

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The top bulb is filled with a dark blue color, and the bottom bulb is filled with a light blue color. The globe is centered in the narrow neck of the hourglass.

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*The Economic Substance Doctrine: Legal Analysis of
Proposed Legislation*

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CRS Report for Congress

The Economic Substance Doctrine: Legal Analysis of Proposed Legislation

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Summary

The economic substance doctrine was judicially developed. A number of bills introduced in the 110th Congress would codify the definition of “economic substance,” provide a strict liability penalty for underpayments resulting from disallowed transactions that lack economic substance, and prohibit deduction of interest on those underpayments. The proposals would not codify the doctrine, itself, nor provide standards for a court’s determination that the doctrine was relevant to a particular case. Codification has been dubbed a “revenue raiser,” though there is disagreement as to both the amount that would be raised and the way in which codification would increase revenue.

Proposed Legislation

The economic substance doctrine is a judicial rather than statutory tax doctrine that has been used by the Internal Revenue Service (IRS) and applied by the courts for many years to disallow, for tax purposes, transactions that technically comply with the Internal Revenue Code (the Code), but produce tax benefits outside of what Congress intended.¹ Throughout the years it has remained a matter of judicial interpretation and case law. There have been, however, suggestions that the doctrine should be codified to produce uniformity among the courts in applying the doctrine. Generally, proposals would codify the definition of “economic substance” rather than codifying the doctrine. This codification has been proposed in several bills during the 110th Congress. Although the language in each proposal has been similar, the overall subject matter for the bills has been diverse. A section entitled “Clarification of Economic Substance Doctrine” has been included in the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007,²

¹ *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff’d* 293 U.S. 465 (1935), established the doctrine. For more information, see CRS Report RS22586, *The Economic Substance Doctrine: Recent Significant Legal Decisions*, by Erika Lunder.

² H.R. 2345, Title I, 110th Congress.

the Stop Tax Haven Abuse Act,³ the Responsible Fatherhood and Healthy Families Act of 2007,⁴ the Export Products Not Jobs Act,⁵ and the Food and Energy Security Act of 2007.⁶ Other bills have contained a similar provision entitled “Codification of Economic Substance Doctrine.”⁷

Thus far, only one bill containing a provision to define “economic substance” in the Internal Revenue Code has been passed by either body of Congress. The Senate passed version of H.R. 2419 contains a section clarifying economic substance. This report analyzes the proposal as contained in the Senate amendment. Unless otherwise noted, all further references to “the Farm Bill,” “H.R. 2419,” or “the current proposal” will be referring to the bill as passed by the Senate.

Clarifying the Economic Substance Doctrine — Amending 26 U.S.C. § 7701. H.R. 2419 adds a subsection to section 7701 of the Internal Revenue Code.⁸ It attempts to define the situations in which a court may find that a transaction has economic substance.⁹ These are limited to those transactions in which the taxpayer’s economic position is changed in a meaningful way¹⁰ and “the taxpayer has a substantial purpose (other than a Federal tax purpose) for entering into such transaction.”¹¹ When a potential for profit is the basis of the taxpayer’s position that a transaction has economic substance, the expectation of profit must be reasonable. Even when it is deemed reasonable, the present value of the expected profit must be compared to the present value of the expected net Federal tax benefit. The profit potential must be considered “substantial” when compared to the tax benefit.¹² Further, if the only “substantial purpose (other than Federal tax purposes)” is a reduction in non-Federal taxes, there is no economic substance if similarities between Federal tax law and the other tax law result in a corresponding reduction in Federal taxes that at least equals the reduction in non-

³ H.R. 2136, § 401; S. 681, § 401, 110th Congress.

⁴ H.R. 3395, § 204; S. 1626, § 204, 110th Congress.

⁵ S. 96, § 201, 110th Congress.

⁶ H.R. 2419, § 12521, 110th Congress (Engrossed Amendment as Accepted by the Senate). Many provisions in the amendment, including the portions regarding the economic substance doctrine, were included in the Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242, 110th Congress.

⁷ *E.g.*, The AMT Relief Act of 2007, H.R. 4351, § 211, 110th Congress; the Tax Reduction and Reform Act of 2007, H.R. 3970, § 3501, 110th Congress.

⁸ Section 7701 provides definitions of terms used under title 26. H.R. 2419 proposes making current subsection (p), subsection (q) and inserting a new subsection (p) between subsections (o) and (q).

⁹ Section 12521 (creating new subsection (p)(1)(A)).

¹⁰ Section 12521 (creating new subsection (p)(1)(B)(i)(I)). Federal tax effects are not considered to result in a meaningful change in economic position. *Id.*

¹¹ Section 12521 (creating new subsection (p)(1)(B)(i)(II)).

¹² Section 12521 (creating new subsection (p)(1)(B)(ii)). “Substantial” is not defined.

