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# Tax Enlightenment

## IRS Still Battling “Abusive Tax Shelters” 25 Years Later

By: Lindsay Wilkinson, *MST Student*

Long gone are the boom days of the individual tax shelter industry of the early 1980's – the Tax Reform Act of 1986 made sure of that by disallowing passive activity losses from reducing a taxpayer's ordinary income. However, nearly two-and-a-half decades later, legislation is still being passed to try and prevent the use of “abusive tax shelters” by individuals and business owners.

In early 2010, the Health Care Reconciliation Act was enacted which, among a host of other changes, codified the “economic substance doctrine.” This doctrine gives the IRS the power to deny the tax benefits associated with transactions that have no “economic purpose” other than to lower a person's tax liability. Therefore, even if a transaction appears to qualify under the statutory language of the Internal Revenue Code (IRC), the transaction will not be allowed if it does not meet a two-pronged test to determine its economic purpose. As defined in Internal Revenue Code (IRC) Section 7701(o), a transaction (or series of transactions) will be treated as having economic substance only if:

- 1) the transaction meaningfully changes the taxpayer's economic position; **AND**
- 2) the taxpayer has a substantial non-federal income tax purpose for completing the transaction.

Profit motive will be taken into account when determining whether a taxpayer has met the two-pronged test. However, the expected pre-tax profit from the transaction must be substantially greater than the expected net tax benefits in order for the transaction to be respected. Although the “economic substance” concept has been around for quite some time, its application by the courts has been inconsistent prior to enactment of this provision. Previously, some courts held that to have economic purpose, a transaction must pass either one of the two tests to sufficiently satisfy the economic substance doctrine.

It is important to note, however, that this provision does not instruct the courts on *when* to utilize the test nor does it revoke the power of the courts to break apart transactions in order to examine each part for economic purpose. Additionally, this provision is not intended to deny businesses the right to select the option with the most beneficial tax treatment when choosing between alternatives that each have economic substance – such as whether to finance a business with debt or equity.

Under the new act, the penalty rate for the underpayment of tax due to a transaction that is found to lack economic substance is 20%. The penalty is increased to 40% if the taxpayer fails to disclose all relevant facts affecting the tax treatment in the return or in an attached statement. This is a strict penalty with no exceptions available even if the taxpayer had “reasonable cause” to believe the transaction would be allowable.

In conclusion, although the IRS will continue to analyze whether the economic substance doctrine is applicable on a case-by-case basis as it did prior to the enactment of Sec. 7701, this provision has made it clear how a transaction will be analyzed to determine economic purpose and the penalties that could be imposed regardless of a taxpayer's due diligence.