STEPTOE & JOHNSON LLP
ATTORNEYS AT LAW

Mark J. Silverman
202.429.6450
msilverm@steptoe.com

Amanda Pedvin Varma
202.429.8116
avarma@steptoe.com

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

July 7, 2010

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

Re: **Request for Guidance on Economic Substance Doctrine (Section 7701(o))**

Dear Sirs:

We are writing to urge the Treasury Department ("Treasury") and Internal Revenue Service ("IRS") to issue guidance on section 7701(o) of the Internal Revenue Code, which codifies the economic substance doctrine.[1] Guidance is needed to assist taxpayers, practitioners, and IRS agents in determining whether and how the doctrine and associated no-fault penalty will apply.

This letter is divided into three parts. First, we provide a brief overview of new section 7701(o) and describe the critical need for guidance. Second, we describe substantive guidance that the Treasury and IRS should consider issuing, including guidance on (a) when the economic substance doctrine is "relevant," (b) the significance of the safe harbors in the Joint Committee on Taxation report, (c) the definition of "transaction," and (d) the meaning of "any similar rule of law" under the new penalty

[1] 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.

provisions.[2] Third, we discuss procedures that the IRS should consider developing to ensure that section 7701(o) is applied fairly and consistently, including (a) a "no-action letter" process to confirm economic substance is not relevant to a transaction, (b) audit guidelines describing how agents should apply section 7701(o), and (c) an internal IRS review process to approve the assertion of the no-fault penalty for transactions determined to lack economic substance.

I. Background

A. Section 7701(o)

On March 30, 2010, the Health Care and Education Reconciliation Act of 2010 (the "Reconciliation Act") was signed into law.[3] The Reconciliation Act added section 7701(o) to the Internal Revenue Code.[4] Section 7701(o) codifies a conjunctive economic substance test that must be applied "[i]n the case of any transaction to which the economic substance doctrine is relevant." The "economic substance doctrine" is defined as "the 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."[5] The statute provides that "[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."[6]

If the economic substance doctrine is relevant, section 7701(o) provides that a transaction must have a substantial non-tax business purpose and result in meaningful economic changes in order to satisfy the doctrine. Specifically, a transaction shall 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 has a "substantial purpose" (apart from federal income tax effects) for entering into such transaction.[7]

The Reconciliation Act also added a strict liability penalty for transactions lacking economic substance or "failing to meet the requirements of any similar rule of law."[8] The penalty is calculated as

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[2] Section 7701(o) raises many issues that should be addressed by guidance, but we do not purport to address all such issues herein.

[3] Health Care and Education Reconciliation Act of 2010, P.L. 111-152.

[4] § 1409, P.L. 111-152.

[5] Section 7701(o)(5)(A).

[6] Section 7701(o)(5)(C).

[7] Section 7701(o)(1).

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

20% of the underpayment for disclosed transactions and 40% for undisclosed transactions."[9] The new penalty does not have a reasonable cause exception.[10]

B. Immediate Need for Guidance

The newly-codified economic substance doctrine creates substantial uncertainty for taxpayers. As the IRS develops its initiative to require taxpayers to disclose their uncertain tax positions,[11] reducing tax law uncertainty is crucial to help minimize taxpayer burden in preparing disclosures and reduce the IRS's expenditure of resources in evaluating those disclosures. As IRS Commissioner Shulman has stated:

> [U]ncertain tax positions are uncertain for a number of reasons, including ambiguity in the law and a lack of published guidance on issues. As a result, we need to engage with taxpayers early—in pre-filing venues, if possible—to eliminate uncertainty as quickly as possible, whenever possible. The most obvious way to do this is to publish guidance. IRS Chief Counsel Bill Wilkins will work with me and our colleagues at the Treasury Department to eliminate as much uncertainty as possible through published guidance that is grounded in business realities and practical administration of the law. . . . We look forward to working with you on identifying and addressing the areas in most need of clarification.[12]

Section 7701(o) is in urgent need of clarification. As described in further detail below, the statute contains several ambiguities that create uncertainty for taxpayers engaging in real business transactions with significant tax aspects.[13] Further, because the new penalty is substantial (up to 40%)

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[9] Section 6662(b)(6); section 6662(i).

