Economic Substance Doctrine: New Directive for IRS Examiners and Managers

LB&I Directive Sets Out Detailed Substantive and Procedural Standards for IRS Examiners to Follow – This Provides Valuable Information to Taxpayers and Their Advisors

SUMMARY

The Commissioner of the Large Business and International Division of the IRS ("LB&I") recently issued a directive (the "Directive") to LB&I examiners and managers setting out specific analytical steps that the examiners must complete before asserting the newly codified economic substance doctrine with respect to a particular transaction. The Directive establishes a detailed four-step analysis that an examiner must complete, and fully document, before asserting the new strict liability penalty that applies when an underpayment is determined to be attributable to a failure to satisfy the codified economic substance doctrine.

Even though the Directive states that it "is not an official pronouncement of law, and cannot be used, cited, or relied upon as such", the Directive is a significant development for taxpayers for numerous reasons, including:

- The fact that LB&I is taking steps to ensure that the new statute is applied consistently and fairly across the country is positive and should benefit taxpayers and the IRS alike.

- The Directive states that, until further guidance is issued, the new strict liability penalties will not be imposed based on other doctrines pursuant to the "similar rule of law" clause of the new economic substance penalty rule. This should alleviate (at least until further guidance is issued) the concerns taxpayers and practitioners had expressed over use (and potential misuse) of this aspect of the new rules.

- The Directive gives the first guidance on how to define the "transaction" for this purpose and, significantly, instructs examiners to define the transaction to include the entire transaction, and require an IRS examiner to obtain approval from his or her manager and local counsel to look at any steps in isolation.
The questions an examiner must ask in Step 3 (prior to asking for permission to apply the doctrine) may lead the examiner away from relying on the economic substance doctrine when it is not necessary (either because there is a more appropriate judicial doctrine or an alternative strong argument that can be used).

Although the Directive does not include an actual “angel list” of specific types of transactions to which the economic substance doctrine should not be applied, it does in several places indicate that it is likely not appropriate to apply the doctrine to certain types of transactions (including those already subject to a “detailed statutory or regulatory scheme” or those that have previously been challenged on other grounds) or certain business decisions (such as whether to capitalize a corporation with debt or equity and whether to structure a transaction to fit within the tax-free reorganization rules of subchapter C).

Overall, the Directive seems to lean towards not using the economic substance doctrine. For example, the Directive gives LB&I examiner multiple opportunities to find another, more appropriate, way of approaching the transaction (whether it be recharacterization or a different un-codified judicial doctrine); and at various decision points (if a particular circumstance exists that leans towards not applying the doctrine) instructs the examiner not to continue to pursue the doctrine without manager and counsel approval.1

Although the Directive is not enforceable by taxpayers and does not authorize taxpayers to use the same analysis in reviewing proposed transactions, or in preparing a defense to an actual or proposed economic substance challenge, it is all but certain that taxpayers will use the Directive in that way.

BACKGROUND

In 2010, the economic substance doctrine was codified (added to the Internal Revenue Code), along with a related new penalty provision. The new law, which applies to transactions entered into after March 30, 2010, provides that:

[i]n the case of any transaction to which the economic substance doctrine is relevant, such 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 the transaction.2

Under the new penalty rule, any underpayment attributable to a disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any “similar

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1 It is interesting that, while the new statute provides that the economic substance doctrine is to be applied when it is “relevant”, the Directive instructs LB&I examiners to evaluate whether applying the doctrine is “appropriate”.

2 Section 7701(o)(1). Unless otherwise noted, all Section references contained in this memorandum are to the Internal Revenue Code of 1986, as amended. A discussion of the economic substance doctrine can be found in the Sullivan & Cromwell LLP publication entitled “IRS Issues Notice on Codification of the Economic Substance Doctrine” (September 14, 2010), which may be obtained by following the instructions at the end of this publication.
rule of law" is subject to a strict liability penalty of 40% (reduced to 20% if the transaction was adequately disclosed in the filed tax return).\(^3\)

An LB&I directive issued in September 2010 required an IRS examiner to obtain approval of the appropriate IRS Director of Field Operations (the “DFO”)\(^4\) before challenging a transaction on the basis of the economic substance doctrine (and thus asserting the new strict liability penalty). This Directive expands upon that prior directive by providing a detailed four-step analysis that an LB&I examiner must complete and document before seeking the DFO’s approval.

**DISCUSSION**

**Determining that the Four-Step Analysis Should Be Undertaken**

The Directive sets out four steps that an LB&I examiner must complete “to determine when it is appropriate to seek the approval of the DFO in order to raise the economic substance doctrine”. The Directive states that, once an examiner “determines that raising the doctrine may be appropriate”, the examiner must use the steps below to determine whether it should seek approval to actually raise it. The Directive does not provide any more detail on how an examiner would reach the initial decision that the doctrine may be appropriate.

**Notifying the Taxpayer**

Importantly, the Directive instructs that LB&I examiner “should notify a taxpayer that the examiner is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins” the four-step analysis described in the Directive.

**“The Transaction” to Which the Four-Step Analysis Is to Apply**

The Directive provides guidance to LB&I examiners on defining the transaction to which the four-step analysis should be applied.\(^5\) The Directive essentially provides a general rule, and then an exception:

**The General Rule:** when a transaction involves a series of interconnected steps with a common objective, the “transaction” refers to all the steps taken together.

**The Exception:** in certain situations, it may be appropriate to apply the Directive’s analysis separately to one or more steps that are included within a series of arguably interconnected steps. The Directive states that this may be the case when “an integrated transaction includes one or more tax-motivated steps that bear only a minor or incidental relationship to a single common business or financial transaction”.

