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Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Notice 2010-62

Dear Commissioner Shulman:

Enclosed are comments on Notice 2010-62 regarding the implementation of the economic substance legislation. These comments represent the views of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the policy of the American Bar Association.

These comments were prepared by members of the Section of Taxation and by members of the American Institute of Certified Public Accountants. Representatives of both organizations would be pleased to meet with you or your staff to discuss these comments. Please contact Helen Hubbard, the Section of Taxation's Vice Chair for Government Relations, at 202-452-7005, or Armando Gomez, the co-chair of the Section of Taxation's working group responsible for the preparation of these comments, at 202-371-7868, if that would be helpful

Sincerely,



Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Joshua Odintz, Senior Advisor to the Assistant Secretary (Tax Policy), Department of the Treasury
Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury
Steven T. Miller, Deputy Commissioner for Services and Enforcement, Internal Revenue Service
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Christopher B. Sterner, Deputy Chief Counsel (Operations), Internal Revenue Service
Clarissa C. Potter, Deputy Chief Counsel (Technical), Internal Revenue Service
Deborah Butler, Associate Chief Counsel (Procedure and Administration), Internal Revenue Service

Request for Guidance on Implementation of Economic Substance Legislation

In Notice 2010-62,¹ the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”) requested comments on certain aspects of the economic substance legislation contained in the Health Care and Education Reconciliation Act of 2010 (the “2010 Act”).² These comments, which have been prepared by members of the American Bar Association Section of Taxation (the “Tax Section”)³ and by members of the American Institute of Certified Public Accountants (the “AICPA”),⁴ generally address the need for prompt guidance on the implementation of the statutory provisions, comment on the interim guidance set forth in Notice 2010-62, and

¹ 2010-40 I.R.B. 411.

² Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

³ These comments represent the views of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the policy of the American Bar Association.

The Tax Section steering committee that was primarily responsible for preparation of these comments on behalf of the Tax Section consisted of Michael Desmond, Armando Gomez, Helen Hubbard, Fred Murray and Cary Pugh. The Tax Section working group that participated in the development of these comments included Ronald Buch, Rita Cavanagh, Julian Kim and Tom Greenaway from the Administrative Practice Committee; Bob Pope from the Bankruptcy and Workouts Committee; Larry Campagna and Brendan O’Dell from the Civil and Criminal Tax Penalties Committee; Robbie Turnipseed from the Closely Held Businesses Committee; Neil Barr, Erik Corwin, Jack Cummings, Roger Ritt, David Sherwood, Mark Silverman, David Strong, Amanda Varma, Robert Wellen and Lisa Zarlenga from the Corporate Tax Committee; Althea Day from the Employee Benefits Committee; Michael Sanders from the Exempt Organizations Committee; Joe Calianno, Alan Granwell, Rebecca Rosenberg and Carol Tello from the Foreign Activities of U.S. Taxpayers Committee; Matthew Stevens from the Financial Transactions Committee; Elinore Richardson from the Foreign Lawyers Forum; Ann Cammack from the Insurance Companies Committee; Susan Mello and Jeanne Sullivan from the Partnerships and LLCs Committee; Eliot Kaplan from the Real Estate Committee; Paul McKenney and Mark Wilensky from the Sales, Exchanges and Basis Committee; Linda Beale and Diana Erbsen from the Standards of Tax Practice Committee; Susan Grais, Kevin Jacobs, Ed Morse and Wayne Hamilton from the Tax Accounting Committee; Tracy Kaye and Michael Lang from the Teaching Taxation Committee; Elizabeth Lieb from the Young Lawyers Forum; and Stanley Ruchelman from the U.S. Activities of Foreigners & Tax Treaties Committee. The comments were reviewed by Kenneth W. Gideon of the Tax Section’s Committee on Government Submissions, and were further reviewed by Eric Solomon, Council Director for the Tax Shelters Committee.

Although the members of the Tax Section who participated in preparing these comments have clients who might be affected by the Federal income tax principles addressed by these comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

⁴ These comments represent the views of the American Institute of Certified Public Accountants. Members of the AICPA Economic Substance Task Force primarily responsible for preparation of these comments on behalf of the AICPA are: John A. Galotto, Chair; Andrew W. Cordonnier; Eve Elgin; Gregory M. Fowler; and Jean E. Trompeter, AICPA Technical Manager. The Task Force also acknowledges the substantial contribution to these comments made by Anita Soucy. The comments have been approved by the AICPA Tax Executive Committee.

make recommendations to promote fair and consistent application of the economic substance legislation. Both of our organizations are separately submitting these comments to Treasury and the Service.

Executive Summary

The enactment of section 7701(o) and the related penalty in sections 6662(b)(6) and 6676 as part of the 2010 Act marked the culmination of efforts over more than a decade to codify the economic substance doctrine.⁵ This legislation changes the playing field significantly by mandating the two-prong test and imposing a strict liability penalty. Despite the detailed consideration of the legislation over the years, the 2010 Act did not resolve major pre-existing ambiguities in the economic substance doctrine (*e.g.*, what counts as a substantial business purpose) and brings to the fore a number of other ambiguities, most particularly the question of when the doctrine is relevant. Because of these ambiguities, and because the strict liability penalty provides no opportunities for taxpayers to avoid penalties through diligence and reliance on advisors, we believe it is appropriate for Treasury and the Service to provide prompt guidance so that taxpayers and their advisors will know how the legislation is to be applied. Moreover, by dedicating resources now to developing and issuing guidance on the application of this legislation, the government may avoid unnecessary controversy later, can better promote uniform application of the law, and can further the purpose of the statute in deterring taxpayers from entering into aggressive tax transactions while not curtailing legitimate business planning.

We are, of course, aware that Notice 2010-62 states that Treasury and the Service “do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.” Although we understand and appreciate the difficulties that these new statutory provisions present for the government, we respectfully submit that the government should provide guidance, particularly when the failure to provide guidance is likely to result in the inappropriate assertion of the economic substance doctrine, and the associated strict liability penalty. Accordingly, as detailed below, we recommend that Treasury and the Service issue regulations or other published guidance on some of the more significant interpretative aspects of the statutory provisions.

We place the highest priority for guidance on establishing a framework for determining when the economic substance doctrine may be relevant to a particular transaction. Historically, the precise contours of when the doctrine applies have been subject to considerable debate,⁶ but Congress made clear in the 2010 Act that relevance is an issue that must be addressed and answered before the economic substance doctrine can

⁵ Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”).

⁶ One need only review the numerous opinions of the courts that have ruled on these issues (some of which are discussed in succeeding sections of this report), to observe the difficulty those courts have had in answering that threshold question.

be asserted. With codification and the 40 percent strict liability penalty, we believe that it is important that Treasury and the Service issue guidance on this question or run the risk of having the statute deter legitimate business planning. To that end, we recommend that guidance be issued adopting a framework for taxpayers and the Service to apply when determining whether the doctrine may be relevant to a particular transaction.

We propose a framework involving four distinct and fundamental steps: (1) determine whether the transaction in fact occurred or was completed as documented, using all common law methods of fact finding; (2) determine whether the claimed tax treatment complies with the substantive provisions of the Code and Regulations upon which the taxpayer relied, as informed by the usual methods of statutory interpretation and construction; (3) determine whether the claimed tax treatment is consistent with the Congressional purposes underlying the relevant substantive provisions of the Code; and (4) determine whether the facts and circumstances indicate that the economic substance doctrine is relevant to the transaction at issue.

Once it has been determined that the economic substance doctrine is relevant to a transaction, there remain additional issues with respect to which we believe guidance is necessary, including:

- (1) Providing definitions for key terms contained in section 7701(o), including:
 - (a) “economic substance doctrine;”
 - (b) “transaction;” and
 - (c) “meaningful way,” “economic position” and “substantial purpose;”
- (2) Clarifying when State and local tax benefits are “related” to Federal tax benefits;
- (3) Providing guidance for determining “potential for profit;” and
- (4) Confirming that the reference in section 6662(b)(6) to “any similar rule of law” is limited to situations in which a court fails to expressly invoke section 7701(o) or the economic substance doctrine by name, and that the penalty does not encompass situations in which the merits of the transaction are determined through application of judicial doctrines distinct from the economic substance doctrine or through other anti-abuse provisions.

Mindful of the statements in Notice 2010-62 that the Service intends to administer the new economic substance legislation by reference to authorities in effect prior to the enactment of section 7701(o), each of our recommendations is supported by reference to such authorities, except when there is no authority (thus making guidance even more appropriate). And while we would prefer to see the guidance issued in the form of binding regulations with a full opportunity for notice and comment, at a

minimum we believe it is important that the Service issue detailed internal directives (which should be made public) so that revenue agents and field counsel will better understand the proper contours of the economic substance doctrine and so that taxpayers will better know when it might apply, thereby furthering its intended deterrent effect.

In light of the stakes presented by the strict liability penalty for transactions found lacking in economic substance, taxpayers have a greater than ever need for guidance on prospective transactions. Accordingly, we recommend that the Service expand its expedited private letter ruling procedures to cover broader categories of transactions and issues. We also recommend that the Service specifically address the applicability or nonapplicability of section 7701(o) to the transactions covered in the private rulings that it does issue. Failing that, we recommend that the Service develop a procedure for “no action” type letters that would assure taxpayers obtaining such letters that the Service will not assert the applicability of section 7701(o) to the transaction described in the letter. When a taxpayer seeks a ruling on a prospective transaction, the Service should be willing to specify whether that transaction truly will withstand scrutiny.

With respect to the interim disclosure rules provided in Notice 2010-62, we believe that Treasury and the Service have struck a proper balance. We request that those rules be made permanent through promptly issued Regulations, and offer certain clarifications and suggestions for enhancement of those rules.

With respect to the recent Industry Directive requiring approval by a director of field operations (“DFO”) before a revenue agent asserts the strict liability penalty under section 6662(b)(6) (and, by implication, section 7701(o) itself) in a particular case, we recommend that the Service expand the approval process to require robust review by Counsel and a conference of right. We also recommend that Large Business & International (“LB&I) division leadership be consulted prior to the proposed assertion of section 7701(o) in any particular case so that the division commissioner and her deputies can carefully monitor how the statute and the accompanying strict liability penalty are being applied in the field.

Finally, we urge Treasury and the Service to afford taxpayers and practitioners a meaningful opportunity to comment on any guidance before it takes effect. An inclusive approach affords valuable input and will result in an end product that better serves the interests of all stakeholders. Members of both of our organizations stand ready to provide that input, and would be pleased to meet with you to discuss the recommendations set forth herein.

Discussion

I. The Statute & Legislative History

In the months since enactment of the 2010 Act, many articles describing the economic substance legislation and commenting on its meaning have been published.⁷ Following is a very brief summary of the key provisions of the statute and the relevant legislative history.

A. Statutory provisions

Section 1409(a) of the 2010 Act “codified” a conjunctive economic substance doctrine test in new section 7701(o). This statute defines the doctrine as a “common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose”⁸ and states that “[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if” the legislation had never been enacted.⁹ It further states that

[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.¹⁰

Thus, the enactment of section 7701(o) resolved the longstanding conflict among various circuit courts of appeal regarding how the doctrine should be applied by codifying a two-part conjunctive test.¹¹

⁷ See generally Monte A. Jackel, Dawn of a New Era: Congress Codifies Economic Substance, 2010 TAX NOTES 75-3, Mar. 29, 2010; Jeremiah Coder, The Journey to Codify the Economic Substance Doctrine is Over: But Will It Be Worth It?, 2010 TAX NOTES 61-1, Mar. 30, 2010; Martin J. McMahon Jr., Living With the Codified Economic Substance Doctrine, 2010 TAX NOTES 736-37, Aug. 16, 2010; Rochelle L. Hodes, The Case for a Different Kind of Disclosure Regime, 2010 TAX NOTES 975, Aug. 30, 2010. For a discussion of earlier codification proposals, see Yoram Keinan, The Economic Substance Doctrine - Past, Present and Future, 47 TAX MGM’T MEMO 259, June 26, 2006.

⁸ I.R.C. § 7701(o)(5)(A).

⁹ I.R.C. § 7701(o)(5)(C).

¹⁰ I.R.C. § 7701(o)(1).

¹¹ The three prevailing economic substance tests were (1) a conjunctive test, (2) a disjunctive test and (3) a facts and circumstances test. The conjunctive test required the taxpayer to establish the presence of both economic substance (measured objectively in terms of pre-tax profit potential) and business purpose (measured subjectively in terms of the taxpayer’s intent). See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993); *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537 (5th Cir. 2009). The

The statute also provides that any State and local income tax effects related to a Federal income tax effect shall be disregarded in determining whether the transaction changes a taxpayer's economic position in a meaningful way;¹² and any financial accounting benefit generated by a reduction in Federal income tax shall be disregarded in determining whether a taxpayer has a substantial purpose for entering into such transaction.¹³ Additionally, the statute provides a special rule regarding the consideration of a transaction's profit potential: it shall be taken into account "only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected."¹⁴ However, in calculating the pre-tax profit, fees and other transaction expenses shall be deducted.¹⁵

The 2010 Act also established a strict liability accuracy-related penalty attributable to any disallowed tax benefits for a transaction lacking economic substance or failing to meet the requirements of any similar rule of law. The minimum penalty is 20 percent of the underpayment, but is increased to 40 percent if the disallowed benefits were not "adequately disclosed" in the return or in a statement attached to the return.¹⁶ Amendments to section 6664 make clear that the "reasonable cause" exception is not applicable to this penalty, and a corresponding amendment to section 6676 provides that a strict liability penalty also applies to refund claims, although in that case it is limited to 20 percent.

Section 7701(o) and the related strict liability accuracy-related penalty apply to transactions entered into after March 30, 2010, which was the date of enactment of the 2010 Act.

B. Legislative History

There is no "official" legislative history for the 2010 Act. However, useful guidance is available from several sources.

disjunctive test required a transaction to have either economic substance or business purpose to survive scrutiny. *See, e.g., Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *IES Indus. v. United States*, 253 F.3d 350 (8th Cir. 2001). Courts that instead applied a facts and circumstances test tended to view business purpose and economic substance as factors to consider in determining whether the transaction had any practical economic effects other than the creation of tax benefits. *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1998).

¹² I.R.C. § 7701(o)(3).

¹³ I.R.C. § 7701(o)(4).

¹⁴ I.R.C. § 7701(o)(2)(A).

¹⁵ I.R.C. § 7701(o)(2)(B).

¹⁶ Pub. L. No. 111-152 § 1409(b), 124 Stat. 1029, 1068-1070 (codified at I.R.C. §§ 6662(b)(6), 6662(i), 6664(c)(2), 6664(d)).

As discussed in greater detail in Appendix A to these comments, Congress considered a variety of codification proposals over the decade leading up to the enactment of the 2010 Act, and numerous committee reports from the Senate Finance Committee and House Committee on Ways and Means, as well as technical explanations issued by the staff of the Joint Committee on Taxation, describe and analyze those proposals. In this regard, the report issued by the Committee on Ways and Means on October 15, 2009, in connection with its approval of H.R. 3200 (the “Ways and Means Committee Report”), was the most recent statement of that Committee’s motivations behind the economic substance legislation.¹⁷ Because that bill ultimately was not enacted, and because the economic substance legislation ultimately enacted contained several material differences from that approved by the Committee, the report may be persuasive, but cannot be considered “official” legislative history to the 2010 Act.

The technical explanation of the tax provisions contained in the 2010 Act, prepared by the staff of the Joint Committee on Taxation, is the closest thing to an “official” legislative history.¹⁸ Although the Technical Explanation was never approved by either tax-writing committee, its contemporaneous analysis of the provisions of the 2010 Act may be persuasive in evaluating the intentions of Congress and in interpreting how certain aspects of the legislation should be applied.¹⁹

In explaining the limitation of the application of the economic substance doctrine, the Technical Explanation states, “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.”²⁰ The Technical Explanation goes on to provide that the legislation “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

¹⁷ H.R. Rep. 299, pt. 2, 111th Cong., 1st Sess. (2009).

¹⁸ 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” (JCX-18-10)* March 21, 2010 (hereinafter “Technical Explanation”). Please refer to Appendix A to these comments for a discussion of the atypical legislative process followed in the enactment of the 2010 Act.

¹⁹ See *Estate of Hutchinson v. Commissioner*, 765 F.2d 665, 669-70 (7th Cir. 1985) (reasoning set forth in Joint Committee on Taxation explanation “does not rise to the level of legislative history, because it was authored by Congressional staff and not by Congress. Nevertheless, such explanations are highly indicative of what Congress did, in fact, intend.”). See also, *Bank of Clearwater v. United States*, 55 AFTR 2d 1552 (Ct. Cl. 1985) (“Absent any definitive legislative history that is more revealing, the court believes it is proper nevertheless, in the absence of any comparable contrary assertions, to give substantial weight to this [Joint Committee on Taxation] Explanation.”); *Robinson v. Commissioner*, 119 T.C. 44, 73 (2002) (acknowledging that Joint Committee summary “is not the official legislative document” and “may not be a complete or thorough statement” of decisions made by a conference committee, but because it “was provided to the Members of the House and Senate for their reference before Congress enacted [the legislation] . . . it is part of the history of the legislation.”).

²⁰ Technical Explanation, *supra* note 18, at 152 n.344.

comparative tax advantages” and lists four illustrative examples that also were included in the Ways and Means Committee Report.²¹

The Technical Explanation provides some insight into the slight differences between the “codified” economic substance doctrine in the 2010 Act and prior proposals. One such difference is the treatment of foreign taxes in determining whether a transaction has a pre-tax profit. The 2010 Act requires Treasury to issue regulations to provide for the situations in which foreign taxes are to be considered, instead of automatically reducing a transaction’s profit. The Technical Explanation states that this change was designed so that the legislation would not “restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law.”²²

Additionally, the Technical Explanation provides insight into the imposition of the penalty for failing to meet the requirements of any similar rule of law,²³ by explaining that the provision “is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”²⁴

II. Interim Guidance

On September 13, 2010, Treasury and the Service announced interim guidance in Notice 2010-62 regarding section 7701(o) and the related penalty amendments. That interim guidance generally provides that the Service will apply the statute as written by Congress,²⁵ but that in doing so the government will rely on relevant case law applying the common-law economic substance doctrine.²⁶ The Notice generally makes clear that Treasury and the Service “do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.” Separately, the Notice provides that the Service will not issue private letter rulings or determination letters regarding whether the economic

²¹ *Id.* at 152.

²² *Id.* at 155 n.357.

²³ I.R.C. § 6662(b)(6).

²⁴ Technical Explanation, *supra* note 18, at 155 n.359.

²⁵ For example, the Notice provides that the Service “will challenge taxpayers who seek to rely on prior case law under the common-law economic substance doctrine for the proposition that a transaction will be treated as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary).”

²⁶ For example, the Notice provides that Service “will rely on relevant case law” in determining “whether a transaction sufficiently affects the taxpayer’s economic position,” “whether a transaction has a sufficient nontax purpose,” and “when the economic substance doctrine will apply.”

substance doctrine is relevant to any transaction, or whether any transaction complies with the requirements of section 7701(o).

Notice 2010-62 provides that the adequate disclosure requirements of section 6662(i), which must be met to reduce the penalty from 40 percent to 20 percent, generally will be satisfied if a taxpayer discloses on a timely filed original return or a qualified amended return. Disclosures will be deemed adequate only if made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications or other guidance. In addition, the Notice provides that disclosures made consistent with the terms of Rev. Proc. 94-69,²⁷ which allows large corporate taxpayers under constant examination to make disclosures to avoid penalties, also will be taken into account for purposes of section 6662(i). In the case of reportable transactions found lacking in economic substance, disclosure will not be adequate unless, in addition to the requirements set forth in the Notice, the taxpayer also complies with the reporting requirements under section 6011 applicable to reportable transactions.