[10] Section 6664(c)(2), section 6664(d).

[11] *See* Announcement 2010-9, 2010-7 I.R.B. 408; Announcement 2010-17, 2010-13 I.R.B. 515; Announcement 2010-30, 2010-19 I.R.B. 668.

[12] Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman before the Tax Executives Institute 60th Mid-Year Meeting, Washington, D.C. (Apr. 12, 2010), *available at* http://www.irs.gov/newsroom/article/0,,id=221280,00.html.

[13] In addition, the weight taxpayers and practitioners should give to certain statements (e.g., codification "is not intended to alter the tax treatment of certain basic business transactions") in the Joint Committee on Taxation Technical Explanation of the Health Care and Education Reconciliation Act of 2010 (the "JCT Technical Explanation") is not clear. *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. Because JCT reports are "authored by Congressional staff and not by Congress," they are technically not legislative history. *Hutchinson v. Commissioner*, 765 F.2d 665 (7th Cir. 1985). Several courts have viewed them, however, as "highly indicative of what Congress did, in fact, intend." *See, e.g., id.*; *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009); *Robinson v. Commissioner*, 119 T.C. 44 (2002). Further,

and has no exception for reasonable cause, the IRS should provide guidance to allow taxpayers and their advisors to understand the implications of transactions under consideration.

Guidance should be a top priority for Treasury and the IRS because section 7701(o) is currently effective. Many, if not all, of the basic transactions that continue to be conducted post-codification involve some level of tax planning. Further, individual steps are often taken to achieve a particular tax result. If, as the JCT Technical Explanation states, a particular step in a transaction is subject to challenge under the codified economic substance doctrine, taxpayers could be subject to a 40% penalty regardless of the issuance of opinions by respected tax advisors. We believe that this result will stifle appropriate tax planning and is not intended by the legislation. As a result, immediate clarification is essential, as shown by the simple examples below.

1. Sale of Loss Property

X, a savings and loan association, exchanges a pool of mortgages with another savings and loan association for a pool of different mortgages. The exchange is consummated solely to generate a tax loss. The transaction is disregarded for all purposes except tax purposes.

Will the loss be disallowed under section 7701(o) and subject to the 40% penalty? We believe the loss should be allowed, as these are facts of the Supreme Court decision in *Cottage Savings*, in which the Supreme Court held that losses were realized under section 1001(a) because the exchanged properties were "materially different."[14] However, practitioners are concerned that if *Cottage Savings* had not been decided and if this transaction occurred after codification, the IRS could successfully challenge and deny the loss. As a result, guidance is needed to clarify whether economic substance is "relevant" to this transaction so that taxpayers cannot be subject to deficiencies and penalties for tax-motivated sales of property at a loss.

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.").

[14] *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). In *Cottage Savings*, the taxpayer simultaneous sold and purchased interests in depreciated residential mortgages. For regulatory purposes, Cottage Savings was treated as having exchanged its mortgages for "substantially identical" mortgages. For tax purposes, Cottage Savings claimed a deduction for the difference between the face value of the interests it gave up and the fair market value of the interests it received. The Supreme Court held that Cottage Savings realized losses under section 1001(a) because the exchanged properties were "materially different"—the interests derived from loans made to different obligors and secured by different homes. Further, the court rejected the IRS's assertion that the transactions lacked economic substance and were not bona fide.

2. "Busted 351" Transaction

X corporation transfers built-in gain assets to Y, a newly formed corporation. Immediately thereafter, and as part of a fixed plan, X sells 25% of the Y stock to an unrelated party. The sale breaks the section 351 control requirement and makes the exchange taxable. The purpose of the sale is to make the transaction taxable, and X's sale of 25% of the Y stock to an unrelated party is done solely for tax reasons. Is the economic substance doctrine relevant? Is the step subject to challenge by the IRS?

Longstanding transaction planning often involves converting a tax-free transaction into a taxable one. Economic substance should not be "relevant" to this transaction, but clarification is needed.

