LB&I Internal Directive Limits Application of the Economic Substance Doctrine and Related Penalties, but Raises Concerns about Transparency and Consistency of Process

On July 15, 2011, the IRS Large Business and International (LB&I) Division issued an internal directive that provides examiners and managers with guidelines for determining when it is appropriate to apply the codified economic substance doctrine (ESD) and related penalties (the Directive) (LB&I-4-0711-015). (For prior discussions of the codified economic substance doctrine, see the following Sutherland Legal Alerts from March 25, 2010 and September 14, 2010.

In the Directive, the IRS has provided a welcome framework for avoiding the haphazard assertion of the economic substance doctrine by examiners. Key points are:

- Examiners are to consider a number of factors and answer a series of inquiries before seeking approval to apply the economic substance doctrine.
- As part of the above process, examiners are to consider whether another judicial doctrine is more “appropriate” to challenge the transaction, e.g., step transaction or substance over form.
- The Directive indicates assertion of the economic substance doctrine is “likely not appropriate” for:
  - Capitalizing a business with debt or equity;
  - The use of a foreign or domestic corporation to make a foreign investment;
  - The choice to enter a transaction that constitutes a corporate organization or reorganization under subchapter C;
  - The choice to utilize a related party entity, provided that section 482 is satisfied.
- The Directive limits the application of the section 6662(b)(6) 20% strict liability underpayment penalty to only the economic substance doctrine because, until further guidance is issued, the statutory language “or other similar rule of law” will not be given effect.

While the Directive provides insight into the intended application of the economic substance doctrine, it is not public guidance on which taxpayers may rely, and it leaves many questions unanswered. Moreover, taxpayers may have reason to be concerned about the transparency of the process and the consistency of its application among examiners and local IRS counsel, especially given the continuing absence of any substantive public guidance.

Background

The Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, codified the economic substance doctrine. On September 13, 2010, the IRS issued Notice 2010-62, which provided interim guidance regarding the IRS’s intent to rely on existing case law and what constitutes adequate disclosure of tax return positions that may be subject to the economic substance doctrine for purposes of the section 6662(i) 40% penalty. On September 14, 2010, the former Large and Mid-Sized Business Division issued LMSB Directive, LMSB 4-0910-024, which required that any assertion of the strict liability penalty be approved by the Director of Field Operations (DFO).
Determination of Whether to Apply ESD – Four Steps

The July 15 Directive provides four steps for an examiner to follow when determining whether to apply the codified economic substance doctrine.

- First, the examiner should evaluate whether the circumstances in the case include those to which application of the doctrine is likely *not* appropriate. The Directive provides numerous circumstances where the application of the doctrine is not appropriate (e.g., the transaction is at arm's length with unrelated third parties, the transaction does not accelerate a loss or duplicate a deduction, etc.).
- Second, if the examiner continues to believe application of the economic substance doctrine may be appropriate, the examiner must determine whether the transaction contains facts and circumstances that tend to show that application of the doctrine is appropriate (the list in the second step consists of largely the same “yes/no” questions as the first step, e.g., the transaction is *not* at arm’s length with unrelated third parties, the transaction accelerates a loss or deduction, etc.).
- Third, the examiner must make a series of further inquiries in consultation with local counsel before seeking the requisite DFO approval to apply the doctrine.
- Fourth, the examiner, in consultation with the examiner’s manager and territory manager, should request approval from the DFO. If the DFO believes approval is appropriate, the DFO is to provide the taxpayer with an opportunity to explain its position before making a final decision.

The Directive explains that when a transaction involves a series of interconnected steps with a common objective, the term “transaction” refers to all of the steps together. However, the Directive suggests that, under certain circumstances, it may be appropriate to apply the Directive separately to steps that are included within a series of arguably interconnected steps, similar to the court’s analysis in *Coltec Industries Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006). Doing so may be appropriate where 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.

Finally, the Directive provides that the examiner should notify the taxpayer as soon as possible, if the examiner is considering whether to apply the doctrine to a particular transaction. This notice should be issued no later than when the examiner begins the analysis using the four steps described above. The Directive does not specify what form this notice must take (i.e., is a phone call sufficient?).

Questions Remain

The Directive sets forth a framework for determining whether to assert the economic substance doctrine. However, a number of process-related questions remain about how the Directive will be applied.

