

## ECONOMIC SUBSTANCE DOCTRINE CODIFIED

### OVERVIEW

On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010, HR 4872. The bill approved last week by the US House of Representatives and US Senate. Notably, the law is not limited to healthcare reform, but also includes amendments to the Internal Revenue Code in an effort to raise revenue to offset some of the costs of healthcare reform. Included among the tax provisions is the codification of the economic substance doctrine.

The economic substance doctrine is a judicially-developed rule that a proposed transaction must have a meaningful economic purpose or investor risk to be respected for tax purposes. Courts have consistently rejected a variety of tax shelters because the transactions lacked economic substance.<sup>1</sup> Over the years, however, the courts have articulated different standards for determining the presence of economic substance.<sup>2</sup> The law's provisions relating to the economic substance doctrine codify that a transaction will be treated as having economic substance only if it changes the taxpayer's economic position in a meaningful way and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such a transaction.<sup>3</sup>

### ELEMENTS OF THE JUDICIALLY DEVELOPED ECONOMIC SUBSTANCE DOCTRINE

Judicial approaches to the economic substance doctrine have varied. Some courts have applied a conjunctive test that requires a taxpayer to establish the presence of both economic substance and business purpose for the transaction

**Brussels**  
+32 (0)2 290 7800

**Denver**  
+1 303.863.1000

**London**  
+44 (0)20 7786 6100

**Los Angeles**  
+1 213.243.4000

**New York**  
+1 212.715.1000

**Northern Virginia**  
+1 703.720.7000

**San Francisco**  
+1 415.356.3000

**Washington, DC**  
+1 202.942.5000

<sup>1</sup> See Yoram Keinan, *The Economic Substance Doctrine*, 508 Tax Mgmt. (BNA) US income at X.

<sup>2</sup> See *id.*

<sup>3</sup> Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a) (2010) (to be codified at 26 U.S.C. § 7701(o)).

#### US TREASURY CIRCULAR 230 NOTICE

ANY US FEDERAL TAX ADVICE INCLUDED IN THIS COMMUNICATION (INCLUDING ANY ATTACHMENTS) WAS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING US FEDERAL TAX-RELATED PENALTIES OR (II) PROMOTING, MARKETING, OR RECOMMENDING TO ANOTHER PARTY ANY TAX-RELATED MATTER ADDRESSED HEREIN.

*This advisory is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation. © 2010 Arnold & Porter LLP*

**arnoldporter.com**

to survive scrutiny.<sup>4</sup> Other courts have treated either a business purpose or economic substance as sufficient to respect the transaction.<sup>5</sup> A broader approach taken by some courts regards economic substance and business purpose simply as factors to consider in determining whether a transaction has any practical economic effects other than the creation of federal tax benefits.<sup>6</sup>

Judicial interpretation has also varied regarding the type of non-tax economic benefit a taxpayer must establish to demonstrate that a transaction had economic substance. Courts have denied tax benefits on the grounds that the transaction lacked profit potential.<sup>7</sup> Other courts have disallowed tax benefits in a transaction that had profit potential and exposed the taxpayer to risk, but where the court concluded that the risks and profit potential were insignificant compared to the tax benefit.<sup>8</sup> Yet, other courts

have required no more than an objective determination of whether a reasonable possibility of profit existed apart from the tax benefits.<sup>9</sup>

## CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE ADOPTS A TWO-PRONG TEST

The new law codifies the economic substance doctrine by amending the Internal Revenue Code to include specific criteria for determining whether a transaction has economic substance. The law amends Internal Revenue Code section 7701 to add a new section (o), "Clarification of Economic Substance Doctrine." The amendment mandates the application of a conjunctive test under which a transaction is treated as having economic substance only if both "the transaction changes 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."<sup>10</sup> The potential for profit will not be considered in determining whether the transaction meets these requirements unless "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."<sup>11</sup> The determination of whether the economic substance doctrine is relevant to a transaction is specifically stated as to be made "in the same manner as if this subsection had never been enacted"—in other words, by the courts.<sup>12</sup> The amended Internal Revenue Code provision applies to transactions entered into after March 30, 2010.

4 See Staff of J. Comm. on Taxation, 111th Cong., Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," As Amended, in Combination with the "Patient Protection and Affordable Care Act" 143 (Comm. Print 2010), (available at <http://www.jct.gov/publications.html?func=startdown&id=3673>), citing *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 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.").

5 See *id.*, at 143, citing *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes 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."); *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001) ("in determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose outside of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test).").

6 See *id.* at 144, citing *ACM Partnership v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998); *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("instead, the consideration of business purpose and economic substance are simply more precise factors to consider... We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

7 See *id.* at 145, citing *Knetsch v. United States*, 364 U.S. 361, 361(1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

8 See *id.*, citing *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating that "potential for gain...is infinitesimally nominal and

vastly insignificant when considered in comparison with the claimed deductions").

9 See *id.*, citing *Rice's Toyota World*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits).

10 Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a) (2010) (to be codified at 26 U.S.C. § 7701(o)(1)).

11 *Id.* (to be codified at 26 U.S.C. § 7701(o)(2)(A)).

12 *Id.* (to be codified at 26 U.S.C. § 7701(o)(5)).

## INCREASE IN PENALTY AND EXPECTED INCREASE IN REVENUE

The law amends the Internal Revenue Code accuracy-related penalty provisions to provide an increase in penalty in the case of non-disclosed noneconomic substance transactions; the penalties would be mandated at 40 percent, up from the current 20 percent.<sup>13</sup> The law also renders the reasonable cause exception inapplicable to noneconomic substance transactions.<sup>14</sup>

By increasing the cost to taxpayers when a transaction is determined to lack economic substance, the law is intended to change the taxpayer's cost-benefit analysis and deter aggressive behavior. The Joint Committee on Taxation projects that the provision will generate US\$4.5 billion dollars in revenue over the next nine years,<sup>15</sup> which may represent a hope for aggressive use of the doctrine by the Internal Revenue Service (IRS).

## CONCLUSION

Transactions that create arguably inappropriate tax benefits are a persistent problem for the IRS. Courts have relied on the economic substance doctrine to distinguish abusive transactions from legitimate ones. However, courts have been inconsistent in applying the doctrine, and the application has and continues to be heavily dependent upon the facts and circumstances of a particular transaction. The codification of the economic substance doctrine adds a modest amount of clarity for taxpayers, although several concepts remain that require further clarification (e.g., "changes in a meaningful way," "substantial purpose"). What remains unclear is whether the application of the new statutory provisions ultimately will be more or less favorable to a particular transaction than the doctrine as historically—and judicially—applied.

*We hope that you find this advisory helpful. If you would like more information on this or other tax issues, please feel free to contact:*

**Joseph G. Howe III**  
+1 202.942.5230  
Joseph.Howe@aporter.com

**James P. Joseph**  
+1 202.942.5355  
James.Joseph@aporter.com

**Rebecca L. D. Gordon**  
+1 202.942.5372  
Rebecca.Gordon@aporter.com

**Jonathan Hommer**  
+1 202.942.6803  
Jonathan.Hommer@aporter.com

<sup>13</sup> *Id.* § 1409(b) (to be codified at 26 U.S.C. § 6662(i)(1)).

<sup>14</sup> *Id.* § 1409(c) (to be codified at 26 U.S.C. § 6664(c)).

<sup>15</sup> House Passes Reconciliation Bill to Complete \$940 Billion Health Care Bill," Daily Tax Real Time (BNA) (March 22, 2010).