3. 331 Liquidation

P corporation owns all the stock of S corporation. P has a built-in loss in the S stock, and P wants to recognize that loss. If P liquidates S in a section 332 liquidation, the built-in loss disappears. To claim the loss, P first sells 25% of stock to a related foreign affiliate. Subsequently, S is liquidated under section 331. The sale is done solely to recognize a tax loss.

A sale of stock to avoid section 332 historically has been approved by courts, such as in *Granite Trust v. United States*.[15] A recent decision, however, states that *Granite Trust* had been "effectively overruled. . . . at least as to the broad contours of the economic substance doctrine."[16] This uncertainty raises concerns that a 40% penalty could be applied to liquidations designed to fall under section 331 to generate a loss.[17]

4. Acceleration of Income

P corporation has an expiring net operating loss ("NOL"). P sells a built-in gain asset to an affiliate to generate gain and thereby use the expiring NOL and increase the basis of the asset sold. The sole purpose of the sale is to refresh the losses.

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[15] *Granite Trust v. United States*, 238 F.2d 670 (1st Cir. 1956); *see also Commissioner v. Day & Zimmerman*, 151 F.2d 517 (3d Cir. 1945).

[16] *Fidelity International Currency Advisor A Fund LLC v. United States*, No. 05-40151-FDS (D.C. Ma. May 17, 2010).

[17] There may be other rules besides economic substance that could apply to defer a loss. *See* CCA 201025046 (June 25, 2010) (determining that when parent sells more than 20% of its domestic subsidiary's stock to a foreign subsidiary and then liquidates the domestic subsidiary, both the loss from the liquidation and the loss from the sale of stock to the foreign subsidiary are deferred under Treas. Reg. § 1.1502-13 and section 267).

Again, this transaction represents longstanding transaction planning that has generally not been challenged by the IRS. Economic substance should not be "relevant" to this transaction.[18]

II. Substantive Guidance

A. When the Economic Substance Doctrine is "Relevant"

Section 7701(o) mandates the application of a conjunctive economic substance test "[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."[19]

The JCT Technical Explanation describes two general safe harbors consistent with pre-codification standards in determining when an economic substance analysis should be applied. First, the Technical Explanation states 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."[20] Specifically, "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."[21]

Second, the JCT Technical Explanation states 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 meaningful economic alternatives is largely or entirely based on comparative tax advantages."[22] The JCT Technical Explanation provides several examples of these "basic business transactions":

(1) the choice between capitalizing a business enterprise with debt or equity;

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[18] Additional examples may be found in Mark J. Silverman and Jasper L. Cummings, *The Economic Substance Doctrine*, *in* PLI TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2010; Mark J. Silverman and Amanda P. Varma, *The Future of Tax Planning? From* Coltec *to* Schering-Plough, 126 TAX NOTES 341, 2010 TNT 11-9 (Jan. 18, 2010); Mark J. Silverman, Matthew D. Lerner, and Gregory N. Kidder, *A New Form of Obscenity? Sorting Through the Federal Circuit's "We Know it When We See It" Ruling in* Coltec, TAX EXECUTIVE (Nov.-Dec. 2006).

[19] *See* JCT Technical Explanation, *supra* note 13, at 152 (stating that codification "does not change present law standards in determining when to apply an economic substance analysis").

[20] *Id.* at 152, n. 344.

[21] *Id.*

[22] *Id.* at 152.

> (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.[23]

The JCT Technical Explanation states that these examples are "among" the basic transactions the tax treatment of which is not intended to be altered—the list is intended to be "illustrative and not exclusive."[24]

Treasury and the IRS should explain and expand these safe harbors in published guidance.[25] We suggest that guidance provide a presumption that the economic substance doctrine is not "relevant," and thus section 7701(o) does not apply, to transactions falling within these safe harbors. With respect to the first general safe harbor, taxpayers should be entitled to a presumption that their transaction will not be challenged on economic substance grounds if the tax benefits arising from the transaction are "consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate." Guidance should provide that a transaction will be considered to be within this safe harbor if the taxpayer shows that the transaction satisfies the technical rules of a provision and that the tax results are not inconsistent with a Congressional purpose or plan.[26] Treasury and the IRS should also confirm that the safe harbor includes not only tax credits but also deductions and other tax benefits. If a Congressional purpose or plan dictating the tax results is not apparent, the taxpayer could still qualify under the second general safe harbor, described below.