In Notice 2010-62, the Service requested comments on the disclosure requirements with regard to section 6662(i), especially with regard to the interaction of Rev. Proc. 94-69, the proposed (now finalized) Schedule UTP, and the compliance assurance process program.

On September 14, 2010, the Commissioner of LMSB (now known as LB&I) issued a field directive “to ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6)” that requires any proposal to impose that penalty at the examination level to be reviewed and approved by the appropriate DFO.²⁸

III. Recommendations

A. Guidance on when the doctrine is relevant

Congress referred twice in section 7701(o) to the “relevance” of the economic substance doctrine. We understand these references to reflect Congress’ view that the doctrine is not always or even presumptively relevant to taxpayers’ transactions. This emphasis on relevance is not reflected in the pre-codification cases and, therefore, we believe it needs to be addressed going forward.

Section 7701(o)(1) provides that “[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if” the codified two-prong test is met. Elaborating on when the doctrine applies, section 7701(o)(5)(C) provides that “[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same

²⁷ 1994-2 C.B. 804.

²⁸ Internal Revenue Service, Directive for Industry Directors, et al. regarding Codification of Economic Substance Doctrine and Related Penalties (LMSB-20-0910-024) Sept. 14, 2010.

manner as if [section 7701(o)] had never been enacted.” The Technical Explanation makes clear that codification was intended to have no effect on the threshold question of when the doctrine will apply or, in the language of the statute, when the doctrine will be “relevant.”²⁹ Because of the absence of any meaningful analysis of relevance in the case law, use of the term “relevant” in section 7701(o) has created significant uncertainty as to the circumstances in which the codified rule will apply, reflecting ambiguity under prior law as to the reach of the doctrine and its overlap with other anti-abuse rules.³⁰

Prior to codification taxpayers took comfort in knowing that there were certain types of transactions that, under judicial precedent or administrative practice, would generally not be subject to challenge under the economic substance doctrine.³¹ This authority arose largely (if not entirely) in the context of courts considering the merits of a transaction and applying, or not applying the doctrine to challenge that transaction. Thus, this authority tends to imply a definition of “relevance” by saying when the economic substance doctrine will not apply. Although one can indirectly discern from this authority certain circumstances in which the economic substance doctrine might apply, it does not *per se* frame the threshold question of when the doctrine is “relevant.”

Notice 2010-62 refers to prior “authorities” in considering when the economic substance doctrine will apply, although it does not cite to any such authorities; and we have not been able to identify any authorities that frame or consider the threshold question in terms of a relevance inquiry, at least as the term “authorities” is defined in Regulation section 1.6662-4(d)(3)(iii).³² Rather, the economic substance doctrine has historically been applied (and thus been deemed “relevant”) only when the Service asserts it as an affirmative defense to the normative tax treatment of a transaction and the

²⁹ Technical Explanation, *supra* note 18, at 152 (“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.”).

³⁰ While the term “relevant” is used elsewhere in the Code, it is only in the traditional context of evidentiary relevance as defined in Fed. R. Evid. 401. See, e.g., I.R.C. §§ 45H(e)(2) (requirement that application for production credit include “relevant” information); 382(h)(8) (determination of fair market value in certain cases involving NOL limitations dependent in part on consideration of “other relevant items”); and 982(d)(1) (defining “foreign-based documentation” by reference to “relevant” documentation).

³¹ Notice 2010-62 describes “authorities prior to the enactment of section 7701(o)” providing that the economic substance doctrine was “not relevant.” While there are certainly cases that have rejected government assertions of the doctrine, those cases were necessarily in situations in which the Service thought the doctrine relevant so they provide only indirect guidance on when the doctrine will apply.

³² We infer that this refers to cases like *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991), where the tax benefit was allowed in a transaction lacking a business purpose and, arguably, lacking a meaningful change in the economic position. The Service took the position through briefing to the Supreme Court that the doctrine was “relevant” to the exchange of economically equivalent mortgages, a position that the Court ultimately rejected, but the opinion does not discuss its decision in terms of the doctrine, much less its “relevance.” *Cottage Savings* illustrates the evolving nature of the relevance inquiry and the inherent limitation in the statutory approach of linking to a dynamic and uncodified standard for determining when the doctrine will apply.

courts (and taxpayers) respond by analyzing it.³³ Thus, the Service has historically acted as the gatekeeper in determining when the doctrine is relevant, although it has never published guidance on the analysis that it applies.³⁴

Under the historical framework, the precise contours of when the economic substance doctrine would apply were subject to considerable debate – which debate continues today in the context of cases involving pre-enactment periods. Ambiguity surrounding the relevance inquiry created tension that, on balance, served the Service’s interest of keeping aggressive tax planning in check. Historically, this may have counseled against issuing published guidance on when the doctrine would and would not apply. With codification and the accompanying 40 percent strict liability penalty, however, we believe that the paradigm has changed and that it is now important that Treasury and the Service issue guidance on the threshold question of when the economic substance doctrine will be relevant.³⁵

From an examination perspective, economic substance is now part of the Code itself and without any statutory or regulatory limitations on the circumstances in which it will be asserted, revenue agents may see it as their responsibility to consider application in connection with every issue raised in an examination. In light of the strict liability penalty, such broad assertions of the doctrine could have a significant chilling effect on a wide range of business transactions that the doctrine has historically been thought not to cover. Broad assertion of the doctrine may also present a significant risk of judicial precedent adverse to the Service, ultimately weakening the effectiveness of the doctrine and frustrating the stated purpose of “clarifying and enhancing” its application.³⁶

³³ See Jasper L. Cummings, Jr., *The Supreme Court’s Federal Tax Jurisprudence* (American Bar Association, 2010), at 155 (noting that the economic substance and other common law doctrines “do not arise and are not applied without the urging of the Service”).

³⁴ While not set forth in any binding guidance, we do note that a former Chief Counsel forcefully argued that “the economic substance doctrine should be used only rarely and judiciously” and should not be used as a general anti-abuse rule to challenge tax benefits that the Service “views as unintended or just because we do not like the transactions,” but should be raised only “in those cases where the tax result produced by the transaction does not appear to be in accord with Congressional intent and common sense.” Donald L. Korb, *Remarks at the 2005 University of Southern California Tax Institute: The Economic Substance Doctrine in the Current Tax Shelter Environment* (January 25, 2005). See also Coordinated Issue Paper on Notice 2002-50, available at <http://www.irs.gov/businesses/article/0,,id=138832,00.html> (stating that “discretion must be exercised in determining whether to utilize an economic substance argument in any case”).

³⁵ This is not a novel concept. A white paper issued by Treasury in 1999 specifically contemplated the need for taxpayers to obtain certainty on transactions in the face of heightened penalties, and suggested expedited rulings from the National Office as one solution. U.S. Dept. of Treas., *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/ctswhite.pdf> (hereinafter “Treasury White Paper”) at 104.

³⁶ Technical Explanation, *supra* note 18, at 152.

While the Technical Explanation does provide taxpayers with some measure of comfort in evaluating the circumstances in which the doctrine will apply, the explanation is too general in its discussion of the relevance inquiry and we believe more detailed guidance is needed. Moreover, there is some uncertainty over the extent to which the courts (and, in turn, taxpayers and the Service) may rely on the Technical Explanation for guidance.³⁷ We recommend that Treasury and the Service confirm that the Technical Explanation is authoritative so that taxpayers can act in reliance on that explanation when applying the law.

On a more conceptual level, we believe guidance on the threshold question is also needed because, as a default rule, the tax law must be form driven and the rules must be written in terms of forms that may be objectively observed by both taxpayers and revenue agents. An open-ended rule permitting a broad override of the substantive rules in the Code would lead to greater uncertainty in implementation and administration of the tax law. We understand that court opinions and Service pronouncements commonly state that “substance controls form,” but we understand those statements either to refer (in recent years) to the economic substance doctrine, which admittedly has its limits of relevance, or more traditionally to the ability of courts to find facts based on all of the facts and circumstances (*i.e.*, the substance of the event).³⁸

Moreover, because Congress legislates with the understanding that the law will be applied based on the forms of transactions that its words describe, as informed by the common law ability of courts to find facts, it is inevitable that taxpayers are able to properly claim tax benefits by complying with the statute’s words in a way that a revenue agent might think was not intended by Congress.³⁹ Enforcing the law on the basis of such opinions of intent can lead to inequitable application of the tax laws.

Recognizing the reluctance on the part of Treasury and the Service to publish an “angel list” of specific transactions to which the doctrine will not apply,⁴⁰ we believe that a framework can be developed that will give taxpayers some comfort with respect to legitimate business transactions that have not been – and should not be – subject to an economic substance challenge. This framework would provide some guidance to both examination teams and to taxpayers, all of whom must understand how to apply the economic substance doctrine while also permitting the relevance analysis to

³⁷ See *Estate of Hutchinson*, *supra* note 19.

³⁸ See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (finding no loan).

³⁹ Examples of such benefits approved by the courts abound, including *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955) and *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991).

⁴⁰ See Notice 2010-62 (“The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either does or does not apply.”). We believe that the relevance framework we suggest is consistent with this position, in that it does not contemplate designation of specific transactions that are or are not subject to scrutiny under the doctrine. Rather, it contemplates only broad guidance that explains the framework for the analysis as to whether the doctrine applies.

continue to evolve, ensuring that new and unanticipated abuses of the Code are kept in check by the doctrine and its accompanying strict liability penalty.⁴¹ In contrast, without a published framework, the relevance inquiry will continue to be made episodically with the Service acting as the gatekeeper for when to assert the doctrine, and taxpayers not knowing the factors being considered and left with no process to seek relief. In other words, including a framework in published guidance makes transparent the process that the Service should apply in any event.

The framework we propose would involve four distinct and fundamental steps:

Step 1: Determine whether the transaction in fact occurred or was completed as documented, using all common law methods of fact finding.

Step 2: Determine whether the claimed tax treatment complies with the substantive provisions of the Code and Regulations upon which the taxpayer relied, as informed by the usual methods of statutory interpretation and construction.

Step 3: Determine whether the claimed tax treatment is consistent with the Congressional purposes underlying the relevant substantive provisions of the Code.

Step 4: Determine whether the facts and circumstances indicate that the economic substance doctrine is relevant to the transaction at issue.

These four steps would be applied in order, and analysis of subsequent steps would only be required depending on the outcome of the preceding step. Thus, for example, a transaction that fails Step 1 would not be respected – because a transaction that is a “sham in fact” did not actually happen – and further scrutiny would not be required. As discussed below, we believe that this four-part framework is consistent with the statute, and is supported by the Technical Explanation and by prior law.

Some might wonder why the economic substance doctrine cannot be applied first rather than last, when it is “obvious” that the doctrine is relevant. There are several reasons. First, the statute requires it by defining the doctrine as disallowing otherwise allowable benefits and limiting its application to transactions to which it is relevant. Second, proper analysis of relevance will show that the doctrine’s application is not always so “obvious” as it has been assumed to be in many pre-codification cases. Third, the no fault penalties apply only when the denial of tax benefits is “by reason of” the economic substance doctrine, and so taxpayers must be accorded the right to avoid the penalty if they should lose on some other grounds. Finally, whether the taxpayer’s facts actually occurred and whether the law, as properly interpreted, allows the claimed

⁴¹ See Cummings, *supra* note 33, at 126 n.694 (noting that one of the problems with the anti-abuse rule in section 269 is that it (and the Regulations implementing it) has not evolved to address current abusive transactions).

tax benefits should inform the issue of the doctrine's relevance because some pre-codification cases purportedly decided under the doctrine also were based on finding that facts did not occur as claimed or that the statute did not allow the benefit claimed.

1. Step One: Determine whether the transaction in fact occurred or was completed as documented, using all common law methods of fact finding

The first step in the consideration of any transaction should be to find facts to establish what actually happened. Although this may seem to be an obvious step, it tends to be conflated with the economic substance doctrine and thus is often overlooked as an independent step.

For example, in *Mahoney v. Commissioner*, the Sixth Circuit Court of Appeals stated that if it is determined that a transaction is a complete sham, “then such niceties as whether it was ‘primarily’ for profit, or whether the test is an objective or subjective one are simply not involved.”⁴² Likewise, in *Enrici v. Commissioner*, the Ninth Circuit Court of Appeals concluded that because “no real transactions were taking place” it was not necessary to reach the issues of whether the transactions were entered into for profit, or whether the losses were ordinary or capital in nature.⁴³ Both of these decisions involved appeals of Tax Court decisions involving so-called London options, in which the taxpayers claimed losses from alleged commodity straddles. But when the courts found, for example, that “during the years in issue . . . neither gold nor platinum were traded on any exchange in London and no prices were published in London for forward contracts in those metals,” and when the courts further found that trading records had been “manipulated” and that the taxpayers did not introduce any evidence to corroborate the transactions, they necessarily concluded that the transactions were factual shams.⁴⁴

There are countless other cases that have been litigated over the years involving similar factual shams. For example, the so-called “Hoyt partnership” cases involved partnerships that allegedly purchased cattle or sheep, but in many cases the courts ultimately found that the alleged purchase price of the flock sold to each partnership exceeded the value of the flock and that many of the animals purportedly sold did not in fact exist.⁴⁵

Moreover, there are even more cases that have been decided based on the facts found by the courts. Among the most famous of these cases is *Knetsch v. United*

⁴² 808 F.2d 1219, 1220 (6th Cir. 1987).

⁴³ 813 F.2d 293, 295 (9th Cir. 1987).

⁴⁴ *Forseth v. Commissioner*, 85 T.C. 127, 157 (1985). For a discussion of the London options cases, see Jasper L. Cummings, Jr. *The New Normal: Economic Substance First*, 126 TAX NOTES 521 (Jan. 25, 2010).

⁴⁵ See, e.g., *River City Ranches #1 Ltd. v. Commissioner*, 94 T.C.M. (CCH) 1 (2007).

States,⁴⁶ in which the Supreme Court disallowed the taxpayer's claimed interest deductions when it found that there was no real indebtedness and that the difference between the amounts paid by the taxpayer and what it received in exchange was the fee paid by the taxpayer for "the facade of 'loans'." Conversely, in *Goldstein v. Commissioner*,⁴⁷ the Second Circuit Court of Appeals concluded that the loan at issue was real, before it then concluded that the deductions for payments on that loan were not allowable under section 163.

The Technical Explanation supports our view that consideration of the economic substance doctrine does not begin unless the transaction actually occurred. Specifically, the Technical Explanation begins its discussion of the economic substance doctrine with the following sentence:

Courts generally deny claimed tax benefits if the transaction that gives rise to those tax benefits lacks economic substance independent of U.S. Federal income tax considerations – notwithstanding that the purported activity actually occurred.⁴⁸

Thus, the analysis of the economic substance doctrine does not start until it has first been determined that the activity actually occurred.

While treating the factual sham doctrine as separate from the economic substance doctrine may appear to be a grant of leniency to factual shams, in practice that should not be the case. First, there is no need to resort to a business purpose analysis in order to identify and deal with factual shams. Further, while factual shams may not be subject to the strict liability penalty under section 6662(b)(6), taxpayers that participate in such transactions may yet have difficulty demonstrating reasonable cause and good faith to defend against negligence or substantial understatement penalties, and in the more egregious cases, the 75 percent fraud penalty under section 6663 may be appropriate.

2. Step Two: Determine whether the claimed tax treatment complies with the substantive provisions of the Code and Regulations upon which the taxpayer relied, as informed by the usual methods of statutory interpretation and construction

The second step in the consideration of any transaction should be to determine whether the asserted tax treatment complies with the applicable provisions of the Code and Regulations. As the Supreme Court stated in *Gregory v. Helvering*, "the question for determination is whether what was done . . . was the thing that the statute intended."⁴⁹ Again, this may seem obvious, but the incorporation of a business purpose

⁴⁶ 364 U.S. at 366.

⁴⁷ 364 F.2d 734 (2nd Cir. 1966).

⁴⁸ Technical Explanation, *supra* note 18, at 142.

⁴⁹ 293 U.S. 465, 469 (1935).

requirement into a particular provision, as occurred in *Gregory*, has been conflated into an episodically applicable business purpose requirement in the economic substance doctrine. However, some courts have properly sequenced the doctrine after application of the Code and Regulations, as normally interpreted. For example, in *Black & Decker Corp. v. United States*, the Fourth Circuit Court of Appeals stated that “the sham transaction doctrine permits the IRS to disregard a transaction that literally complies with the terms of the IRC but that is devoid of any legitimate business purpose.”⁵⁰ Likewise, in *Coltec v. United States*, the Federal Circuit Court of Appeals turned to its economic substance analysis only after first concluding that the taxpayer’s claimed loss “falls within the literal terms of the statute.”⁵¹

The definition of “economic substance doctrine” set forth in section 7701(o)(5)(A) supports the view that consideration of the substantive merits must come first. That definition provides that the term means:

The common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if a transaction does not have economic substance or lacks a business purpose.

Implicit in this definition is the conclusion that if the transaction has economic substance and a business purpose, the tax benefits would be allowable. Furthermore, under section 6662(b)(6), the economic substance penalty only applies to the “disallowance of claimed tax benefits *by reason of* a transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law” (emphasis added). Accordingly, we believe a proper reading of the statute leads to the conclusion that the substantive provisions of the Code and Regulations must be considered before economic substance.

The Technical Explanation supports our view that consideration of the economic substance doctrine does not begin until after it has been determined that the asserted tax treatment complies with the Code. Specifically, the Technical Explanation states that:

[T]he fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.

Failure to first challenge a transaction under the substantive rules could have adverse and unintended consequences, including the deterioration of the substantive rules and development of guidance and judicial decisions under those rules, as well as the assertion of strict liability penalties in situations where they should not apply because the transaction fails on its substantive merits.

⁵⁰ 436 F.3d 431, 440 (4th Cir. 2006).

⁵¹ 454 F.3d 1340, 1351 (Fed. Cir. 2006).

3. Step Three: Determine whether the claimed tax treatment is consistent with the Congressional purposes underlying the relevant substantive provisions of the Code

Once it is clear that the transaction in fact happened as described and that it passes muster under the applicable provisions of the Code and Regulations, it is appropriate to consider whether the asserted tax benefit is consistent with the Congressional purpose in enacting the benefit, in which case we do not believe it would be appropriate to apply the economic substance doctrine.

The courts have used the economic substance doctrine to deny only those benefits that, under the taxpayer's particular circumstances, are contrary to the intent of the drafters of the relevant statute or regulation. Where Congress or Treasury have either expressly authorized the tax benefit for all taxpayers or at least might reasonably have contemplated the tax benefit, courts have allowed the tax benefit even absent a non-tax business purpose or economic substance. For example, in *Cottage Savings Association v. Commissioner*,⁵² a taxpayer entered into a tax-motivated transaction (an exchange of economically similar mortgage portfolios) solely for the purpose of accelerating the deduction of an otherwise unrecognized economic loss. Although the exchange lacked a non-tax business purpose and did not meaningfully change the taxpayer's economic position, the Supreme Court refused to disallow the deduction under the economic substance doctrine, reasoning that Congress and Treasury might reasonably have contemplated the availability of a loss deduction under these circumstances.⁵³

The Technical Explanation supports our view that it is appropriate to assess Congressional purpose before turning to application of the economic substance doctrine. Specifically, in its brief discussion of present law standards for determining when to utilize an economic substance analysis, the Technical Explanation states that:

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.⁵⁴

The Technical Explanation goes on to reference Regulation section 1.269-2, which provides that application of section 269 requires an examination of the transaction "in light of the basic purpose or plan which the deduction, credit, or other allowance was

⁵² 499 U.S. 554 (1991).

⁵³ See also *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (holding that commodities dealer need not show that it expected to earn a pre-tax profit in connection with a straddle transaction to claim a loss incurred from closing out a leg of the straddle because Congress enacted section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984) in order to specifically allow commodities dealers to claim such losses).

