

February 2, 2015

Emily S. McMahon
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: **Request for Substantive Guidance on Codified Economic Substance Doctrine**

Dear Ms. McMahon:

Thank you for taking the time to meet on December 22, 2014 to discuss guidance relating to the economic substance doctrine as codified under section 7701(o).¹ We commend the efforts of the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) in issuing Notice 2014-58, 2014-44 I.R.B. 746, and we appreciate your willingness to consider additional guidance to clarify the application of the economic substance doctrine.

I. Recommendations

As discussed during the meeting, we recommend that Treasury and the IRS issue substantive guidance on which taxpayers and practitioners can rely regarding whether the economic substance doctrine is “relevant” to a transaction. We also recommend guidance to clarify statements in Notice 2014-58 regarding the “similar rule of law” standard in section 6662(b)(6).

In 2011, the IRS issued LB&I-4-0711-015 (the “LB&I Directive”), which is helpful in focusing on key facts to consider in the economic substance analysis, but unfortunately does not serve as guidance to taxpayers.² We believe the substance of the LB&I Directive can be refined and adopted in published guidance to aid in the critical threshold determination of whether the economic substance doctrine is “relevant” to a transaction. Guidance on this subject is especially important because of the strict liability penalty that applies uniquely to transactions that violate the economic substance doctrine and similar rules of law.

Substantive guidance would reduce uncertainty and controversy and consequently would save resources, both for the government and for a wide range of taxpayers, including individuals and large and small businesses. In the absence of this guidance, there is no common ground for assessing the applicability of the economic substance doctrine. The guidance would assist practitioners in rendering well considered advice and opinions, financial auditors in their determinations regarding the proper financial accounting treatment of transactions, and taxpayers

¹ Section references are to the Internal Revenue Code of 1986, as amended.

² The LB&I Directive states that it “is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.”

in understanding the advice received. Such guidance could be issued as administrative guidance in the form of a notice that cross-references parts of the LB&I Directive.

II. Suggested Content of Guidance

A. Relevance

It is acknowledged that the application of the economic substance doctrine is inherently factual. We therefore recommend that a number of the factors and inquiries identified in the LB&I Directive be adopted in guidance that implements a facts and circumstances test for analyzing whether the economic substance doctrine is relevant to a particular transaction. The guidance could adopt the approach of the LB&I Directive by identifying particular facts and circumstances to show that the economic substance doctrine either is or is not relevant.

A list of facts and circumstances suggesting that the economic substance doctrine is not relevant could be developed based on the factors and basic business transactions identified in Step 1 of the LB&I Directive. Similarly, a list of facts and circumstances suggesting that the economic substance doctrine is relevant could be developed based on the factors identified in Step 2 of the LB&I Directive. Some of the inquiries in Step 3 of the LB&I Directive could be redrafted as additional facts and circumstances tending to show that the economic substance doctrine is or is not relevant.³ The guidance should specify that the lists of factors are not exclusive, and that the mere counting of favorable and unfavorable factors is not determinative of whether the economic substance doctrine is or is not relevant.

The lack of official legislative history of section 7701(o) adds to the uncertainty regarding the application of the economic substance doctrine. The Technical Explanation of section 7701(o) and related provisions, prepared by the Staff of the Joint Committee on Taxation (the “JCT Technical Explanation”),⁴ provides a detailed analysis of the intended application of section 7701(o). We recommend that the guidance include a statement that the IRS will consider the JCT Technical Explanation as authority on which taxpayers and practitioners can rely in the same manner as official legislative history.

B. Similar Rule of Law

We recommend that guidance clarify the statement in Notice 2014-58 regarding the meaning of “similar rule of law.” There is concern that Notice 2014-58 may be interpreted as suggesting that a transaction found only to lack a valid business purpose could be subject to the strict liability penalty, irrespective of whether such transaction is subject to a rule or doctrine that

³ Some of the factors listed in Steps 1 and 2 and inquiries in Step 3 relate entirely to the relevance of the economic substance doctrine, whereas others relate more to the actual objective and subjective prongs of the economic substance requirement.

⁴ 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.

applies the same two-prong analysis that applies to section 7701(o). To eliminate this ambiguity, we recommend replacing the second paragraph of the discussion of similar rule of law in Notice 2014-58 with the following language:

In other words, a similar rule of law means a rule or doctrine that is articulated as a two-prong test that requires the taxpayer to satisfy an objective economic effect test and a subjective business purpose test, as under section 7701(o), even if a term or terms other than “economic substance doctrine” (for example, “sham transaction doctrine”) are used to describe the rule or doctrine. A similar rule of law applies only if both the objective test and the subjective test are reasonably in issue. For example, the assertion that a merger fails to qualify as a reorganization because it lacks a business purpose is not an assertion under a similar rule of law.

III. Conclusion

Significant uncertainty continues to exist for taxpayers and practitioners with regard to the codified economic substance doctrine and its related strict liability penalty. We appreciate the continuing efforts by Treasury and the IRS to provide guidance in this area. We believe the adoption of the guidance outlined above would provide greater clarity and would benefit both the government and taxpayers.

Thank you for your consideration with regard to this very important matter. Please let us know if we can be of further assistance.

Sincerely,

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