Favorite Tax Strategies May No Longer Pass Muster

By Isaac Grossman, Chair of the Tax Group, Morrison Cohen LLP

As part of the health care reform legislation passed earlier this year, Congress codified the economic substance doctrine, a common law theory used in several court cases to deny tax benefits to taxpayers from transactions that do not result in a meaningful change in the economic position of the taxpayer, other than by reducing taxes. Unfortunately, in the process, Congress has created new ambiguities and added severe penalties that cast a shadow over many ordinary transactions in a manner that threatens to trap even the most well-advised private equity firms.

Specifically, Congress added new Internal Revenue Code Section 7701(o) for the purpose of "clarifying and enhancing" the application of the doctrine of economic substance, along with new penalties for transactions lacking economic substance as defined under the new provision. Under Section 7701(o), when the economic substance doctrine is relevant, a transaction will have economic substance only if it changes in a meaningful way (apart from income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (other than income tax) for entering into the transaction. For this purpose, the potential for profit is taken into account only where the present value of the reasonable expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits. State and local tax benefits related to the federal tax benefits and financial accounting benefits originating from the reduction in federal taxes are not considered good business purposes.

The two basic problems are (i) the scope of the provision and (ii) the harshness of the penalties for failure to comply with the provisions.

The problem of scope is self evident. The new provision is riddled with undefined, ambiguous terms. When is the economic substance doctrine "relevant"? When is a purpose "substantial"? When is an expectation of profit considered "substantial"? Unfortunately, the statutory language is relatively short, which leaves the detail to be prescribed in guidance from the Treasury Department. In the absence of guidance, some direction may be found in the legislative history, such as the technical explanation of the Joint Committee on Taxation dated March 21, 2010. However, the technical explanation provides very little taxpayer comfort.

The description of current law in the technical explanation clearly indicates that the doctrine can be applied even when the transaction "may satisfy the literal requirements of a specific tax provision." The focus is directed away from the technical requirements of the tax code to an analysis of "the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate." Statutory provisions do not typically include prefaces explaining their purpose. The source for the intent of Congress in enacting a particular provision will be primarily legislative history. Needless to say, the legislative history for previously enacted tax provisions was never written with this important function in mind.

In recognition of the broad reach of the doctrine, the technical explanation states that the intent was not to alter the tax treatment of "certain basic business transactions that, under longstanding judicial and administrative practice are respected." The technical explanation mentions specifically, (1) the choice between capitalizing a business with debt or equity, (2) a U.S. person's choice to utilize a foreign or domestic corporation to make a foreign investment, (3) the choice to enter into a reorganization or corporate organization transaction under Subchapter C, and (4) the choice to utilize a related party in a transaction provided transfer pricing and similar rules are followed. The technical explanation specifically states that the list is not exclusive. However, the items chosen are so ordinary and presumptively non-abusive that the list suggests that every transaction effected by even the most innocent of taxpayers may be suspect. Moreover, it seems the IRS intends to utilize the full breadth of the statute. In an interview with a tax reporter in December before the adoption of the legislation, IRS Chief Counsel William Wilkins was quoted as saying that "any transaction that accomplishes a tax result by trying to seem like something that it isn't is going to attract the application of the doctrine. No transaction is immune."

Implications For Private Equity

Frequently private equity transactions are conducted with tax benefits in mind. For example, assume a fund is holding a bad investment in a portfolio company that it fully expects to become worthless sometime in the following year or two. However, in the current year the fund has significant gains from the disposition of better investments. The fund may attempt to sell the bad investment for a nominal sum back to the portfolio company or to another investor in the current year to match the profit and loss. Will the loss accelerated into the current year be disallowed under the economic benefit doctrine? Is there a meaningful substance change and business purpose for this sale? Similarly, in many buyout transactions a purchasing fund will want the sellers to reinvest or "rollover" some of the consideration into a newly formed holding corporation. Under certain circumstances, it is preferable from the fund's perspective for that rollover to be taxable for the sellers, rather than tax-free. In an asset transaction, a taxable rollover will provide a greater step up in the tax basis of the acquired business assets and may generate more depreciation/amortization deductions for the holding company. In addition, in a stock acquisition, a fully taxable purchase may be necessary to qualify for a step-up in tax basis utilizing a Section 338(h)(10) election when the target corporation is a Subchapter S corporation or a subsidiary in a consolidated tax group. With some tax planning, a rollover may be made taxable by intentionally falling outside the parameters of the statutory tax free rollover provision in Internal Revenue Code Section 351 (also known as "busting the 351"). Technically, this is done by granting holding company stock (sometimes of very limited economic value) to a service provider or other person not directly involved in the transaction. Will the step-up arising from this stock transfer be disallowed under the economic substance doctrine? Is there a meaningful economic change and business purpose for this transfer?

