taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

May 2, 2011

The Honorable Michael F. Mundaca
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

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

Re: **Request for Guidance on Economic Substance Doctrine Codification**

Dear Sirs:

We are writing to request that the Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") issue substantive guidance on selected issues regarding the codified economic substance doctrine and related no-fault penalty.[1] Although the economic substance doctrine codification and the new no-fault penalty raise many substantive and procedural issues that could be addressed in guidance, we focus on the substantive issues that we believe present the most urgent need for guidance. We recommend that Treasury and the IRS issue guidance on (1) when the economic substance doctrine is "relevant" to a transaction; (2) the definition of "transaction;" and (3) the meaning of "any similar rule of law" under the new penalty provisions.

I. Recommended Guidance

A. When the Economic Substance Doctrine is "Relevant"

Section 7701(o)[2] provides that a conjunctive test 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),

[1] This letter reflects the views of the signatories only and is not being sent on behalf of any specific client(s) or their firms or any organizations with which they may be affiliated.

[2] 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.

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

"[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."[3]

We urge Treasury and the IRS to reconsider Notice 2010-62, which states that Treasury and the IRS "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 Treasury and the IRS need not write an "angel list" of specific transactions to which the economic substance doctrine is not relevant, we believe that some guidance on when the economic substance doctrine is relevant to a transaction is urgently needed.[4]

Notice 2010-62 states:

> If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.

We are not aware of any authorities that "provided that the economic substance doctrine was not relevant" to a transaction. Rather, the economic substance doctrine generally is applied by courts only after the doctrine is asserted by the IRS.

By using the relevance of the doctrine as the trigger for application of the statutory provisions, Congress clearly intended that not all transactions be subject to the new conjunctive test. Taxpayers and their advisers may analyze whether the test is relevant to a transaction by considering the JCT Technical Explanation to the economic substance doctrine legislation (discussed below), prior case law, and administrative practice. Nevertheless, the novelty of the "relevance" concept means that it is difficult to gain comfort on even routine transactions. Even if a taxpayer and its advisers diligently analyze the issues, real risk of a penalty, up to 40%, will remain.

[3] *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").

[4] It may be argued that establishing firm rules on when the economic substance doctrine is or is not relevant to a transaction (such as an "angel list") could encourage taxpayers to use such rules to plan around the doctrine and enter into transactions the IRS finds abusive. We do not believe our proposal would encourage abusive transactions. Rather, as discussed below, our proposal would establish rebuttable presumptions and a series of facts and circumstances that would provide taxpayers and practitioners with a framework for considering whether economic substance is relevant, but would not automatically "bless" transactions.

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

1. Suggested Framework for Guidance

We recommend that guidance provide (1) two rebuttable presumptions covering transactions for which the economic substance doctrine is not relevant, and (2) a non-exclusive list of facts and circumstances that would support or counsel against application of the codified economic substance doctrine. This guidance would be consistent with the plain language of section 7701(o) (described above), the JCT Technical Explanation, prior case law, and administrative practice. This presumption/facts and circumstances approach could be modeled on the regulations under section 355(e), which provide safe harbors covering situations where section 355(e) was not intended to apply and facts and circumstances to be considered in determining whether a distribution and acquisition are part of a "plan" under which new shareholders acquire ownership of a business in connection with a spin-off. This approach could also be modeled on the regulations governing the device requirement of section 355, which state "the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances, including, but not limited to, the presence of specified device factors and nondevice factors" and list transactions "ordinarily considered not to have been used principally as a device."[5]

The JCT Technical Explanation, which describes two general types of tax results not intended to be altered by codification of the economic substance doctrine, should be the basis for the two rebuttable presumptions. The first presumption should be based on the statement in the JCT Technical Explanation that "[i]f the realization of the tax benefits 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."[6] The JCT Technical Explanation further explains, "it is not intended that a tax credit . . . 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."[7] Consistent with this approach, guidance should provide that a transaction will be considered to be within the first presumption if the taxpayer shows that the transaction satisfies the technical rules of a provision and that the tax results are consistent with a Congressional purpose or plan. Transactions within this presumption could include credits, such as those mentioned in the JCT Technical Explanation, as well as transactional "fictions" mandated by the Code and other tax benefits or results specifically mentioned as intended by Congress in a provision's legislative history.[8]

The second presumption should be based on the statement in the JCT Technical Explanation that codification "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

[5] Treas. Reg. § 1.355-2(d)(1), (2), (3), (5).

