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IRS Notice 2010-62 Interim Guidance on Economic Substance Codification

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On September 13, 2010, the Internal Revenue Service (IRS) issued Notice 2010-62 to provide interim guidance with respect to the codification of the economic substance doctrine under Section 7701(o) of the Internal Revenue Code (IRC), and amendments related to various penalty provisions enacted under the Health Care and Education Reconciliation Act of 2010 (Act).

The notice applies with respect to transactions entered into on or after March 31, 2010, which is the effective date for the amendments made by the Act.

This article summarizes the notice and implications for NMTC transactions.

Economic Substance Doctrine – Two Prong Test

If a transaction is required to have economic substance to be respected, Section 7701(o)(1) provides that the transaction will be treated as having economic substance only if: (i) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

The notice states that the IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test. The IRS will rely on judicial authorities relating to each of the two prongs of the test to determine whether the applicable requirement is satisfied. Prior case law under the common-law economic substance doctrine cannot be relied on for the proposition that a transaction will be treated as having eco-

nomically substance merely because it satisfies either one of the two requirements. Section 7701(o), to the extent applicable to a transaction, requires satisfaction of both prongs of the economic substance doctrine.

Whether the Economic Substance Doctrine Applies

The determination as to whether a transaction is subject to the economic substance doctrine is made as if Section 7701(o) were never enacted.

Notice 2010-62 states that the IRS and Treasury Department do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine applies or does not apply. The IRS will continue to rely on the applicable authorities and anticipates that the case law will continue to develop. The IRS will not issue a private letter ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o).

Calculating the Pre-Tax Profit

Section 7701(o) provides that a transaction's potential for profit is taken into account in determining whether the two prongs of Section 7701(o)(1) are met only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the claimed net tax benefits.

Notice 2010-62 states that the IRS will apply existing relevant case law and other published guidance to perform this calculation. No specific case law or guidance is identified in the notice.

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Accuracy-Related Penalties - Disclosure

The amendments provide generally that the 20 percent accuracy-related penalty applies to an underpayment arising from a transaction that lacks economic substance under Section 7701(o) or "failing to meet the requirements of any similar rule of law." The penalty is increased to 40 percent if the relevant facts are not adequately disclosed in the tax return. The reasonable cause exception to the penalty does not apply to any portion of an underpayment attributable to a failure to satisfy the Section 7701(o) economic substance requirements.

The notice provides that unless the transaction is a "reportable transaction," the adequate disclosure requirements will be satisfied if a taxpayer adequately discloses the relevant facts affecting the tax treatment of the transaction on a timely filed original return (determined with regard to extensions) or a "qualified amended return" (as defined in the Treasury regulations). Generally, adequate disclosure is determined under the rules in effect prior to the enactment of the economic substance doctrine provisions. The notice provides that additional disclosure requirements apply to "reportable transactions." Reportable transactions are transactions specified in Treasury regulations that are considered to have a potential for tax avoidance or tax evasion. The notice does not provide guidance with respect to the imposition of the penalties due to a failure to meet requirements of "similar rules of law."

Due to the severity of the penalties, practitioners have requested enhanced review procedures prior to imposition of the penalties. On September 14, 2010, the Large and Midsize Business Division of the IRS issued examination guidance, which provided that to ensure consistent administration of the accuracy-related penalty, any proposal to impose the penalty at the examination level must be reviewed and approved by the appropriate director of field operations before the penalty is proposed.

Request For Comments

Comments on Notice 2010-62 are due by December 3, 2010. The IRS is particularly interested in comments regarding the disclosure requirements.

Conclusion

The new markets tax credit (NMTC) industry is in the same position as before Notice 2010-62 was issued. The notice does not provide specific guidance other than that taxpayers should rely on existing authorities to determine whether the economic substance doctrine is relevant to the transaction. The Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as amended, in combination with the Patient Protection and Affordable Care Act, footnote 344, provides the following guidance related to the application of Sec-

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tion 7701(o): "if the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. ... Thus, for example, it is not intended that a tax credit (e.g., Section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage." Certain judicial authorities support this approach.

Specific guidance has been requested to further support the exclusion of tax credit transactions from the application of Section 7701(o) on the basis described in the footnote. Due to the concerns raised by the codification of the economic substance doctrine, practitioners and taxpayers are likely to continue to call for more specific guidance regarding the transactions subject to the new provisions. Based on the Technical Explanation, the challenge for the NMTC industry will be to evaluate whether transactions are consistent with the congressional purpose and generate the activity intended to be created by the credit. As the published guidance issued with respect to various aspects of NMTC transactions increases, such guidance will also provide support that the proposed structures which are the subject of such guidance should be upheld as consistent with congressional intent.

Ruth Sparrow is a principal of Future Unlimited Law PC. Ms. Sparrow represents community development entities, developers, lenders and investors nationwide in new markets tax credit, historic rehabilitation and low-income housing tax credit transactions. For more information contact Ruth Sparrow, of Future Unlimited Law PC at rsparrow@futureunlimitedlaw.com; 360-458-1720; futureunlimitedlaw.com.

The information presented in this article is intended solely for informational purposes and should not be construed as legal advice by the author or Future Unlimited Law PC. ♦

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