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February 13, 2007

Via Messenger

The Honorable Charles B. Rangel
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The Honorable Jim McCrery
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The Honorable Max Baucus
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Committee On Finance
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The Honorable Charles Grassley
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Re: **Codification of the Economic Substance Doctrine & Related 40 Percent "No Fault" Penalty**

Dear Chairmen and Ranking Members:

In July 2004, we submitted to the tax press the enclosed letter (and, in November 2005, we submitted a copy of that letter to members of Congress), which states why the economic substance doctrine should not be codified. Since Congress is once again considering whether to codify that doctrine, we believe that the substance of that letter is as important today as it was when we first submitted that letter. We continue to believe that, for the reasons discussed in that letter as well as due

to the mounting number of victories for the government in economic substance cases, the economic substance doctrine should not be (and need not be) codified.

Further, we believe that the related proposal to impose a 40 percent strict liability penalty fails to carry out any appropriate tax policy. The most recent version of this proposed penalty is contained in S. 96, § 202, which was introduced by Senator Kerry on January 4, 2007.¹ That version imposes a 40 percent penalty on an understatement of tax attributable to a non-disclosed transaction² that fails to meet the proposed codified version of the economic substance doctrine or any similar rule of law. The reasonable cause exceptions in section 6664³ that apply to all other accuracy-related penalties would not apply to this penalty. The only way to avoid all or any portion of this penalty would be to obtain the personal approval of the Commissioner of Internal Revenue. This proposed structure effectively makes the penalty a 40 percent “no-fault” penalty.

“No fault” penalties may make sense when there are relatively clear standards to apply to determine whether such penalties will be imposed. For example, in order to increase transparency, a virtual “no-fault” penalty is imposed on taxpayers who fail to disclose reportable transactions. See section 6707A. The imposition of a “no fault” penalty in this context can be justified, since it can be avoided simply by disclosing the reportable transaction. Also, taxpayers have been given relatively objective standards to determine when a particular transaction requires disclosure. See, e.g., Treas. Reg. § 1.6011-4.

In contrast, a “no fault” penalty does not make sense in the context of the codification of the economic substance doctrine. As explained in detail in the enclosed letter, the economic substance doctrine is a vague and subjective principle of equity that has been developed over decades in finely nuanced cases, and ambiguity over its application would only increase if it were codified. Further, the proposal to codify the economic substance doctrine expressly leaves to the courts the initial decision of whether a transaction should be required to meet the codified doctrine. Different courts may reach different decisions on the same transaction. Further, the penalty applies if the relevant transaction fails to meet the codified economic substance doctrine or “any similar rule of law.” Such a broad phrase could be interpreted as placing virtually no limit on the scope of this “no fault” penalty.

In these circumstances, a taxpayer considering whether to enter into a transaction would have no objective standards to use to determine whether such transaction would be subject to the

¹ Previous bills have contained virtually identical versions of this proposed penalty. See, e.g., S. 2020, 109th Cong. § 512 (Nov. 16, 2005); S. 1637, 108th Cong. § 404 (May 11, 2004); S. 476, 108th Cong. § 704 (April 14, 2003).

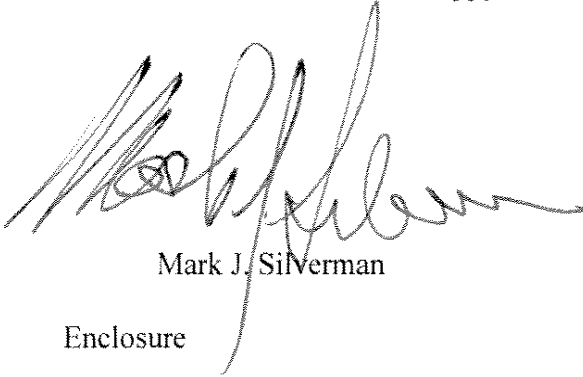
² If the facts relevant to the transaction are adequately disclosed, a 20 percent penalty is substituted for the 40 percent penalty.

³ Any reference to a “section” in this letter refers to a section of the Internal Revenue Code of 1986, as amended (the “Code”). Any reference to “Treas. Reg. §” in this letter refers to a section of the Treasury Regulations issued by the Department of Treasury.

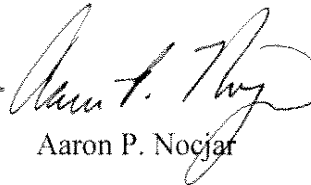
proposed 40 percent "no fault" penalty. A "no fault" penalty without clear standards for its application represents poor tax policy.

We would be happy to discuss these issues further with you at your convenience.

Sincerely,



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Gregory N. Kidder

Enclosure

Cc:

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July 12, 2004

To the Editor:

As part of the FSC/ETI legislative package, Congress again is considering whether to codify the economic substance doctrine. The Senate's version of that package would codify the doctrine, while the House's version would not.¹ For the reasons discussed below, we believe that Congress should not codify the economic substance doctrine.