⁵⁴ Technical Explanation, *supra* note 18, at 152 n.344. Note, however, that the Ways and Means Committee Report, *supra* note 17, at 296 n.124, used the term "clearly consistent with the Congressional purpose."

designed by Congress to effectuate.”⁵⁵ The Technical Explanation then references several targeted tax credit provisions and states that “it is not intended that [these credits] 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.”⁵⁶ In light of the continued growth in the number of tax expenditure provisions intended to deliver an economic benefit to targeted taxpayers, we submit that taxpayers should be encouraged to properly utilize these provisions and not be concerned that they will be subject to attack under the codified economic substance doctrine, or be subject to a 40 percent strict liability penalty.

Historically, the Service has examined transactions utilizing targeted tax credits by limiting its inquiry to an analysis of the substantive requirements of the relevant Code provision and has not looked beyond those requirements for broader arguments on why the claimed benefit should be disallowed.⁵⁷ In addition to these and other credit provisions, the Code has numerous other business tax expenditure provisions that are intended to deliver a tax benefit, such as the deduction for research and experimental expenditures under section 174 and the deduction for domestic production activities under section 199.⁵⁸ Where claiming such targeted deductions is consistent with the statutory requirements, we believe the codified economic substance rule should not apply. Similarly, targeted non-recognition provisions in the Code, such as the like-kind exchange rules in section 1031 and the involuntary conversion rules in section 1033, evidence Congressional intent in providing a targeted tax benefit and should likewise not be subject to unnecessary scrutiny under the codified economic substance rule; in addition, nonrecognition provisions already are heavily regulated by case law and Regulations.⁵⁹ Finally, we believe certain statutory and regulatory elections should be carved out from application of the economic substance doctrine as consistent with

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ However, in *Sacks v. Commissioner*, the Tax Court, in a memorandum decision, agreed with the Service that energy credits and depreciation deductions relating to solar water heating equipment could be disallowed on economic substance grounds. 64 T.C.M. (CCH) 1003 (1992). That decision (and its reasoning) was rejected on appeal. 69 F.3d 982 (9th Cir. 1995). Nonetheless, because the Service attempted to challenge a taxpayer’s entitlement to energy credits in *Sacks* on the basis of economic substance, and because the government continues to challenge other transactions involving claims for targeted tax credits on economic substance grounds (even if unsuccessfully, as in *Historic Boardwalk Hall, LLC v. Commissioner*, 136 T.C. No. 1 (2011)), the guidance we seek is all the more necessary.

⁵⁸ Our focus is limited to business tax expenditures because section 7701(o)(5)(B) provides that the new statute does not apply to personal transactions of individuals.

⁵⁹ *See, e.g.*, Reg. §§ 1.368-1 and 1.1002-1; *LeTulle v. Scofield*, 308 U.S. 415 (1940).

Congressional intent,⁶⁰ and “fictions” created by the Code or Regulations should also not be subject to challenge under the economic substance doctrine.⁶¹

When tax benefits (including non-recognition treatment) are claimed under targeted credit, deduction, non-recognition and election rules, it can generally be readily determined that those benefits are consistent with the language of the operative Code provision and underlying Congressional purpose. In order to ensure that Congressional intent in delivering such benefits is not frustrated by assertions of the codified economic substance rule, we recommend that published guidance be issued creating a presumption that the codified economic substance rule will not apply where the tax benefit is consistent with Congressional purpose. While it may be unlikely that the Service would assert the economic substance rule in these situations, in light of the strict liability penalty, even a remote risk that it will be asserted will have a chilling effect on transactions Congress intended to encourage. A tax benefit is consistent with Congressional intent under this part of the four-part analysis if it is either expressly authorized by, or capable of being reasonably inferred from, the relevant statutory provisions, their legislative history or the overall statutory framework. Thus, the inquiry as to consistency would be sufficiently meaningful to ensure that close cases would not escape heightened scrutiny by taxpayers and the Service. We believe revenue agents should be required to consider persuasive and well-supported arguments that the claimed tax benefit is consistent with Congressional intent. At the same time, we acknowledge that the government should not be required to consider every colorable argument a taxpayer may make, particularly where those arguments lack tangible support in the statutory text or legislative history of the provisions at issue. In any event, in our view, the inability to show Congressional intent should not create any presumption as to how the codified economic substance doctrine might apply. Rather, it means only that further analysis is required.

To illustrate the application of this part of our framework for the relevance analysis, we recommend that published guidance also include detailed examples. These examples would include targeted tax credits, deductions, non-recognition provisions and statutory and regulatory elections. The examples would also include transactions in which an asserted tax benefit is not presumptively allowed, including for example a wind energy partnership when the presumptive allowance of a section 45 credit to the partnership does not necessarily extend to the manner in which the partnership allocates that credit to the partners under subchapter K.

Under the threshold relevance test, when it can be readily determined that Congress intended to convey a targeted tax benefit and that the transaction at issue claims benefits consistent with that intent, we believe guidance should make clear that the codified economic substance rule and accompanying strict liability penalty do not apply.

⁶⁰ See, e.g., Rev. Rul. 2003-125, 2003-2 C.B. 1243 (permitting a worthless securities deduction where corporation makes a check-the-box liquidation election under Reg. § 301.7701-3).

⁶¹ See, e.g., Reg. §§ 301.7701-1, -2 and -3 (check-the-box regulations).

4. Step Four: Determine whether the facts and circumstances indicate that the economic substance doctrine is relevant to the transaction at issue

For transactions not removed from the application of the economic substance doctrine by the three preceding steps, a further analysis of key facts and circumstances will be required to determine whether the doctrine is relevant. Under this fourth and final part of the test, the analysis would involve application of a defined but non-exclusive list of factors derived from prior case law and other authorities.

a) Why a Factors Test is Necessary

A factors-based test as described below would serve the important function of distinguishing legitimate business transactions from those transactions that should be subject to closer scrutiny. This analysis is consistent with and supported by the Technical Explanation, which describes several categories of “basic business transactions” that the doctrine “is not intended to alter,” including:

- (1) *The choice between capitalizing a business with debt or equity.* The ability of a taxpayer to reduce its taxable income by deducting interest is an accepted aspect of our income tax system and is generally not viewed as tax avoidance unless the nominal debt is in substance equity, as determined under debt-equity principles and certain targeted anti-abuse rules (e.g., section 163(j)) that largely supplant the economic substance doctrine in this area.
- (2) *The choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment.* The ability of U.S. businesses to defer the taxation of active foreign business income by earning it in controlled foreign corporations is an accepted aspect of our business income tax system. Subchapter N and subpart F contain numerous rules, as expanded by regulations, to prevent abuse of this choice, which largely supplant the economic substance doctrine in this area.
- (3) *The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C.* These nonrecognition provisions are not only of longstanding use and importance in the Code, but they also are qualified and constrained by decades of development of anti-abuse rules, mostly originating in the courts and now encompassed in the Regulations, which largely supplant the economic substance doctrine in this area.
- (4) *The choice to utilize a related-party entity in a transaction that otherwise meets the arm’s length standard of section 482.* This item is a recognition of the inevitability of taxpayers dealing with related parties and of the implicit blessing of that fact by the presence of detailed rules like section 482 and the Regulations thereunder that govern such dealings, which largely supplant the economic substance doctrine in this area.

Unlike the tax credit transactions and other targeted tax benefits discussed above in Step 3, the basic business transactions described in the Technical Explanation

should not be presumptively excluded from application of the doctrine. These transactions involve a more nuanced analysis to infer Congressional intent. The need for a more nuanced analysis is illustrated by the caveat included in the Technical Explanation, which provides that “whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances.”⁶² In other words, Congressional intent to provide a tax benefit is established, but more through an understanding of the overall structure of the Code than from the text of a specific statutory provision.

To reflect this more nuanced approach to determining whether the asserted tax benefits from a “basic business transaction” are consistent with Congressional intent and should therefore not be subject to scrutiny under the codified economic substance rule, we recommend an evaluation of a non-exclusive list of factors that weigh in favor of, or against, application of the codified rule. These factors are derived from prior case law and other authorities evaluating application of (and, indirectly, the “relevance” of) the doctrine. The factors include both substantive and procedural considerations that look not only at the operative Code provisions but also the context in which the transaction was implemented to determine whether it should be subject to scrutiny under section 7701(o).

b) Recommended Factors to be Considered

An evaluation of the factors below will assist taxpayers in determining whether their transactions may be subject to scrutiny under the doctrine (and may be subject to the accompanying strict liability penalty). The same evaluation will assist the Service in determining whether the doctrine, rather than some other rule, may be used to challenge a transaction. The factors we believe should be incorporated in published guidance include:

- (1) *Whether a stand-alone anti-abuse rule may apply.* If a targeted anti-abuse rule such as section 269 or Regulation section 1.701-2 has been developed that applies to a particular transaction, that rule, rather than the doctrine, should be utilized.⁶³ The fact that a stand-alone rule could have applied but did not deny the benefit supports a finding that the doctrine is not “relevant.”

⁶² Technical Explanation, *supra* note 18, at 153.

⁶³ In concept, a large number of Code provisions can be characterized as “anti-abuse” rules in that they act to override the normative tax treatment of a transaction if certain technical rules or requirements are not met. *See, e.g.*, I.R.C. §§ 367 (otherwise tax-free transactions involving foreign counter-parties), 465 (at-risk rules); 469 (passive activity rules); 1091 (wash sale rules); 7701(i) (conduit financing rules). An argument could be made that when any of these targeted rules apply, or the transaction meets the requirements of the rule, Congress has occupied the field and an economic substance override should not be relevant. Recognizing that courts have been willing to disallow tax benefits on economic substance grounds even when a transaction survives challenge under such anti-abuse rules, as the *Coltec* court did when it applied the economic substance doctrine even though it found that the transaction survived application of section 357(b)(1), we stop short of that position in recommending only that the existence of a targeted anti-abuse rule be a factor in determining whether the codified economic substance rule should apply.

- (2) *Whether judicial or administrative precedent affirmatively considers and rejects application of the economic substance doctrine, or chooses not to apply the economic substance doctrine, in the context of a substantially similar transaction.* For certain transactions, the Service’s efforts to challenge those transactions using an economic substance theory have been rejected by the courts. This has created an assumption by taxpayers and the Service going forward that such transactions including, for example, the exchange of economically identical mortgages in *Cottage Savings Association v. Commissioner*,⁶⁴ or the sale of subsidiary stock to a related affiliate to facilitate loss recognition in a corporate liquidation in *Granite Trust v. United States*,⁶⁵ will not be subject to scrutiny under the economic substance doctrine.⁶⁶ Similarly, when the Service has, in published guidance, by letter ruling or Chief Counsel advice, considered a transaction and found either that it passed muster under the economic substance doctrine, or did not apply an economic substance analysis after determining that the substantive requirements were satisfied, this should be a factor in favor of determining that the doctrine is not relevant.⁶⁷
- (3) *Whether a transaction has been historically engaged in by taxpayers and there is a longstanding administrative practice not to challenge the transaction.* In addition to the transactions described in factor (2) above that have been the subject of judicial and administrative precedent, there are numerous basic business transactions that have long existed but have not been challenged by the Service. Even though there may be no specific judicial or administrative rulings

⁶⁴ 499 U.S. 554 (1991). We recognize that judicial rejection of an economic substance argument, particularly if it is only a trial court determination, may not be the last word, as illustrated in recent cases involving so-called “Son-of-Boss” and corporate contingent liability cases. *See, e.g., Sala v. United States*, 552 F. Supp. 2d 1167 (D. Co. 2008), *vacated and remanded by* 613 F.3d 1249 (10th Cir. 2010) (reversing trial court’s determination that transaction had economic substance); *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716 (2004) (suggesting in dicta that the economic substance doctrine was not “relevant” because it was extra-statutory), *vacated and remanded by* 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007). For this reason, we again limit our recommendation to the presence of case law on point being only a factor in the relevance analysis. In applying this factor, taxpayers and the Service would obviously accord more weight to decisions of the Supreme Court and the Courts of Appeals than to decisions of trial courts.

⁶⁵ 238 F.2d 670 (1st Cir. 1956). *Granite Trust* involved assertions by the Service that sale of stock to the subsidiary effected the liquidation “in such manner as to achieve a tax reduction” that was “without legal or moral justification,” an assertion that was rejected by the court and that we equate to an economic substance argument. *Id.* at 674.

⁶⁶ In this regard we note that, although the Treasury White Paper, *supra* note 35, at 97-98, questioned whether *Cottage Savings* transactions would be respected if Congress had enacted the Clinton Administration’s proposed expansion of section 269, Notice 2010-62 clearly states that if authorities prior to the enactment of section 7701(o) provided that the economic substance doctrine was not relevant, then the Service will not assert now that the economic substance doctrine is relevant.

⁶⁷ However, the mere inclusion of a caveat at the conclusion of a private letter ruling to the effect that the ruling does not address the potential application of section 7701(o), which caveats we understand some divisions of the Chief Counsel’s office have recently included in some private letter rulings, ought not create an inference that the doctrine is in fact relevant.

addressing these transactions, the longstanding respect for these transactions under the Service’s administrative practice should also be a factor in determining that the economic substance doctrine is not relevant. This factor is consistent with the Technical Explanation, which provides that the codified doctrine “is not intended to alter the tax treatment of certain basic business transactions that, under *longstanding judicial and administrative practice* were respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”⁶⁸

- (4) *Whether the transaction involves a corporate reorganization provision that historically has been examined under the business purpose doctrine alone, rather than under a conjunctive business purpose/economic substance test.* Historically, the Service has limited its analysis of certain corporate restructurings under section 351, section 355 and other provisions of subchapter C to a business purpose inquiry. If a transaction involves one of these provisions, this should be a factor suggesting that the transaction will not be subject to scrutiny under the codified economic substance rule.⁶⁹ In addition, nonrecognition rules are subject to their own requirements.⁷⁰
- (5) *Whether the transaction involves the acceleration of an economic loss borne by the taxpayer.* It is well understood that taxpayers properly may take actions to accelerate economic losses, absent specific authority to the contrary. For example, a taxpayer generally may track separate tax bases in tranches of stock, and may choose to divest stock with higher basis before divesting stock with lower basis.⁷¹ Similarly, as discussed above, pursuant to the Supreme Court’s decision in *Cottage Savings*, a taxpayer may choose to accelerate an economic loss through a bona fide sale, even if the transaction does not materially change the taxpayer’s economic position. Accordingly, the existence of a real economic loss and a transaction that accelerates a deduction with respect to that loss should be a factor in favor of determining that the doctrine is not relevant.
- (6) *Whether the tax benefit involves the creation of a non-economic loss or deduction, or the duplication of an economic loss or deduction.* In recent years, it seems that the vast majority of cases decided against taxpayers explicitly on grounds of economic substance have involved non-economic losses.⁷² The Technical

⁶⁸ Technical Explanation, *supra* note 18, at 152 (emphasis added).

⁶⁹ As discussed *infra* at part III.B., clarification of the definition of “economic substance doctrine” under section 7701(o)(5)(A) may also address this particular concern.

⁷⁰ See note 59, *supra*.

⁷¹ But note that acceleration of a loss with respect to high basis stock in a consolidated subsidiary may be limited pursuant to the specific authority provided in Reg. § 1.1502-36.

⁷² For example, numerous decisions have rejected taxpayers’ efforts to rely on *Helmer v. Commissioner*, T.C. Memo 1975-160 in an effort to generate non-economic losses. See, e.g., *Palm Canyon X Inv., LLC v. Commissioner*, 98 T.C.M. (CCH) 574 (2009); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009); *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636 (2008), *aff’d* 608 F.3d 1366 (Fed. Cir.

Explanation supports the view that section 7701(o) was enacted in response to cases such as these.

- (7) *Whether the transaction involves a tax indifferent counter-party.* Historically, the presence of a tax-indifferent counter-party suggests a risk that the transaction may create a disconnect between the economics and the tax reporting of the transaction. The presence of this factor would support application of the codified rule.
- (8) *Whether the transaction results in separation of income recognition from a related deduction, either between different taxpayers or between the same taxpayer in different tax years.* Separation of taxable income and related deductions suggests that a transaction should be subject to heightened scrutiny under the codified rule.⁷³ The presence of this factor would support application of the codified rule.
- (9) *Whether the asserted non-tax benefit from the transaction relates to the taxpayer's core business operations.* Historically, courts have been more likely to reject asserted tax benefits from a transaction (and thus find the economic substance doctrine “relevant”) where that transaction has no logical nexus to the taxpayer's historical business operations.⁷⁴ The presence of this factor would support application of the codified economic substance rule.

We believe this “factors” approach to discerning Congressional intent and answering the threshold relevance question is appropriate because of the critical need for guidance in this area. While such tests have been criticized in the past as ineffective in identifying potentially abusive transactions,⁷⁵ we believe that many of the problems with this approach in the past will be avoided if the factors are specifically framed as illustrative and non-exclusive, thereby retaining flexibility for the Service and the courts to continue to assert and develop application of the doctrine to an evolving category of transactions. Moreover, use of a nonexclusive factors approach would address the legitimate concern that Treasury and the Service may not be able to anticipate the many and varied situations that might arise. In addition, the approach would provide flexibility

2010). In addition, the government prevailed in contingent liability cases that had the effect of duplicating economic losses, such as *Coltec* and *Black & Decker*.

⁷³ See, e.g., Rev. Rul. 80-198, 1980-2 C.B. 113.

⁷⁴ Compare *Shell Petroleum Inc. v. United States*, 102 AFTR 2d 5085 (S.D. Tex. 2008) with *Coltec Indus. Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006); and compare *Consol. Edison Co. v. United States*, 90 Fed. Cl. 228 (2009) with *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008).

⁷⁵ In temporary and proposed regulations issued on February 28, 2000, Treasury and the Service required disclosure of certain transactions that had several indicia of potential abuse. Temp. Reg. § 1.6011-4T, T.D. T.D. 8877, 65 Fed. Reg. 11,205 (Mar. 2, 2000). That “factors” approach to disclosure was later replaced with the more targeted disclosure regime that is contained in current Reg. § 1.6011-4. Because it does not trigger mechanical reporting requirements, we believe that a factors approach to the relevance inquiry under section 7701(o) will be better suited than the approach under the old reportable transaction rules.

for the Service and the courts to articulate new and different factors that might ultimately be incorporated in published guidance.

In addition, we recommend that the published guidance make clear that when application of the factors results in analysis of a transaction under the codified rule, no adverse inference should be drawn. That the economic substance doctrine may be “relevant” says nothing about the conclusion that should be reached from application of the codified two-part rule. Further, we suggest that published guidance clarify that the use of the factors approach does not encompass a mere counting of factors for and against, but that the analysis must consider the proper weight to be given each factor in the particular circumstances.

B. Guidance on definition of “economic substance doctrine”

Section 7701(o)(5)(A) defines the term “economic substance doctrine” as the common law doctrine under which tax benefits under subtitle A of the Code with respect to a transaction are not allowable “if the transaction does not have economic substance or lacks a business purpose.” However, as discussed above, the statute goes on to provide in section 7701(o)(1)(B) that a transaction will be treated as having economic substance only if it changes in a meaningful way the taxpayer’s economic position and has a substantial purpose (apart from Federal income tax effects). Accordingly, the term “economic substance” appears to be used both as a shorthand for the two-prong test and as shorthand for the meaningful economic effect prong of that test. The Technical Explanation does little to elaborate on the definition, stating only that “the definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both.”⁷⁶

Some courts have applied what has become known as the economic substance doctrine but have described it as something else.⁷⁷ Due to the inclusion of the “or lacks a business purpose” clause in the statutory definition, it is possible that some revenue agents may seek to apply the new statute (including the penalty) to situations in which claimed tax benefits are not realized solely because an independent “business purpose” requirement is not satisfied. In this regard, we note that several longstanding

⁷⁶ Technical Explanation, *supra* note 18, at 154 n.353.

