

Codification of the Economic Substance Doctrine

The President signed the Health Care and Education Reconciliation Act of 2010 (the "HCERA") on March 30, 2010. One of the most significant tax changes in the HCERA is the codification of the economic substance doctrine.

A Two-Part Test

The common law based economic substance doctrine is sometimes applied to deny tax benefits in transactions that would otherwise qualify for such benefits under the literal language of the Internal Revenue Code. Under the codified doctrine, when the economic substance doctrine is relevant a transaction will be treated as having economic substance only if: (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economics and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

Profit Potential Must be Present Valued

For this purpose, a profit potential for a transaction is taken into account only if the present value of pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits from the transaction, assuming the transaction is respected.

Fees and other expenses, including foreign taxes to the extent provided by regulations, will be taken into account in determining pre-tax profit. State and local tax benefits are treated in the same manner as Federal tax benefits. Accounting benefits are disregarded if the origin of the accounting benefit is a reduction in Federal tax.

When the Doctrine Will Be Applied

The new provisions only apply to transactions entered into in connection with a trade or business or for the production of income.

The new provision expresses an intent not to change the determination of whether the economic substance doctrine is relevant to a transaction.

The report of the Staff of the Joint Committee indicates that tax benefits realized in a transaction consistent with the Congressional purpose or plan for the tax benefits as designed by Congress will not be disallowed under the new provision. Thus, for example, the report of the Staff of the Joint Committee indicates 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.) will not 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.

According to the legislative history, 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 corporate tax law; and (4) the choice to utilize a related-party entity in a transaction, provided that an arm's length pricing standard is used and other applicable concepts are satisfied. Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances. 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.

Effective Date and Penalties

The amendment, which is immediately effective, also increases penalties for transactions without economic substance in some circumstances. A new 20% strict liability penalty is added for understatements due to the failure of a transaction to satisfy the economic substance doctrine, which is increased to 40% if the transaction is not disclosed. There is no reasonable cause defense to the penalty.

Uncertainty as to Application

Although energy projects seem to have been given the green light, other common commercial transactions such as leasing may have the amber showing. The legislative history indicates that "a facts and circumstances" test will be applied to determine if transactions need to be tested under the economic substance doctrine. Until further guidance is promulgated there may be uncertainty as to whether the doctrine will be applied and if the doctrine is applied what will be necessary to satisfy the two-part test.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact Paul Carman at carman@chapman.com, Steve Frost at frost@chapman.com, or Melanie Gnazzo at mgnazzo@chapman.com, or visit us at chapman.com.

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