

STEPTOE & JOHNSON ^{LLP}

ATTORNEYS AT LAW

Mark J. Silverman
202.429.6450
msilverm@steptoe.com

Philip R. West
202.429.6247
pwest@steptoe.com

Gregory N. Kidder
202.429.6755
gkidder@steptoe.com

1330 Connecticut Avenue, NW
Washington, DC 20036-1795
Tel 202.429.3000
Fax 202.429.3902
steptoe.com

November 28, 2007

Via Messenger

The Honorable Charles B. Rangel
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Jim McCrery
242 Cannon House Office Building
Washington, DC 20515

The Honorable Max Baucus
Chairman
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Charles Grassley
135 Hart Senate Office Building
Washington, DC 20510

Re: Codification of the Economic Substance Doctrine in H.R. 3970 and S. 2242

Dear Chairmen and Ranking Members:

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For reasons set forth below, we urge you to reconsider codification of the economic substance doctrine.

In February 2007 and November 2005, we submitted letters explaining our opposition to the codification of the economic substance doctrine. In recent weeks, both the House and the Senate have again introduced economic substance codification legislation. The new codification proposals make certain modifications to the past ones, but remain significantly flawed. The current proposals would likely increase the ambiguity and complexity of the Tax Code, hinder legitimate tax planning, and potentially make enforcement more difficult. Although economic substance codification has been labeled a revenue raiser, the estimates of the revenue impact have been uncertain and changing. Given the government's recent victories in economic substance cases, it is questionable whether codification will raise any revenue at all. For these reasons and others, Assistant Treasury Secretary for Tax Policy Eric Solomon¹ and IRS Chief Counsel Donald L. Korb² have both expressed opposition to the codification proposals. As explained in our previous letters and further below, the benefits of economic substance codification are highly uncertain and likely to be outweighed by the costs.

The Current House Bill - H.R.3970

The current House bill, "The Tax Reduction and Reform Act of 2007," H.R. 3970, includes a provision stating that in any case in which the economic substance doctrine is "relevant" to a transaction, the transaction shall be treated as having economic substance only if (1) the transaction changes in a "meaningful" way (apart from federal income tax consequences) the taxpayer's economic position and (2) the taxpayer has a "substantial" non-federal tax purpose for "entering into" such transaction. The additional requirement included in past bills that the transaction be a "reasonable means of accomplishing" the "substantial" non-federal tax purpose has been eliminated. In addition, the

¹ During a conference sponsored by the Practising Law Institute on October 12, 2007, Assistant Secretary Solomon stated that the codification proposal would put a heavy and unnecessary administrative burden on the IRS. See *Solomon Says Rule Not Enough to Fix Tax Patent Problem; Other Issues Discussed*, Daily Tax Rep. (BNA), Oct. 15, 2007, at G-6.

² In comments to the UCLA Tax Controversy Institute on October 31, 2007, IRS Chief Counsel Donald Korb had several criticisms of the attempt at codification. First, Korb pointed out that codification is not likely to be a large revenue raiser, since the estimated amount of money coming in from an economic substance penalty has dropped from a Senate estimate several months ago of \$10 billion to a more recent House estimate of \$3.5 billion. Second, Korb noted that this is just the latest example of Congress piling on penalties. The result, according to Korb, is that it makes it difficult to assert and sustain those penalties. Third, Korb stated that Congress's attempt to replace a flexible judicial doctrine with a written statutory rule could have adverse consequences, such as taxpayers going to the edge of the law and structuring around the statutory rules. Finally, Korb noted that the language of the proposals could apply to other judicial doctrines in addition to economic substance, which could chill a number of otherwise legitimate business transactions. See *Korb Notes Declining Revenue Estimate for Economic Substance Codification*, 2007 Tax Notes Today 212-6 (Nov. 1, 2007).

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special rule in past bills requiring a transaction motivated by profit to have a reasonably expected pre-tax profit in excess of a risk-free rate of return has also been eliminated. These modifications improve the proposal somewhat by removing additional requirements, but they do nothing to address the fundamental problem that when and how the economic substance bill would apply is still uncertain. “Relevant,” “meaningful,” and “substantial” are not clear and objective standards.

Further, in addition to denying any tax benefits from a transaction lacking economic substance, the House bill would impose a 20% penalty on the portion of any underpayment attributable to “any 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.” The bill would increase the penalty to 40% if the transaction lacking economic substance is not disclosed to the Internal Revenue Service. The uncertain and potentially broad application of the vague standard in the House proposal makes such a penalty overly harsh and unwise.

The Current Senate Bill – S. 2242

The current Senate bill, “The Heartland, Habitat, Harvest, and Horticulture Act of 2007,” S. 2242, contains modifications similar to those contained in the House Bill, but also remains significantly flawed. The Senate bill provides that in any case in which a court determines that the economic substance doctrine is relevant to a transaction (or series of transactions), a transaction shall have economic substance only if (1) the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position, and (2) the taxpayer has a substantial purpose (other than a Federal tax purpose) for entering into such transaction. Although certain mechanics of application have been modified, the same problem of uncertainty and ambiguity remains. Like the House Bill, the Senate bill eliminates the requirement in old bills that a transaction be a reasonable means of accomplishing its nontax purpose and that a transaction motivated by profit have a pre-tax profit potential in excess of a reasonable rate of return. However, similar to the House Bill, the Senate bill contains the same vague standards of “relevant,” “meaningful,” and “substantial” to determine when and how the economic substance doctrine will apply. These vague standards will have to be applied by numerous lower level IRS revenue agents, IRS appeals officers, and ultimately, different courts, and will likely produce different results, eliminating the clarity and uniformity intended by the bill. The Senate bill reduces the penalty imposed on transactions that fail the economic substance test from the 40% contained in a prior bill to 30% (reduced to 20% with respect to the portion of the understatement in which the relevant facts affecting the tax treatment of the transaction are adequately disclosed).³