[6] JCT Technical Explanation, *supra* note 3, at p. 152, n. 344.

[7] *Id.*

[8] *See, e.g.*, H.R. Conf. Rep. No. 101-964 (1990) (with respect to section 355(d), providing examples of transactions that do not fall within the purpose of the statute).

taxanalysts® DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

meaningful economic alternatives is largely or entirely based on comparative tax advantages."[9] The Technical Explanation provides several examples of these "basic business transactions":

(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.[10]

These examples are mentioned as "among" the basic transactions the tax treatment of which is not intended to be altered and the JCT Technical Explanation states that the list is intended to be "illustrative and not exclusive."[11] The second presumption should include the "basic business transactions" specifically enumerated in the Technical Explanation, while the general concept that the tax treatment of long-respected business transactions should not be changed by codification should be incorporated into the facts and circumstances test, discussed below.

If a transaction does not clearly fall in one of the above presumptions, it should be tested under a "facts and circumstances" test.[12] This test should list both factors suggesting the economic substance doctrine is relevant and factors suggesting that the economic substance doctrine is not relevant. Consistent with section 7701(o)(5)(C), which states that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted," the factors would look to case law and administrative practice.

---

[9] JCT Technical Explanation, *supra* note 3, at p. 152.

[10] *Id.*

[11] *Id.* at p. 152 & n. 345.

[12] Our proposed list of "facts and circumstances" is similar, but not identical, to the factors suggested in the American Bar Association Section of Taxation and American Institute of Certified Public Accountants' January 18, 2011 letter to Treasury and the IRS.

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

Similar to the regulations under sections 355(a)(1)(B) [13] and 355(e),[14] the facts and circumstances test could provide:

> Whether the economic substance doctrine is relevant to a transaction is determined based on all the facts and circumstances. The facts and circumstances to be considered in determining whether the economic substance doctrine is relevant to a transaction include, but are not limited to, the facts and circumstances set forth below. In general, the weight to be given each of the facts and circumstances depends on the particular case. Whether the economic substance doctrine is relevant to a transaction does not depend on the relative number of facts and circumstances set forth below as evidencing the non-relevance of the economic substance doctrine as compared to the relative number of facts and circumstances set forth below as evidencing the relevance of the doctrine.[15]

The facts and circumstances tending to show that the economic substance doctrine is not relevant to a transaction should include the following:

1. The applicability and satisfaction of a stand-alone statutory or regulatory anti-abuse rule.[16]

2. Judicial and/or administrative precedent (a) rejects application of the economic substance doctrine to the transaction or a substantially similar transaction, (b) upholds the transaction and makes no reference to the doctrine when considering the transaction or a substantially similar transaction,[17] or (c) holds the transaction or a substantially similar transaction must be recognized for federal income tax purposes regardless of whether it is motivated, in whole or in part, by a business purpose.[18]

3. The transaction is subject to, and satisfies, a detailed statutory or regulatory scheme.[19]

4. The transaction is a statutory or regulatory election.[20]

---

[13] *See* Treas. Reg. § 1.355-2(d).

[14] *See* Treas. Reg. § 1.355-7(b)(3), (4).

[15] *See* Treas. Reg. § 1.355-7(b).

[16] *See, e.g.*, section 269; Treas. Reg. § 1.701-2.

[17] *See, e.g.*, *Cottage Savings v. Commissioner*, 499 U.S. 554 (1991).

[18] *See id.*; *Sun Properties v. United States*, 220 F.2d 171 (5th Cir. 1955).

[19] As examples, the consolidated return regulations or the passive loss rules.

[20] For example, an election under section 338.

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

The facts and circumstances tending to show that economic substance is relevant to a transaction should include the following:

1. The transaction accelerates or duplicates a loss or deduction.

2. The transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset).

3. The taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction.

4. The taxpayer's transaction involves a tax-indifferent counterparty that recognizes substantial income.

We believe that this presumption/facts and circumstances approach would provide taxpayers with needed guidance without unduly limiting the IRS's ability to assert the economic substance doctrine in appropriate cases.

