



## Economic Substance Doctrine: Consequences of Codification

By: Bruce Givner, J.D. and Owen Kaye, J.D.



**Long History.** The Economic Substance Doctrine (“ESD”) is a composite of the ‘business purpose,’ ‘substance over form,’ and ‘sham transaction’ doctrine.” Congress has tried several times to “codify” or “clarify” it. The IRS has opposed codification. However, the revenue estimates have been too good for Congress to pass up. It became law on March 30, 2010, as part of the Health Care and Education Reconciliation Act, signed into law on March 30, 2010.

**ESD Defined.** Congress defined the ESD by reference to the case law: “The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”

New Code §7701(o) adopts the conjunctive or “two-prong” test: a transaction shall be treated as having economic substance only if:

- (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and
- (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

**Profit Potential.** A taxpayer who wishes to use a transaction’s profit potential to satisfy either of the two prongs of the ESD test must establish that the present value of the reasonably expected pre-tax profit is “substantial” in comparison to the present value of the expected net tax benefit, in each case resulting from the transaction (were it to be respected). But what minimum return will be needed to get a transaction over the ESD hurdle?

**Strict Liability.** New paragraph (6) of §6662(b) provides that the 20% accuracy-related penalty applies to an under-

payment related to the “disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of §7701(o)) or failing to meet the requirements of any similar rule of law.” The phrase “any similar rule of law” appears to greatly expand the penalty’s scope, so that the IRS will assert it when attacking transactions due to the assignment of income, sham transaction, step-transaction, substance over form and business purpose doctrines.

**Failure To Disclose.** The Act adds a new subsection 6662(i) which increases the gross valuation misstatement penalty to 40% for a “nondisclosed noneconomic substance transaction.” It defines a “NNEST” as “any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.”

**Removal Of Reasonableness Exceptions.** The “reasonableness” of a taxpayer’s action is often the basis for avoiding various penalties. However, the Act eliminates “reasonableness” as an excuse when a taxpayer engages in a transaction that lacks economic substance.

**When is ESD to be Invoked.** New §7701(o)(5)(C) provides that the determination of when the ESD is relevant shall be made as if the new section had not been enacted. The statute, however, gives no guidance as to as to the nature of the “transaction” to which the provision is to apply, although it is clear that it does not apply to estate planning.

**Danger.** Will more transactions be viewed through the §7701(o) prism? Due to the harsh penalties, taxpayers and their advisors will now be pressured to consider whether an ordinary commercial or investment transaction might fall within the scope of the ESD as applied by an aggressive IRS agent. This is not a good development for our business environment. The provision is said to raise \$4.5 billion in revenue. Will that revenue come from the broad-

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ening of the transactions which will be disregarded or from the strict liability penalties?

**Closing Thoughts.** Codification of the ESD will have a significant chilling effect upon those who seek to engage in aggressive planning. However, less aggressive practitioners are not out of the danger due to the Code's ambiguity. It is unclear what, if any, normal commercial or investment transactions with tax benefits will come under ESD scrutiny. The strict liability penalties are further cause for practitioners considering ordinary business transactions to pay special attention to the ESD.

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