⁷⁷ For example, in *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989), the court referred to “substantive shams” as “transactions that actually occurred but which lack the substance their form represents.” Likewise, in *Lerman v. Commissioner*, 939 F.2d 44, 49 n.6 (3rd Cir. 1991), the court described shams in substance as transactions that “actually took place, but are nonetheless without economic substance.” Other courts describe the inquiry as relating to business purpose, testing whether the taxpayer entered into the transaction to “conduct business activity for a purpose other than tax avoidance.” *See, e.g., ASA Investorings P’ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000). Similarly, in its discussion of the test applied by the Supreme Court in *Gregory*, in *ACM P’ship v. Commissioner*, T.C. Memo 1997-115, the Tax Court described it as a “doctrine of ‘business purpose.’” A more detailed discussion of the variations on the economic substance doctrine as applied by the courts is included in Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) July 22, 1999 (hereinafter, “JCT 1999 Study”).

provisions of the Code contain independent “business purpose” requirements,⁷⁸ as do various provisions of the Regulations.⁷⁹

Because the strict liability penalty under section 6662(b)(6) necessarily depends on a finding that a transaction lacks economic substance under section 7701(o), we recommend that Treasury and the Service issue guidance clarifying that section 7701(o) encompasses transactions to which the common law economic substance doctrine applied, regardless of whether the court used the term “economic substance,” but that the new statute will not apply to situations in which an independent business purpose, such as those in the referenced provisions of the Code and Regulations, is not satisfied.

C. Guidance on definition of “transaction”

Closely related to the question of when the economic substance doctrine will be deemed “relevant” is the threshold issue of how the “transaction” subject to scrutiny under the codified rule should be defined. Section 7701(o) uses the term “transaction” (or “transactions”) on 16 separate occasions, but does not define the term beyond stating in section 7701(o)(5)(D) that “[t]he term ‘transaction’ includes a series of transactions.” This statutory language appears limited to a grant of authority for the Service to aggregate elements of a transaction (or what a taxpayer may claim to be separate transactions). The Technical Explanation goes further than the statute and gives a more expansive description, stating that:

The provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.⁸⁰

As evidenced by the frequency with which the statute uses the term, how the “transaction” is defined will have outcome-determinative consequences in many cases.⁸¹ In general, the more narrowly defined the transaction is, the more difficult it will

⁷⁸ See, e.g., I.R.C. §§ 274(d) (requiring substantiation of business purpose for certain business deductions), 357(b)(1) (treating certain assumptions of liabilities as giving rise to receipt of money in an exchange where the liability was not assumed for a bona fide business purpose), and 706(b)(1)(C) (permitting a partnership to select an alternate taxable year if it establishes a business purpose therefor).

⁷⁹ See, e.g., Reg. §§ 1.355-2(b) (providing that section 355 applies only to a transaction carried out for one or more corporate business purposes); 1.701-2(a) (providing that implicit in the intent of subchapter K is that each partnership transaction be entered into for a substantial business purpose).

⁸⁰ Technical Explanation, *supra* note 18, at 153 (citing *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007), *ACM P’ship v. Commissioner*, 157 F.3d 231, 256 n.48 (3d Cir. 1998) and *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938)).

⁸¹ For a thorough discussion of the tension surrounding the definition of “transaction” in the context of an economic substance analysis, see David P. Hariton, *The Frame Game: How Defining ‘The Transaction’ Decides the Case*, 63 Tax Lawyer 1 (2009).

be for a taxpayer to show that it has the requisite non-tax purpose and economic substance, although there are cases in which it may be advantageous for the Service to argue for a broader, aggregate approach.⁸² Like the threshold relevance question, case law and other authorities prior to codification generally do not provide a definitional framework for identifying the transaction subject to scrutiny.⁸³ Rather, in asserting an economic substance argument, the Service defines the transaction in the first instance through the manner in which it frames an adjustment to the taxpayer's return position. Taxpayers and the courts respond accordingly. In many cases the definitional exercise will end there, notwithstanding the critical nature of the inquiry. With the potential for a 40 percent strict liability penalty, we believe that the historical approach of defining the transaction on a case-by-case basis without any definitional framework should be abandoned and that published guidance on this critical question should be issued.

The transactional uncertainty and potential for unintended consequences can be illustrated by several simple illustrations. For example, how should the sale of an asset at a loss be viewed under the codified rule? In isolation, the sale will never generate a pre-tax profit and will always fail the economic substance test, resulting in disallowance of any loss deduction under section 165. Such a narrow, "disaggregate" approach would obviously be rejected and the "transaction," if it is going to be scrutinized at all, should be defined to include the original asset acquisition not just the disposition.⁸⁴ In another simple example, a taxpayer builds the first nuclear power plant to be licensed in Country X. Because of the extended regulatory approval and redesign process, the taxpayer knows that the plant will never generate a profit, although it hopes to make money on future plants to be built in Country X. Should the "transaction" be narrowly defined to include only the single power plant so that depreciation and other tax deductions associated with the plant are denied as lacking economic substance?⁸⁵

While these examples illustrate the outcome-determinative nature of how the "transaction" is defined, nothing in section 7701(o) or the Technical Explanation

⁸² More often, the aggregation approach will be applied in connection with a step transaction argument, when the Service looks to the result ultimately achieved to collapse or aggregate ostensibly separate steps in a transaction and argue for a different tax result. *See, e.g., Merrill Lynch & Co., Inc. v. Commissioner*, 120 T.C. 12 (2003), *aff'd*, 386 F.3d 464 (2d Cir. 2004); *see also* Martin J. McMahon Jr., *Living with the Codified Economic Substance Doctrine*, 2010 TNT 158-2 (Aug. 16, 2010) ("Aggregation will likely be based on traditional step transaction doctrine analysis . . ."). To the extent that the statutory reference to aggregation authority implicates the related step transaction doctrine, it is inconsistent with and goes beyond the statutory definition of the "economic substance doctrine" in section 7701(o)(5)(A). This, in turn, raises questions as to whether an "aggregation" approach is subject to the strict liability economic substance penalty as a "similar rule of law" – an issue we discuss in more detail below in part III.G.

⁸³ *See* Hariton, *supra* note 81 (summarizing several recent cases in which the definition of the "transaction" was outcome determinative, but the courts did not separately frame or consider the definitional issue).

⁸⁴ *See Curry v. Commissioner*, 43 T.C. 667, 695 (1965) (rejecting the argument that a taxpayer needed a separate business purpose for sale of real property).

⁸⁵ For the sake of illustration, we assume here that the taxpayer relies solely on profit potential to meet the codified economic substance test.

provides guidance on that issue. Taxpayers and the Service will, at least in the context of these simple examples, have an intuitive sense of what the right definition of the transaction might be, but in countless other situations the definitional question will be a source of significant controversy. With the introduction of the strict liability penalty, reliance on intuition to define the transaction will give taxpayers significant pause and may result in otherwise economic transactions (*e.g.*, the power plant) not taking place, a result that Congress did not intend.

We recognize that the facts-and-circumstances nature of the economic substance inquiry and the broad range of transactions that section 7701(o) may cover does not lend itself to a targeted definitional rule. Nonetheless, we believe that some published guidance, illustrated by examples, would give much needed direction for taxpayers and the Service in how to define the transaction subject to codified economic substance review. Accordingly, we suggest that the Service consider issuing published guidance that would include certain broad definitional principles, along with several more targeted provisions.

First, we believe the guidance should create a presumption that the “transaction” will be defined broadly to include a connected set of business, economic and investment objectives. It is a fundamental principle of the tax law that taxpayers are allowed to select the most tax favorable steps for a transaction that is otherwise undertaken for valid business reasons.⁸⁶ This principle is implicit in historical application of the economic substance doctrine to a broader definition of the transaction to sanction the taxpayer’s choice of a favorable intermediate step. The presumption for a broad definition of transaction is also consistent with existing regulatory guidance in related areas,⁸⁷ and would prevent undue, post-hoc scrutiny of taxpayers’ business judgments separated from the overall context in which they were made. Moreover, application of the pre-tax profit analysis under section 7701(o)(2) to the broader transaction – rather than to a narrower definition of “transaction” that is more likely to result in a failure of the test for a “substantial” profit – would allow the Service to utilize the doctrine to challenge aggressive tax planning when framed in a broader context, while providing taxpayers with assurance that each discrete element of a transaction will not be subject to separate scrutiny for “substantial” profitability.

Second, we believe published guidance under section 7701(o) should specifically recognize transactions in which the addition of a specific step to a broader transaction solely to achieve a desired tax effect is appropriate.⁸⁸ This would not immunize these transactions from scrutiny under section 7701(o), but rather direct

⁸⁶ *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934).

⁸⁷ See Reg. § 1.6011-4(b)(1) (“The term transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan.”).

⁸⁸ *E.g.*, Rev. Rul. 74-79, 1974-1 C.B. 81 (holding that liquidation of subsidiary solely to obtain the subsidiary’s existing trade or business for purpose of then being able to complete tax-free spin-off under section 355 was permissible).

taxpayers and the Service to examine them without focusing narrowly on a sanctioned tax-motivated element of a broader transaction.

Third, we believe guidance should clarify how the effective date of section 7701(o) (transactions entered into after March 30, 2010) should be taken into consideration in defining the transaction. In this regard, we recommend that the broad default approach outlined above also apply when considering the effective date. Under this approach, the derivative tax consequences of a transaction that was largely completed prior to March 30, 2010 should be covered by pre-codification law. For example, if a tax free corporate restructuring was completed in 2009 resulting in a transferred basis in assets, then depreciation being claimed on those assets after March 30, 2010 should not be subject to scrutiny, if at all, under the codified rule.

The general principles we describe above would by no means address the broad range of questions that are bound to arise in applying the codified economic substance rule. They would, however, provide some framework for taxpayers to evaluate application of the rule without unduly limiting the flexibility of the doctrine or the ability of the Service to use it to challenge aggressive tax planning.

D. Guidance on “meaningful way,” “economic position” and “substantial purpose”

Section 7701(o)(1) provides that a transaction “shall be treated as having economic substance only if” the following conditions are met: “(A) the transaction changes in a *meaningful way* (apart from Federal income tax effects) the taxpayer’s *economic position*; and (B) the taxpayer has a *substantial purpose* (apart from Federal income tax effects) for entering into such transaction” (emphasis added).

There is scant legislative history explaining how the terms “meaningful way,” “economic position” and “substantial purpose” in the foregoing definition are to be interpreted and applied. Without additional guidance, these terms create a great deal of uncertainty as to the nature and quantum of economics required to imbue a transaction with economic substance. However, we recognize that these terms are inherently difficult to define and, at the same time, there is a large body of case law that must be considered in interpreting these terms.⁸⁹ Therefore, we recommend that guidance be issued: (1) establishing certain rules based upon the statutory language and legislative history of section 7701(o), and (2) confirming the importance of the existing common law economic substance doctrine in resolving other interpretive issues regarding these terms.

There are three specific rules that we believe can be established based upon the text of section 7701(o)(1) and the Technical Explanation. The first is a rule that the change to the taxpayer’s economic position under (1)(A), and the taxpayer’s purpose

⁸⁹ See I.R.C. § 7701(o)(5)(A) (defining “economic substance doctrine” by reference to the “common law doctrine” of economic substance); Technical Explanation, *supra* note 18, at 152 (“the provision does not change present law standards when determining when to utilize an economic substance analysis.”).

apart from Federal income tax effects under (1)(B), must both exceed a *de minimis* threshold to warrant any further consideration. The terms “meaningful” and “substantial,” together with the citation in the description of current law in the Technical Explanation to *Goldstein v. Commissioner*,⁹⁰ suggest that Congress intended something more than a peppercorn of economics or business purpose for a transaction to have economic substance. Satisfaction of this *de minimis* standard for both (1)(A) and (1)(B) would be a necessary, but not sufficient, condition for the taxpayer to demonstrate that the transaction had economic substance. If a court determined that the *de minimis* standard was not met, no further analysis would be necessary; if the standard were met, a court would have to proceed to consider the rules described below and the case law of the relevant jurisdiction.

The second rule that should be established is one providing that neither the change to the taxpayer’s economic position under (1)(A), nor the taxpayer’s purpose apart from Federal income tax effects under (1)(B), would be required to exceed the tax benefits from the transaction. It is clear from the statutory text that Congress did not intend to require that the non-tax consequences of the transaction exceed the tax consequences, only that there be some real non-tax consequences. Presumably if Congress intended to impose such a requirement it would have expressly mandated a comparison of the economic effects of the transaction with and without regard to the tax effects. Indeed, the statute provides for this type of comparison in section 7701(o)(2), in the special rule that applies when the taxpayer relies on profit potential. That a similar comparison was not included outside of the “special rule” strongly suggests that Congress intended the general rule to focus on the substantiality, rather than the relative weight, of the economic effect and business purpose. Further, we believe that by using the term “substantial” Congress expressly recognized that the tax motivations for the transaction might equal or exceed the business purpose for the transaction. Congress did not select terms such as “primary” or “principal,” which would have required a business purpose that predominates. Indeed, in this regard, we believe the existing Regulations regarding the substantial authority standard are instructive.⁹¹ Those Regulations require that the weight of the authorities supporting the taxpayer’s position be substantial in relation to the weight of the authorities supporting contrary treatment. Significantly, the Regulations expressly acknowledge that there may be substantial authority for more than one position. Likewise, here, we believe guidance should expressly recognize that a taxpayer may have a substantial non-tax purpose for entering into a transaction even if the tax motivations are of equal or even greater significance than the non-tax ones.

The third rule should clarify that the terms “economic position” and “changes . . . the taxpayer’s economic position” take into account all facts and circumstances, and are not limited to assets, liabilities, revenue, profit and loss. An unduly narrow interpretation of “economic position” would focus only on a taxpayer’s balance sheet, and a similarly narrow interpretation of “changes . . . the taxpayer’s economic position” would focus on the taxpayer’s income statement. However, it is clear

⁹⁰ 364 F.2d 734 (2d Cir. 1966) (in which the taxpayer had a possibility of only a small gain or loss).

⁹¹ See Reg. § 1.6662-4(d)(3).

from the economic substance case law that a wide spectrum of economic positions and effects can be relevant to the economic substance analysis, including economic positions that would not be reflected in a taxpayer's financial statements, and positions that may be difficult to quantify or are not quantifiable at all. For example, corporate transactions designed to help a business expand into a new market or diversify its service offerings or geographic reach are not always readily susceptible of measurement in terms of their impact on the business' economic position. Also, it is well-established that the level of a taxpayer's risk is relevant to the economic substance analysis; therefore, a taxpayer that undertakes a transaction with great downside risk would satisfy the economic substance doctrine even if the transaction results in no profit or loss to the taxpayer. Given Congress' intent to incorporate prior case law, together with the drafters' choice of the non-quantitative term "meaningful," it should be made clear by rule that the terms "economic position" and "changes . . . the taxpayer's economic position" must be interpreted to encompass all facts and circumstances regarding the nature of the transaction and the taxpayer's business.

E. Guidance regarding when State and local tax benefits will be "related" to Federal tax benefits

Section 7701(o)(3) provides that "any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect" for purposes of evaluating whether a transaction has a substantial non-tax business purposes (and therefore satisfies the second prong of the economic substance test). There is virtually no explanation in the legislative history about the intent of this provision.⁹² Based on the language in the Technical Explanation regarding a similar rule involving financial accounting benefits, the objective of this provision appears to be to prevent taxpayers from resurrecting an otherwise disallowable transaction by arguing that the business purpose of the transaction was to achieve benefits under State or local law when those benefits simply mirror what would be disallowed under Federal law. Indeed, the economic substance legislation approved by the Senate in 2007 provided that the reduction of non-Federal taxes would not be a substantial business purpose if it would "result in a reduction of Federal taxes substantially equal to, or greater than, the reduction in non-Federal taxes because of similarities between the laws imposing the taxes."⁹³ Read literally, however, section 7701(o)(3) as enacted appears to

⁹² The pamphlet issued by the staff of the Joint Committee on Taxation that analyzed the economic substance codification proposal included in the Obama Administration's fiscal year 2010 budget proposal explained that prior proposals containing similar provisions were "intended to prevent a taxpayer from claiming that obtaining a State (or other non-Federal) tax benefit is a sufficient 'non-Federal tax' purpose to satisfy the codified economic substance doctrine, even though the results under the two laws are similar or related (as one example, if a State tax law follows the Federal tax law)." See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Two: Business Tax Provisions (JCS-3-09)* Sept. 2009 (hereinafter "JCT 2009 Pamphlet"), at 52.

⁹³ S. 2242, 110th Cong., 1st Sess. § 511 (2007). The Senate's definition apparently drew on Regulation section 1.355-2(b)(2), which provides that the reduction of non-Federal taxes will not constitute a valid business purpose for a section 355 spin-off if: (i) the transaction will effect a reduction in both Federal and

be broader, potentially sweeping within its scope numerous routine State tax planning activities that we believe Congress did not intend to disallow. Therefore, guidance should clarify when State and local tax benefits will be treated as “related” to Federal tax benefits and therefore disregarded as a business purpose.

Businesses make many decisions to achieve an efficient State and local tax structure. For example, the burden of complying with tax laws in multiple jurisdictions can be heavy. Significant savings can result from reorganizing a corporate structure to reduce the number of State tax returns corporations must file or consolidating related operations into one jurisdiction. In our experience, such concerns regularly motivate taxpayers to undertake these steps. Such a reorganization might involve multiple complex intragroup transactions qualifying for Federal tax-free treatment. This is an example of proper tax planning, but a broad interpretation of section 7701(o)(3) could suggest that the reorganization is “related” to an impermissible purpose under subchapter C.

Similarly, many States intentionally structure their tax statutes to provide differences in how various legal entities are taxed. For example, a State may choose to tax corporations individually, rather than as a single economic group. Other States may provide differences based on the type of legal entity, creating tax differences between corporations, limited liability companies and partnerships. Choosing a particular legal structure in this context is appropriate planning regularly undertaken by taxpayers. This is another example of legitimate State tax planning that could be affected if a broad interpretation of section 7701(o)(3) could suggest that a particular reorganization is “related” to subchapter K or subchapter C.

Consolidated groups are often structured with a parent holding company and operating subsidiaries. If the parent company were to borrow capital from third-party lenders and make payments thereon, it generally would be entitled to interest deductions at both the Federal and State levels. In the Federal context, the fact that the parent company has little income of its own to match against the interest deductions is irrelevant due to the consolidated return regulations. But many States either do not permit the filing of consolidated returns or permit them only in limited circumstances. As a result, the parent company might lend the capital to one or more operating subsidiaries able to take State interest deductions, or enter into an intragroup restructuring transaction to ensure that the assets and income of the operating subsidiaries are aligned with the interest deductions. Furthermore, a parent company may choose to loan money to a subsidiary in lieu of making a capital contribution to protect its investment as a secured creditor, or because the parent company receives different treatment between interest income and dividend income under the laws of a particular State. In all of these situations, a broad interpretation of section 7701(o)(3) would suggest that the desired State tax effects are “related to a Federal income tax effect”—interest deductions, consolidated returns, and subchapter C reorganizations.

non-Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction and (ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non-Federal taxes.

Thus, under a broad interpretation of section 7701(o)(3), the above transactions, if they also create Federal tax benefits, might be improperly disallowed under section 7701(o). We therefore recommend the issuance of guidance to narrow the application of section 7701(o)(3) to those situations we believe Congress intended to address. In particular, we believe guidance should clarify that the provision applies to those situations in which State or local tax benefits are likely to be used to justify improper Federal tax avoidance. By contrast, the provision does not apply to tax planning designed to create business advantages and reduce costs associated with State and local tax compliance. Rather such planning may constitute “a substantial purpose (apart from Federal income tax effects)” for entering into a transaction.