The second general safe harbor should confirm that basic business transactions meeting technical Code requirements and that are generally respected under "longstanding judicial and administrative

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[23] *Id.*

[24] *Id.* at 152 & n. 345.

[25] The use of "safe harbors" in guidance is not uncommon. For example, the final section 355(e) regulations provide a "super safe harbor," safe harbors, and facts and circumstances to be considered in determining whether a distribution and acquisition are part of a plan. *See* Mark J. Silverman and Lisa Zarlenga, *Final Section 355(e) Plan Regulations—The Final Chapter in the Saga*, THE TAX EXECUTIVE (Nov. 2005). The Treasury and IRS should be commended for these regulations, which provide useful guidance to taxpayers in interpreting the broad language of section 355(e). We believe that safe harbors could also be effectively used in providing taxpayers guidance on understanding the broad language and potentially applicability of section 7701(o).

[26] We emphasize that that our proposed safe harbor is intended as a safe harbor from the application of the economic substance conjunctive test and not a separate requirement to be satisfied in order for a transaction to be considered to have economic substance.

practice" will not be subject to challenge under section 7701(o). For example, this safe harbor should confirm that *Cottage Savings Association v. Commissioner* is still good law as a "basic business transaction" respected under "longstanding judicial and administrative practice." Other transactions that have been regularly accepted by courts or not challenged by the IRS on economic substance grounds should similarly fall under this safe harbor.[27]

B. Disaggregation

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 for economic substance. This is consistent with long-standing judicial precedent.[28]

In contrast to the language of section 7701(o)(5)(D) and case law, however, the JCT Technical Explanation 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 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.[29]

We believe that the plain language of section 7701(o)(5)(D) does not "reiterate" disaggregation and should not be construed as Congressional support for the disaggregation approach.[30] This should be confirmed in guidance.

Alternatively, guidance should address the definition of "transaction" and when the economic substance doctrine is considered "relevant." For example, does one determine whether economic substance is relevant by aggregating all related steps in a transaction? Or must certain steps be evaluated separately? Because many bona fide, business-driven transactions may have certain steps that are done only for tax reasons, guidance is necessary to provide taxpayers certainty on whether a

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[27] Additional examples may be found in the authorities cited in footnote 18.

[28] *See, e.g., Commissioner v. Gordon*, 391 U.S. 83 (1968); *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); *Kuper v. Commissioner*, 553 F.2d 152 (5th Cir. 1976); *McDonald's Restaurant of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

[29] JCT Technical Explanation, *supra* note 13, at 153.

[30] *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.").

transaction's tax-driven steps could invalidate the entire transaction for lack of economic substance. In sum, codification of economic substance should not change the long-standing principle of aggregating all related steps in a transaction to determine the substance of the transaction.[31]

C. Penalties: "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 transaction lacking economic substance or "failing to meet the requirements of any similar rule of law."[32] Because taxpayers should not be subject to a strict liability penalty for failing to anticipate what may be considered "similar rule[s] of law" (and thus scrutinize their transactions accordingly), guidance is urgently needed to define the scope of this term. Guidance should provide that an "any similar rule of law" penalty will not apply to a transaction unless section 7701(o) is also applied (i.e., the economic substance doctrine is "relevant" to the transaction).

Guidance should also 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 section 7701(o)). Further, guidance should also provide that "any similar rule of law" does not include statutory or regulatory anti-abuse rules or business purpose requirements.[33] Until guidance is issued, the IRS should not assert penalties for transactions failing to "meet the requirements of any similar rule of law."

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[31] If economic substance is applied to one step of an overall transaction (disaggregation), it is unclear how certain transactions will be evaluated. For example, in *Merrill Lynch*, 120 T.C. 12 (2003), *aff'd* 386 F.3d 464 (2d Cir. 2004), the Tax Court and Second Circuit aggregated various steps (under the step transaction doctrine) to determine that a section 304(a)(1) sale was, in substance, a section 302(a) sale or exchange, and not a section 302(d)/301 distribution. Could the IRS also or alternatively apply economic substance/disaggregation to these series of transactions? How will taxpayers determine which approach is appropriate?

