PUBLICATION

Congress Clarifies The Economic Substance Doctrine

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On March 30, 2010, President Obama signed the Health Care and Education Reconciliation Act of 2010 (the Act). Among the provisions of the Act is the codification of the common law "economic substance doctrine," which is one of several antiabuse doctrines[1] that the courts may invoke to disallow the tax benefits of a transaction that it determines has little or no economic effect other than a reduction in federal income tax. By codifying the economic substance doctrine, the Act provides much needed clarity to the doctrine and resolves a split among the courts as to how to test a transaction for economic substance. The Act applies to transactions entered into after March 30, 2010.

Economic Substance Doctrine Prior to The Act

Prior to codification of the economic substance doctrine, the courts considered two factors in determining whether a transaction had economic substance. Those factors were (1) whether the transaction changed in a meaningful way the taxpayer's economic position, other than federal income tax effects (the Objective Factor), and (2) whether the taxpayer had a substantial purpose for entering the transaction, other than federal income tax effects (the Subjective Factor). The courts, however, were divided as to how the two factors were to be applied and three very distinct tests were developed by the various courts for determining whether a transaction lacked economic substance.

The three tests that the courts developed were (1) the conjunctive test, (2) the disjunctive test and (3) the unitary analysis. In jurisdictions that applied the conjunctive test, a transaction was treated as having economic substance only if both the Objective Factor and Subjective Factor were satisfied. Conversely, in jurisdictions that applied the disjunctive test only one of the two factors had to be satisfied in order for the transaction to be respected. Lastly, in jurisdictions that applied the unitary analysis a totality of the circumstances test was used and both factors were considered but neither was dispositive.

The lack of uniformity among the courts resulted in similar transactions being respected in some jurisdictions and disallowed in others. In response to the discord among the courts, proposals to clarify the economic substance doctrine through codification began as early as 1999. The various drafts and proposals for codification, however, never took root, and Congress was unsuccessful in codifying the economic substance doctrine prior to passage of the Act.

Economic Substance Doctrine After The Act

As stated above, the Act codifies the economic substance doctrine by amending Section 7701 of the Internal Revenue Code. Specifically, the Act adopts the conjunctive test which requires that both the Objective Factor and Subjective Factor be satisfied. Further, the Act clarifies that an economic profit is not a requirement for economic substance and that financial accounting benefits may qualify as a "substantial purpose" for engaging in a transaction if the reason for the benefit is not the reduction of federal income taxes.

In addition to clarifying the common law economic substance doctrine, the Act also imposes a new penalty for transactions that lack economic substance. The new penalty is a 20% accuracy related penalty for any transaction that lacks economic substance. This new penalty is a strict liability penalty and there are no exceptions, such as reasonable cause or good faith, to its application. It is increased to 40% if the transaction is not disclosed on the taxpayer's federal tax return.

Summary

The codification of the economic substance doctrine resolves the split among the coursts and provides much needed clarity in analyzing whether or not a transaction has economic substance. Specifically, the Act (1) adopts the conjunctive test, (2) clarifies that an economic profit is not a requirement for economic substance, and (3) allows certain financial accounting benefits to qualify as a "substantial purpose" for engaging in a transaction. Despite this clarity, there are still many unanswered questions regarding the economic substance doctrine and a thorough analysis of any proposed transaction must be made. Additionally, the new penalty, which imposes strict liability, underscores the need for competent advice whenever a transaction is contemplated.

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1. Other judicially created anti-abuse doctrines include: (1) substance over form doctrine, (2) sham transaction doctrine, (3) step transaction doctrine, and (4) business purpose doctrine.