Federal taxes.¹³ When the purpose of the transaction is a financial accounting benefit, that will not be considered a “substantial purpose (other than Federal tax purposes)” if the financial accounting benefit stems from a reduction in Federal taxes.¹⁴

Penalizing Noneconomic Substance Transactions — Adding 26 U.S.C. § 6662B. In addition to clarifying economic substance, the bill would establish a penalty for transactions found lacking in economic substance. This penalty would be 30% of the understatement in tax that resulted from disallowance of the transaction.¹⁵ The penalty would be reduced to 20% in cases where the facts relevant to the tax treatment of the disallowed transaction are “adequately disclosed in the return on a statement attached to the return.”¹⁶ In contrast to most penalties provided for in the Code, the proposed penalty is calculated on the tax understatement rather than on the underpayment,¹⁷ so a taxpayer may be liable for a penalty even if that taxpayer does not have an outstanding tax balance.

The penalty can only be imposed by the Chief Counsel of the IRS or by an Office of Chief Counsel branch chief to whom the Chief Counsel has delegated such authority (hereinafter “Chief Counsel or delegate”).¹⁸ The authority to compromise all or part of the penalty is similarly limited.¹⁹ Compromise of the penalty is also limited to situations in which the understatement from the noneconomic substance transaction has been reduced.²⁰

The bill requires the individual asserting the penalty to first notify the taxpayer of the intent to assert the penalty.²¹ The taxpayer must also have the opportunity to respond in writing.²² While the penalty may be imposed following litigation in which a court finds that the economic substance doctrine is relevant and that the transaction lacked economic substance, such litigation is not required for assertion of the penalty. The Chief Counsel or delegate may determine that the economic substance doctrine is relevant and assert the penalty after finding that a transaction lacked economic substance.²³ The penalty must be

¹³ Section 12521 (creating new subsection (p)(1)(B)(iii)(II)).

¹⁴ Section 12521 (creating new subsection (p)(1)(B)(iii)(I)).

¹⁵ Section 12522 (creating new section 6662B).

¹⁶ Section 12522 (creating new subsection 6662B(b)).

¹⁷ E.g., 26 U.S.C. §§ 6651, 6656, 6662 (calculating the penalty based on the outstanding tax balance); *but see* 26 U.S.C. § 6662A (calculating the penalty on understatement for reportable transactions).

¹⁸ Section 12522 (creating new subsection 6662B(d)(1)).

¹⁹ *Id.*

²⁰ Section 12522 (creating new § 6662B(d)(2)(B)).

²¹ Section 12522 (creating new § 6662B(d)(2)(A)(i)).

²² Section 12522 (creating new § 6662B(d)(2)(A)(ii)).

²³ Section 12522 (creating new § 6662B(d)(3)(A)).

rescinded, however, if a court determines, in a final order, that the economic substance doctrine was not relevant to the transaction.²⁴

Interest on Noneconomic Substance Underpayments not Deductible — Amending 26 U.S.C. § 163(m). When taxpayers underpay their taxes, they must pay interest on the amount that was underpaid. This is true even when the underpayment is created by a determination that a position taken on a tax return is not allowed for tax purposes — resulting in an assertion of additional tax liability. Section 163(m) of the Internal Revenue Code prohibits deduction of interest on understatements due to reportable transactions²⁵ that were not properly disclosed. The bill would add language to also prohibit deduction of interest on underpayments due to a transaction that lacked economic substance.²⁶ There is no exception to allow deduction of the interest if the facts relevant to the transaction had been disclosed on the tax return.

Analysis of Proposed Legislation

Clarifying the Economic Substance Doctrine. The proposed bill provides a definition of “economic substance” for courts to use when they find that the economic substance doctrine is relevant. It makes no claim to clarify when the doctrine is relevant. Instead it codifies a definition that settles some differences between courts in terms of what is required to find that a transaction has economic substance.²⁷

The rationale provided by the Court of Federal Claims in *Coltec Industries v. United States*²⁸ suggests an additional justification for codifying the definition of economic substance (if not the doctrine itself). The court said that, in determining their tax liabilities, taxpayers “must be able to rely on clear and understandable rules established by Congress. If federal tax laws are applied in an unpredictable and arbitrary manner, albeit by federal judges for the ‘right’ reasons . . . , public confidence in the Code and tax enforcement system surely will be further eroded.”²⁹

Codifying the definition of economic substance arguably could provide a “clear and understandable rule.” There are, however, phrases and concepts in the proposed definition that may be less than clear. If so, they may cause uncertainty rather than

²⁴ Section 12522 (creating new § 6662B(d)(3)(B)).

²⁵ Defined in 26 U.S.C. § 6662A(b).

²⁶ Section 12523 (adding § 163(m)(2)).

²⁷ These differences include whether the two-pronged test was conjunctive (requiring both economic substance and a business purpose), whether nominal profit potential was sufficient, and whether a financial accounting benefit is a non-tax business purpose if it results from federal tax savings. See S. REPT. 110-206, nn. 113-123 and accompanying text (2007).

²⁸ 62 Fed. Cl. 716, 752-56 (2004) *rev'd* 454F.3d 1340 (Fed. Cir. 2006).

