

PUBLICATION

IRS Issues Interim Guidance on the Recently Codified Economic Substance Doctrine

November 30, 2010

Notice 2010-62, as published last month in Internal Revenue Bulletin 2010-40, was issued by the IRS to provide interim guidance on the economic substance doctrine as codified by the Health Care and Education Reconciliation Act of 2010 (the Act). This interim guidance applies to transactions entered into after March 30, 2010 and addresses certain issues with respect to the application of the economic substance doctrine as so codified by the Act, including: (i) application of case law under the common-law economic substance doctrine to the newly codified economic substance doctrine, (ii) determining whether economic substance is relevant to a particular transaction, (iii) calculating net present value of the reasonably expected pre-tax profit, (iv) treatment of foreign taxes in determining whether a transaction has economic substance, and (v) satisfying the adequate disclosure requirements in order to avoid accuracy-related penalties. This Alert addresses the interim guidance under Notice 2010-62 as well as how such guidance may be used by state taxing authorities.

Background

As discussed in further detail in our Tax Newsletter (Spring/Summer 2010), Congress codified the economic substance doctrine to resolve a split among the various federal courts as to which common law test¹ applied to determine whether a transaction should be respected for tax purposes as having economic substance. Pursuant to the Act, transactions entered into after March 30, 2010 will be deemed to have economic substance only if the conjunctive test is satisfied. The conjunctive test is a two-prong test that requires (i) that the transaction change in a meaningful way the taxpayer's economic position, (apart from the federal income tax effects), and (ii) that the taxpayer has a substantial purpose (apart from the federal income tax effects) for entering into the transaction.

Application of Prior Case Law

Notice 2010-62 clarifies that the Service will continue to rely on relevant case law under the common-law economic substance doctrine for purposes of applying the codified economic substance doctrine. Specifically, the IRS, according to the Notice, will look to case law under the common-law economic substance doctrine to determine if each prong of the conjunctive test is satisfied. Additionally, the Notice warns that the Service will challenge taxpayers who seek to rely on case law under the common-law economic substance doctrine for the proposition that satisfying only one prong of the test is sufficient.

Determining Whether Economic Substance Is Relevant

As clarified by Notice 2010-62, the IRS will continue to analyze when the economic substance doctrine will apply in the same manner as it did prior to codification. Thus, if the relevant authorities prior to codification provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS presumably will continue to take the position that the economic substance doctrine is not relevant to that particular inquiry. Additionally, according to Notice 2010-62, neither the Treasury Department nor the Service intends to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine applies. Further, the Notice advises 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 satisfies the economic substance doctrine.

Calculating Net Present Value of the Reasonably Expected Pre-tax Profit

Although the codified economic substance does not require a transaction to have a profit motive, Notice 2010-62 provides guidance regarding how the Service will measure profit motive in cases where a taxpayer relies on profit motive. Specifically, the IRS will take into account a taxpayer's profit motive only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits. For purposes of determining whether the substantial standard is met, the IRS, according to the Notice, will apply existing case law and other published guidance.

Treatment of Foreign Taxes

Notice 2010-62 provides that the IRS will issue regulations requiring foreign taxes to be treated as expenses for purposes of determining pre-tax profit in appropriate cases. In the interim, the Notice states that federal courts are not restricted in their ability to consider the appropriate treatment of foreign taxes in economic substance cases.

Satisfying the Adequate Disclosure Requirements

In order to avoid accuracy-related penalties, Notice 2010-62 clarifies the types of disclosures deemed to be adequate. Specifically, according to the Notice, if a disclosure would be considered adequate for purposes of Section 6662(d)(2)(B) of the Internal Revenue Code prior to codification of the economic substance doctrine, then such disclosure will still be adequate. Additionally, a disclosure must be made on Form 8275, Form 8275-R, or as otherwise prescribed in forms, publications, or other guidance in order to be deemed adequate. Further, if a transaction lacking economic substance is also a reportable transaction, the Notice states that the adequate disclosure requirements will be satisfied only if the taxpayer satisfies the disclosure requirements above as well as the disclosure requirements for a reportable transaction under Section 6011 of the Internal Revenue Code. The IRS is seeking taxpayers' comments regarding the adequate disclosure requirements. The current deadline to submit comments is December 3, 2010.

Application By State Taxing Authorities

Several states have already adopted the codified economic substance doctrine for purposes of analyzing transactions under state tax law. In states employing the codified economic substance doctrine, the interim guidance provided by Notice 2010-62 should prove helpful in analyzing transactions for purposes of state law.

Should you have any questions and want to discuss the economic substance doctrine, or should you wish to provide comments to the IRS regarding the adequate disclosure requirements, please contact any of the attorneys within the Firm's Tax Department.

¹ Prior to codification, the common law tests employed by the various federal courts were the conjunctive test, the disjunctive test and the unitary analysis.