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Economic Substance Doctrine Codification Passed By Congress

On March 25, 2010, both the Senate and the House passed the Health Care and Education Reconciliation Act of 2010 (the "Reconciliation Act"). In addition to the various health care proposals, the Reconciliation Act (Section 1409) codifies the economic substance doctrine and adds a new penalty regime for transactions lacking economic substance. The President is expected to sign the Reconciliation Act — with the economic substance doctrine codification provision — into law in the next few days.

According to the Technical Explanation accompanying the Reconciliation Act, the new provision "clarifies and enhances the application of the economic substance doctrine." Specifically, the Reconciliation Act provides that for any transaction to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction. The taxpayer is permitted to rely on factors other than profit potential to demonstrate that these requirements are satisfied. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected pretax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

The "clarification" and "expansion" of the economic substance doctrine are expected to have a significant effect on tax planning. Transactions that may have satisfied the disjunctive test or pretax profit standards of prior law will need to be reconsidered in light of the codification. In addition, the codification provides a powerful tool for IRS audit teams and its enforcement and litigation activities. The codification provision will apply to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after the date of enactment.

In addition to codifying the economic substance doctrine, the provision adds a new penalty for underpayments and understatements attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance as defined in the new codification provision or by reason of failing to satisfy the requirements of any similar rule of law (i.e., tax benefits disallowed under common law applications of economic substance and similar rules). The penalty generally is 20 percent but is increased to 40 percent if the taxpayer fails to adequately disclose the relevant facts affecting the tax treatment of the item. The codification provision also provides that the reasonable cause exception, normally applicable to accuracy-related penalties, does not apply in the case of a transaction lacking economic substance. This is a significant expansion from the standards of existing case law.

Fortunately, the Technical Explanation includes a critical exclusion from the codification for certain transactions for which the economic substance doctrine is not "relevant." Footnote 344 of the Technical Explanation provides that "[i]f 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 benefit be disallowed." As examples, the Technical Explanation then cites a list of specific tax credits and states that such credits and other similar tax benefits are not intended to "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." The specific list of tax credits includes the following credits:

- 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

The exclusion in footnote 344 represents an important exclusion for renewable energy and other congressionally incentivized tax credits. In most cases, these types of transactions must rely upon the tax credits in order to be profitable and otherwise may have a difficult time satisfying the requirements of the economic substance doctrine codification.

View Section 1409 of the Reconciliation Act or the relevant portions of the Technical Explanation.