In evaluating a change such as this, it is important to articulate its objectives, to evaluate the desirability and likelihood of achieving the objectives, and to determine its costs. In this regard, we believe that the proponents of change should bear in mind the following:

- Although there are several technical elements of the proposal that would bring certainty to the economic substance analysis where the authority is currently ambiguous (conjunctive vs. disjunctive test, impact of foreign tax payments, financial statement tax asset as a business purpose, etc.), it is clear that numerous questions will remain that will continue to require judicial resolution (e.g., whether the doctrine should apply to a transaction), and numerous other new issues will be created by the proposal that will require judicial or administrative resolution.² As such, it is unclear

¹ See S. 1637, 108th Cong. § 401 (May 11, 2004) (passed by the Senate on May 11, 2004); H.R. 4520, 108th Cong. (June 17, 2004) (passed by the House on June 17, 2004).

² The recent proposals to codify the economic substance doctrine require that a transaction have economic substance only if a court determines that the economic substance doctrine is "relevant" to the transaction. See, e.g., S. 1637, 108th Cong. § 401 (May 11, 2004) (passed by the Senate on May 11, 2004); S. 476, 108th Cong. § 701 (April 14, 2003) (passed by the Senate on April 9, 2003). As such, the question arises regarding the meaning of the term "relevant" in this context. The proposals also provide that, when a court finds the doctrine "relevant," a transaction will have economic substance only if, among other requirements, the transaction changes in a "meaningful way" the taxpayer's economic position. The term "meaningful" is, of course, not self-defining. The proposals also provide that the

(Continued...)

that the proposal will yield a net reduction in uncertainty. Put another way, the proposal will likely add complexity rather than reduce it. In addition to the other deleterious effects of a more complex tax system, adding complexity will likely impair the ability of taxpayers to engage in legitimate transactions.

- Additional complexity might be worth materially enhanced compliance. However, we do not believe that the case is strong that the proposal will materially enhance compliance. Under one view, the proposal will draw the attention of those who may have been ignoring the doctrine altogether. Because the statute adds nothing to current law regarding when the doctrine should be applied, however, this result is at least uncertain. Under another view, the proposal will prevent advisors from picking and choosing the most favorable of the case law where the law is ambiguous or conflicting. This may be a salutary objective, but taxpayers are free to forum shop only in, at most, three fora: their circuit, the Federal Circuit, and, in some cases, the D.C. Circuit. And taxpayers have no more freedom to forum shop regarding the economic substance doctrine than they do on any other point of law. Although it may be argued that the economic substance doctrine should be singled out for anti-forum shopping treatment since it is more broadly applicable than other rules, differences exist among the circuits in high-stakes areas, including the step transaction doctrine, section 482, and the clear reflection of income doctrine. And, as discussed in the next paragraph, it is not necessarily undesirable that, as with these other doctrines and rules, there is variation in how the economic substance doctrine is applied by different courts.
- As is the case with all judicial doctrines, the economic substance doctrine is, to some extent, vague and subjective and, as discussed above, would remain so in large measure after codification. The doctrine may be thought of as a principle of equity, enabling a court to do justice in circumstances in which, because of the inflexibility of technically drawn statutes, the court otherwise would be unable to adapt its

taxpayer have a "substantial" nontax purpose for "entering into" such transaction. The term "substantial" is facially vague, and it is similarly unclear when a taxpayer is to be treated as "entering into" a transaction. The transaction also must be a "reasonable" means of accomplishing the taxpayer's substantial nontax purpose. Not only is "reasonable" subjective, but additional guidance will be needed to define the "transaction" that is being subjected to the doctrine, and it is unclear whether any definition can anticipate all factual contexts in which the term will become relevant. Finally, the legislative history states that, if tax benefits are "clearly contemplated and expected by the language and purpose of the relevant authority," Congress does not intend that such tax benefits be disallowed by the codified economic substance standard. See S. Rep. No. 108-11 (Feb. 27, 2003). "Clearly contemplated and expected" is a phrase that will spawn much debate, as will the "purpose of the relevant authority."

judgment to the special facts and circumstances of a particular case.³ Historically, “law” and “equity” were separate; “equity” was a tool to be used by courts to modify the “law.” To expect that every court would perceive “equity” similarly would be unrealistic and undesirable. And to turn this principle of equity into a law by codifying it would be at odds with the traditional role of “equity.” Economic substance is a judicial doctrine that, when used by a neutral arbiter, generally can be relied on to produce reasonable results over a range of time and subjects. To codify the doctrine, however, would put in the hands of revenue agents a vague and subjective tool best used by those whose job is to be a neutral arbiter.

