

**Subject** Economic substance test

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## Overview

H.F. 2429 would allow the commissioner of revenue to disallow the tax effects of any transaction that lacks economic substance. The IRS has similar authority under section 7701(o) of the Internal Revenue Code.

Generally, under the economic substance doctrine, a transaction that is undertaken solely for the purpose of deriving a tax benefit is disregarded when determining taxable income. This bill would follow the federal understanding of economic substance, and allow the commissioner to disallow the tax effects of a transaction that does not change a taxpayer's economic position in a meaningful way (aside from the tax effect) and is not undertaken for a substantial purpose (other than the tax effect).

## Summary

Section	Description
1	<p><b>Powers.</b></p> <p>Updates a cross-reference related to the change in section 2.</p> <p><b>Effective date:</b> Tax year 2019.</p>
2	<p><b>Powers and duties.</b></p> <p>Grants the commissioner of revenue the power to disallow the tax effects of transactions without economic substance.</p> <p><b>Effective date:</b> Tax year 2019.</p>
3	<p><b>Assessment presumed valid.</b></p> <p>Requires a taxpayer rebutting the presumption that the commissioner's decision that a transaction lacks economic substance is prima facie valid to provide clear and convincing evidence that it is not.</p> <p><b>Effective date:</b> Tax year 2019.</p>

Section	Description
4	<p data-bbox="355 275 639 302"><b>Preventing tax evasion.</b></p> <p data-bbox="355 317 1304 380">Provides a set of standards and definitions to determine when a transaction has economic substance.</p> <p data-bbox="453 394 1393 600"><b>Subd. 1. Economic substance.</b> Creates a standard for transactions that have economic substance. The transaction must change the taxpayer’s economic position in a meaningful way and be undertaken for a purpose other than a tax purpose. Allows the profit potential of a transaction to be considered for purposes of determining economic substance if the pretax value of the transaction substantially exceeds the expected tax benefits.</p> <p data-bbox="453 638 1425 741"><b>Subd. 2. Apart from tax effects.</b> Defines “apart from tax effects” to mean apart from the state and local tax effects on the form of the transaction, the federal tax effects, or both.</p> <p data-bbox="453 779 1273 842"><b>Subd. 3. Transaction.</b> Provides that “transaction” includes a series of transactions.</p> <p data-bbox="453 879 1385 982"><b>Subd. 4. Personal transactions of individuals.</b> Provides that the rules for determining economic substance under subdivision 1 only apply to individuals with respect to business or income-generating transactions.</p> <p data-bbox="453 1020 1382 1123"><b>Subd. 5. Rulemaking.</b> Requires the commissioner to adopt rules related to enforcing this section and to provide examples of transactions that would and would not have economic substance.</p> <p data-bbox="453 1161 810 1188"><b>Effective date:</b> Tax year 2019.</p>
5	<p data-bbox="453 1245 1341 1272"><b>Subd. 27a. Noneconomic substance transaction understatement penalty.</b></p> <p data-bbox="453 1278 1409 1413">Imposes penalties on taxpayers who understate their tax using transactions that lack economic substance. A higher penalty is imposed for taxpayers who do not disclose relevant facts relating to the tax effects of a transaction without economic substance.</p> <ul data-bbox="505 1451 1425 1831" style="list-style-type: none"><li data-bbox="505 1451 1390 1554">• <b>Paragraph (a).</b> Imposes a penalty equal to 20% of the disclosed noneconomic substance transaction understatement if a transaction is disallowed under section 4 of the bill.</li><li data-bbox="505 1591 1362 1694">• <b>Paragraph (b).</b> Imposes a penalty equal to 40% of the nondisclosed noneconomic substance transaction understatement, in the manner provided in paragraph (a).</li><li data-bbox="505 1732 1425 1831">• <b>Paragraph (c).</b> Defines “disclosed noneconomic substance transaction” as a transaction without economic substance but about which the relevant facts affecting the tax treatment of the transaction are disclosed.</li></ul>

Section	Description
	<ul style="list-style-type: none"><li>• <b>Paragraph (d).</b> Defines “nondisclosed noneconomic substance transaction” as a transaction similar to that in paragraph (c), except that the relevant facts affecting the tax treatment of the transaction are not disclosed.</li><li>• <b>Paragraph (e).</b> Disallows any amendments filed after the date that the commissioner first contacts a taxpayer about examining a return from being used to determine the amount of the noneconomic substance transaction understatement.</li><li>• <b>Paragraph (f).</b> Defines “understatement” as the product of:<ul style="list-style-type: none"><li>○ the increased amount of taxable income between:<ul style="list-style-type: none"><li>▪ the amount of income calculated if the transaction without economic substance were disallowed; and</li><li>▪ the amount calculated by the taxpayer; and</li></ul></li><li>○ the highest rate of tax that may be imposed on the taxpayer, disregarding the understatement.</li></ul></li><li>• <b>Paragraph (g).</b> Provides that the noneconomic substance transaction understatement penalty is imposed in lieu of the other civil penalties imposed under section 289A.60.</li></ul>

**Effective date:** Tax year 2019.



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