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

[33] In addition to section 7701(o), we have counted over fifty anti-abuse and business purpose requirements in the Code and regulations. *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). Taxpayers should be on notice if the violation of any of these rules could lead to a 40% no-fault penalty.

III. Procedural Guidance

As described below, we recommend that the IRS develop procedures to help alleviate taxpayer uncertainty and ensure that the economic substance doctrine is applied fairly and consistently.

A. Advance Guidance

1. No Action Letter

There is an urgent need for advance certainty on how the economic substance doctrine will apply to contemplated transactions. Because the penalty for transactions determined to lack economic substance (or any other similar provision of law) is strict liability and thus cannot be avoided by obtaining an opinion from counsel, taxpayers should be provided with some mechanism by which they may obtain greater certainty.

To provide taxpayers with increased certainty, the IRS should consider developing a "no action" letter process to provide taxpayers with certainty that their transaction will be not challenged on economic substance grounds.[34] The IRS could require taxpayers to provide information similar to that required for private letter rulings, including a complete statement of facts, copies of relevant documents, and an analysis of material facts.[35] Further, the taxpayer could be required to describe why the economic substance doctrine is not relevant to the transaction, including whether the contemplated transaction should fall under a safe harbor. If the IRS were satisfied that economic substance is not "relevant" to the transaction, it could provide the taxpayer with a letter so stating. The letter could be predicated on the accuracy of the taxpayer's submission and required to be submitted with the taxpayer's return. Because many contemplated transactions for which no-action letters would be sought would likely be fast-moving, the IRS should aim to provide taxpayers with a response in four weeks.

2. Substantive Guidance

In addition to fact-specific guidance, Treasury and the IRS should provide general substantive guidance, as described above, on (a) when the economic substance doctrine is "relevant," (b) the

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[34] *See* U.S. Securities and Exchange Commission, "No Action Letters," *available at* http://www.sec.gov/answers/noaction.htm ("An individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a 'no-action' letter from the SEC staff. Most no-action letters describe the request, analyze the particular facts and circumstances involved, discuss applicable laws and rules, and, if the staff grants the request for no action, concludes that the SEC staff would not recommend that the Commission take enforcement action against the requester based on the facts and representations described in the individual's or entity's original letter.").

Alternatively, the IRS could consider implementing a special program for economic substance related private letter rulings.

[35] Rev. Proc. 2010-4, 2010-1 I.R.B. 122.

significance of the safe harbors in the Joint Committee on Taxation report, (c) the definition of "transaction," and (d) the meaning of "any similar rule of law" under the new penalty provisions. This guidance could take the form of regulations, revenue rulings, and/or notices.

B. Audit Guidance

The IRS should provide audit guidelines to agents that describe when and how section 7701(o) should be applied. Providing these guidelines to agents will be a critical step in promoting the consistent and fair treatment of taxpayers. These guidelines should incorporate or reference the substantive guidance described above. Further, agents should be instructed to (1) determine whether section 7701(o) is "relevant," considering any safe harbors and past judicial and administrative practice, and (2) if economic substance is determined to be relevant, apply the conjunctive analysis of section 7701(o). Audit guidelines should also describe procedures for how the penalty should be asserted, including (as discussed below) a high-level internal review process.

The IRS should also instruct agents that section 7701(o) should be asserted only after relevant technical arguments are made, as it did in its 2005 coordinated issue paper on notional principal contracts.[36] In this paper, the IRS stated:

> Discretion must be exercised in determining whether to utilize an economic substance argument in any case. . . . [e]ven in those cases when it is appropriate to raise the argument, economic substance should only be asserted as a secondary or tertiary argument, following any appropriate technical arguments.

C. Process for Application of Doctrine and Penalty

Treasury and the IRS should issue guidance on how section 7701(o) and the associated no-fault penalty must be asserted by IRS agents. Guidance should state when the doctrine and the potential of any associated penalties must first be raised, how taxpayers can challenge the penalty, and what procedures must be carried out before the penalty is formally assessed.

