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## **ACA Repeal Would Embolden Tax Avoidance Would Eliminate “Economic Substance Doctrine” Provisions Designed to Curtail Business Tax Shelters**

By Chye-Ching Huang

If, as expected, the Republican bill to repeal the Affordable Care Act (ACA) mirrors the repeal measure that President Obama vetoed in 2016, it will include provisions that would invite more corporate tax avoidance. The ACA revised the tax code to clarify and strengthen the “economic substance doctrine,” which helps prevent businesses from making transactions that have either no economic effect or no business purpose other than avoiding tax. Members of both parties had developed and supported legislation to accomplish this goal for many years before the ACA (see box).

Repealing these ACA provisions, which the Congressional Budget Office (CBO) estimates would cost \$5.8 billion from 2016 through 2025,<sup>1</sup> would scale back protections against business tax shelters and reduce penalties on businesses that underpaid taxes by using transactions that have no economic substance. These changes would embolden tax lawyers, accountants, and businesses to devise and use complex tax-avoidance schemes. The changes come just as congressional Republicans also propose fundamental changes in the corporate income tax that, in turn, could spur activity by lawyers and accountants to game the new system. Thus, Republicans are proposing to strike the economic substance doctrine provisions from the tax code at just the time when we most need a clear doctrine with strong penalties against tax avoidance.

In fact, repealing the economic substance doctrine provisions could ultimately prove costlier than what CBO has estimated. That’s because CBO issued its estimate in connection with the ACA repeal bill that Obama vetoed — and, thus, it cannot account for current Republican plans to fundamentally change the corporate income tax, creating potentially significant new opportunities for lawyers, accountants, and businesses to craft tax-avoidance schemes.

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<sup>1</sup> Congressional Budget Office, “Estimate of Direct Spending and Revenue Effects of H.R.3762,” January 4, 2016, <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/costestimate/hr3762followingenactmentofconsolidatedappropsof2016.pdf>.

## ACA Provisions Target Tax-Avoidance Schemes

Judges developed the economic substance doctrine as an approach to applying tax law when deciding tax cases.<sup>2</sup> No matter how hard lawmakers and regulators might try when they draft tax laws and regulations, lawyers and accountants will find ways to get around the tax law's technical provisions; some tax professionals focus their work on developing complex tax-shelter schemes that comply with the letter of the law but allow taxpayers to escape taxes on their real-world income. Over the years, the courts decided that the IRS can disallow tax savings that a business transaction would have generated under the tax code's technical provisions if the transaction lacks economic substance — that is, has no real economic effect or is intended solely to gain tax benefits and has no other non-tax business purpose.

The ACA clarified aspects of this doctrine and increased penalties for filers who try to underpay tax by using transactions that lack economic substance:<sup>3</sup>

- **Clarifying economic substance.** The ACA clarified that for a business transaction to have economic substance, it must *both* “change the taxpayer’s economic position” *and* the taxpayer must have a substantial purpose for entering into it — apart from reducing federal income tax.<sup>4</sup> If a transaction fails *either* test, the courts may find that it has no economic substance and ignore the tax benefits that it would otherwise generate. The definition of economic substance applies only to businesses and to individual filers’ business transactions.<sup>5</sup>

Prior to the ACA, some courts applied a looser standard, so that a transaction would satisfy the economic substance doctrine if it had *either* an actual economic effect *or* a non-tax business purpose. Other courts treated economic effects and business purposes as just two factors to consider among many.<sup>6</sup>

The ACA also clarified that a transaction generating enormous tax savings wouldn’t satisfy the “business purpose” prong of the test just because it might lead to miniscule profits.<sup>7</sup>

- **Increasing penalties.** The ACA provided that when a transaction is disregarded under the economic substance doctrine, the taxpayer must pay a penalty on top of the tax owed. The penalty is 20 percent of the tax understatement, or 40 percent if the taxpayer didn’t adequately disclose the transaction in the tax return.

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<sup>2</sup> For the history of the doctrine, see 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,’” March 21, 2010, pp. 142-143, <https://www.jct.gov/publications.html?func=startdown&id=3673>.

<sup>3</sup> For further detail, see Joint Committee on Taxation, *ibid*.

<sup>4</sup> Section 7701(o) of the Internal Revenue Code.

<sup>5</sup> Section 7701(o)(5)(B)

<sup>6</sup> *General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals*, Department of the Treasury, May 2009, pp. 25-26, <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf>.

<sup>7</sup> Section 7701(o). See also Shamik Trivedi, “Wilkins Defends Economic Substance Doctrine, Schedule UTP,” *Tax Notes*, October 28, 2011, <http://www.taxnotes.com/tax-notes-today/compliance/wilkins-defends-economic-substance-doctrine-schedule-utp/2011/10/28/4742506>.