- This leads to perhaps the greatest criticism of the proposal, that it will either do too much or do too little. It is very hard to say which, and it is doubtful whether either is preferable to the current state of affairs. If the advocates of the proposal believe it will not have a significant effect, it is hard to see why it is worth the effort, in light of the problems outlined herein. Conversely, if the advocates of the proposal believe it will have a significant effect and think it appropriate that it have such a significant effect, its proponents would have to rest their case on the twin premises that (a) tax shelters are currently too aggressive and (b) it is appropriate to devolve from judges to revenue agents the discretion to apply this vague and subjective standard. We question both premises. Our experience is that marketed tax shelter activity has abated significantly. In part, this may be due to increased enforcement activity, including criminal enforcement activity (about which, see the following paragraph). We also believe it is no disrespect to the fine work done by revenue agents to point out that they generally are not trained to interpret and apply complex judicial principles developed over decades in finely nuanced cases, each of which, it is fair to say, turns to a greater or lesser extent on its own facts.
- Another significant criticism of the proposal is that, to the extent there is still a tax shelter problem to be addressed, the proposal enables Congress to effectively proclaim that it has done something about the problem without expending any resources to actually enhance compliance. There can be little doubt that the most significant single step Congress can take to make a difference in combating tax shelters is to enhance the resources of the Internal Revenue Service (the “Service”). While debates rage over whether the audit rate has risen or fallen recently, there would appear to be no debate that the Service continues to be under-resourced.⁴

³ This is generally the definition of “equity,” as compared to “law.” See, e.g., Garrett v. Arrowhead Improv. Assoc., 826 P.2d 850 (Colo. 1992).

⁴ See, e.g., General Accounting Office, Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives, GAO-03-732T (May 7, 2003) (“IRS’s often-cited audit rate declined approximately 38 percent comparing 1993 to 2002. . . . The increasing gap between collection workload and collection work completed led IRS in March 1999 to start deferring collection (Continued...)”)

Combined with the new faster audit times mandated from Washington, this will result in less enforcement than would otherwise be the case.

- Congress has a long tradition of acting to overturn cases with which it disagrees. The proposal, however, is not within this tradition, because it does not seek to overturn a case that interprets a congressionally drawn statute or agency regulation promulgated pursuant to congressional authorization. Rather, the proposal seeks to articulate a comprehensive standard, harmonizing numerous decisions in equity which, arguably, cannot adequately be harmonized.

The economic substance doctrine has evolved since the Supreme Court decided Gregory v. Helvering, 293 U.S. 465 (1935), and has become far more significant in all areas of tax law. The longstanding application of the doctrine to an almost unending array of different circumstances confirms its strength and flexibility. And there is no reason to believe that, in the hands of the courts, this strength and flexibility will diminish. Although flexibility can be frustrating at times, to both taxpayers and the government, a doctrine of equity such as the economic substance doctrine should remain flexible to respond to current issues.

action on billions of dollars in delinquencies. . . . IRS is still deferring collection action on about one out of three collection cases. . . . Although IRS has received increases in its budgets since fiscal year 2001 in part to increase staffing to enhance in its compliance and collection programs, IRS has been unable to achieve the desired staffing levels. Based on past experience and uncertainty regarding some expected internal savings that would enable IRS to reallocate staff to these programs, fiscal year 2004 staff increases might not fully materialize.”); IR-2004-34 (remarks of Commissioner of Internal Revenue Mark W. Everson before the National Press Club on March 15, 2004) (“Our enforcement statistics for Fiscal 2003 . . . demonstrate that we have arrested the enforcement decline which began in the nineties and worsened with the implementation of RRA 98. Audits, criminal investigations and monies collected were all up.”); Syracuse University, Transactional Records Access Clearinghouse, TRAC: IRS -- New Findings on Tax Collection and IRS Criminal Enforcement, 2004 TNT 73-19 (April 14, 2004) (“Audits for business taxpayers are down, 3 audits per 1,000 tax returns five years ago, 2 audits per 1,000 returns in FY 2003. . . . In several of his recent talks, [Commissioner of Internal Revenue] Everson also has emphasized that the overall audit rate for individual taxpayers -- as distinct from businesses and corporations -- has increased from their all time lows of a few years ago. However, the claimed increases are entirely the result of [sic] agency’s growing reliance on computer-generated correspondence audits that by their very nature are comparatively superficial. . . . An absolute essential element in delivering on the Administration’s promise of tougher tax enforcement -- particularly for business organizations and the wealthy -- is having a trained staff who have the knowledge and skills required to deal with these often complex cases. And while the number of taxpayers and the size of the economy have ballooned, there is no arguing with the simple fact that IRS resources have shriveled. . . . In FY 1999, the agency employed 6,399 revenue officers. In FY 2003, there were 5,004. . . . For the same period, revenue agents went from 13,022 to 11,513.”).

