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“Economic Substance” and Renewable Energy Financing  
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The recently-enacted Health Care and Education Affordability Reconciliation Act of 2010 (H.R. 4872) (the “Reconciliation Act”) provides statutory rules for applying the economic substance doctrine. See Section 7701(o) of the Code, as amended by section 1409(a) of the Reconciliation Act. The Reconciliation Act defines the economic substance doctrine as the common law doctrine under which the federal income tax benefits of a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Accordingly, its provisions apply to transactions entered into on or after March 30, 2010.

The economic substance doctrine is one of several judicially created doctrines that are used by courts to deny the tax benefits of a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific provision in the Internal Revenue Code. The doctrine generally disallows tax benefits if the transaction does not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in Federal income tax.

Courts have disagreed over the proper test to determine whether a transaction has economic substance, as illustrated by the divergent application of the doctrine in the tax shelter litigation that has occupied the courts during the last decade. Some courts require only that the taxpayer demonstrate a reasonable expectation of profit from the transaction aside from tax benefits. Other courts require that the taxpayer demonstrate both an objective potential for profit as well as a more subjective business purpose. The Act attempts to address this lack of uniformity.

New Section 7701(o) of the Internal Revenue Code provides that any transaction or series of transactions to which the economic substance doctrine “is relevant” is treated as having economic substance only if (1) the transaction changes, in a meaningful way, the taxpayer’s economic position, and (2) the taxpayer has a substantial purpose for entering into such transaction. The determination of whether the economic substance doctrine is “relevant” to a transaction is made in the same manner as if the provision had never been enacted. Thus, the provision does not change present law standards in determining whether a transaction raises economic substance issues.

The provision clarifies that the economic substance doctrine involves a conjunctive analysis. A transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from tax effects) the taxpayer’s economic position and the

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taxpayer must have a substantial non-federal-income-tax purpose. This clarification eliminates the disparity that existed among the federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

#### **Demonstrating Profit Potential**

Under the provision, a taxpayer may rely on profit potential to demonstrate both that a transaction results in a meaningful change in the taxpayer’s economic position and that the taxpayer has a substantial non-federal-income-tax purpose for entering into the transaction. The taxpayer can rely on other factors as well, but an expected pre-tax profit alone can satisfy both prongs of the test. The provision does not require or establish a minimum pre-tax return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, “the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit.” No guidance is provided on how to present value future pre-tax cash flows. Using a low federal rate will yield a higher present value and favor the taxpayer, while a discount rate appropriate to uncertainties in the transaction will yield a lower present value. The requirement that pre-tax profit be measured on a present value basis has little precedent under law prior to the Reconciliation Act.

A taxpayer’s non-federal-income-tax purpose for entering into a transaction must be “substantial.” The Joint Committee Explanation of the Act states that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and useful in light of the taxpayer’s economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.

Although the Joint Committee Explanation states that the new provision is not intended to change current law standards in determining when to utilize an economic substance analysis, the Explanation does provide important guidance on when the economic substance doctrine should not be utilized to disallow certain credits and deductions:

If the realization of 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 those tax benefits be disallowed. As stated by Reg §1.269-2, characteristic of the circumstances in which a tax benefit is disallowed are those where the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed to produce. 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.

The Joint Committee Explanation also provides that the provision is not intended to alter the tax treatment of certain “basic business transactions” that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Partnership flip and sale-leaseback transactions by their nature are tax-advantaged alternatives to other forms of financing. In this context, the Explanation provides that leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances, citing recent case law for the proposition that “considerations of economic substance are factually specific to the transaction involved.” As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. The Explanation also provides that no inference is intended as to the proper application of the economic substance doctrine under present law.

#### **Application to Renewable Energy Financing**

Renewable energy projects take advantage of federal tax credits and grants and other tax benefits (such as accelerated depreciation) as a source of financing. Much of the tax planning surrounding the financing transactions (whether partnership flip, sale-leaseback or otherwise) involves the explicit maximization of the value of these tax benefits. Congress certainly is aware of and has actively encouraged the use of these financing transactions as an incentive for investment in renewable energy projects.

In many transactions the taxpayer can demonstrate that it reasonably expects to satisfy both prongs of the *judicial* economic substance test by reference to its reasonable expectation of significant pre-tax profit. It is not entirely clear, however, whether that same transaction would comply with the requirement of new Section 7701(o) that the present value the pre-tax profit be substantial in relation to the present value of the tax benefits. It is particularly difficult to apply the Section 7701(o) present value test absent guidance on appropriate discount rates.

However, as noted above, the provisions of Section 7701(o) do not apply to disallow the expected tax benefits from a transaction where, in accordance with the express intention of Congress, the realization of tax benefits are “consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate.” The Joint Committee Explanation is quite specific that it is not intended that tax benefits 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 tax benefit was intended to encourage. Each transaction must be analyzed under standards in light of its particular facts and circumstances. However, many renewable energy financings will qualify as such a transaction because the Section 48 investment tax credit and the associated depreciation deductions are tax benefits expressly designed by Congress to encourage investment in renewable energy projects. Accordingly, even though a tax-credit based project financing may fail the pre-tax profit test of Section 7701(o), a properly structured transaction will not be treated as lacking economic substance as a result of the application of new Section 7701(o).

#### Strict Liability Penalties

Importantly, the Act creates a new “strict liability” penalty regime applicable to transactions lacking economic substance or failing to meet “any similar rule of law.” A 20% “strict liability” penalty is imposed on any underpayment attributable to a transaction lacking economic substance, and the penalty is increased to 40% if the relevant facts of the transaction are not adequately disclosed on the taxpayer’s tax return. Similarly, any claim for refund that is excessive due to its lacking economic substance is subject to a 20% penalty. Notably, the reasonable cause and good faith exception and the reasonable basis exception do not apply in connection with these new penalties. Thus, opinions of tax counsel will not shield a taxpayer from these penalties. Further, it is unclear what is encompassed by “similar rule of law,” the violation of which would also give rise to the strict liability penalty. It is possible that transactions that run afoul of judicial doctrines such as “step-transaction,” “business purpose,” “substance over form,” and “sham transaction” would be subject to the penalties as well.

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