³ The amount of the “understatement” under the provision is determined as “the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer’s treatment of the item and the proper treatment of the item (without regard to other items on the tax return), and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer’s treatment of an item and the proper tax treatment of such item.” See Senate Finance Committee Report (S. Rept. No. 110-206) to Accompany Heartland, Habitat, Harvest, and Horticulture Act of 2007. In comparison, the

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The Codification Effort is Flawed

Regardless of the specific modifications to the mechanics of application, the fundamental premise of codification is flawed. The proposed statutory language is no less uncertain or vague than prior proposals. Similar to past proposals, the current House and Senate codification bills remain ambiguous with respect to when and how the economic substance doctrine would apply. The economic substance doctrine is a subjective principle of equity that is better left to the courts to apply based on past judicial authority. This authority has developed through finely nuanced cases with specific facts. Replacing this authority with a new uncertain standard is unnecessary and potentially harmful. For example, the Senate Finance Committee's report on S. 2242 includes a list of "certain basic business transactions, that under longstanding judicial and administrative practice are respected" and that according to the report are not intended to be affected by the codified economic substance doctrine in the Senate Bill. These transactions include "(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-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied."⁴ The mere necessity of including this list in the Senate Finance Committee's report indicates the potential broad application of the proposed statutory language. The list included is far from exhaustive of all the common ordinary transactions that have been respected pursuant to well established authority. Imposing a new statutory standard subjects this authority to risk and introduces unneeded uncertainty for minimal gain.

Moreover, codification of the economic substance doctrine will not necessarily improve compliance or increase revenue. Courts are already willing to apply the economic substance doctrine, and do not need Congress to codify it. The evolution of the economic substance doctrine since the Supreme Court decided *Gregory v. Helvering*⁵ and its longstanding application to an almost unending array of different circumstances confirms its strength and flexibility. There is no reason to believe that, in the hands of the courts, this strength and flexibility will diminish. For example, recently in *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert denied*, 127 S. Ct. 1261 (2007), the U.S. Court of Appeals held that, although the Internal Revenue Code produced the federal income tax benefits claimed by the taxpayer from the transaction at issue, the taxpayer was not entitled to those benefits because the transaction violated the economic substance doctrine. The Court of Federal Claims reached a similar result in *Heinz v. United States*, 76 Fed. Cl. 570 (Ct. Cl. 2007). A codified economic

current House bill, H.R. 3970, limits the application of the penalty to cases where an underpayment, not understatement, actually results.

⁴ Senate Finance Committee Report on Heartland, Habitat, Harvest, and Horticulture Act of 2007, pg. 115.

⁵ 293 U.S. 465 (1935)

substance doctrine would replace the judicial authority applied in *Coltec* and *Heinz*, as well as other cases.

As we pointed out in our earlier letters, if Congress wants to enhance compliance, it would be better off increasing the resources of the Internal Revenue Service to implement and enforce the already complex Internal Revenue Code that Congress has enacted. Adding more complexity without materially increasing compliance would appear to be the wrong choice. We urge Congress to carefully consider these issues before passing legislation to codify the economic substance doctrine. For the reasons discussed above, we believe the economic substance doctrine is better left to the courts.

Sincerely,


Mark J. Silverman


Philip R. West


Gregory N. Kidder

Enclosures

Cc:

Ms. Janice Mays
Staff Director/Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Mr. John Buckley
Chief Tax Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

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Mr. Brett Loper
Staff Director
1139E Longworth House Office Building
Washington, DC 20515

Mr. Jon Traub
Chief Tax Counsel
1139E Longworth House Office Building
Washington, DC 20515

Mr. Russ Sullivan
Staff Director
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Mr. Patrick G. Heck
Chief Tax Counsel
219 Dirksen Senate Office Building
Washington, DC 20510

Mr. Kolan Davis
Staff Director/Chief Counsel
219 Dirksen Senate Office Building
Washington, DC 20510

Mr. Mark A. Prater
Chief Tax Counsel
219 Dirksen Senate Office Building
Washington, DC 20510

Mr. Edward D. Kleinbard
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, DC 20515

Mr. Eric Solomon
Assistant Secretary for Tax Policy
Department of the Treasury, Room 3120
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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Ms. Karen Gilbreath Sowell
Deputy Assistant Secretary for Tax Policy
Department of the Treasury, Room 3120
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. Michael Desmond
Tax Legislative Counsel
Department of the Treasury, Room 3040
1500 Pennsylvania Ave., NW
Washington, DC 20220

Mr. Marc Countryman
Attorney-Advisor
Department of the Treasury, Room 4206B
1500 Pennsylvania Ave., NW
Washington, DC 20220

Mr. Donald L. Korb
Chief Counsel
Internal Revenue Service, Room 3026
1111 Constitution Avenue, NW
Washington, DC 20224-0002