Of course, the bottom line is how and when the doctrine will be applied on audit. In light of the ambiguity and permissive legislative history, the doctrine may become the IRS auditor's new "Hail Mary Pass" when a transaction meets the technical requirements of the tax code but is too good (tax efficient) for the taxpayer.

The second problem is the penalty associated with the new economic substance provision. The penalty is both significant in amount and strict in application.

Specifically, Internal Revenue Code Section 6662 has been amended to include a penalty for an underpayment of tax due to a transaction lacking economic substance (defined under Section 7701(o)) or due to a failure to meet the requirements of any "similar rule of law." The legislative history indicates that a "similar rule of law" is intended to cover an approach that applies the factors and analysis required by the economic substance doctrine even if a different term is used to describe the approach. The amount of the penalty is generally 20 percent of the underpayment but the penalty is increased to 40 percent of the underpayment if the taxpayer did not adequately disclose the relevant facts affecting the transaction in its tax return.

The size of the penalty is relatively large. Disregarding economic substance, under current law, a 20 percent penalty for the underpayment of income tax exists but only if the underpayment is substantial (the greater of 10 percent of the tax required to be shown on the return or a fixed amount, $10 million for corporations). In contrast, no minimum amount limits the application of the economic substance penalty. In addition, the model used for the new economic substance penalty seems to be the penalty regime for the IRS's public enemy number one—tax shelters and similar transactions. In the context of reportable and listed transactions (a number of transactions highlighted by the IRS as being potentially abusive), a 20 percent understatement penalty applies when an understatement of tax is due to such transactions and the penalty is increased to 30 percent when the transaction is not adequately disclosed. It is odd that Congress chose to use the listed and reportable transactions model for the economic substance penalties. Unlike economic substance, these listed and reportable transactions are limited in number and have distinct features that have been described in detail by the IRS in regulations and rulings.

The penalty has also been drafted strictly, without the standard "reasonable cause" exception. Generally, under the "reasonable cause" exception in Internal Revenue Code Section 6664, a taxpayer who acts in good faith and relies on the advice of a professional tax advisor may avoid an understatement penalty, unless the taxpayer failed to disclose relevant facts or knew or should have known that the advisor was deficient. This reduction in penalties is often the primary reason that taxpayers seek tax opinions on transactions occurring outside the ordinary course of their business. Even in the context of listed and reportable transactions, a reasonable cause exception exists (albeit drafted with more limitations) with the same basic notion: taxpayers may rely on qualified professional advisors to avoid penalties. In contrast, the best legal advice and third- party confirmation of a taxpayer's return position cannot protect the taxpayer from understatement penalties if the IRS concludes the transaction lacks economic substance. It is particularly difficult to live within the confines of such strict liability where the details of the economic substance provisions are shrouded in ambiguity.

The proposal to codify economic substance was not the brainchild of the Obama administration. It was discussed during several past administrations but was not adopted until now. Several pundits have noted the extraneous political factors that favored the adoption of the provision, including the large revenue estimate available as an offset to the costs of the new health care legislation and the notion that this provision could be seen as a further crackdown on tax abuse. Despite the absence of a driving need for the new provisions, taxpayers and their advisors must deal with the new rule immediately. Unlike many of the new tax related provisions in the health care legislation, the effective date of the economic substance provision is not delayed until 2013. It applies to transactions entered into after the date of enactment, or March 30, 2010.

The breadth, strict penalties and immediate effective date of the economic substance provisions are a potent combination. However, at this time, taxpayers are left without specific direction. As a result, the immediate consequence of this particular piece of legislation may simply be an increase in taxpayer paranoia.