

Congress Gives the IRS a New Weapon

By Harvey Berenson

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NEW YORK CITY - The 2010 Health Care Act contains a provision codifying the economic substance doctrine into the tax law and imposing severe penalties for violations. The economic substance doctrine has existed for decades; it is invoked by courts to disallow tax benefits for transactions whose only purpose is avoiding tax. The doctrine generally was invoked when a transaction followed the literal rules of the tax law but the results were far outside of the “spirit” of the law—it was one of the IRS weapons in fighting tax shelters. Codification has been proposed for years, but was opposed by tax professionals who believed that the current regime worked.

The new law does not define when the economic substance doctrine will be applied. It simply provides that the doctrine should be applied in any situation in which the courts would have applied it in the past—and the courts have been far from consistent in invoking the doctrine. Once the doctrine is applicable, the new law requires that a taxpayer show the transaction (a) changes in a meaningful way (apart from federal income tax effects) the taxpayer’s economic position and (b) the taxpayer has a substantial non-tax purpose for entering into the transaction. Previously, many courts simply required

a taxpayer to satisfy one, but not both, of these two tests or applied a different standard.

If the taxpayer is relying on the potential economic profit to justify the transaction, it must show that the pre-tax profit is substantial in relation to the present value of the expected tax benefits. Fees and expenses must be taken into account in determining the pre-tax profit and, as provided by regulations, foreign taxes may be treated as expenses. State tax and financial accounting benefits do not count if the benefits are related to the federal tax treatment. The IRS may dissect any transaction or series of transactions, claiming that specific parts of a deal fail the economic substance test even if the overall deal is driven by non-tax economic reasons.

The legislative history states that Congress did not intend to alter the tax treatment of certain basic business transactions, such as the choice of capitalizing a business enterprise with debt or equity, engaging in a corporate reorganization or choosing a foreign or domestic entity to make a foreign investment. But the list of specifically identified acceptable transactions is small and, when asked at a recent tax meeting, the IRS representatives stated they do not intend to bless other transactions.

The real meaning of the new law is the penalties. There is a penalty equal to 20% of the tax if the transaction fails the test and the penalty will be 40% if the IRS determines that the transaction was not adequately disclosed. Unlike other penalty provisions, the taxpayer may not prove that it had reasonable cause for its position. If the taxpayer loses, the 20% or 40% penalty is automatic.

The new law is already effective; it applies to any transaction entered into after March 30, 2010. The new rules were intended to raise \$6.5 billion in penalties (rather than in tax) over the next 10 years, providing a small revenue offset to fund the cost of health care reform.

Congress has now given the IRS a potential hammer in any audit and it is likely that examining IRS agents will not hesitate to use their new leverage. Tax professionals may be less willing to push the envelope in structuring deals, which is where real estate investors could ultimately be affected. Will courts now apply a stricter standard in determining whether a



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non-tax business purpose is substantial and how much change is meaningful? There is no guidance in the law or the legislative history and the case law is not uniform. Taxpayers are, in effect, told to act at their own risk.

The new rules clearly will have an impact on tax planning. Taxpayers can only hope that the rules will be applied to punish tax avoidance schemes and not to discourage innovative planning that is necessary in navigating a complex tax system.



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