F. Guidance regarding reliance on “profit potential”

Section 7701(o)(2)(A) provides that the potential for profit of a transaction shall be taken into account in determining whether the transaction meets the two requirements of the codified economic substance test only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. This mechanical test raises four main definitional issues. First, what is pre-tax profit? Second, what does it mean for pre-tax profit to be “reasonably expected?” Third, what discount rate should be used in discounting the pre-tax profit and the tax benefits? Fourth, what does “substantial” mean in this context? We discuss each in turn.

1. Definition of pre-tax profit

In our view, the definition of pre-tax profit should reflect the common law definition of this term. Accordingly, it should refer to the gross income produced by the transaction reduced by fees and other expenses that are directly allocable to the transaction, such as borrowing that is directly linked to the transaction. Consistent with authorities in place prior to the enactment of section 7701(o), pre-tax profit should also include, as a revenue item, any Federal, State, or local tax credits to the extent such credits are specifically intended to encourage a particular activity, and the transaction actually results in that activity.⁹⁴ (In that case, the government is providing credits as a substitute for the revenue that would be provided by a third party in a market transaction, were it not for the market failure believed by the government to have necessitated the provision of the credits.)⁹⁵ Pre-tax profit should not reflect any imputed cost of capital

⁹⁴ See, e.g., *Sacks v. Commissioner*, 69 F.3d 982, 992 (9th Cir. 1995) (refusing to disallow energy investment credit for lack of economic substance when, absent the credit, the transaction did not have a pre-tax profit because to do so would be to “take[] away with the executive hand what [the government] gives with the legislative”), *rev’g* 64 T.C.M. (CCH) 1003 (1992); see also Rev. Rul. 79-300, 1979-2 C.B. 112 (concluding that section 183 is not applicable to low-income housing projects, as application of that statute would frustrate the intent of Congress in enacting section 42).

⁹⁵ As discussed above, the Technical Explanation specifically addressed this issue, indicating that “it is not intended” that [certain tax credits] 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 is intended to encourage.” See discussion *supra* note 56.

relating to equity, nor should it reflect interest on indebtedness not linked to the specific transaction under consideration. Moreover, it should not include any internal costs of the taxpayer (such as the time spent by the taxpayer's employees on the transaction, except to the extent that such compensation is explicitly linked to the completion of the transaction). Consistent with section 7701(o)(2)(B), however, all fees to outside tax advisors should be taken into account to the extent they are related to the transaction (other than fees for advice rendered after the transaction that was not reasonably anticipated at the time).

Section 7701(o)(2)(B) provides that the Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. The Technical Explanation includes no analysis of this provision, other than a footnote that provides that "there is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases."⁹⁶ An earlier version of the legislation would have required foreign taxes to be taken into account as expenses in computing pre-tax profit.⁹⁷ The staff of the Joint Committee on Taxation discussed the possible rationale for such a requirement in its September 2009 analysis of the Obama Administration's budget proposals, noting that two Federal courts of appeal had rejected the Service's efforts to treat foreign taxes as expenses in determining economic profit because "profit potential should be tested instead by reference to pre-foreign-tax income."⁹⁸

Notice 2010-62 states that Treasury and the Service intend to issue regulations pursuant to section 7701(o)(2)(B). We expect to submit separate comments on this question in the near future.

2. Definition of "reasonably expected"

In our view, the main issue in defining "reasonably expected" is what it means to say that a profit is "expected." In one sense of the word, an event is "expected" if one possesses a belief that a particular outcome is much more likely than not to occur. In another sense, however, "expected" can be understood to refer to the probabilistic concept of expected value, which can be substantial even if the event is not expected to occur. To see this distinction, consider a lottery in which 20 lottery tickets are sold for one dollar apiece, and the winner of the lottery (who is chosen by a random process) receives the \$20 prize. A statistician would say that the expected value of buying one ticket is \$1 ($1/20 \times \$20 = \1). However, given the chance of winning is only 1 in 20, or five percent, no given player has any rational basis for expecting that his ticket will be selected out of the 20 tickets that make up the pool of potential winners (*i.e.*, an event generally is not said to be expected in the common parlance if there is only a five percent probability that it will occur). Here, the "reasonably expected" pre-tax profit should be

⁹⁶ Technical Explanation, *supra* note 18, at 155, n.357.

⁹⁷ *See, e.g.*, H.R. 3200, 111th Cong., 1st Sess. § 452 (2009).

⁹⁸ JCT 2009 Pamphlet, *supra* note 92, at 39, 50-51 (citing *Compaq* and *IES*).

viewed as one dollar, not zero. Taxpayers do make business motivated investments that are somewhat speculative, and, if such investments result in tax benefits, we do not believe there is any policy reason for such benefits to be disallowed by the economic substance doctrine merely because the investment's outcomes exhibited a high degree of variability (assuming its other requirements are satisfied).

We recognize that Treasury and the Service may have a concern about adopting this concept because of the possibility that a taxpayer could point to a highly unlikely event as resulting in a very small probability of a very large profit. (Certain of the recent generation of tax shelter transactions involving foreign currency options had this characteristic.)⁹⁹ However, the burden should still be on the taxpayer to demonstrate that his expectation of such profit was actually a motivating factor underlying his decision to engage in the transaction at issue. A taxpayer who had never before engaged in currency option speculation, but who entered into a pair of currency options pursuant to which the taxpayer could make money only by predicting the U.S.-Canadian dollar exchange rate to the thousandth of a cent on a particular date is very unlikely to persuade a court that his expected pre-tax profit was in fact the business purpose for his entering into the transaction.

Again, the absence of official legislative history makes the application of the “reasonably expected” language in section 7701(o)(2)(A) uncertain. The staff of the Joint Committee on Taxation suggested in its analysis of the Obama Administration’s budget proposals that the phrasing was “intended to preclude a finding that a mere ‘reasonable possibility of profit,’ without regard to its relative amount, could be sufficient to satisfy a profit potential test.”¹⁰⁰ So that taxpayers can understand how this provision will be administered, and so that revenue agents and local counsel advising them also understand the rules of the road, we recommend that Treasury and the Service confirm through published guidance how the “reasonably expected” language will be applied.

3. Discount rate

Courts generally have not required taxpayers to discount pre-tax profit in determining whether a particular transaction possessed a pre-tax profit motive.¹⁰¹ This reflects the traditional view that taxpayers are allowed to take tax consequences into account in planning their transactions, and, thus, were allowed to forego some pre-tax profit (including on a present value basis) as long as they are not engaging in the transaction entirely (or almost entirely) for tax benefits.

⁹⁹ See, e.g., *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010); *Stobie Creek Inv., LLC v. United States*, 608 F.3d 1366 (Fed. Cir. 2010).

¹⁰⁰ JCT 2009 Pamphlet, *supra* note 92, at 45.

¹⁰¹ See, e.g., *Estate of Thomas v. Commissioner*, 84 T.C. 412, 440 n.52 (1985) (declining to discount the stipulated residual value, stating that “we do not feel competent, in the absence of legislative guidance, to require that a particular return must be expected before a ‘profit’ is recognizable, the necessary conclusion to be drawn if we were to discount residual value.”).

In its 1999 White Paper, the Treasury Department noted that “the choice of the appropriate discount rate likely will depend on the facts and circumstances surrounding the transaction and the identity of the transaction participants.”¹⁰² The White Paper went on to suggest that in some cases the discount rate may be the taxpayer’s average cost of capital and in other cases the applicable Federal rate would be appropriate. Conversely, in its 1999 penalty study, the staff of the Joint Committee on Taxation suggested that a discount rate equal to the short-term applicable Federal rate plus 100 basis points would be appropriate.¹⁰³

While the suggestions made by Treasury and the Joint Committee staff in 1999 are both reasonable, we do not believe that section 7701(o) supports the use of a specific discount rate for all cases.¹⁰⁴ That said, because taxpayers require guidance to understand how the statute will be applied, and because there is no clear common law authority on this issue, we recommend that Treasury and the Service publish a safe harbor, which would not preclude the possibility that a lower rate could also pass muster. For this purpose, we believe the safe harbor discount rate should equal the relevant applicable Federal rate multiplied by one minus the highest tax rate. This rule may be taken as a rough equivalent to the yield on a tax-exempt municipal bond. (Alternatively, one could use the yield on a tax-exempt municipal bond, but this raises issues as to which bond to use; the applicable Federal rate is much easier for taxpayers and the Service to determine.)

4. Substantiality

The final step in establishing whether a profit potential exists is determining whether the present value of the pre-tax profit is substantial in relation to the present value of the tax benefits. A similar test first appeared in Notice 98-5,¹⁰⁵ which stated that the Treasury and the Service would promulgate regulations that would “disallow foreign tax credits in an arrangement such as those described in Part II above from which the reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement.” Practitioners generally believed that the “substantiality” criterion of Notice 98-5 would be met if the creditable foreign taxes did not exceed the pre-tax economic profit by a factor of more than four. Phrased differently, the “substantially” criterion generally would be satisfied if the creditable foreign taxes did not exceed 80 percent of the sum of

¹⁰² Treasury White Paper, *supra* note 35, at 162.

¹⁰³ JCT 1999 Study, *supra* note 77, at 228.

¹⁰⁴ As discussed *infra* in Appendix A, prior proposals, such as that approved by the Senate Finance Committee in February 2003, would have required the reasonably expected pre-tax profit of a transaction to exceed the risk-free rate of return to satisfy the economic substance test. We read the absence of any such minimum return requirement in section 7701(o) as confirmation that Congress did not expect the courts to impose one. See *Estate of Thomas*, *supra* note 101.

¹⁰⁵ 1998-1 C.B. 334. Notice 98-5 was withdrawn by Notice 2004-19, 2004-1 C.B. 606, in which Treasury and the Service announced that they would not issue the Regulations described in Notice 98-5.

those taxes and the pre-tax profit. This strikes us as a good balance between permitting the recognition of tax benefits for transactions that are overwhelmingly tax-motivated, and disallowing tax benefits for transactions with substantial business purposes. Therefore, we recommend that the same criteria be adopted here.

G. Guidance regarding “any similar rule of law”

The strict liability penalty under newly enacted section 6662(b)(6) applies to underpayments or portions thereof attributable to “[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) *or failing to meet the requirements of any similar rule of law*” (emphasis added). The term “any similar rule of law” is not defined in the statute. Based upon the overall statutory scheme as well as the discussion of this provision in the Technical Explanation, we believe the term “any similar rule of law” encompasses only instances in which a court or the Service calls the economic substance doctrine by another name (*i.e.*, only situations that fall under the definition of economic substance under section 7701(o)(5)(A)).

In view of the special status of the economic substance doctrine for penalty purposes, we do not expect the Service to assert, or a court to find, a violation of the doctrine without referring to the doctrine by name and with particular reference to section 7701(o). Nevertheless, in view of the strict liability penalty, we recommend that Treasury and the Service issue prompt guidance confirming this interpretation.

1. Initial observations

The term “any similar rule of law” is not defined in either section 6662(b)(6) or section 7701(o). We note, however, that the amendments to both statutes were contained in the same provision of the 2010 Act, entitled “Codification of Economic Substance Doctrine and Penalties.” The wording of this heading, while not having binding effect, belies the notion that Congress intended the “any similar rule of law” clause as anything other than a backstop to section 7701(o), covering only those situations in which a court should have explicitly referred to a violation of the “economic substance doctrine” or section 7701(o) but instead used another term. In this regard, the Technical Explanation provides:

It is intended that the [section 6662(b)(6)] penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the *similar factors and analysis* that is required under the provision for an economic substance analysis, *even if a different term is used to describe the doctrine.*¹⁰⁶

Furthermore, in describing the contours of the economic substance doctrine by way of background to the enactment of section 7701(o), the Technical Explanation states:

¹⁰⁶ Technical Explanation, *supra* note 18, at 155 n.359 (emphasis added).

Closely related doctrines also applied by the courts (*sometimes* interchangeable with the economic substance doctrine) include the “sham transaction doctrine” and the “business purpose doctrine.” *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a “sham transaction” that lacked “commercial economic substance”). Certain “substance over form” cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed. *See, e.g., TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff’d* 523 F.3d 461 (4th Cir. 2008).¹⁰⁷

We believe that this language reflects the recognition by the Joint Committee on Taxation that jurisprudence under the economic substance doctrine is not always altogether clear, and that in the past courts have applied the economic substance doctrine by using a different term. This language does not support the interpretation of “any similar rule of law” as encompassing anything more than what is, in substance but not in name, the doctrine defined in section 7701(o)(5)(A).

Based on the statutory scheme and the direction provided in the Technical Explanation, “similar rules of law” for purposes of section 6662(b)(6) should be limited to cases involving “similar factors and analysis” to those in section 7701(o). Such cases could include the “sham transaction” cases, and possibly “business purpose” cases, but only if the case requires an examination of whether there was a lack of meaningful change of economic position and substantial business purpose.¹⁰⁸ Thus, in the unlikely event that a court were to determine that the “sham transaction doctrine” is relevant to a particular transaction without referring to section 7701(o), and determines that the transaction does not result in a meaningful change in economic position or is not motivated by a substantial purpose apart from Federal income tax effects, the 6662(b)(6) penalty nevertheless could apply.

Guidance as to the scope of the “any similar rule of law” clause is necessary because its plain language could be interpreted far more broadly than Congress intended, and could sweep in: (1) other judicial doctrines distinct from the economic substance doctrine, particularly the substance-over-form doctrine and the step-transaction doctrine, and (2) some or all of the many anti-abuse statutory and regulatory provisions, such as section 269 and Regulation section 1.701-2. For the reasons discussed below, we do not believe it would be appropriate to interpret the strict liability section 6662(b)(6) penalty to apply beyond the economic substance doctrine (as defined in section 7701(o)) to this vast body of statutes, regulations and common law.

¹⁰⁷ *Id.* at 142 n.300 (emphasis added)

¹⁰⁸ *See supra* note 77 for references to cases describing the economic substance doctrine using different terms.

2. Judicial doctrines distinct from economic substance

By all indications, the Joint Committee on Taxation did not believe that Congress had enacted a penalty that would apply to a significantly broader class of transactions than are covered by section 7701(o). Similar to the heading in the 2010 Act, the title of the applicable section of the Technical Explanation is “Codification of Economic Substance Doctrine and Imposition of Penalties.” The Technical Explanation does not even mention the step-transaction doctrine and makes only an isolated passing reference to the substance-over-form doctrine.¹⁰⁹ At no point does the Technical Explanation suggest that either the step-transaction doctrine or the substance-over-form doctrine would be within the scope of the “any similar rule of law” provision. Moreover, in its analysis of the Obama Administration’s budget proposals, the staff of the Joint Committee on Taxation specifically noted that “if economic substance as such is not explicitly stated as one of the grounds for disallowance of tax benefits, the application of the companion penalty provision may be in doubt.”¹¹⁰

Furthermore, neither the substance-over-form doctrine nor the step-transaction doctrine involve “similar factors and analysis” when compared to what the economic substance doctrine requires. Section 7701(o) focuses on whether a transaction that actually occurred and would normally result in tax benefits results in a meaningful change in economic position and is motivated by a substantial purpose apart from Federal tax effects. These two questions are geared toward ascertaining whether a transaction (or a piece of a transaction) should be ignored by the tax law as illusory, or a mere sham. By contrast, the substance-over-form doctrine, in all its incarnations, including the step-transaction doctrine and the conduit doctrine, looks to the substance of that real transaction, rather than its form, to determine the tax consequences that flow therefrom. When applying the substance-over-form doctrine, courts often do not conduct an analysis of a taxpayer’s motives or whether there was a meaningful change in economic position, because the substance-over-form doctrine can be applied regardless. For example, in *Rogers v. United States*, the Tenth Circuit stated:

[The substance-over-form doctrine] is distinct from the economic substance doctrine, and it is applicable here. The transaction in question was not an attempted tax shelter entered into for the creation of tax losses, a mere sham devoid of economic substance. Since the transaction clearly had real-world economic consequences, application of the economic substance doctrine is not appropriate. Rather, this is a case in which the taxpayers seek to characterize a

¹⁰⁹ The Technical Explanation, *supra* note 18, at 142 n.300, provides that “certain ‘substance over form’ cases involving tax-indifferent parties” have examined change in economic position and business purpose. Apart from this reference to a subset of substance-over-form cases, there is no other mention of the substance-over-form doctrine. Also of relevance is the fact that much earlier bills explicitly included all substance-over-form violations (referred to as transactions in which “the form of the transaction did not reflect its substance”) under the umbrella of the strict liability penalty. *See* H.R. 2255, 106th Cong. § 4 (1999); H.R. 2520, 107th Cong. § 201 (2001). This language fell by the wayside early in the evolution of codified economic substance doctrine.

¹¹⁰ JCT 2009 Pamphlet, *supra* note 92, at 47.

substantive transaction as one thing rather than another and force the Commissioner--and this court--to accept the automatic consequences of the characterization.¹¹¹

The Treasury Department recognized that the economic substance doctrine is fundamentally different from the substance-over-form doctrine in its 1999 White Paper:

Judicial anti-avoidance doctrines have been useful in curbing tax avoidance behavior. In this regard, the IRS has two primary means at its disposal: First, the IRS may argue that the objective facts of the transaction are not as the taxpayer has presented them. That is, the formal way in which the taxpayer has presented the facts belies their real substance and, as a result, the taxpayer is applying the wrong set of mechanical rules in reaching its purported tax consequences. Second, the IRS may argue that, while the facts are as the taxpayer has represented, the technical tax results produced by a literal application of the law to those facts are unreasonable and unwarranted, and therefore should not be respected. This second line of argument, which encompasses long-standing principles of business purpose and economic substance, is an important and essential gloss on our generally mechanical system of determining tax liabilities.¹¹²

As with the substance-over-form doctrine generally, the various step-transaction doctrine tests do not involve the same factors and analysis as the economic substance doctrine. Under the “binding commitment” test, separate steps are collapsed into a single transaction only if, at the time the first step takes place, the taxpayer has a binding commitment to complete the remaining steps. Under the “interdependence” test, separate steps are collapsed if, under a reasonable interpretation of the objectively stated facts, the steps are dependent on one another. Under the “end result” test, separate steps are collapsed if a court finds that they are merely the means to achieve a particular end result. The step-transaction doctrine is used solely to recharacterize the form of a transaction and not to treat a transaction as illusory. Further, the step-transaction doctrine will apply regardless of the business purpose of a transaction.¹¹³

The fundamental difference between the economic substance doctrine and the substance-over-form and step-transaction doctrines can also be seen in the way the doctrines are applied. When applying the substance-over-form and step-transaction doctrines, courts are always concerned with the tax consequences flowing from the substance of the transaction. However, courts feel much less inclined to rearrange the pieces after applying the economic substance doctrine – claimed tax benefits sometimes are simply denied.¹¹⁴ Also, subject to certain limitations, taxpayers can affirmatively rely

¹¹¹ 281 F.3d 1108, 1118 (10th Cir. 2002).

¹¹² Treasury White Paper, *supra* note 35, at 46.

¹¹³ *See, e.g., Aeroquip-Vickers, Inc. v. Commissioner*, 347 F.3d 173, 183 (6th Cir. 2003) (“Here, although the individual steps of the transaction had a legitimate business reason, the transaction must be treated as a single unit and judged by its end result.”), *cert. denied*, 543 U.S. 809 (2004).

¹¹⁴ *See* John P. Warner, *Statutory, Regulatory, and Common Law Anti-Abuse Weapons*, 485 PLI/Tax 883, 889 (2000) (“The major purpose of the substance-over-form doctrine is to recharacterize transactions in

on the step-transaction doctrine and the substance-over-form doctrine,¹¹⁵ but it is inconceivable that a taxpayer would affirmatively rely on the economic substance doctrine.