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\(^3\) Section 6662(i)(1); section 6662(b)(6).

\(^4\) DFOs are the second-highest officials in each Industry Group within LB&I, second only to the Director, and there are currently only 12 DFOs.

\(^5\) As illustrated in many court decisions, defining the “transaction” is often of paramount importance in determining the outcome of an economic substance analysis.
However, in order to proceed under this “Exception” (i.e., to apply the analysis to one or more separate steps), LB&I examiner must first seek guidance from his or her manager and consult with local counsel from the IRS Office of Chief Counsel.

**STEP 1: DOCTRINE LIKELY NOT APPROPRIATE**

In Step 1, an LB&I examiner should evaluate whether the circumstances in the case are those under which applying the economic substance doctrine to a transaction is “likely not appropriate”. This involves the following list of factors set out in the Directive, under the heading “Doctrine Likely Not Appropriate”:

1) Transaction is not promoted/developed/administered by tax department or outside advisors;
2) Transaction is not highly structured;
3) Transaction includes no unnecessary steps;
4) Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives;
5) Transaction is at arm’s length with unrelated third parties;
6) Transaction creates a meaningful economic change on a present value basis (pre-tax);
7) Taxpayer’s potential for gain or loss is not artificially limited;
8) Transaction does not accelerate a loss or duplicate a deduction;
9) Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
10) Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction;
11) Transaction does not involve a tax-indifferent counterparty that recognizes substantial income;
12) Transaction does not result in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
13) Transaction has credible business purpose apart from federal tax benefits;
14) Transaction has meaningful potential for profit apart from tax benefits; \(^6\)
15) Transaction has significant risk of loss;
16) Tax benefit is not artificially generated by the transaction;
17) Transaction is not pre-packaged;
18) Transaction is not outside the taxpayer’s ordinary business operations; or
19) The transaction relates to:
   a) the choice between capitalizing a business with debt or equity,
   b) a U.S. person’s choice between making a foreign investment through a foreign corporation or a domestic corporation,

\(^6\) In listing these factors, the Directive refers to “federal tax” in certain places and “tax” in others. We have repeated that above. Whether the use of “tax” is intended to refer to other taxes is not clear.
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c) the choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C of the Internal Revenue Code, or
d) the choice to use a related party in a transaction, provided that the transaction satisfies the arm’s length standard of IRC section 482 and other applicable concepts.\(^7\)

The Directive specially states that even if some of the factors set out above apply, and LB&I examiner continues to believe that applying the doctrine is appropriate, then the examiner should proceed to the remaining steps.

**STEP 2: DOCTRINE MAY BE APPROPRIATE**

In Step 2, LB&I examiner should evaluate whether the circumstances in the case are those under which applying the doctrine to the transaction “may be appropriate”. These 17 factors are the exact converse of the 19 factors listed above under “Doctrine Likely Not Appropriate”, excluding factors 4 and 19.

**STEP 3: IN-DEPTH INQUIRIES BEFORE REQUESTING DFO APPROVAL**

In Step 3, the examiner must answer a series of questions apparently intended to reduce the circumstances in which the economic substance doctrine is asserted. These questions include, among others:

- Is the transaction subject to a detailed statutory or regulatory scheme, or has the transaction been upheld in judicial or administrative precedent without reference to the doctrine?

If the answer is “yes” to any of these types of questions, the Directive provides that LB&I examiner may not apply the doctrine without specific approval of the examiner’s manager in consultation with local counsel from the IRS Office of Chief Counsel.

- Does another judicial doctrine (e.g., substance over form or step transaction) or recharacterization of the transaction (e.g., recharacterizing debt as equity, recharacterizing one party 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, then an LB&I examiner should apply the more appropriate doctrine, or recharacterize the transaction, as appropriate.

- 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 an LB&I examiner may not apply the doctrine without specific approval of the examiner’s manager in consultation with local counsel from the IRS Office of Chief Counsel.

\(^7\) This list of four circumstances is as close as the IRS has come to issuing an “angel list”.

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STEP 4: PROCEDURE FOR REQUESTING DFO APPROVAL

If, after completing Steps 1 through 3, LB&I examiner concludes that seeking approval to apply the economic substance doctrine is appropriate, then the examiner should undertake Step 4. In Step 4, the examiner should, after consultation with the examiner’s manager and territory manager, submit to the appropriate DFO a written report describing how the examiner completed the three steps set out above.

With respect to the DFO, the Directive provides:

- the DFO should review the report and consult with the IRS Office of Chief Counsel before deciding whether to approve the request to apply the doctrine to the transaction;
- if the DFO believes that approving the request is appropriate, then the DFO should provide the taxpayer an opportunity, either in writing or in person (at the DFO’s discretion), to explain the taxpayer’s position as to whether the doctrine should apply to the transaction;\(^8\) and
- the DFO should convey the final decision to the examiner in writing.\(^9\)

NEW STRICT LIABILITY PENALTY TO BE APPLIED ONLY TO ECONOMIC SUBSTANCE, NOT “SIMILAR RULE OF LAW”

The Directive states that, until further guidance is issued, the new harsh strict liability penalties will not be imposed pursuant to the “similar rule of law” clause of the new penalty rule (e.g., when step transaction, substance over form, or sham transaction doctrine is applied).

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\(^8\) Whether the taxpayer must (or even should) follow the Directive’s three-step analysis is not addressed.

\(^9\) The Directive does not address whether this writing should be shared with the taxpayer.
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