

September 7, 2011

The Honorable Douglas H. Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Ave., NW  
Washington, DC 20224

The Honorable William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Ave., NW  
Washington, DC 20224

Ms. Heather C. Maloy  
Commissioner, Large Business & International Division  
Internal Revenue Service  
Mint Building  
801 Ninth Street, NW  
Washington, D.C. 20001

**Re: LB&I Directive and Guidance on Economic Substance Doctrine Codification**

Dear Sirs and Madam:

We are writing to commend the Internal Revenue Service ("IRS") Large Business & International Division ("LB&I") on its July 15, 2011 directive entitled "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties"<sup>1</sup> and to suggest areas in which additional guidance would be especially helpful.

We believe that the directive will help promote consistent and considered application of the codified economic substance doctrine and associated no-fault penalty. In particular, we commend the following elements of the directive:

- The list of facts and circumstances and other inquiries that must be considered by an examiner in determining whether assertion of the codified economic substance doctrine is likely not appropriate or may be appropriate;
- An acknowledgment of the "basic business transactions" mentioned in the JCT Technical Explanation as transactions not intended to be affected by codification of the economic substance transaction;
- The recognition that a "transaction" should generally include all interconnected steps with a common objective, taken together;
- The limiting (at least until further guidance is issued) of the no-fault penalty to transactions in which the codified economic substance doctrine is failed and not those in which a "similar rule of law" is violated;

- The general recognition that the economic substance doctrine should be asserted only in limited circumstances and not to challenge routine transactions permitted prior to codification;
- The requirement that an examiner must notify a taxpayer, as soon as possible, that the economic substance doctrine may be applied to a transaction and the ability of a taxpayer to explain its position on why the economic substance doctrine should not be applied to a particular transaction;

Although we believe that the issuance of the directive is a very positive development, we continue to believe that substantive guidance on section 7701(o) is needed. The directive helps taxpayers and practitioners understand how LB&I may apply the codified economic substance doctrine, but it "is not an official pronouncement of law, and cannot be used, cited, or relied upon as such." Further, the directive is limited to LB&I and does not provide guidance to examiners in other IRS divisions or to the courts. Thus, substantive guidance continues to be necessary to promote consistent application of the codified doctrine by the IRS and courts and to assist taxpayers in evaluating the potential tax consequences of contemplated transactions.

We describe below five areas of uncertainty raised by the codified economic substance doctrine. We respectfully request that the Department of Treasury ("Treasury") and the IRS issue substantive guidance on these and other related issues. In addition, we request that Treasury and the IRS provide taxpayers and practitioners the opportunity to comment on any such guidance.

## **I. Recommended Substantive Guidance**

### **A. When the Economic Substance Doctrine is "Relevant"**

Section 7701(o)<sup>2</sup> provides that the two-part test for determining whether a transaction has economic substance must be applied "[i]n the case of any transaction to which the economic substance doctrine is relevant." According to section 7701(o)(5)(C), "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [section 7701(o)] had never been enacted."<sup>3</sup>

We understand that Treasury and the IRS have stated they "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."<sup>4</sup> We continue to urge,<sup>5</sup> as have other concerned practitioners and professional associations,<sup>6</sup> that Treasury and the IRS re-consider this approach. Because there is no precedent on when economic substance is considered "relevant," taxpayers face uncertainty in evaluating the effect of codification on transactions.

We applaud the IRS for taking earlier submissions into account in formulating the directive. We urge Treasury and the IRS to build upon this good work and consider converting the facts and circumstances and other inquiries mentioned in the directive into substantive guidance on when the codified economic substance doctrine will be considered relevant to a transaction. Although

Treasury and the IRS may wish to refine the various factors and other considerations mentioned in the directive, we think it provides a strong basis for the development of substantive guidance.

#### B. The Status of the JCT Technical Explanation

There is no official legislative history addressing codification of the economic substance doctrine. There is, however, a JCT Technical Explanation addressing section 7701(o) and the associated penalty provisions. Because JCT reports are "authored by Congressional staff and not by Congress," they are technically not official legislative history.<sup>7</sup> Several courts have viewed them, however, as "highly indicative of what Congress did, in fact, intend."<sup>8</sup>

The JCT Technical Explanation is currently the only source for interpreting the ambiguous and novel aspects of the statute. As a result, we suggest that Treasury and the IRS incorporate the JCT Technical Explanation in substantive guidance, or indicate that taxpayers will be permitted to rely on it.

#### C. The "Transaction" to be Tested

Section 7701(o)(5)(D) defines the term "transaction" as including "a series of transactions." Because the definition of "transaction" may have outcome-determinative consequences, we request that Treasury and the IRS provide guidance on the term. As the directive recognizes, "when a transaction involves a series of interconnected steps with a common objective, the term 'transaction' refers to all of the steps taken together." The economic substance doctrine should be applied to individual steps only in rare circumstances. Thus, we suggest that guidance provide a rebuttable presumption that, when a transaction involves a series of interconnected steps with a common objective, the term "transaction" refers to all of the steps taken together. This presumption could be rebutted where a step in the overall transaction has no economic significance and is included solely to achieve an abusive tax benefit unintended by Congress.