- **Procedural Fairness:** The Directive raises potential issues concerning the taxpayer’s rights during the process.
  - While the examiner is instructed to provide notice to the taxpayer that the IRS is considering application of the economic substance doctrine, there appear to be no taxpayer remedies if the agent fails to provide such notice. If a taxpayer receives notice that the doctrine may be asserted, it should consider whether to prepare its own analysis (or to wait and see what happens once the examiner requests approval from the DFO). A taxpayer that prepares such an analysis should consider whether protections should be invoked under the work product doctrine and attorney-client privilege.
Similarly, the Directive provides that at the DFO level, the taxpayer should be given an opportunity to explain its position, but does not specify whether the taxpayer may obtain a meeting with the National Office if it disagrees with the DFO. However, because the examiner is instructed to consult with the territory manager when submitting a request for DFO approval, the taxpayer may have some recourse at the territory manager level.

Finally, it is unclear how the IRS intends to ensure its stated goal of consistent administration among the numerous DFOs and whether the taxpayer may obtain a copy of the memorandum that the DFO is instructed to prepare with respect to his or her decision.

- **Local Counsel**: IRS counsel will likely play a prominent role in cases where there is potential for the economic substance doctrine to be asserted, but it is not obvious which level of counsel (i.e., local, regional, or National Office) will be involved at each step. In many cases, local counsel will be most closely involved, although in some stages of the process, such as Step 4, it is proposed that the DFO should “consult with Counsel before a decision is made”—leaving it uncertain as to whether counsel at the local, regional, or National Office is intended. Moreover, it is unclear whether the taxpayer has any right to meet with local IRS counsel during the process, although it may be advisable to ask for such a meeting.

- **Ambiguous Factors**: There are several outstanding questions related to the listed factors indicating appropriate or inappropriate circumstances in which to apply the doctrine. Some factors, including that “the transaction is not promoted/developed/administered by a tax department or outside advisors” or “the transaction is not highly structured,” are vague. In particular, the use of the term “developed” is troubling because it could be construed to include the process by which a taxpayer obtains tax advice from legal counsel. Furthermore, the Directive does not provide any guidance for weighing the listed factors. For instance, no one factor will be more important than others, or that no single factor is controlling.

- **Favorable Factors**: Other aspects of the Directive may be viewed as favorable to taxpayers.
  - For instance, in Step 3, the Directive instructs examiners to determine whether “another judicial doctrine (e.g., substance over form or step transaction) more appropriately addresses the noncompliance that is being examined” and seek the advice of the examiner’s manager and local counsel. This provides an opportunity for examiners (in addition to managers and local counsel) to decide whether another doctrine is more suitable, thereby precluding application of the heightened economic substance doctrine penalties.
  - In addition, Step 3 provides that where transactions are subject to, and comply with, “a detailed statutory or regulatory regime,” the application of the economic substance doctrine should not be pursued without specific approval from the examiner’s manager in consultation with local counsel.
  - Including these factors may be a result of taxpayer comments about the difficulties in applying the economic substance doctrine, and may indicate a willingness to temper reliance on the doctrine when other arguments are available. Moreover, publicly stating that it will limit the application of certain statutory penalties is a positive, and indeed unusual, step for the IRS.

**Sutherland Conclusion**

The Directive clearly fills a void in the absence of guidance on the application of the economic substance doctrine. The Directive states that it is not an official pronouncement of law and cannot be relied upon as such, and, in any case, applies only to LB&I and not to other divisions of the IRS. However, the Directive provides taxpayers with a list of factors indicating when the economic substance doctrine will and will not be considered applicable. The multi-step procedure that the examining agent must follow in obtaining
approval to assert the doctrine suggests a tempered approach by the IRS in applying the statutory economic substance doctrine. It remains to be seen whether the burden placed on examining agents by the Directive will drive them to focus more on substance over form and other related doctrines. Nonetheless, taxpayers may find the current Directive gives some indication of how the economic substance doctrine will be applied. However, unless public guidance is issued, taxpayers are left with little direction on how to approach an arguably mystifying doctrine. Thus far, the IRS and Chief Counsel have stated they do not intend to issue any public guidance on the doctrine.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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