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LEGAL ALERT

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Not Much Substance in IRS Interim Guidance on Codification of the Economic Substance Doctrine

The economic substance doctrine was codified in the Health Care and Education Reconciliation Act of 2010 (the Act), Pub. L. No. 111-152, applicable to transactions entered into on or after March 31, 2010. The codification is silent regarding the transactions to which the economic substance doctrine applies, but once the doctrine has been determined to apply, new section 7701(o) of the Code provides the criteria under which a transaction is to be evaluated for economic substance. Section 7701(o) treats a transaction as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. The test is conjunctive, not disjunctive.

Any underpayment attributable to any disallowance of a claimed tax benefit because of a transaction lacking economic substance (under section 7701(o) or any similar rule of law) is subject to a 20% accuracy-related penalty under new section 6662(b)(6). If the relevant facts affecting the tax treatment of the transaction are not adequately disclosed in the taxpayer's return (or a statement attached to the return), the underpayment attributable to such transaction is subject to a 40% strict liability penalty under new section 6662(i). The penalty is imposed on a strict liability basis—the reasonable cause exception does not apply. On September 14, 2010, the IRS issued LMSB Directive, LMSB 4-0910-024, requiring that any assertion of the strict liability penalty be approved by the Director of Field Operations.

On September 13, 2010, the IRS issued Notice 2010-62, which is intended to provide interim guidance regarding the application of new section 7701(o). Unfortunately, the interim guidance does not contain much of substance. For the economic substance test itself, the guidance merely notifies taxpayers that the IRS intends to rely on existing case law. The guidance does, however, provide general rules regarding sufficient disclosure of tax return positions that may be subject to the economic substance doctrine, although details are lacking.

The notice provides that the IRS intends to apply existing case law, both in determining whether the economic substance doctrine would apply to a particular transaction, and in applying each of the prongs of the economic substance test as codified in section 7701(o). Notice 2010-62 states that the IRS intends to apply the conjunctive two-pronged economic substance test to all transactions to which the economic substance doctrine applies and will challenge taxpayers who seek to apply a common-law disjunctive test in reliance on case law.

Under new section 7701(o), a potential profit is taken into account in determining whether the requirements of section 7701(o) are met only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the claimed tax benefits. Notice 2010-62 provides that the IRS intends to apply existing relevant case law and other public guidance in calculating the present values of the reasonably expected pre-tax profit and the expected net tax benefits that would be allowed if the transaction were respected. No guidance is provided concerning the applicable discount rates to be utilized in calculating the present values of the tax benefits or the pre-tax profit or what ratios of pre-tax profit to tax benefits would be acceptable. Nor does the interim guidance specify what "relevant case law and other public guidance" the IRS will apply. The Joint Committee on Taxation (JCT) Report on the Act likewise does not cite any case in which a net present value analysis has been applied.

Section 7701(o) requires the Treasury to issue regulations requiring foreign taxes to be treated as expenses for purposes of calculating pre-tax profit in appropriate cases. Consistent with the direction in the JCT Report that "there is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law," Notice 2010-62 states that Treasury and the IRS intend to issue such regulations, and in the interim, that enactment of section 7701(o) does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases.

For purposes of penalties, Notice 2010-62 provides that, if the transaction is not a reportable transaction, the disclosure requirements will be satisfied if the taxpayer discloses the relevant facts affecting the tax treatment of the transaction on a timely filed original return (determined with regard to extensions) or a qualified amended return (as defined under Treas. Reg. § 1.6664-2(c)(3)). Disclosures that satisfied section 6662(d)(2)(B) prior to the enactment of the Act will also satisfy the disclosure requirements of the Act. Disclosure is adequate only if it is made on Form 8275 or 8275-R, or as otherwise prescribed by the IRS in subsequent forms, publications or guidance. Disclosures made consistent with the terms of Rev. Proc. 94-69, which provides special procedures for taxpayers subject to the Coordinated Industry Case Program, also will be taken into account for purposes of section 6662(i). No guidance is provided regarding what level of detail is required in the disclosure, and, in particular, whether the economic substance doctrine must be referred to.

If a transaction is a reportable transaction, the adequate disclosure requirement will be met only if the taxpayer meets the disclosure requirements for transactions that are not reportable transactions, and, in addition, meets the disclosure requirements of the section 6011 regulations, generally the filing of a Form 8886 with its return and with the Office of Tax Shelter Analysis. A taxpayer will not meet the reportable transaction disclosure requirements simply by attaching Form 8275 or 8275-R to its return.

As was expected from the public comments of IRS officials, Notice 2010-62 does not contain an "angel list" of transactions to which the economic substance doctrine is not relevant. Significantly, the Notice also provides that the IRS will not issue a private letter ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction, or whether any transaction complies with the requirements of section 7701(o). As a result, taxpayers will generally not be able to seek IRS pre-approval of transactions to avoid the strict liability penalty.

As a result, the position adopted in the JCT Report is left in limbo. The JCT Report stated that section 7701(o) "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." The JCT Report listed the choices between debt and equity, the choice of using a domestic or foreign corporation to make a foreign investment, corporate organizations and reorganizations, and the choice to use a related-party entity in a transaction (provided that section 482 and other applicable arms'-length rules are complied with) as examples of such basic business transactions. The JCT Report also provided that leasing transactions would continue to be analyzed in light of all the facts and circumstances. The JCT Report further indicated that it was intended that tax benefits would be allowed if their realization "is consistent with the Congressional purpose or plan that the tax benefits were designed to effectuate," citing as examples the credits under sections 42 (low income housing credit), 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit) and section 48 (energy credit).

Notice 2010-62 asks for comments concerning the disclosure requirements, especially with regard to the interplay between Rev. Proc. 94-69, proposed Schedule UTP (relating to uncertain tax positions), and the LMSB Compliance Assurance Process (CAP) program. Comments are due by December 3, 2010.

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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