

IRS Issues Guidance on the Application of the Codified Economic Substance Test

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In March of last year, the Health Care and Education Reconciliation Act of 2010 (the "2010 Act") reconciled a long standing conflict among the circuit courts regarding the scope of the economic substance doctrine and codified the test in section 7701(o) of the Internal Revenue Code of 1986, as amended (the "Code"). The statute generally provides that certain tax benefits are not allowable if a transaction does not have economic substance and a transaction shall be treated as having economic substance only if—

- (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction (the "Codified Economic Substance Doctrine").

The 2010 Act also imposed a penalty on any underpayment attributable to the disallowance of claimed tax benefits from transactions lacking economic substance or failing to meet the requirements of any similar rule of law (the "Economic Substance Penalty"). The strict liability penalty is imposed at a rate of 20 percent but is increased to 40 percent if the taxpayer fails to adequately disclose the relevant facts relating to the transaction. The Codified Economic Substance Doctrine is discussed, in further detail, in the [Bracewell client alert](#) dated April 1, 2010.

The Codified Economic Substance Doctrine includes a two-prong test for identifying transactions with economic substance. However, Code section 7701(o) does not include detailed guidance with respect to the scope of transactions subject to the Codified Economic Substance Doctrine or how to interpret the requirements for finding economic substance. Instead, it provides that the determination of whether the Codified Economic Substance Doctrine is relevant shall be made in the same manner as if such Code section had never been enacted. That is, taxpayers should look to prior administrative and judicial guidance not inconsistent with the Codified Economic Substance Doctrine.

In September 2010, the Internal Revenue Service ("IRS") released Notice 2010-62 (the "Notice") providing limited clarification with respect to certain aspects of Code section 7701(o) and the related penalty provision. The Notice, however, also stated that neither the Treasury Department nor the IRS intends to issue general administrative guidance regarding the types of transactions to which the Codified Economic Substance Doctrine does or does not apply and the IRS will not issue private letter rulings or determination letters with respect to whether economic substance is relevant to any transaction or whether any transaction complies with the requirements set forth in Code section 7701(o). In the same month, the IRS Large and Midsize Business Division ("LMSB"), issued a directive (the "2010 LMSB Directive") that, to ensure consistent administration of the Economic Substance Penalty, any proposed penalty must be reviewed and approved by the appropriate Director of Field Operations ("DFO"). No further guidance was given as to how a DFO should evaluate proposed penalties for transactions lacking economic substance.

This limited guidance has left taxpayers and tax practitioners without clarity as to the intended scope of Code section 7701(o) or if any transactions are exempt from its application. Since its release, taxpayers and tax practitioners have expressed their desire for greater clarification as to the factors relevant in determining when the Codified Economic Substance test is met and whether any safe harbors exist. The new guidance released this month provides some insight into the factors the IRS will consider when imposing Economic Substance Penalties.

The New Guidance

The LMSB directive issued July 15, 2011 ("[2011 LMSB Directive](#)") expands the guidance contained in the 2010 LMSB Directive and instructs examiners and their managers how to determine when it is appropriate to seek the approval of the DFO for the imposition of Economic Substance Penalties. There are a number of significant features of the 2011 LMSB Directive that likely will have the effect of limiting the imposition of Economic Substance Penalties. First, the 2011 LMSB Directive provides that, until further guidance is issued, the Economic Substance Penalty only should be imposed with respect to tax benefits from transactions that fail to satisfy the Codified Economic Substance Doctrine and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

Second, the 2011 LMSB Directive appears to create four safe harbors by stating it likely is not appropriate to apply the Codified Economic Substance Doctrine with respect to:

- The choice between capitalizing a business enterprise with debt or equity;
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
- The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C of the Code; or
- The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of Code section 482 and other applicable concepts are satisfied.

This list of transactions likely excluded from the application of the Codified Economic Substance Doctrine is not new. The Joint Committee report issued in connection with the enactment of Code section 7701(o) (the "Joint Committee Report") noted that the section was not intended to alter the tax treatment of certain basic business transactions that generally were respected merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. The Joint Committee Report listed all four of the transactions above as included within such transactions not intended to be subject to analysis under the Codified Economic Substance Doctrine.

