 21, 2003) expresses doubt that whether a court saying that it is using a conjunctive or a disjunctive test, without more, would affect the outcome in many cases.