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# IRS LB&I DIVISION ISSUES GUIDANCE TO EXAMINERS ON THE CODIFIED ECONOMIC SUBSTANCE DOCTRINE

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In March 2010, Congress codified the judicial economic substance doctrine in an effort to raise revenue as part of the health care reform legislation.[1] The law provides for strict liability penalties of 20 percent for understated taxes and refund claims that result from transactions that lack economic substance.[2] The strict liability understatement penalty increases to 40 percent for positions the taxpayer does not properly disclose on its tax returns.[3] The Staff of the Joint Committee on Taxation estimated that the effect of codifying the doctrine and imposing the associated penalties will generate approximately $5 billion in tax revenues over the 10 years from 2010 to 2019.[4] This relatively small amount of tax revenue may seem insignificant in the light of health care reform and the overall federal budget over a 10-year period. However, it is difficult to understate the concern that the strict liability penalty aspect of the economic substance legislation has caused among corporate taxpayers, tax planners and advisors. The judicial economic substance doctrine historically created great uncertainty for taxpayers, and for agents charged with enforcement, because it was difficult to predict how the courts would apply it to particular transactions.

Unfortunately, the language of the new code provision does not do much to provide comfort or guidance to taxpayers or agents as to its scope. The code section expressly incorporates by reference from the courts the common law definition of the doctrine of economic substance to the extent the case law is not inconsistent with the new code provision.[5] In addition, the section 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 this subsection had never been enacted."[6] Despite numerous requests for Internal Revenue Service (IRS) written guidance, the IRS Chief Counsel's Office has consistently stated that additional public guidance on when the doctrine is relevant and applicable would not be forthcoming. For example, in Notice 2010-62, released on Sept. 13, 2010, IRS Chief Counsel provided limited guidance on the disclosure requirements and the application of penalties and sought comments regarding the disclosure requirements, but nevertheless stated that "[t]he Treasury Department 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."[7]

This void in guidance regarding the application of the codified economic substance doctrine has been filled, in a more indirect manner, in the form of instructions to IRS auditors. In July 2011, the commissioner of the Large Business and International Division (LB&I) of the IRS evidently recognized this state of uncertainty and issued very helpful guidance to all LB&I examiners.[8] The LB&I Directive provides examiners with a four-step framework for applying the doctrine and requires them to seek guidance from local managers and counsel and obtain approval from a Director of Field Operations (DFO; a high-level IRS manager) in all cases before applying the doctrine.[9]

Before considering the substance of the LB&I Directive, it is useful to review the codification provision to understand the uncertainty inherent in the application of the judicial doctrine. In summary, the codified economic substance doctrine provides that a transaction will not be treated as having economic substance for tax purposes unless (1) it changes the taxpayer's economic position "in a meaningful way" apart from federal income tax consequences, ***and*** (2) the taxpayer had a "substantial purpose" for entering the transaction apart from federal income tax consequences.[10] If a taxpayer relies on the profit potential to pass this conjunctive test, the new section clarifies that the present value of the "reasonably expected pre-tax profit" potential must be "substantial" in relation to the expected tax benefits. Given the fact that the doctrine incorporates by reference a large, amorphous body of common-law cases and turns on such words as "meaningful," "substantial" and "reasonably expected," it is easy to see how inconsistently it could be administered from agent to agent and taxpayer to taxpayer.

More importantly, there has been substantial uncertainty regarding the threshold question of whether the doctrine is even relevant to particular situations, and the doctrine as codified does little to resolve this uncertainty. Traditionally, the

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doctrine of economic substance was applied in cases where taxpayers sought to take advantage of tax incentives or tax benefits that were based on literal provisions in the Internal Revenue Code (the "Code") but that Congress nevertheless did not intend to be extended as far as the particular transaction at issue. The line was drawn by the courts at the limit of congressional intent. The Supreme Court, in *Gregory v. Helvering,* described the operative question as follows: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[11] This line-drawing exercise between the literal language in the Code and the limits of congressional intent has always created uncertainty. The Tax Bar and others have requested "angel lists" of transactions that will be respected, but IRS Chief Counsel has not provided any such guidance.[12]

The LB&I Commissioner's Directive goes a long way to address the potential for inconsistent administration of the economic substance doctrine and its inherent uncertainty by providing a workable and easy-to-understand four-part framework for its application. First, the Directive requires an agent to evaluate whether the application of the doctrine is "likely not appropriate" in light of facts and circumstances derived from case law and prior administrative sources that tend to indicate that the application of the doctrine is not appropriate. The Directive lists 18 facts and circumstances to consider. A few examples include that the transaction: was not "promoted/developed/administered" by the company's tax department or tax advisors, was not "highly structured," contains no "unnecessary steps," does not "accelerate a loss or duplicate a deduction," and was not "outside the taxpayer's ordinary course of business." Additionally, the Directive identifies four situations in which the application of the doctrine is likely not appropriate: (1) if the transaction involves a choice between capitalizing a business enterprise with debt or equity; (2) if the transaction involves a choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) if the transaction or series of transactions constitute a corporate organization or reorganization; or (4) if the transaction involves the choice to use a related party and the arm's-length standard for transfer pricing under section 482 is met.

Second, if the IRS agent has considered all of the facts and circumstances described in the first step and still thinks that it may be appropriate to apply the doctrine of economic substance, the agent must consider facts and circumstances that indicate that it is appropriate to apply the doctrine. The Directive provides 17 facts and circumstances that are the inverse of the factors considered in the first step. For example, if the transaction is "promoted/developed/administered" by the company's tax department or tax advisors, this is a factor that may indicate it is appropriate to apply the doctrine.