#### D. The Meaning of "Similar Rule of Law"

Section 6662(b)(2) imposes a strict liability penalty where the transaction fails to satisfy the codified economic substance doctrine or "fail[s] to meet the requirements of any similar rule of law."<sup>9</sup> The phrase "any similar rule of law" is not defined, although the JCT Technical Explanation states that the phrase should be narrowly construed:

It 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.<sup>10</sup>

As stated above, we commend LB&I's decision to limit the no-fault penalty to cases in which the economic substance doctrine itself is not satisfied until further guidance is issued on the meaning of "any similar rule of law." We suggest that guidance provide, consistent with the JCT

Technical Explanation, that "any similar rule of law" does not include the mere application of the step transaction doctrine or the substance over form doctrine (although the recharacterized transaction may itself be subject to the penalty if it fails to meet the requirements of section 7701(o)), an applicable business purpose requirement or another statutory or regulatory anti-abuse rule.

#### E. The Meaning of Other Key Terms

If the economic substance doctrine is relevant, a transaction is 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 has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." Profit potential of a transaction may satisfy either prong 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."

We request that Treasury and the IRS issue guidance on the key concepts used in the two-part test. For example, guidance should explain what is considered a "meaningful" change and what is considered a "substantial purpose." Further, with respect to the special rule where the taxpayer relies on profit potential, guidance should explain how the discount rate used in calculating present value should be determined, when pre-tax profit is "reasonably expected," and when potential pre-tax profit is considered "substantial" in relation to the net tax benefits that would be allowed if the transaction were respected. Professional associations have offered thoughtful comments on these issues,<sup>11</sup> and we urge Treasury and the IRS to continue considering these and other comments.

## II. Conclusion

Although the directive is a welcome development, the codified economic substance doctrine continues to be a source of significant uncertainty for taxpayers and tax practitioners. We urge Treasury and IRS to issue substantive guidance on the important issues described above and to provide taxpayers and practitioners an opportunity to comment on such guidance.

Sincerely,

Jerred G. Blanchard, Jr.  
Ernst & Young LLP

Joshua T. Brady  
Ivins, Phillips & Barker

Jasper L. (Jack) Cummings, Jr.  
Alston & Bird LLP

Peter L. Faber  
McDermott Will & Emery LLP

Louis S. Freeman  
Skadden, Arps, Slate, Meagher &  
Flom LLP

Philip J. Levine  
McDermott Will & Emery LLP

Jere D. McGaffey  
Foley & Lardner LLP

David D. Sherwood  
Ivins, Phillips & Barker

Joseph M. Pari  
Dewey & LeBoeuf LLP

Mark J. Silverman  
Steptoe & Johnson LLP

David B. Strong  
Morrison & Foerster LLP

Amanda P. Varma  
Steptoe & Johnson LLP

Robert H. Wellen  
Ivins, Phillips & Barker

cc:

Ms. Emily S. McMahon  
Acting Assistant Secretary (Tax Policy)  
Department of the Treasury

Mr. Erik H. Corwin  
Deputy Chief Counsel (Technical)  
Internal Revenue Service

Mr. Christopher B. Sterner  
Deputy Chief Counsel (Operations)  
Internal Revenue Service

Mr. William D. Alexander  
Associate Chief Counsel (Corporate)  
Internal Revenue Service

Ms. Deborah A. Butler

Associate Chief Counsel (Procedure and Administration)  
Internal Revenue Service

Mr. Jeffrey Van Hove  
Tax Legislative Counsel  
Department of the Treasury

Ms. Lisa M. Zarlenga  
Deputy Tax Legislative Counsel  
Department of the Treasury

Ms. Lee A. Kelley  
Attorney-Advisor  
Department of the Treasury

## FOOTNOTES

<sup>1</sup> LB&I 4-0711-015 (July 15, 2011).

<sup>2</sup> All sections references are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. § " are to the regulations thereunder, unless otherwise stated or clear from context.

<sup>3</sup> See Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act"* (JCX-18-10), March 21, 2010 (the "JCT Technical Explanation"), at p. 152 (stating that codification "does not change present law standards in determining when to apply an economic substance analysis").

<sup>4</sup> Notice 2010-62, 2010-40 I.R.B. 411.

<sup>5</sup> See, e.g., Letter from Barr, Blanchard, Brady, Cummings, Divola, Faber, Ferrell, Freeman, Glickman, Gordon, Levine, McGaffey, Pari, Sherwood, Silverman, Strong, Varma & Wellen to Internal Revenue Service and Department of Treasury (May 2, 2011).

<sup>6</sup> See, e.g., Letter from the American Bar Association Section of Taxation and American Institute of Certified Public Accountants' to Internal Revenue Service and Department of Treasury (Jan. 18, 2011); New York State Bar Association Tax Section Report on Codification of the Economic Substance Doctrine (Jan. 5, 2011).

<sup>7</sup> *Hutchinson v. Commissioner*, 765 F.2d 665 (7th Cir. 1985).

<sup>8</sup> See, e.g., *id.*; *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009); *Robinson v. Commissioner*, 119 T.C. 44 (2002). Further, JCT Technical Explanations available to lawmakers before a statute is enacted may be considered more authoritative than post-enactment JCT reports, such as the Blue Book. Compare *Kalahasthi v. United States*, 630 F.Supp.2d 1120 (C.D. Cal. 2008) (stating that, although a JCT Technical Explanation "does not constitute legislative

history," it is "strong and persuasive evidence of the proper interpretation to be given to the statute"); *with Wallace v. Commissioner*, 965 F.2d 1038 (11th Cir. 1992) ("We cite the General Explanation not as an expression of legislative intent, as it was prepared by committee staff after enactment of the statute, but as a valuable aid to understanding the statute. We accord it no weight as binding authority on legislative intent.").

<sup>9</sup> Section 6662(b)(6).

<sup>10</sup> JCT Technical Explanation, *supra* note 3, at p. 155 n.359.

<sup>11</sup> *See supra* note 6.