The ACA also stipulated that the 20 percent penalty applies on a “strict liability” basis, meaning that the penalty applies even if the taxpayer has an opinion from a tax advisor saying that the transaction likely passes the economic substance test. Applying this standard helps to “level the playing field between more aggressive and more conservative practitioners and their clients.”<sup>8</sup> This is particularly important because many of the tax-avoidance schemes to which the economic substance doctrine has been applied were large corporate tax shelters that tax lawyers and accountants marketed to various clients. These shelters “often bear clever acronyms, are marketed with elaborate flip-charts, and purport to create large deductible losses to offset gains or other income.”<sup>9</sup>

The penalties also help to deter businesses from entering into tax-avoidance transactions that have no economic substance. As Senator Chuck Grassley noted of an earlier, similar proposal to codify the economic substance doctrine and increase penalties: “according to the Joint Committee on Taxation, the bulk of the revenue score is attributable to the strict liability penalty. Not because the IRS will collect the penalty, but because the penalty will alter taxpayer behavior and cause [taxpayers] to forgo entering into non-economic tax-motivated transactions that Congress didn’t intend.”<sup>10</sup>

The ACA inserted these provisions in the Internal Revenue Code, so the doctrine is no longer found solely in the judgments of the courts in various tax cases.<sup>11</sup> While clarifying and strengthening the economic substance doctrine did not end tax avoidance, it has deterred abuses in these specific types of cases. The ACA uses the revenues that these provisions raise to help offset the cost of expanding health coverage.

## Repealing Provisions Would Embolden Business Tax Avoidance

IRS Chief Counsel William J. Wilkins has said that the ACA’s economic substance provisions have helped discourage schemes designed to generate tax losses to offset taxes on other income. They also helped clear up misconceptions among tax practitioners about how to structure transactions to get around the judicial tests, Wilkins notes.<sup>12</sup>

Repealing those provisions could revive some of the pre-ACA confusion about how to determine whether a transaction has economic substance. This would allow tax lawyers to press judges to apply the looser standards that some courts used before the ACA, or even try to persuade courts to

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<sup>8</sup> Joint Committee on Taxation, “Description of Revenue Provisions Contained in The President’s Fiscal Year 2010 Budget Proposal Part Two: Business Tax Provisions,” September 9, 2009, <https://www.jct.gov/publications.html?func=startdown&id=3576>.

<sup>9</sup> Mark E. Berg, “Tax Planning in the ‘Economic Substance’ Era,” *Tax Notes*, October 5, 2015, <http://www.feingoldalpert.com/siteFiles/10203/Berg%20Tax%20Planning%20in%20Economic%20Substance%20Era.pdf>.

<sup>10</sup> United States Senate Committee on Finance, “Grassley: Economic Substance Provision is Right Policy, Fits into Senate Farm Bill,” November 6, 2007, <http://www.finance.senate.gov/ranking-members-news/grassley-economic-substance-provision-is-right-policy-fits-into-senate-farm-bill>.

<sup>11</sup> While the ACA provision is commonly referred to as the “codified economic substance doctrine,” more accurately, the ACA “codified” the *definition* of economic substance, leaving it to the courts to decide when the economic substance doctrine is relevant and should be applied at all.

<sup>12</sup> Trivedi.

abandon the doctrine altogether. (Preventing such a reversal of the doctrine was one reason why Senator Grassley promoted efforts prior to the ACA to codify the doctrine; see box.)

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### **Longstanding Bipartisan Support for Clarifying and Strengthening Economic Substance Doctrine**

The ACA's enactment of economic substance doctrine provisions in the Internal Revenue Code followed extensive efforts over more than a decade by members of both parties to enact similar provisions.

The Treasury Department in 1999 noted "widespread agreement and concern among tax professionals that the corporate tax shelter problem is large and growing." It cited the American Bar Association's expression of "growing alarm [at] the aggressive use by large corporate taxpayers of tax 'products' that have little or no purpose other than the reduction of Federal income taxes," and the "blatant, yet secretive marketing" of such products.<sup>a</sup> Such sheltering loses revenues, breeds disrespect for the tax system, spawns complex laws to address specific complex shelters, and diverts business resources to tax lawyers and accountants that could be used more productively, Treasury explained.