3. Other anti-abuse provisions

As noted above, there is no indication that Congress intended the section 6662(b)(6) penalty to apply to violations of statutory and regulatory anti-abuse provisions other than section 7701(o). By some counts, there are over fifty anti-abuse and business purpose requirements in the Code and Regulations.¹¹⁶ The Technical Explanation does not mention any of these rules, and there is no other indication that the “any similar rule of law” clause was intended to sweep in these provisions.¹¹⁷ Telling in this regard is the wording of section 6662(b)(6). The term “rule of law” appears numerous times in the Code, but it is almost always preceded by the words “law or.” The absence of a reference to “laws” in addition to “similar rules of law” is an indication that Congress was focused only on application of the economic substance doctrine using a different term, and not on violations of other statutory provisions like section 269 (which is a law, not a rule of law).

Moreover, statutory and regulatory anti-abuse provisions generally do not involve an analysis of whether a transaction results in a meaningful change in economic position. Rather, these anti-abuse provisions are generally targeted at specific behavior that is considered abusive (such as the wash sale rules under section 1091 or the disguised sale provisions under section 707) or are aimed at transactions determined to be contrary to the spirit of the statute (such as the partnership anti-abuse Regulation). A number of anti-abuse provisions do include an analysis of taxpayers’ motives, but they involve a different type of analysis than the business purpose requirement of section 7701(o). Many of these provisions, such as section 183 (hobby losses) and section 274(d) (travel and entertainment expenses),¹¹⁸ are aimed at distinguishing business transactions from personal ones, and not distinguishing business transactions from illusory ones. The corporate business purpose requirement for spinoffs under Regulation section 1.355-2(b) can similarly be viewed as distinguishing corporate business purposes from shareholder business purposes. Other provisions, such as section 269 and section 357(b), deny tax benefits where tax avoidance is the principal purpose for a transaction. However,

accordance with their true nature. The economic substance doctrine . . . in contrast, seeks to deny tax benefits on the ground that the non-tax basis for the transaction is insufficient to warrant application of those benefits.”)

¹¹⁵ See, e.g., Treasury White Paper, *supra* note 35 at 52-54.

¹¹⁶ See Mark J. Silverman, Philip R. West, and Aaron P. Nocjar, *Establishing Business Purpose in a Transparent World*, TAX NOTES, Doc. 2004-16634 (Aug. 14, 2004).

¹¹⁷ While regulatory provisions are rules of law, rather than laws, we can see no reason why regulatory provisions would fall under the umbrella of section 6662(b)(6) if statutory provisions do not.

¹¹⁸ We note that section 7701(o)(5)(B) specifically provides that the statute does not apply to the personal transactions of individual taxpayers. However, section 6662(b)(6) is not similarly limited unless the penalty is applied no further than section 7701(o) can be properly applied.

transactions can still have substantial business purposes, even when they are principally motivated by tax saving. Furthermore, we are aware of no other anti-abuse provision that involves an analysis of both of the factors under section 7701(o) (change in economic position and business purpose).

A number of the examples above highlight the danger of expanding the scope of section 6662(b)(6) beyond violations of the economic substance doctrine. A strict liability penalty can be an effective deterrent, but it is also a blunt instrument. While it increases the cost of aggressive transactions, and dissuades taxpayers from viewing opinions as “penalty insurance,”¹¹⁹ it can also increase the cost of legitimate business transactions whose tax treatment is not perfectly clear.¹²⁰ Congress has made the decision that the benefits of deterrence outweigh the costs with respect to the most egregious transactions – those lacking economic substance. The calculus is quite different for statutory and regulatory anti-abuse rules and judicial doctrines such as the substance-over-form doctrine and the step-transaction doctrine. Shareholders should be allowed to rely on opinions that the stock they receive in a spinoff is tax-free because the spinoff has a good corporate business purpose, and that the stock they receive in a section 351 transaction was tax-free even though they sold a large block of stock a year later. Taxpayers should be allowed to rely on the judgment of their tax advisors that a transaction that is, in form, a debt is not, in substance, equity; that is, in form, a leasing transaction is not, in substance, a financing; that is, in form, a license is not, in substance, a sale. The hobby loss rules should not be enforced by a 40 percent strict liability penalty when taxpayers do not realize that disclosure is necessary to cut the penalty in half. We do not believe that Congress intended section 6662(b)(6) to apply to any of these transactions. Nevertheless, the statute could be misinterpreted to include these transactions and thus prompt guidance from Treasury and the Service is needed to provide that the strict liability penalty is asserted only in cases intended by Congress.

4. Practical Effect of Scope of “Similar Rule of Law”

These comments strongly urge that guidance be issued on the economic substance doctrine in large part because of the heavy strict liability penalty that applies when a taxpayer’s transaction fails to meet the requirements of section 7701(o). Of course, we recognize that taxpayers who engage in aggressive tax sheltering are likely to still be exposed to the accuracy-related penalty arising in cases of negligence, substantial understatement or substantial or gross valuation misstatements unless they can

¹¹⁹ See Treasury White Paper, *supra* note 35, at 90 (“Thus, perhaps the strongest rationale for elimination of the reasonable cause exception lies in transparency, *i.e.*, dispelling any notion at the time the transaction is being evaluated by the taxpayer that a ‘more likely than not’ opinion is a mechanism for penalty insurance.”).

¹²⁰ It is worth noting that, where the tax benefit being sought is one of deferral, a 20 percent penalty can represent well over 20 percent of the amount actually at issue. The penalties under section 6662 are based on the amount of the underpayment in the year in which the Service claims that the taxpayer should have reported income (or should not have reported a deduction). However, the tax benefit of deferral, based on the time value of money, is only a fraction of the amount of the underpayment. In fact, when deferral lasts for only a few years, the section 6662 penalty can be significantly larger than the tax benefit.

demonstrate reasonable cause and good faith. Therefore, our recommended reading of “similar rule of law” will not likely affect the imposition of the 20 percent penalty (40 percent in the case of gross valuation misstatements) to aggressive tax shelter cases that are not decided under section 7701(o). And as discussed above, the most aggressive factual sham cases may be subject to even higher penalties, such as the 75 percent penalty under section 6663. Thus, any concern that a “sham” might escape penalty just because it is not decided under section 7701(o) is more theoretical than real.

Conversely, an expansive reading of “similar rule of law” would affect many more transactions than just the aggressive tax shelters that lead to the enactment of section 7701(o). Many legitimate business transactions can nevertheless give rise to issues under the substance-over-form doctrine, the step-transaction doctrine or targeted anti-abuse provisions. Taxpayers should be encouraged to seek out competent tax advisors for counsel on how to report such transactions properly, and should not be discouraged from entering into such transactions altogether. Our recommended reading of “similar rule of law” would accomplish these goals while giving little aid or comfort to those engaging in the most aggressive tax shelters.

H. Improved procedures for taxpayers to obtain certainty

As discussed in detail above, there are many uncertainties presented to taxpayers and their advisors by the new economic substance legislation. In addition to the areas for which we recommend prompt guidance, we anticipate significant increased demand for guidance on particular types of transactions, both through the published guidance process and through the private letter ruling process. In light of the demands that likely will be placed on the Service, both of our organizations reaffirm our longstanding support for more resources so that the Service can fulfill this important aspect of tax administration. Public assurances from certain government officials that “codification hasn’t changed much,”¹²¹ are reassuring but not authoritative. Taxpayers need published guidance so that they can act with certainty in this new world of the 40 percent strict liability penalty provided in section 6662(b)(6).

Our request for this guidance is based on two fairly obvious conclusions: (i) no tax benefit will be denied by reason of the application of section 7701(o) unless the Service takes the position that the tax benefit should be denied on that ground, and the Service will be compelled to determine relevance in every case in which it asserts the economic substance doctrine; and (ii) the doctrine is not relevant for the sole reason that the taxpayer fails the two-prong test – such an interpretation would impermissibly read the issue of relevance out of the Code. All we request is that Treasury and the Service be transparent as they determine when they will assert the doctrine, and that they do so with a purpose of establishing a framework on which taxpayers also may rely.

¹²¹ See, e.g., Amy S. Elliott, *Codification of Economic Substance Should Have Minimal Impact on Practice*, *IRS Official Says*, 2010 TNT 90-2 (May 11, 2010).

1. Enhanced and expedited ruling procedures

We are encouraged by recent comments by Chief Counsel Wilkins suggesting that he is fostering a broader change in the Office's culture toward published guidance.¹²² We wholeheartedly agree with the Chief Counsel that guidance on the central components of an issue should not be held up by working out the details on tangential fringe questions. This is particularly true with respect to the economic substance guidance we request herein. To that end, we recommend that Treasury and the Service publicly commit to expediting taxpayer-specific guidance on economic substance, and offer two specific suggestions that we believe would provide meaningful improvement over existing procedures.

First, we recommend that the Office of Chief Counsel revise the annual revenue procedure that explains how the several Associates Chief Counsel issue guidance to taxpayers. Section 7.02(4) of Revenue Procedure 2011-1¹²³ currently commits the office of Associate Chief Counsel (Corporate) to issue expedited rulings on reorganizations when certain requirements are satisfied. Specifically, we recommend that the expedited procedures should be expanded to specifically provide for expedited rulings on the application of section 7701(o) to particular transactions regardless of whether the rulings are solely within the jurisdiction of the Associate Chief Counsel (Corporate). While we recognize that Notice 2010-62 takes the opposite view, and states that the annual revenue procedure will be revised to preclude rulings on the application of section 7701(o), we respectfully request that Treasury and the Service revisit that decision. Particularly when viewed in light of the strict liability penalty, we believe sound tax administration requires the government to answer the hard questions of whether the economic substance doctrine is relevant to a particular transaction, and if so, whether the transaction passes muster under section 7701(o).

Second, if Treasury and the Service are unwilling to revisit their decision to refuse to entertain ruling requests, we recommend as an alternative that the Service consider issuing expedited "no-action" letter rulings on the application of section 7701(o). Rather than committing the Service to the positive tax treatment of a given transaction, a no-action ruling would be a negative ruling: the Service would commit not to assert the economic substance doctrine on a given set of facts.¹²⁴ In most cases, it should be easier for the Service to give a negative ruling than a positive ruling. This approach would not ask the Service to commit to drawing the line for all cases. Rather, the Service would only be asked to acknowledge that certain transactions are not even close to the line. No inference would be drawn from a decision not to issue a no-action letter, in order to ensure that taxpayers are not discouraged from seeking one.

¹²² Jeremiah Coder, *Wilkins Gives Update on UTP Regime, Economic Substance*, 2010 TNT 142-1 (July 26, 2010).

¹²³ 2011-1 I.R.B. 1.

¹²⁴ As with private letter rulings, such a no-action letter could be relied upon only by the taxpayer to whom it was issued, and ordinarily would not be subject to retroactive revocation or modification. *See* Reg. § 601.201(l).

2. Disclosure considerations

We also urge Treasury and the Service to expand on the interim guidance provided in Notice 2010-62 regarding the application of the disclosure rules for purposes of the new strict-liability penalty in section 6662(b)(6). That guidance provides that the adequate disclosure requirements of section 6662(i) are satisfied if the taxpayer adequately discloses on a timely original return or qualified amended return the relevant facts affecting the tax treatment of the transaction. The guidance also provides that the disclosure must be made on Form 8275 of 8275-R, or in the manner provided in Revenue Procedure 94-69.

a) Methods of disclosure

We agree with Notice 2010-62 that, consistent with the rules for the substantial understatement penalty, disclosure for purposes of the noneconomic substance penalty should be considered adequate if made on a Form 8275, *Disclosure Statement*, or, in the case of a position contrary to a Treasury Regulation, Form 8275-R, *Regulation Disclosure Statement*, attached to the taxpayer's tax return for the tax year in which the taxpayer claims a tax benefit from the transaction. Disclosure also should be considered adequate for items listed in the annual disclosure revenue procedure,¹²⁵ if made in accordance with the applicable tax forms and instructions. The availability of the revenue procedure is particularly important as a method of disclosure as it incorporates certain of the expansive disclosures already required on Schedules M-1 and M-3 and, thus, would help to reduce redundant disclosures.

Further, and consistent with the existing approach for the substantial understatement penalty, we agree with Notice 2010-62 that large (Coordinated Industry Case or "CIC") taxpayers should be permitted to disclose for purposes of the new penalty upon commencement of an examination in accordance with the general approach set forth in Revenue Procedure 94-69. The use of the same forms and revenue procedure for all section 6662 accuracy-related penalties should help to mitigate the burden and confusion for taxpayers, practitioners, and tax administrators that would be associated with multiple and potentially overlapping requirements.

Announcement 2010-75, issued in connection with the finalization of Schedule UTP, provides that a taxpayer who files a complete and accurate Schedule UTP is treated as if the taxpayer had filed a Form 8275 or 8275-R, and further confirms that the Service will treat such disclosure as satisfying the adequate disclosure requirements of section 6662(i). We agree with this conclusion, as it strikes the appropriate balance of providing notice to the Service without undue burden or duplication on taxpayers.

Notice 2010-62 requested comments on the interplay of the adequate disclosure requirements in section 6662(i) and the disclosure rules applicable to taxpayers who participate in the LB&I Compliance Assurance Process ("CAP"). We recommend that a taxpayer that discloses a transaction to its exam team in accordance with the

¹²⁵ See, e.g., Rev. Proc. 2011-13, 2011-3 I.R.B. 318.

memorandum of understanding pursuant to which the taxpayer participates in CAP should be automatically treated as also having satisfied any accuracy-related penalty disclosure requirements. The CAP program, which involves a pre-tax return filing review, has much greater transparency than a tax return disclosure and benefits both the Service and taxpayers by addressing issues on a current basis. Once the Service has been provided the relevant facts relating to a transaction through the CAP process, no further disclosure should be required.

b) Other disclosure considerations

Section 6662(i)(3) provides that an amendment or supplement to a return is taken into account for purposes of the disclosure provision only if filed before the earlier of the date the taxpayer is first contacted by the Service in connection with an examination of the return or such other date as the Service may specify. Notice 2010-62 confirms that the “qualified amended return” rules will apply for purposes of the strict liability penalty. Accordingly, an amendment or supplement to a return would not constitute an adequate disclosure for purposes of the new penalty if filed after certain persons apart from the taxpayer were contacted by the Service.¹²⁶ There are numerous other special disclosure rules that apply for purposes of the substantial understatement penalty and that we believe would be appropriate for the noneconomic substance penalty as well.¹²⁷ Thus, disclosure with respect to a recurring item should be made for each tax year in which the item is taken into account; disclosure with respect to any item that is included in any loss, deduction or credit that is carried to another year should be considered adequate if made for the tax year in which the loss or credit arises; and disclosure in the case of items attributable to a pass-through entity should be considered adequate if made either with respect to the return of the entity or of its owners (i.e., partners, S corporation shareholders, trust beneficiaries, or other owners).

I. Guidance on application of the doctrine by the Service

1. Coordination procedures

The strict liability penalty in section 6662(b)(6) is a significant stick provided to the Service by Congress, and we urge the Service to be measured in how it swings this stick. The severe penalties that can follow from the assertion of the economic substance doctrine require, in our view, that a transparent procedure be implemented to ensure that it is being asserted only in appropriate and thoroughly vetted cases. In this context, we compliment the Service for its recently issued Industry Directive requiring that any proposed assertion of the strict liability economic substance penalty be reviewed by a DFO. While this directive provides a good starting point, we believe that a more

¹²⁶ See, e.g., Reg. § 1.6664-2(c)(3) (providing, for example, that in the case of a pass-through item, a “qualified amended return” does not include an amended return filed by the taxpayer after the date of contact of a pass-through entity in connection with a return to which the pass-through item relates).

¹²⁷ See, e.g., Reg. § 1.6662-4(f)(3)-(5).

robust and transparent process is required. Indeed, it is the duty of the Service to ensure that these rules are applied fairly, impartially, and in a reasonable, practical manner.¹²⁸

Specifically, we recommend that the Service implement a procedure whereby to assert the economic substance doctrine (and the attendant strict liability penalty) in a 30-day letter, 60-day letter or any other final examination determination, approval must first be obtained from the applicable DFO after consultation with the relevant Associate Chief Counsel's office and after providing the taxpayer with a conference of right. While requesting that consultation with the Office of Chief Counsel be required, we believe that the ultimate decision on whether to assert the economic substance doctrine in a final examination determination should remain within LB&I.

Precedent for a robust review procedure can be found in existing procedures used by the Service in analogous contexts. For example, in Announcement 94-87,¹²⁹ the Service explained the internal procedures it would follow in determining whether to assert the partnership anti-abuse regulation under Regulation section 1.701-2 to ensure that assertions of that Regulation would be made consistently and with an appropriate level of oversight. Similarly, in high stakes cases that the government is considering to designate for litigation, the Internal Revenue Manual sets forth detailed procedures for evaluating the appropriateness of such a designation, including procedures for taxpayer input in the decision-making process.¹³⁰ Moreover, similar to the recent Industry Directive, there are a number of regulatory provisions that require DFO review or approval.¹³¹

While assertions of the economic substance doctrine may not warrant a process as detailed and robust as designation for litigation, we nevertheless believe that it is extremely important that there be some heightened level of review, including input from both taxpayers and the appropriate Associate Chief Counsel office. Without some fences around the circumstances in which the doctrine will be applied, we are concerned it will have a chilling effect on legitimate business transactions and targeted tax benefits that Congress intends to provide. From the Service's perspective, if left unchecked, assertions of the doctrine run the risk of diluting its effectiveness, particularly in light of the strict liability penalty that may cause courts to apply the doctrine more narrowly than

¹²⁸ See Rev. Proc. 64-22, 1964-1 C.B. 689.

¹²⁹ 1994-27 I.R.B. 1.

¹³⁰ I.R.M. 33.3.6.1 (Aug. 11, 2004).

¹³¹ See, e.g., Reg. § 1.367(a)-8(p) (requests for reasonable cause relief with respect to gain recognition agreements subject to DFO review); Prop. Reg. § 1.959-1(b)(5), 71 Fed. Reg. 51,155 (Aug. 29, 2006) (entitlement of successor in interest to exclusion from gross income for previously taxed earnings and profits subject to DFO review); Prop. Reg. § 1.6038B-1, 73 Fed. Reg. 49,277 (Aug. 20, 2008) (certain presumptions regarding foreign transfers inapplicable where it is established to the satisfaction of the DFO that tax avoidance was not a principal purpose). See also LMSB Commissioner Memorandum (July 10, 2003) ("In all cases in which there is an underpayment attributable to a listed transaction, the [DFO] must approve the decision to impose or not to impose the accuracy-related penalty.").

might otherwise be the case. Furthermore, the Service should not discount the opportunity for the courts to redefine the contours of the economic substance doctrine.¹³²

Economic substance cases normally involve the consideration of many detailed and nuanced facts and circumstances. In each case, the Service must carefully consider whether it can and should commit the substantial resources needed to develop and win an economic substance argument. Properly developed economic substance cases typically demand many hours of work from Counsel, revenue agents, technical advisors, specialists, experts, and other team members. The operating divisions must commit the substantial resources required to develop economic substance cases in the first instance. For that reason, operating division senior management should have primary authority for decisions to move forward with such a case. Committing to develop even one economic substance case can disrupt other priorities within a territory or program. On the other hand, underdeveloped cases are a waste of time and resources for both taxpayers and the Service; the Service should not be in the business of making undeveloped arguments.

Taxpayer involvement within the approval process is vital. When only one side of an argument is presented to a decision-maker, the risk of a flawed decision rises. Taxpayers are usually best positioned to present relevant facts, substantive analysis, and other considerations to the operating division official considering whether to assert the economic substance doctrine. That is why we recommend that taxpayers be given the opportunity to attend a conference or make a submission to the territory or program manager with approval authority in any case in which the economic substance doctrine is being considered.

