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New Guidance for Examiners and Managers on the Application of the Economic Substance Doctrine

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The economic substance doctrine (ESD) was codified in March 2010 in the Health Care and Education Reconciliation Act of 2010 (HERA) as code section 7701(o), along with a new strict liability penalty of 20 percent, increased to 40 percent if adequate disclosure is not made on any underpayments attributable to transactions lacking economic substance or transactions that fail the requirements of any similar rule of law. The penalty is a strict liability penalty, not subject to any reasonable cause or good faith defenses.

Interim Guidance-Notice 2010-62

On September 13, 2010, the Internal Revenue Service (IRS) released Notice 2010-62 (the Notice) providing limited interim guidance with respect to imposition of the ESD and the related penalty provision. In addition, the Notice stated that neither the Treasury Department nor the IRS intends to issue general administrative guidance regarding the types of transactions to which the ESD 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). Following the issuance of the Notice, the IRS Large Business & International Division (LB&I) — previously known as the Large & Midsize Business Division — issued a directive that, to ensure consistent administration of the economic substance penalty, stated that the appropriate director of field operations (DFO) must review and approve any proposed penalty.

Guidance for Managers and Examiners-LB&I-04-0711-015-General

On July 15, 2011, the LB&I expanded its previous guidance and issued new guidance for managers and examiners on determining when it is appropriate to seek the approval of the DFO in order to raise the ESD. The directive contains a four-step process that the examiner and manager must work through, before seeking the DFO approval to raise the ESD. The directive mandates that the examiner notify a taxpayer as soon as possible about the examiner considering whether or not to apply the ESD, but not later than when the examiner begins the analysis as described in the steps below. The directive suggests that the IRS will consider a series of interconnected steps with a common objective to be a single "transaction." But, it states "[i]n certain circumstances, it may be appropriate to apply this guidance separately to one or more steps that are included within a series of arguably interconnected steps." The directive also states that until further guidance is issued, the ESD penalty should be imposed only with respect to tax benefits from transactions that fail to satisfy the ESD and should not be imposed due to the application of any other "similar rule of law" or judicial doctrine.

Step 1

Step 1 lists the facts and circumstances surrounding the matter that the examiner should evaluate in determining whether the application of the ESD is not appropriate. Included among the factors indicating that the application of the ESD is not

appropriate are that a tax department or outside adviser not promote the transaction, is not highly structured, does not contain unnecessary steps, is at arm's length with unrelated third-parties, carries a significant risk of loss and is not outside the taxpayer's ordinary business operations.

The directive also separately lists in Step 1 the four types of transactions that were listed in the Joint Committee on Taxation Report, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010 (JCX-18-10) as transactions to which it is likely not appropriate to apply the ESD. Those transactions involve:

- 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; and
- 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.

Step 2

Step 2 contains the facts and circumstances that the examiner should evaluate in determining whether the application of the ESD is appropriate. Many factors contained in Step 2 are the direct opposite of those in Step 1. These factors contain whether the transaction includes unnecessary steps, accelerates a loss or duplicates a deduction, does not have a credible business purpose apart from the federal tax benefits, does not have a significant risk of loss and is outside the taxpayer's ordinary business operations.

The directive does not give any guidance to the examiner in the event the factors in both Step 1 and 2 indicate that the ESD may be applicable and may not be applicable. In addition, the directive does not state the relative weight of each factor and whether certain factors count more than others. Finally, the factors are very broad, which may result in the IRS applying the ESD to transactions that are a part of everyday tax planning.

Step 3

If, after examining the factors set forth in Steps 1 and 2 of the directive, an examiner believes that the application of the ESD may be appropriate, Step 3 requires that the examiner answer a series of inquiries before seeking the approval of the examiner's DFO to apply the doctrine. For example the examiner has to answer whether the transaction is a statutory or regulatory election, whether the transaction is subject to a detailed statutory or regulatory scheme, whether the transaction involves tax credits that Congress has designed to encourage certain transactions, whether precedent exists that rejects the application of the ESD to the type of transaction or whether another judicial doctrine, such as form versus substance, applies. With respect to certain inquiries, the examiner is instructed to obtain the approval of the examiner's manager in consultation with local counsel before pursing the application of the doctrine. With respect to other inquiries, the examiner is instructed to seek the advice of the examiner's manager in consultation with local counsel in determining the answer to the inquiry.

Step 4

If, after completing these inquiries, the examiner still believes it is appropriate to apply the ESD, Step 4 requires that the examiner, in consultation with their manager and territory manager, present the matter to the appropriate DFO. In seeking the examiner's DFO approval, the examiner must submit a written analysis of how the guidance in the previous steps was completed. 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 ESD, 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. Finally, the DFO is instructed to convey its final decision to the examiner in writing.

The inquiries that examiners must undertake and the consultation with managers and local counsel that is required before recommending the application of the ESD should put a damper on the number of transactions recommended to the DFO for the application of the ESD.

Conclusion

Although the directive is for IRS examiners, it also goes a long way in providing guidance to taxpayers about how the IRS intends to apply the ESD. Most importantly, the directive requires the examiner to give the taxpayer notice that the examiner is considering the application of the ESD and requires the DFO to give the taxpayer the opportunity to present either in writing or in person the taxpayer's position if the DFO approves the examiner's request to apply the ESD.

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