Third, the 2011 LMSB Directive also provides some assurance that transactions motivated by the opportunity to earn tax credits, including energy credits, may not be appropriate cases for the application of the Codified Economic Substance Doctrine. The directive includes within the list of facts and circumstances that tend to show the application of the doctrine is not appropriate, transactions that generate targeted tax incentives, in form and substance, consistent with Congressional intent in providing the incentives. Further, the directive instructs examiners reviewing transactions that involve tax credits designed to encourage transactions that likely would not be undertaken if such credit were not available to not pursue Economic Substance Penalties with the DFO unless the examiner first gets the approval of his or her manager in consultation with local counsel. This is consistent with the Joint Committee Report position that if the realization of tax benefits from a transaction 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. Examples of such tax benefits include energy credits.

Lastly, the 2011 LMSB Directive lists a number of inquiries examiners must undertake before recommending the imposition of Economic Substance Penalties. These inquiries, discussed in greater detail below, require consultation with managers and local counsel before recommending the application of the Codified Economic Substance Doctrine for transactions already subject to detailed statutory provisions, including transactions involving tax elections or credits, or when another judicial doctrine or recharacterization may be more appropriate to address the asserted understatement. These investigations should have the effect of barring a number of transactions from recommendation to the DFO for imposition of Economic Substance Penalties.

The remainder of the 2011 LMSB Directive sets forth a process for an examiner to establish a case for the imposition of an Economic Substance Penalty. The examiner is instructed to evaluate whether the circumstances in the case are those under which application of the Codified Economic Substance Doctrine likely is or is not appropriate. Next, if the examiner determines it is appropriate, he or she will undertake a series of inquiries before seeking approval to apply the doctrine. Finally, the directive provides procedures for requesting DFO approval for Economic Substance Penalties if the examiner and his or her manager and territory manager determine that application of such penalties is merited. If an examiner wants to apply this guidance separately to one or more steps with a common objective, the examiner is required to seek guidance from his or her manager and consult with local counsel before doing so.

Some of the factors that should be examined to determine whether the Codified Economic Substance Doctrine should be applied are, whether or not:

- the transaction is highly structured;
- the transaction contains unnecessary steps;
- the transaction is at arm's length with unrelated third parties;
- the transaction creates a meaningful economic change on a present value basis (pre-tax);
- the taxpayer's potential for gain or loss is artificially limited;
- the transaction accelerates a loss or duplicates a deduction;
- 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);
- the taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- the transaction involves a tax-indifferent counterparty that recognizes substantial income;
- the transaction results in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- the transaction has a credible business purpose apart from Federal tax benefits;
- the transaction has meaningful potential for profit apart from tax benefits;
- the transaction has significant risk of loss;
- a tax benefit is artificially generated by the transaction;
- the transaction is pre-packaged; or
- the transaction is outside the taxpayer's ordinary business operations.

If, after examining the factors set forth in the 2011 LMSB Directive, an examiner believes that the application of the Codified Economic Substance Doctrine may be appropriate, the examiner must answer the following series of inquiries before seeking the approval of his or her DFO to apply the doctrine:

- Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
- Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
- Does precedent exist (judicial or administrative) that either rejects the application of the Codified Economic Substance Doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
- Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
- Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the Codified Economic Substance Doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.
- Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.
- 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.

If, after completing these inquiries, the examiner still believes it is appropriate to apply the Codified Economic Substance Doctrine, the examiner, in consultation with his or her manager and territory manager, should present the matter to the appropriate DFO. The DFO is instructed to consider an examiner's request for the application of the doctrine by reviewing the written analysis provided and consulting with counsel before reaching a conclusion. If the DFO believes it is appropriate to permit the examiner to apply the Codified Economic Substance Doctrine, the DFO should provide the taxpayer an opportunity to explain its position, either in writing or in person (at the DFO's discretion), addressing whether the doctrine should be applied to a particular transaction.

Conclusion

The 2011 LMSB Directive should have the effect of limiting the application of Economic Substance Penalties. Specifically, the directive (i) instructs examiners to limit the imposition of the Economic Substance Penalty to understatements relating to the Codified Economic Substance Doctrine and not similar rules of law, (ii) identifies certain common transactions to which the Codified Economic Substance Doctrine likely should not apply, (iii) creates specific factors to consider when identifying transactions with tax benefits appropriately challenged under the Codified Economic Substance Doctrine and subjects the examiner's application of such factors to internal review, and (iv) requires the examiner to inquire whether the transaction subject to examination is a type of transaction that likely should not be subject to analysis under the Codified Economic

Substance Doctrine before presenting it to the DFO for review. Each of these steps should exclude some portion of the transactions subject to challenge under the Codified Economic Substance Doctrine and thereby limit the underpayments for which Economic Substance Penalties ultimately are assessed.

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