B. Definition of "Transaction"

Section 7701(o)(5)(D) defines the term "transaction" as including "a series of transactions." This statement appears to confirm that the step transaction doctrine should be applied in testing a transaction under the economic substance doctrine, which is consistent with long-standing judicial precedent.[21]

The statute does not address whether and to what extent a court should focus on a narrow piece of a larger transaction.[22] The JCT Technical Explanation, however, states:

> This 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

[21] *See, e.g.*, *ACM Partnership v. Comm'r*, 157 F.3d 231 (3d Cir. 1998) ("In applying these [economic substance] principles, we must view the transactions 'as a whole, and each step, from the commencement…to the consummation…is relevant.'") (citation omitted).

[22] *See Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert denied* 127 S. Ct. 1261 (2007) ("We must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. That transaction is [the subsidiary's] assumption of [the liabilities]. . . . It is this exchange that provided [the taxpayer] with the high basis in the [subsidiary] stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus.").

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

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.[23]

Because the definition of "transaction" may have outcome-determinative consequences, Treasury and the IRS should provide guidance on the term. We believe that guidance, consistent with the plain language of section 7701(o)(5)(D), should 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. Consistent with the JCT Technical Explanation, however, 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. This guidance would confirm that codification of the economic substance doctrine has not changed the long-standing principle that all related steps in a transaction generally should be aggregated to determine the substance of the transaction. Once the substance of the transaction is determined under these normal rules, then the economic substance doctrine can be applied (if relevant) to determine if the transaction, as so determined, passes or fails its test.

C. "Any Similar Rule of Law"

New section 6662(b)(2) imposes a strict liability penalty of 20% (40% for undisclosed transactions) of an underpayment attributable to the disallowance of claimed tax benefits by reason of a disallowance based on application of the economic substance doctrine or "failing to meet the requirements of any similar rule of law."[24] The phrase "any similar rule of law" is not defined in the statute.

We are concerned that revenue agents may interpret "any similar rule of law" as including any statutory, regulatory, or judicial anti-abuse or recharacterization rules. The JCT Technical Explanation states, however, 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.[25]

We recommend that, until guidance is issued, the "any similar rule of law" penalty will not apply to a transaction unless section 7701(o) is also applied (i.e., unless the economic substance doctrine is "relevant" to the transaction). When guidance is issued, it should confirm that "any similar rule of law" does not include the mere application of the step transaction or substance over form doctrines (although the recharacterized transaction may itself be subject to the penalty if it fails to meet the requirements of

[23] JCT Technical Explanation, *supra* note 3, at p. 153.

[24] Section 6662(b)(6).

[25] JCT Technical Explanation, *supra* note 3, at p. 155 n.359.

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

section 7701(o)). Guidance should also provide that "any similar rule of law" does not include statutory or regulatory anti-abuse rules (such as Treas. Reg. §§ 1.267(f)-1(h), 1.701-2, and 1.1502-13(h)) or business purpose requirements (such as Treas. Reg. §§ 1.355-2(b) and 1.368-1(b)).

II. Conclusion

The codified economic substance doctrine and associated no-fault penalty create substantial uncertainty for taxpayers and tax practitioners. We believe that guidance can be developed, as suggested above, that provides useful guidance for taxpayers without limiting the IRS's ability to attack abusive transactions. We urge the Treasury and IRS to issue guidance on the important issues described above.

Sincerely,

Neil Barr
Davis Polk & Wardwell LLP

Jerred G. Blanchard, Jr.
Ernst & Young LLP

Joshua T. Brady
Ivins, Phillips & Barker

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

Julie A. Divola
Pillsbury Winthrop Shaw Pittman LLP

Peter L. Faber
McDermott Will & Emery LLP

Kathleen L. Ferrell
Davis Polk & Wardwell LLP

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

David G. Glickman
Baker & McKenzie LLP

Stephen L. Gordon
Cravath, Swaine & Moore LLP

Philip J. Levine
McDermott Will & Emery LLP

Jere D. McGaffey
Foley & Lardner LLP

Joseph M. Pari
Dewey & LeBoeuf LLP

David D. Sherwood
Ivins, Phillips & Barker

Mark J. Silverman
Steptoe & Johnson LLP

David B. Strong
Holme Roberts & Owen LLP

Amanda P. Varma
Steptoe & Johnson LLP

Robert H. Wellen
Ivins, Phillips & Barker

taxanalysts®
DOCUMENT SERVICE
Doc 2011-9441 (9 pgs)

cc:

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

Ms. Clarissa C. Potter
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

Ms. Heather C. Maloy
Commissioner, Large Business and International Division
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