Treasury recommended codifying the doctrine, and lawmakers in both parties advanced a number of proposals to do so in subsequent years. Although the Bush Administration did not support these efforts, numerous Republicans, including Senators Grassley, Coleman, Frist, Inhofe, Kyl, McCain, McConnell, Santorum, and Nickles each put forward amendments that included codifying the doctrine.<sup>b</sup>

In sponsoring one proposal to codify the economic substance doctrine in 2006, then-Finance Committee Chairman Grassley said, "I continue to believe that there should be a uniform rule to deny tax benefits where taxpayers hide behind literal compliance in transactions that have little or no economic effects."<sup>c</sup> In 2007, during another attempt, Senator Grassley argued:

[Codifying the doctrine] will give courts a uniform doctrine to apply to non-economic transactions that are inappropriately motivated solely to avoid Federal taxes. It will also ensure that a court will not overturn the doctrine. . . . Most importantly, codifying the economic substance doctrine will provide an additional deterrent against taxpayers entering into transactions solely for tax purposes in ways that are inconsistent with congressional intent. . . . [Codifying] the economic substance doctrine should be considered on its merits. It should not be dismissed because it scores as a revenue raiser. It should not be endorsed because it scores as a revenue raiser. In my view, it should be enacted because it's the right tax policy.<sup>d</sup>

President Obama's 2010 budget also proposed clarifying the economic substance doctrine and increasing penalties in order to "further deter transactions designed solely to obtain tax benefits."<sup>e</sup>

<sup>a</sup> Department of the Treasury, "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals," July 1999, <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Corporate-Tax-Shelters-1999.pdf>.

<sup>b</sup> Charlene Luke, "The Relevance Games: Congress's Choices for Economic Substance Gamemakers," *Tax Lawyer*, Vol. 66, No. 3, Spring 2013, p. 577, <http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1642&context=facultypub>.

<sup>c</sup> Steptoe & Johnson LLP, "Daily Tax Update – April 4, 2006," April 4, 2006, <http://www.step toe.com/resources-detail-3569.html>.

<sup>d</sup> Senate Committee on Finance, "Grassley: Economic Substance Provision is Right Policy, Fits into Senate Farm Bill," November 6, 2007, <http://www.finance.senate.gov/ranking-members-news/grassley-economic-substance-provision-is-right-policy-fits-into-senate-farm-bill>.

<sup>e</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009, pp. 25-26, <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf>.

The potential for the test to become confused and looser, along with the reduced penalties, would likely embolden some tax lawyers and accountants to develop and market even more tax-avoidance schemes with little or no economic effect or business purpose. It would also reduce the risk for businesses to engage in those schemes, thus likely making them more common. Repealing the

provisions would cost \$5.8 billion over 2016 to 2025, according to CBO estimates of the vetoed ACA repeal bill.<sup>13</sup>

## Other Potential Tax Changes Make Repeal Even Less Advisable

Republican lawmakers intend to enact a tax package later this year that could include fundamental changes to business taxation — and could spur attempts at novel tax-avoidance strategies. Thus, it would be particularly irresponsible to first eliminate tax-code provisions that deter business tax avoidance and clarify how the IRS may identify and penalize transactions with no economic substance.

The House Republicans' tax plan includes some of the most extensive changes to business taxation in decades,<sup>14</sup> but they have issued neither detailed explanations of key elements of their proposal nor draft legislation. (By contrast, former House Ways and Means Committee Chairman Dave Camp and Senate Finance Committee Chairman Max Baucus released detailed white papers and draft legislative language, developed over a period of years, for their tax reform proposals.<sup>15</sup>) This means that tax professionals have had no chance to review the proposals and identify ways in which the new rules might be “gamed”— or suggest improvements to prevent gaming.<sup>16</sup> Any such opportunity will be very compressed if Republicans are to enact a package this year.

If enacted, fundamental business tax changes will create a frenzy of activity as lawyers and accountants try to find ways to game the new regime, and the rushed drafting and review of the plan makes it likelier that they will succeed. This could make repealing the economic substance doctrine ultimately costlier than what CBO will estimate when presented with an ACA repeal bill, because those estimates of ACA repeal would precede future business tax reform and thus could not take it into account.<sup>17</sup>

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<sup>13</sup> Congressional Budget Office.

<sup>14</sup> For example, the House GOP plan would move the business tax system to a “destination-based, cash-flow tax,” a type of business taxation that no country (or state) has enacted before.

<sup>15</sup> See United States Senate Committee on Finance, “Baucus Works to Overhaul Outdated Tax Code,” November 21, 2013, <https://www.finance.senate.gov/chairmans-news/baucus-works-to-overhaul-outdated-tax-code>, and Tax Reform Act of 2014, H.R. 1, 113<sup>th</sup> Congress, <https://www.congress.gov/113/bills/hr1/BILLS-113hr1ih.xml>.

<sup>16</sup> For example, the House Republican plan would mean that a number of economically profitable export-intensive businesses will generate large and perpetual tax losses. The plan states only that it will allow firms to carry these losses forward indefinitely, with interest. Practitioners will likely test the new regime by designing transactions that generate significant losses and immediately use them (effectively trading them with other profitable companies), or otherwise game the loss regime.

<sup>17</sup> Estimates of the cost of any business tax reform will reflect the absence of the economic substance doctrine, if it is repealed, but those later estimates will not make it possible to tell specifically how much less revenue business tax reform would cost economic substance doctrine provisions in place.