²⁹ *Coltec*, 62 Fed. Cl. at 755.

providing clarification.³⁰ Some of these are “changes in a meaningful way,”³¹ “substantial purpose,”³² and substantial profit (in comparison to tax benefit).³³ Additionally, since the courts are left to determine when the economic substance doctrine is relevant, there may still be room to apply the codified definition “in an unpredictable and arbitrary manner.”

The Strict Liability Penalty. The current bill proposes a 30% penalty on the understatement resulting from transactions that lack economic substance if the transaction was not disclosed. Some other proposals have set the penalty at 40%.³⁴ If the transaction is disclosed, the penalty would be reduced to 20%. However, in either case, there is no provision for abating the penalty based on reasonable cause. The penalty is one of strict liability. Taxpayer reliance on advice from tax professionals is irrelevant even when that advice is based on substantial authority. Arguably, taxpayers have some protection from the penalty because it can only be imposed by the Chief Counsel or delegate. However, since it is left to the courts to determine whether the economic substance doctrine is relevant, taxpayers are placed in a situation in which they may need professional guidance as to whether the doctrine is applicable, but cannot rely on that guidance to avoid a substantial penalty if a court determines that the doctrine applies and the transaction lacked economic substance. Further complicating taxpayers’ quandary is the assertion by the Joint Committee on Taxation that

If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance it that the transaction fails the economic substance doctrine as defined in this provision.³⁵

Thus, taxpayers, tax professionals, and the courts will still be in the position of trying to determine Congress’s purpose for various provisions of the tax code. In some cases, there is sufficient legislative history to determine the purpose, but in other cases there is not. As a result, taxpayers might avoid legitimate business transactions out of fear of a potential penalty.³⁶ This could reduce risk-taking and innovation in business and, possibly, lead to a decline in productivity and profitability. Some, however, believe that the penalty’s results will be positive “caus[ing] taxpayers to forego entering into noneconomic, tax-motivated transactions that Congress never intended.”³⁷

³⁰ *Kolb Solidly Opposed to Codification of Economic Substance Doctrine*, FED. TAX DAY, #I.5 (Feb. 15, 2007) (comments by Fred Greenwood, III). Available at [<http://tax.cchgroup.com/>].

³¹ Section 12521 (adding § 7701(p)(1)(B)(i)(I)).

³² Section 12521 (adding § 7701(p)(1)(B)(i)(II)).

³³ Section 12521 (adding § 7701(p)(1)(B)(ii)).

³⁴ *E.g.*, S. 1151, 110th Congress; H.R. 4351, 110th Congress.

³⁵ J. Comm. on Taxation Release: Economic Substance Doctrine (October 5, 2007).

³⁶ See Jeremiah Coder and Lee A. Sheppard, *Officials Predict Economic Substance Codification in 2008*, TAX NOTES, 468, 469 (2008); *Senate Finance Committee to Consider Tax Reform, Economic Substance Doctrine*, FED. TAX DAY, #M.3 (February 14, 2008) (available at [<http://tax.cchgroup.com/>]).

³⁷ 153 Cong. Rec. S. 13979 (daily ed. November 6, 2007) (statement of Sen. Grassley).

Two Sides to the Issue. Clarifying the economic substance doctrine through codification has been a persistent provision in legislative proposals in recent Congresses. Though the revenue projections of the current proposal vary,³⁸ the proposal is viewed as providing increased revenue for the “pay-go” budget procedures.³⁹ It may also reduce government costs by eliminating some abusive tax shelter schemes, thus reducing the resources needed to pursue both the promoters and participants in abusive tax shelters.

Others oppose codification of even a definition of economic substance, in part because it may provide “the seeds of the next tax shelter problem.”⁴⁰ It is the business of tax professionals to examine the Code closely to determine how it can best be used to result in the least amount of tax owed. New laws aimed at clarifying current law, both statutory and case law, are apt to be viewed as challenges. It seems likely that someone will devise a transaction that a court might, in the past, have found to lack economic substance but which meets the criteria for having economic substance under the proposed bill. In this case, some may argue that codification of the definition may hinder rather than help actions against abusive tax shelters.

There is also some question about both the cost saving and revenue raising prospects for the proposal. IRS Chief Counsel Donald L. Korb has questioned whether the strict liability penalty would ever be asserted by the IRS and has indicated that it would make litigation more complex and eliminate taxpayers’ incentive to cooperate with the IRS.⁴¹

³⁸ See *Ways and Means Legislative Counsel Explains Proposed Corporate Tax Reduction*, FED. TAX DAY, #M.1 (December 4, 2007) (available at [<http://tax.cchgroup.com/>]).

³⁹ 153 Cong. Rec. S. 13978 (daily ed. November 6, 2007) (statement of Sen. Grassley). For information on the “pay-go” budget procedures, see CRS Report RL34300, *Pay-As-You-Go Procedures for Budget Enforcement*, by Robert Keith.

⁴⁰ *Korb Solidly Opposed to Codification of Economic Substance Doctrine*, FED. TAX DAY, #I.5 (February 15, 2008). Available at [<http://tax.cchgroup.com/>].

⁴¹ *Id.*