Finally, considered review within the Office of Chief Counsel, which should begin in the field due to the fact-bound nature of the inquiry, should further ensure that the doctrine is pursued in only those cases where appropriate. Counsel's review should be guided by the following longstanding guiding principles: (a) factually underdeveloped cases should not be approved because the government should not hope to prepare its cases in litigation discovery and approvals should never depend on the burden of proof; (b) established law and positions of the Service should be changed through legislation or published guidance, not in examination or litigation;¹³³ and (c) substantive

¹³² *E.g., Fidelity Int'l Currency Advisor A Fund, LLC v. United States*, 105 AFTR 2d 2010-2403, 2010 WL 1976822 (D. Mass. May 17, 2010), purporting to undercut *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956). For a sharp critique of the *Fidelity International* case, see Jasper L. Cummings, Jr., *Making Litigation Complex*, 2010 TNT 123-8 (June 28, 2010).

¹³³ See Rev. Proc. 64-22, 1964-1 C.B. 689 ("It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision, and not to adopt a strained construction in the belief that he is 'protecting the revenue.'") See also Prepared Remarks of IRS Commissioner Doug Shulman to New York State Bar Association Taxation Section Annual Meeting, IR-2010-13 (Jan. 26, 2010) ("Our responsibility is the same as the responsibility of our taxpayers – apply the law as it currently exists, not how we would like it to be, and do so with neither a thumb on the scale in favor of the government, nor in favor of the taxpayer.").

arguments, when available, should always be considered first, and should be favored at the expense of the economic substance doctrine.¹³⁴

Because of the significance of section 7701(o) and its possible implications for longstanding applications of other provisions of the Code and regulations, in all cases Area Counsel's review of a request to assert the economic substance doctrine should be coordinated with the Associate Chief Counsel office with subject matter jurisdiction.¹³⁵ This coordination process would ensure that whenever the Service asserts the economic substance doctrine, the position represents the considered, nationally coordinated view of the Office of Chief Counsel, and not merely the position of a particular individual, division, or branch.¹³⁶ This coordination process should also, over time, yield a body of publicly-available Chief Counsel Advice illuminating the position of the Office of Chief Counsel on the economic substance doctrine.¹³⁷ Although not precedential, publicly released Chief Counsel Advice discussing the threshold relevance question would provide taxpayers additional guidance in knowing when the doctrine will and will not apply.

Counsel should view disclosure of economic substance Chief Counsel Advice—a necessary side effect of the coordination process—as a good thing, not as a deterrent to coordination. We hope and expect that Counsel will prepare and release both favorable and unfavorable Chief Counsel Advice, but at the very least, Counsel should give taxpayers notice when it has approved the assertion of the economic substance doctrine on a particular set of facts. In our view, oral advice on the assertion of the economic substance doctrine from Associate Chief Counsel offices to field counsel would compromise not only the purpose of section 6110 but also the proper development and administration of Federal tax law. Moreover, the Commissioner recently committed to more transparency and guidance in tax administration,¹³⁸ in line with the President's directive¹³⁹ and the Attorney General's memorandum¹⁴⁰ on how Federal agencies should interpret the Freedom of Information Act with a presumption towards disclosure.

We note that Area Counsel review of any notice of deficiency asserting the economic substance doctrine—a difficult legal issue—should already be

¹³⁴ See discussion *supra* at part III.A.2.

¹³⁵ See C.C.D.M. 33.1.1.2(3), -(4).

¹³⁶ See C.C.D.M. 30.3.2.2.3(1)(e).

¹³⁷ See I.R.C. § 6110.

¹³⁸ See David Kocienieski, *IRS Plan to Uncover Companies' Tax Strategies*, N.Y. TIMES Aug. 24, 2010 (“[T]he new procedures would also help businesses by encouraging Congress and the I.R.S. to clarify ambiguous portions of the nation's convoluted tax code more quickly.”).

¹³⁹ Memorandum on Freedom of Information Act, 74 Fed. Reg. 4,683 (Jan. 21, 2009), *available at* http://www.whitehouse.gov/the_press_office/FreedomofInformationAct.

¹⁴⁰ Memorandum from the Attorney General for Heads of Executive Departments and Agencies (Mar. 19, 2009), *available at* <http://www.justice.gov/ag/foia-memo-march2009.pdf>.

mandatory.¹⁴¹ In our view, however, mandatory Counsel review and coordination at the notice of deficiency stage is too late. Economic substance doctrine advice from Counsel should be in place before a notice of proposed adjustment or other determination is issued. Most unagreed cases settle in Appeals, after the parties have invested substantial time, effort, and expense. Taxpayers, Appeals, and the operating divisions of the Service should know whether the Office of Chief Counsel concurs with an economic substance argument before a case proceeds to Appeals. Put differently, as Appeals weighs the hazards of litigation, Appeals should know whether the Office of Chief Counsel—the entire office—supports the economic substance argument presented. In all stages of all cases, the government’s position should be consistent, meritorious, and reflect the view of the Service as a whole.

These proposed coordination recommendations on economic substance merely restate current coordination standards that govern the Office of Chief Counsel in all cases. We only ask that Counsel explicitly commit that its attorneys will coordinate, in writing, proposed economic substance arguments with the Associate Chief Counsel with subject matter jurisdiction over the issue. We believe the stakes are too high to leave the questions of whether the economic substance doctrine is “significant new legislation” to individual field counsel, and whether the economic substance doctrine is a “difficult legal issue” to individual Service employees preparing notices of deficiency.

We note that the coordination standards we recommend echo the degree of Chief Counsel approvals that would have been mandated under previous versions of the codified economic substance rule considered by Congress.¹⁴² Given the circumstances in which the economic substance doctrine was codified, the Service and Treasury ought not draw negative inferences from the omission of these procedural protections in the final version of the legislation. In any event, we submit that the coordination controls we recommend would benefit both the Service and taxpayers over time.

Finally, while the Industry Directive and our recommendation above assume that the highest level review within LB&I will be at the DFO level, we believe that in the early years of application of section 7701(o) and the related strict liability penalty, it is appropriate for senior LB&I management to be actively consulted to ensure appropriate oversight of the application of these rules. To that end, we encourage the Division Commissioner and her deputies to be notified sufficiently in advance of any proposed assertions of the strict liability penalty so that they can see the types of cases that their DFO’s are prepared to approve and, where appropriate, step in to consider the details of a case before the penalty is asserted.

2. Application of penalties

Treasury and the Service should issue guidance as to the proper method of calculating an underpayment attributable to a transaction lacking economic substance. In

¹⁴¹ I.R.M. 4.8.9.7.1(12).

¹⁴² See JCT 2009 Pamphlet, *supra* note 92, at 66.

particular, we recommend that this guidance confirm that the accuracy-related penalty base should be reduced to the extent the application of the economic substance doctrine mitigates or eliminates other Federal tax liabilities than the income tax underpayment at issue (such as withholding tax with respect to foreign payments, or on subsequent liabilities).

In addition, we recommend that the Service's economic substance approval procedures be set forth in a revenue procedure, in addition to being incorporated into the Internal Revenue Manual. The procedures explaining how the Service formulates its position on the economic substance doctrine in any given case will affect the rights of taxpayers.¹⁴³ The procedures should be a matter of public knowledge,¹⁴⁴ to promote correct and uniform application of the tax laws and to assist taxpayers in attaining maximum voluntary compliance.¹⁴⁵ By publishing these procedures in the Internal Revenue Bulletin, the Service will foster consistent development of the law.

In the revenue procedure, we recommend the Service also commit to waiving penalties if the important procedural safeguards for the assertion of the economic substance doctrine are not met. Such a commitment would demonstrate to taxpayers, practitioners, and all government employees how important it is to get the economic substance doctrine right.

3. Advisory panel

We also recommend that the Service consider the experience of its counterparts in Canada and Australia who have established advisory panels to assist in the application of their general anti-avoidance rules to particular arrangements.¹⁴⁶ Such advisory panels, which should include senior tax officials, representatives from industry, and tax professionals chosen for their ability to provide expert and informed advice, would be constituted to advise the Service on the application of the strict-liability penalty. However, as in Canada and Australia, we would recommend that the panel not be charged with finding facts, arbitrating disputes, or otherwise be given decision-making authority. With the caveat that all minutes of such a panel should be released to the public (redacted as necessary to ensure compliance with section 6103), we recommend that the Service consider creating a similar sort of panel to consider the application of the codified economic substance doctrine in Federal tax cases.

¹⁴³ See Reg. § 601.601(d)(1).

¹⁴⁴ See Reg. § 601.601(d)(2)(i)(B).

¹⁴⁵ Reg. § 601.601(d)(2)(iii).

¹⁴⁶ See discussion *infra* in Appendix B.

APPENDIX A

History of the Codification Effort

In February 1999, as part of the Clinton Administration's fiscal year 2000 budget proposals, the Treasury Department proposed an expansion of section 269 that would authorize the Service to disallow any deduction, credit, exclusion or other allowance obtained in a tax avoidance transaction.¹⁴⁷ The term "tax avoidance transaction" was proposed to be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present-value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of tax liability from the transaction, determined on a present-value basis) from the transaction. The proposal, however, would not have applied to tax benefits "clearly contemplated by the applicable current-law provision (*e.g.*, the low-income housing tax credit)." The February 1999 proposal also would have provided a 40 percent penalty on understatements attributable to such transactions, subject to reduction to 20 percent if disclosed to the Service within 20 days of closing. The reasonable cause exception would not have been available for either proposed penalty.

In testimony before the House Committee on Ways and Means on March 10, 1999, then Assistant Secretary Don Lubick explained the rationale for the proposal to expand section 269, stating that:

Addressing corporate tax shelters on a transaction-by-transaction, ad hoc basis, however, raises certain concerns. First, it is not possible to identify and address all current and future sheltering transactions. Taxpayers with an appetite for corporate tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions the treatment of which is less clear. Second, legislating on a piecemeal basis further complicates the Code and seemingly calls into question the viability of common law tax doctrines such as sham transaction, business purpose, economic substance, and substance over form. Finally, using a transactional legislation approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the belief that any retroactive legislation would be applied only on a prospective basis.¹⁴⁸

In a subsequent speaking engagement, Assistant Secretary Lubick elaborated that Treasury's concern was with "structures created that are wholly unrelated to the corporate

¹⁴⁷ U.S. Dept. of Treas., *General Explanations of the Administration's Revenue Proposals* (Feb. 1999) at 97, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/grnbk99.pdf>.

¹⁴⁸ U.S. Dept of Treas., Testimony of Assistant Treasury Secretary Donald C. Lubick before the House Committee on Ways and Means (Mar. 10, 1999).

participant's core business," and thus Treasury was seeking a new tool with which to attack such structures.¹⁴⁹

In April 27, 1999, testimony before the Senate Finance Committee, the Tax Section recommended that Congress enact a clarification to the common-law economic substance doctrine in lieu of Treasury's proposal to expand section 269.¹⁵⁰ As described in that testimony, the proposal would "make it clear that the expected economic benefits of the transaction must be meaningful (i.e., more than a *de minimis* or nominal amount) in relation to the expected tax benefits." Subsequent testimony before the House Committee on Ways and Means in November 1999 amplified the Tax Section's proposal, noting that:

Our recommendation does not require the Congress to adopt a definition of economic substance or specify the particular circumstances in which the doctrine is relevant. We think both of these matters are best left to the courts where judicial discretion can be applied on a case-by-case basis. However, we think it is appropriate and important for the Congress to affirm what we believe to be current law, namely, that the non-tax considerations in the transaction must be substantial in relation to the potential tax benefits. It would also be helpful if Congress would make it clear that in evaluating the non-tax aspects of a transaction, such as potential economic profit, all of the costs associated with the transaction, including fees paid to promoters and advisors, should be taken into account.¹⁵¹

On June 17, 1999, Congressman Lloyd Doggett introduced H.R. 2255, which proposed the automatic disallowance of "noneconomic tax attributes" and a strict liability penalty of up to 40 percent.¹⁵² The proposed definition of "noneconomic tax attributes" closely followed the February 1999 Treasury proposal to expand section 269. In July 1999, the Treasury Department issued a white paper entitled "The Problem of Corporate Tax Shelters."¹⁵³ The Treasury White Paper revised the February 1999 proposal to expand section 269 to instead adopt a proposal similar to that embodied in H.R. 2255. The Treasury White Paper also proposed the establishment of a corporate tax shelter task force within the Service to streamline and coordinate application of the penalty and automatic referral from the field to the national office and an expedited private letter ruling procedure to provide guidance to taxpayers. An appendix to the

¹⁴⁹ U.S. Dept. of Treas., Remarks of Hon. Donald C. Lubick before Tax Executives Institute (Mar. 23, 1999).

¹⁵⁰ American Bar Association Section of Taxation, Statement of Stefan F. Tucker before the Committee on Finance of the U.S. Senate on the subject of Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget (Apr. 27, 1999), *available at* <http://www.abanet.org/tax/pubpolicy/1999/427rev99.html>.

¹⁵¹ American Bar Association Section of Taxation, Statement of Paul J. Sax before the Committee on Ways and Means of the U.S. House of Representatives on the subject of Corporate Tax Shelters (Nov. 10, 1999), *available at* <http://www.abanet.org/tax/pubpolicy/1999/taxshel111099.html>.

¹⁵² H.R. 2255, 106th Cong., 1st Sess. (1999).

¹⁵³ Treasury White Paper, *supra* note 35.

Treasury White Paper provided additional detail on the revised proposal, and stated that it would not target any “tax benefit clearly contemplated by the applicable provision (taking into account the congressional purpose for such provision and the interaction of such provision with other provisions of the Code).”¹⁵⁴

On July 17, 2001, Congressman Doggett introduced H.R. 2520, which set forth an updated version of his 1999 proposal.¹⁵⁵ H.R. 2520 proposed to “clarify” the economic substance doctrine by adopting a three-part test under which a transaction would have economic substance if: (1) it changed in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, (2) the taxpayer had a substantial nontax purpose for entering into the transaction, and (3) the transaction was a reasonable means of accomplishing such purpose. H.R. 2520 retained a 40 percent strict liability penalty, which would apply to transactions resulting in understatements due to: (1) lacking economic substance under the new “clarification;” (2) lacking business purpose or because the form did not reflect the substance of the transaction; or (3) a failure to meet the requirements of any similar rule of law.

A year later, on July 11, 2002, Chairman Bill Thomas of the House Committee on Ways & Means introduced H.R. 5095, which included provisions to “clarify” the economic substance doctrine similar to those first proposed by Congressman Doggett in H.R. 2520.¹⁵⁶ H.R. 5095 proposed to adopt the three-part test for economic substance set forth in H.R. 2520, but it did not include any of the more detailed rules contained in that legislation. A technical explanation of this proposal prepared by the staff of the Joint Committee on Taxation stated that administrative guidance rather than statutory definitions would be used to fill in the gaps in the statutory rules.¹⁵⁷

On February 27, 2003, the Senate Finance Committee favorably reported S. 476 (the “Care Act of 2003”), which included clarification of the economic substance doctrine similar to that previously proposed by Congressman Doggett.¹⁵⁸ A special rule

¹⁵⁴ *Id.* at 157.

¹⁵⁵ H.R. 2520, 107th Cong., 1st Sess. (2001).

¹⁵⁶ H.R. 5095, 107th Cong., 2nd Sess. (2002).

¹⁵⁷ Joint Committee on Taxation, *Technical Explanation of H.R. 5095 (the “American Competitiveness Act of 2002”)* (JCX-78-02) July 19, 2002, at 5.

¹⁵⁸ S. 476, 108th Cong., 1st Sess. (2003). The February 27, 2003, language approved by the Senate Finance Committee followed bipartisan staff work that saw three discussion drafts made public for review and comment. The first such draft, released on May 24, 2000, largely followed recommendations by the Joint Committee on Taxation in its 1999 report. See Ryan J. Donmoyer and Heidi Glenn, *Finance Antishelter “Draft” Boosts Penalties, Standards of Conduct*, 2000 TNT 102-1 (May 25, 2000). The second discussion draft, released on October 5, 2000, took a new approach, and would have penalized “abusive tax shelter devices” which were generally defined as devices lacking a material nontax business purpose or economic substance. See Press Release, U.S. Senate Committee on Finance, *Roth, Moynihan Request Comments on Revised Tax Shelter Discussion Draft* (106-470) (Oct. 5, 2000). The third discussion draft, released on August 3, 2001 focused more on reasonable belief requirements necessary to avoid imposition of heightened penalties. See Heidi Glenn, *Baucus and Grassley Crack Down on Abusive Corporate Tax Shelters*, 2001 TNT 151-1 (Aug. 6, 2001).

was included for transactions for which the taxpayer claimed a potential for profit that would have required (a) the present value of the reasonably expected pre-tax profit to be substantial in relation to the present value of the expected net tax benefits and (b) the reasonably expected pre-tax profit to exceed a risk-free rate of return. The committee report included a footnote stating that “if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transactions fails the economic substance doctrine as defined in this provision.”¹⁵⁹ On April 2, 2003, Congressman Doggett introduced H.R. 1555 which set forth an updated version of his prior proposals to “clarify” the economic substance doctrine.¹⁶⁰ H.R. 1555 stated that a purpose of achieving a financial accounting benefit would not be taken into account in determining whether a transaction has a substantial nontax business purpose if the origin of such financial accounting benefit is a reduction of income tax.

On January 27, 2005, the staff of the Joint Committee on Taxation issued a report containing “options to improve tax compliance” that recommended a clarification and enhancement of the economic substance doctrine in the case of an “applicable transaction.”¹⁶¹ This proposal included a conjunctive economic substance test in the case of five specific types of transactions.¹⁶²

The Senate Finance Committee continued its efforts to pursue codification of the economic substance doctrine and included similar codification proposals in numerous bills approved by the committee, many of which also were approved by the full Senate. Examples include the Senate versions of: the American Jobs Creation Act of 2004;¹⁶³ the Tax Increase Prevention and Reconciliation Act of 2005;¹⁶⁴ the Telephone

¹⁵⁹ S. Rep. 11, 108th Cong., 1st Sess. (2003) at 79 n.135.

¹⁶⁰ H.R. 1555, 108th Cong., 1st Sess. (2003).

¹⁶¹ Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05)* Jan. 27, 2005 at 18.

¹⁶² *Id.* at 19-20. The types of transactions are: (1) a transaction in which (a) taxpayer holds offsetting positions that substantially reduce the risk of loss and (b) tax benefits would result from differing tax treatment of the positions; (2) a transaction structured to result in disparity between basis and fair market value which creates or increases a loss or reduces a gain; (3) a transaction structured to create or increase a gain in an asset any portion of which would not be recognized if sold at fair market value; (4) a transaction structured to result in income to a tax-indifferent party for any period that is materially in excess of economic income to that party; (5) a transaction in which taxpayer disposes of property (other than inventory, etc.) held for a period of less than 45 days; and (6) a transaction structured to result in a deduction or loss for tax purposes that is not allowed for book purposes.

¹⁶³ H.R. 4520, 108th Cong., 2nd Sess. (2004).

¹⁶⁴ H.R. 4297, 109th Cong., 1st Sess. (2005).

Excise Tax Repeal Act of 2005;¹⁶⁵ and the Heartland, Habitat, Harvest and Horticulture Act of 2007 (“4H” legislation).¹⁶⁶

In October 2007, the Ways and Means Committee approved H.R. 3970, which included a proposal to codify the doctrine.¹⁶⁷ H.R. 3970 dropped the “reasonable means” of accomplishing the stated business purpose requirement and the proposed penalty would have applied only to underpayments as opposed to the Senate approach that would have applied to understatements.