For example, the IRS should implement an internal review process to approve any assertion of the new no-fault penalty. This review process could be similar to the review process for the assertion of the Treas. Reg. § 1.701-2 partnership anti-abuse rule. Under the partnership anti-abuse rule review process, "the appropriateness of the Treas. Reg. § 1.701-2 determination must be coordinated with the [designated] Issue Specialist and the National Office."[37]

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[36] Coordinated Issue, Notional Principal Contracts (Jan. 6, 2005), *available at* http://www.irs.gov/pub/irs-utl/npc.pdf.

[37] Announcement 94-28, 1994-27 I.R.B. 1; *see also* Internal Revenue Manual 4.35.2.5.2.6 ("Given the Service's broad authorization to recast transactions to reflect the intent of Subchapter K, examiners must coordinate the application of the regulations with both the Partnership Technical Advisors (LMSB — Office of Pre-filing and Technical Guidance) and the IRS National Office. The practice is intended to result in fair and consistent use of the Partnership Anti-Abuse Regulations.").

A review process for economic substance should require chief counsel approval and should provide taxpayers with the opportunity to submit a response on why the penalty should not be applied. This procedure could be based on the prior Senate version of economic substance codification, which provided that the economic substance penalty could be asserted only by chief counsel.[38] The penalty could not be asserted unless, before the assertion of the penalty, the taxpayer was provided with a notice of intent to assert the penalty and an opportunity to present a written response to the proposed penalty within a reasonable period of time.

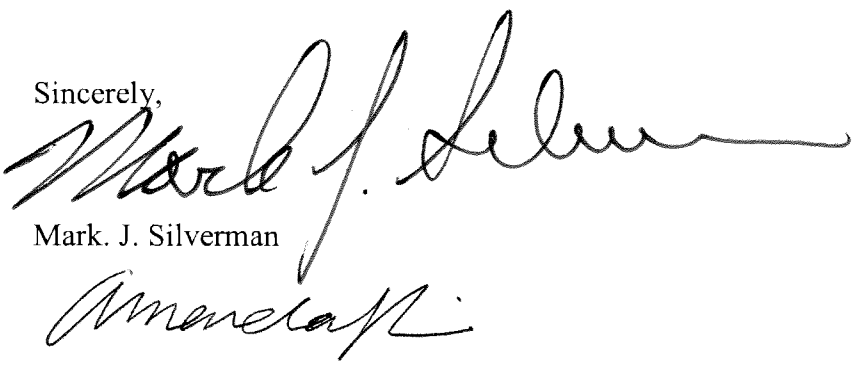
D. Meetings with Professional Organizations

Although several Treasury and IRS officials have stated that codification will not result in major changes in the application of the doctrine besides mandating a conjunctive test, taxpayers and practitioners have many concerns about new section 7701(o). The IRS should meet with professional organizations, such as the Tax Executive Institute, the American Bar Association Tax Section, the New York State Bar Association Tax Section, and the American Institute of Certified Public Accountants, to understand why taxpayers and tax professionals believe there is such an urgent need for guidance, how guidance can best be issued, and how the doctrine should be raised in audits.[39]

IV. **Conclusion**

The newly-codified economic substance doctrine and associated no-fault penalty create substantial uncertainty for taxpayers and tax practitioners. We urge the Treasury and IRS to issue guidance on the important issues described above.

Sincerely,



Mark. J. Silverman

Amanda Pedvin Varma

[38] *See* § 12521, H.R. 2419, Food and Energy Security Act of 2007.

[39] *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, STUDY INTO THE ROLE OF TAX INTERMEDIARIES, ch. 7 (2008) (describing the need for revenue bodies to have a greater commercial awareness to "understand the context within which [tax] planning takes place.").

cc:
The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service

Ms. Emily 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 (Practice and Procedure)
Internal Revenue Service

Ms. Heather Maloy
Commissioner, Large and Mid-Size Business Division
Internal Revenue Service

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

Mr. Donald W. Bakke
Attorney-Advisor - Office of Tax Legislative Counsel
Department of the Treasury