Third, after the agent analyzes the first two steps and determines that it may be appropriate to apply the doctrine of economic substance, the agent must answer seven numbered questions. If the answer to any of the questions 1 through 4 or 7 is "yes," the agent must consult with a local manager and local counsel before pursuing the application of the doctrine any further. If the answer to question 5 or 6 is "yes," the agent is instructed not to apply the doctrine. Discussion of all the questions is beyond the scope of this article, but there are some interesting and revealing things about the two categories of questions that are worthy of note here. One particularly interesting example is question number 7, which reads as follows: "In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel." Taxpayers have complained for years that the IRS uses the economic substance doctrine as a sledgehammer to attack tax-motivated transactions when technical arguments involving the operative Code provisions would suffice. It is encouraging to corporate taxpayers that the LB&I Commissioner's Directive requires agents to consider whether the application of the doctrine better serves tax administration than a technical argument and to involve management and counsel in the decision.

Other particularly noteworthy questions the agent must address in step 3 of the overall framework are questions 5 and 6, which require the agent to consult a local manager and counsel to consider whether other judicial doctrines that are similar to the economic substance doctrine (question 5) or re-characterization of the transaction (question 6) are more appropriate to the circumstances than the economic substance doctrine. If upon consultation with a manager and local counsel the agent determines that the use of a similar judicial doctrine (*e.g.*, substance over form or step-transaction) or re-characterization (*e.g.*, from debt to equity) would be more appropriate than the economic substance doctrine, the agent is instructed not

to apply the economic substance doctrine. These restrictions on agents' authority are noteworthy because they narrow the scope of the strict liability penalty provisions that were passed along with the codification of the economic substance provision. New Internal Revenue Code section 6662(b)(6) provides for a strict liability penalty for an underpayment attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) ***or failing to meet the requirements of any similar rule of law***."[13] The excessive refund penalty provision at Internal Revenue Code section 6676(c) incorporates this language by reference, making it clear that strict liability applies in the refund penalty setting as well. The highlighted language in the section 6662(b)(6) strict liability provision arguably refers to the application of similar doctrines like the step-transaction doctrine or re-characterization that often are applied by courts in tandem with the economic substance doctrine. At least for the time being, LB&I, through its Directive, has limited its discretion to apply the economic substance doctrine strict liability penalty when application of other judicial doctrines or re-characterization would be more appropriate.

The fourth and final step in the LB&I Directive requires an agent in consultation with a local manager and counsel to submit a written application to the DFO detailing how the factors in steps 1 and 2 were considered and how the questions in step 3 were answered before the doctrine can be applied. The ultimate decision whether to apply the doctrine resides with the DFO, but the DFO must consult with counsel and give the taxpayer an opportunity to respond before finalizing the decision.

The detailed and iterative process and multiple levels of review, consultation and approval required in the LB&I Directive should give large corporate taxpayers some comfort that LB&I agents will appropriately exercise discretion and restraint in applying the codified doctrine of economic substance. Furthermore, taxpayers should be pleased that the Directive effectively limits the strict liability penalties to cases in which other judicial doctrines or approaches such as re-characterization are not more appropriate than economic substance. The Directive reflects well on current IRS management. However, taxpayers should note that the Directive is not formal guidance and can be revoked, expanded or otherwise changed at any time. ◂

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END NOTES

1. Health Care and Education Reconciliation Act of 2010, Pub. Law. No. 111-152.
2. *See* I.R.C. § 6662(b)(6) for underpayment penalties and I.R.C. § 6676(c) for refund claim penalties. The underpayment penalty is a strict liability penalty pursuant to I.R.C. § 6664(c)(2), which provides that a reasonable cause defense *does not apply. The refund penalty is a strict liability penalty pursuant to I.R.C. § 6676(c), which provides as a matter of course that a tax position that lacks economic substance does not have a reasonable basis.*
3. *See* I.R.C. § 6662(i).
4. *See* Joint Committee on Taxation Staff Explanation of Tax Legislation Enacted in the 111th Congress, Appendix: Estimated Budget Effects of Tax Legislation Enacted in the 111th Congress.
5. *See* I.R.C. § 7701(o)(5)(A), defining the doctrine as follows: "The term 'economic substance doctrine' means 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 business purpose."
6. I.R.C. § 7701(o)(5)(C).
7. Notice 2010-62, 2010-40 I.R.B. 411 (Sep. 13, 2010). This Notice prompted a flurry of comments, including comments from the American Bar Association, *http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2011/011811comments.authcheckdam.pdf;* the New York Bar Association, *http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1228-rpt.pdf;* and the American Institute of Certified Public Accountants, *http://www.aicpa.org/InterestAreas/Tax/Resources/StandardsEthics/OtherAICPAStandardsEthicsRules/DownloadableDocuments/Economic_Substance_Comments.pdf.*
8. *See* LB&I Directive for Industry Directors, LB&I Control No: LB&I-4-0711-015 (July 15, 2011), from Heather C. Maloy, Commissioner, Large Business & International Division.
9. An earlier Directive issued on Sept.14, 2010, (LB&I Directive, LMSB-20-0910-024), required examiners to obtain approval from their Director of Field Operations before imposing a penalty based on the economic substance doctrine. Interestingly, this earlier Directive was issued one day after Notice 2010-62, in which Chief Counsel gave notice that Treasury and the IRS would not issue guidance on the types of transactions to which the doctrine would be applied. *See supra.*
10. *See* I.R.C. § 7701(o)(1)(A) and (B).
11. 293 U.S. 465, 469 (1935) (citations omitted).
12. *See, e.g.,* the comments from the New York Bar Association, American Institute of Certified Public Accountants, and New York Bar Association referenced above in Note 7.
13. I.R.C. § 6662(b)(6) (emphasis added).