The Senate Finance Committee report for the 2007 “4H” legislation included new language stating that the economic substance codification was “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 alternative is largely or entirely based on comparative tax advantages.”¹⁶⁸ The Senate “4H” legislation included a new proposal that would only permit the strict liability penalty to be asserted after it had been reviewed and approved by the Chief Counsel (or his designate).

As part of its fiscal year 2010 budget proposal, the Obama Administration proposed codification of the economic substance doctrine.¹⁶⁹ The proposal included the following description:

The proposal would clarify that a transaction satisfies the economic substance doctrine only if (i) it changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position, and (ii) the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. The proposal would also clarify that a transaction will not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction. The proposal would allow the Treasury Department to publish regulations to carry out the purposes of the proposal.

A detailed analysis of the proposal was set forth in a pamphlet prepared by the staff of the Joint Committee on Taxation.¹⁷⁰ That pamphlet discussed at length the provisions of a 2007 bill reported by the Senate Finance Committee, S. 2242, and the legislative history to that bill, noting that “[a]lthough the Administration proposal does not contain

¹⁶⁵ S. 1321, 109th Cong., 2nd Sess. (2006).

¹⁶⁶ S. 2242, 110th Cong., 1st Sess. (2007).

¹⁶⁷ H.R. 3970, 110th Cong., 1st Sess. (2007).

¹⁶⁸ S. Rep. 206, 110th Cong., 1st Sess. (2007) at 92.

¹⁶⁹ U.S. Dept. of Treas., *General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals* (May 2009) at 25.

¹⁷⁰ JCT 2009 Pamphlet, *supra* note 92.

statements similar to those in the legislative history to S. 2242, it is likely that similar assumptions are implicit in the proposal.”¹⁷¹

On July 17, 2009, the House Committee on Ways and Means favorably reported H.R. 3200, which included a provision codifying the economic substance doctrine.¹⁷² The text approved by the Committee provided that in the case of any transaction to which the economic substance doctrine was relevant, the transaction would be treated as having economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position; and (2) the taxpayer had a substantial purpose (apart from Federal income tax effects) for entering into the transaction. The bill provided that when a taxpayer relies on profit potential: a present value comparison of the reasonably expected pre-tax profit and the expected net tax benefits would be required; and fees and other transaction expenses and foreign taxes would be taken into account as expenses in determining pre-tax profit.

On October 14, 2009, Chairman Rangel of the Committee on Ways and Means transmitted the committee’s report on H.R. 3200 to the chairman of the House Committee on the Budget.¹⁷³ That report included the following footnote:

If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision. *See, e.g.*, Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which 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 by the Congress to effectuate.¹⁷⁴

The report also stated that the provision was “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.”¹⁷⁵ The committee report then identified four illustrative examples: (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-

¹⁷¹ *Id.* at 44.

¹⁷² H.R. 3200, 111th Cong., 1st Sess. (2009).

¹⁷³ H.R. Rep. 299, pt. 2, 111th Cong., 1st Sess. (2009).

¹⁷⁴ *Id.* at 296, n.124.

¹⁷⁵ *Id.* at 296.

party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

The language approved by the Committee on Ways and Means in H.R. 3200 was incorporated into H.R. 3962, which subsequently was approved by the House of Representatives on November 7, 2009.¹⁷⁶ The Senate did not approve H.R. 3962 as approved by the House. However, on March 10, 2010, the Senate approved H.R. 4213, which included economic substance codification.¹⁷⁷ The language approved by the Senate had some key differences from the House language in H.R. 3962: (1) the Senate bill authorized Treasury to “issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases;” and (2) provided that “the term ‘transaction’ included a series of transactions.” On March 17, 2010, the House Committee on the Budget favorably reported H.R. 4872, as a budget reconciliation bill relating to the health care effort.¹⁷⁸ This bill included the tax provisions of H.R. 3200 that were approved by the Ways and Means Committee in 2009. The report issued by the Committee on the Budget on H.R. 4872 includes the report on H.R. 3200 previously issued by the Committee on Ways and Means. Ultimately, on March 25, 2010, the House approved an amended (unrelated to economic substance codification) version of the bill.

¹⁷⁶ H.R. 3962, 111th Cong., 1st Sess. (2009).

¹⁷⁷ H.R. 4213, 111th Cong., 2nd Sess. (2010).

¹⁷⁸ H.R. 4872, 111th Cong., 2nd Sess. (2010).

APPENDIX B

Experience in Other Contexts

1. California's NEST penalty

In 2003, the state of California enacted a penalty provision that provides if a taxpayer has a “noneconomic substance transaction understatement” there is a penalty of 40 percent of the amount of the understatement (“California NEST penalty”).¹⁷⁹ If the taxpayer adequately discloses on its return the relevant facts affecting the tax treatment of the item then the penalty is reduced to 20 percent of the understatement.¹⁸⁰ The California NEST penalty applies to transactions that lack economic substance. For this purpose, a transaction lacks economic substance if “the taxpayer does not have a valid nontax California business purpose for entering into the transaction.”¹⁸¹ Finally, the California NEST penalty, once assessed, may only be compromised by the Chief Counsel of the Franchise Tax Board (“FTB”).¹⁸² The FTB may apply the California NEST penalty, in lieu of the accuracy-related penalty, in cases in which a taxpayer receives a final Federal audit report if the Federal adjustment was from a transaction lacking economic substance and the tax benefits from this same transaction were reported on the California tax return.¹⁸³ Although the California NEST penalty was enacted in 2003, no reported cases addressing its application have been issued. Likewise, although several other states also have enacted economic substance legislation,¹⁸⁴ experience in the application of those laws is relatively limited to date.

¹⁷⁹ CA Rev. & Tax Code § 19774(a) (West 2003).

¹⁸⁰ CA Rev. & Tax Code § 19774(b)(1) (West 2010).

¹⁸¹ CA Rev. & Tax Code § 19774(c)(2) (West 2010).

¹⁸² CA Rev. & Tax Code § 19774(d)(1) (West 2010).

¹⁸³ FTB Tax News No. 09/01/2008.

¹⁸⁴ *See, e.g.*, Mass. Gen. Laws ch. 62C, §3A (authorizing the Commissioner to disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the Commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance, and (ii) economic substance apart from the asserted tax benefit); Ala. Code § 40-18-35(b)(3) (providing that if a transaction giving rise to interest expenses and costs or intangible expenses and costs, in either case as between related parties, has a substantial business purpose and economic substance and contains terms and conditions comparable to a similar arm's length transaction between unrelated parties, the transaction will be presumed to not have a principal purpose of tax avoidance, subject to rebuttal by the Commissioner); Wis. Stat. Ann. §§ 71.10(1m), 71.30(2m), 71.80(1m) (authorizing the Department to determine the amount of a taxpayer's income without regard to transactions lacking economic substance, providing that a transaction has economic substance only if the taxpayer shows that (i) the transaction changes in a meaningful way the taxpayer's economic position and (ii) the taxpayer has a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing that substantial nontax purpose, and presuming that transactions between related parties lack economic substance unless the taxpayer produces clear and convincing evidence to the contrary).

2. Codified GAARs in Australia, Canada, Germany, New Zealand and Spain

A number of other countries have enacted general anti-avoidance rules (“GAARs”) to prevent taxpayers from engaging in abusive transactions. The experience in administering and litigating these GAARs may be helpful in developing guidance for the application of the economic substance doctrine.

a) Canada

The Canadian GAAR involves the following three steps: (i) determining whether there is a tax benefit arising from a transaction; (ii) determining whether the transaction, either by itself or as part of a series of transactions is an avoidance transaction or whether it has been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; and (iii) determining whether the avoidance transaction is “abusive” in that it results in a “misuse” of the provisions of the Income Tax Act or the Income Tax Regulations or in an “abuse” having regard to those provisions read as a whole.¹⁸⁵

The Canadian GAAR requires that a transaction be both primarily motivated by tax benefits, and that the transaction either misuses an Income Tax Act or Regulation provision or is an abuse of the Income Tax Act as a whole. If either of these requirements is not met, then the GAAR will not apply to a particular transaction. The burden is on the taxpayer to show that there is a nontax business purpose for the transaction, but the burden is on the government to show that the transaction is a misuse or abuse.

In administering the GAAR, the Canadian tax authorities will issue advanced rulings to a taxpayer regarding the application of GAAR and the taxpayer may rely upon these rulings.¹⁸⁶ The government will publish both rulings and technical opinions, which, although not binding when published, provide insight into particular fact patterns to which the government considers that the GAAR will or will not apply. Additionally, the government releases periodically on its website information as to the number of GAAR reviews, the topics subject to review, the number of challenges that result, the cases litigated at various court levels and the ratios on the outcomes. The government also publishes areas that the government is reviewing and whether these areas raise concern with the tax authorities.

Lastly, the government set up a GAAR review committee consisting of representatives from its Justice, Revenue, and Finance departments. All GAAR issues on advanced rulings and penalty assessments are reviewed by this GAAR review committee, which is designed to ensure national uniformity in application of the GAAR and to collect information and expertise in a central repository.

¹⁸⁵ Section 245 of the Income Tax Act (I.T.A.), *reprinted in R.S.C., 1985, ch. 1 (5th Supp.)*.

¹⁸⁶ *See, e.g.,* Information Circular 88-2.

b) New Zealand

New Zealand's GAAR is a broadly drafted statute that provides that any tax avoidance arrangement is void against the Commissioner of Inland Revenue.¹⁸⁷ A "tax avoidance arrangement" is any "arrangement," whether entered into by the person affected by the arrangement or by another person, that directly or indirectly has (i) tax avoidance as its purpose or effect; or (ii) tax avoidance as one of its purposes or effects, if the tax avoidance purpose or effect is not merely incidental.¹⁸⁸ Although the text of New Zealand's GAAR would, by its literal terms, apply to a broad range of transactions, the courts have interpreted New Zealand's GAAR so that it does not apply to tax benefits specifically authorized by statute.¹⁸⁹ Additionally, if there are two ways to arrange a transaction and one will result in less tax, the GAAR will not be applied solely because the taxpayer chose the form of transaction with less tax liability.¹⁹⁰

The New Zealand courts have developed different tests in analyzing the GAAR. Some courts look to the legal form of the transaction, performing a "substance over form" analysis, other courts look to the legal and economic substance of a transaction, and still other courts look to the purpose or effect of the arrangement. To constitute tax avoidance, the arrangement must have a tax avoidance purpose that is more than merely incidental. The tax avoidance purpose test is objective.¹⁹¹ The test is whether parties to the transaction would have entered into the transaction absent the tax advantages.¹⁹² Finally, a third approach used by the courts is that if the arrangement is one that is within the "scheme and purpose" of the Income Tax Act of 2007, then it is not considered tax avoidance. Because the courts apply different rules to different transactions and the approach is not narrowly defined, there remains a certain amount of uncertainty in the application of the New Zealand GAAR.

The New Zealand tax authority publishes guidance and court decisions related to the New Zealand GAAR on its website and issues rulings on certain fact patterns.

c) Australia

Australia's GAAR is also a broadly worded statute, which provides that the GAAR applies if there is (1) a scheme; (2) a tax benefit obtained by the taxpayer in

¹⁸⁷ Section BG 1(1) of the Income Tax Act 2007 (N.Z.).

¹⁸⁸ Section YA 1 of the Income Tax Act 2007 (N.Z.).

¹⁸⁹ Challenge Corporation Ltd v Commissioner of Inland Revenue [1986] 2 NZLR 513, 561 line 41.

¹⁹⁰ Europa Oil (NZ) Limited v. Commissioner of Inland Revenue (No. 2) [1976] 1 WLR 464, 475 Lord Diplock (PC).

¹⁹¹ Commissioner of Inland Revenue v. Challenge Corporation Limited (1986) 8 NZTC 5.001 (CA).

¹⁹² This test is similar to the "adequacy" test for the form of transaction under the German GAAR (discussed *infra*).

connection with that scheme; and (3) based on eight statutorily defined business purpose factors, objectively speaking, the dominant purpose of the person who entered into or carried out the scheme was to enable the taxpayer to obtain the tax benefit.¹⁹³

Similar to Canada, Australia has a GAAR screening panel (“GAAR Panel”). The GAAR Panel serves a purely consultative role in the application of the Australian GAAR. Nonetheless, the screening panel has allowed the Australian Tax Office (“ATO”) to apply the Australian GAAR consistently. In published guidance on the application of the GAAR, the ATO described the seriousness of the GAAR and the importance of the GAAR Panel review:

Application of the GAAR is a serious matter. Its potential application should not be raised lightly. It should be made clear to a taxpayer or advisor that a careful analysis of the facts will be undertaken before a decision is taken to apply a GAAR. The process leading to a decision, including consideration by GAAR Panel, should also be explained. As explained in this practice statement, the application of a GAAR is based on an objective analysis of an arrangement against a set of factors specified in the relevant provisions of the law. It is not a test of a taxpayer’s motives and care should be taken to avoid any implication that a decision to apply a GAAR is a judgment on a taxpayer’s ethics.¹⁹⁴

d) Germany

The German GAAR disallows the tax effects of any legal arrangement that constitutes an abuse of rights (*Rechtsmissbrauch*).¹⁹⁵ The German GAAR allows the German tax authorities to recast abusive transactions. The text of the German GAAR provides that taxpayers may not circumvent the tax law through an inappropriate legal option – a legally permissible form of transaction – that is otherwise permitted. If there is such an option selected by the taxpayer, the taxpayer shall be taxed as if he had chosen a nonabusive legal option.¹⁹⁶

An abuse of legal options occurs if a legal option is selected by the taxpayer that, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer or a third party.¹⁹⁷ The German courts generally perform a three-part analysis in deciding whether to apply the German GAAR. First, the court determines whether the taxpayer’s chosen legal option must be found to be inadequate, which means that an objective third party in the same circumstances, and

¹⁹³ See Income Tax Assessment Act, 1936, pt. IVA (Austl.).

¹⁹⁴ PS LA 2005/24. ATO Practice Statement Law Administration providing guidance as to how the Australian GAAR should be applied, *available at* <http://law.ato.gov.au/atolaw/view.htm?Docid=PSR/PS200524/NAT/ATO/00001&PiT=99991231235958>.

¹⁹⁵ Section 42 of the Federal Code of Tax Procedure (Ger.).

¹⁹⁶ Section 42(1) of the Federal Code of Tax Procedure (Ger.).

¹⁹⁷ Section 42(2) of the Federal Code of Tax Procedure (Ger.).

with the same economic purpose as the taxpayer, would not proceed as the taxpayer did. In this regard, tax motivation does not by itself make an option inadequate. Second, if the court establishes that the transaction is inadequate, it must be shown that the option had the effect of reducing tax. Third, the taxpayer has the burden of showing that there was a business purpose behind the selection of the form of the transaction. Finally, German courts have also looked at subjective factors of intent in determining whether there has been an abuse of legal options.

e) Spain

The Spanish General Tax Act contains two codified anti-abuse rules. The first rule, contained in article 15, is known as “*fraus legis*”, applies when it is found that the taxpayer has reduced or eliminated tax by reason of one or more acts that (i) considered individually or as a whole, are plainly artificial and (ii) have no relevant legal or economic effects other than to obtain tax savings. This rule is also sometimes referred to as applying to transactions that result from an “abuse of legal forms” or to preclude tax benefits that arise from a “conflict in the application of the tax law.” Regardless of the description, the effect of the rule is that, when it is applied, the tax benefits are eliminated and the tax effects of the transaction are adjusted to reflect what would have happened if the act or acts that are disregarded had not been implemented. The Spanish tax authorities cannot impose additional penalties when this rule is invoked.

The second Spanish GAAR is codified in article 16 of the General Tax Act, pursuant to which rule “simulated transactions” are taxed according to their real nature. For this purpose, a “simulated transaction” is deemed to exist when the parties had the intention to enter into a different transaction than the one formally closed, or when the parties did not intend to enter into any transaction at all. The Spanish tax authorities are entitled to impose additional penalties when article 16 applies to a “simulated transaction.”

3. Anti-abuse regulations

The Service has long had statutory and regulatory tools to combat tax avoidance or abusive transactions. Following is a brief summary of two such tools that have been employed regularly by the Service in recent years.

Section 269 disallows deductions, credits or other allowances in corporate acquisitions if the principal purpose of the acquisition is evasion or avoidance of Federal income tax. Initially enacted in 1943, section 269 has been held by the courts to have a broad reach, covering a broad range of tax attributes beyond loss-generating assets.¹⁹⁸ Nonetheless, the Service has ruled that certain tax attributes specifically contemplated by Congress should not be disallowed under section 269 even though corporate acquisitions may have been made with the intent to qualify for those attributes and reduce the

¹⁹⁸ See, e.g., *Army Times Sales Co. v. Commissioner*, 35 T.C. 688 (1961) (disallowing under section 269 corporate deductions for interest paid on corporation’s bonds and to convert capital gains treatment into ordinary income).

taxpayer's Federal income tax liability.¹⁹⁹ A critical feature of section 269 is the subjective intent of the taxpayer – principal purpose of evasion or avoidance. The courts have developed extensive caselaw analyzing different factors to determine whether there exists a legitimate business purpose for the transaction that outweighs the tax benefits or intent to avoid Federal income tax.²⁰⁰

Regulation section 1.701-2, commonly referred to as the “partnership anti-abuse regulation,” was finalized in 1995 and uses examples to illustrate the competing policy considerations that underlie partnership taxation, as well as the difficulty in crafting a general anti-abuse rule. In addition to describing abusive arrangements, the regulation acknowledges that some of the rules of subchapter K provide partners with tax advantages, and that some are simply rules of administrative convenience. The partnership anti-abuse regulation has two components: (1) provisions relating to the use of the substantive rules of subchapter K and (2) provisions relating to treatment of the partnership as an entity rather than an aggregate. The Regulation explains that an abuse of subchapter K occurs when a partnership is “used or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate Federal tax liability in a manner that is inconsistent with the intent” of the partnership rules.²⁰¹ The Regulation also explains that the intent of subchapter K is to allow partners flexibility in conducting a joint economic arrangement without incurring an entity level tax and that certain of the rules of subchapter K were “adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions do not properly reflect income.”²⁰² Thirteen examples are included to illustrate both abusive uses of the rules of subchapter K as well as the proper use of those rules. The abuse of entity provisions delineate the considerations that underlie treatment of the partnership as an aggregate when necessary to effectuate the proper application of provisions that are not included in subchapter K and provide examples of aggregate versus entity treatment for purposes of non-subchapter K provisions of the Code. In recent years the Service has asserted the partnership anti-abuse regulation as one of many arguments, including the economic substance doctrine, in support of its challenges to aggressive transactions. Most courts considering these cases have decided them on economic substance grounds without reaching the merits of the partnership anti-abuse regulation, however.²⁰³ Other courts have effectively combined their discussion of the partnership anti-abuse regulation with traditional

¹⁹⁹ See, e.g., Rev. Rul. 70-238, 1970-1 C.B. 61 (ruling that the creation of a corporation with the principal purpose of qualifying for lower tax rates was not “tax avoidance”).

²⁰⁰ See, e.g., *Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411 (1948); *Cromwell Corp. v. Commissioner*, 43 T.C. 313 (1964); *Canaveral Int’l Corp. v. Commissioner*, 61 T.C. 520 (1974).

²⁰¹ Reg. § 1.701-2(b).

²⁰² Reg. § 1.701-2(a)(3).

²⁰³ See, e.g., *Southgate Master Fund v. United States*, 651 F. Supp. 2d 956 (N.D. Tex. 2009).

economic substance analysis, with the result that there is not a clear application of the Regulation.²⁰⁴

²⁰⁴ See *Nev. Partners Fund, LLC v. United States.*, 714 F. Supp. 2d 598 (S.D. Miss. 2010).