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IRS ISSUES GUIDANCE TO EXAMINERS ON THE CODIFIED ECONOMIC SUBSTANCE DOCTRINE AND ASSOCIATED PENALTIES

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On July 15, the IRS Large Business and International Division (LB&I) issued an Industry Director's Directive (Directive) providing guidance to examiners and their managers regarding the Codified Economic Substance Doctrine (ES Doctrine) and its penalties. The Directive describes when it is appropriate to raise the ES Doctrine in a case and the series of steps the examiner must take to seek approval for the application of the ES Doctrine in the particular case. An LB&I Directive issued in 2010 required that, for the consistent administration of the strict liability penalty associated with the application of the ES Doctrine, a proposal to impose the penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations (DFO).

One thing that is lacking from the most recent guidance is some form of a so-called "angel list" of transactions, i.e., a list of certain basic business transactions that, under longstanding judicial and administrative practice, are respected for tax purposes, notwithstanding that the selection of the form of the transaction is largely or exclusively tax-driven. The absence should come as no surprise. The IRS announced in Notice 2010-62 that it rejected issuing any list of transactions to which the ES Doctrine would not apply.

Steps Required to be Taken by the Agent.

Under the new guidance, when an agent has determined that raising the ES Doctrine is appropriate, the agent must develop and analyze the application of the ES Doctrine through the following four steps in order to seek approval from the DFO

(a) First, the agent must evaluate whether the circumstances in the case are those in which the application of the ES Doctrine *is not appropriate*. There are 18 nonexclusive factors to be considered and four circumstances given where the application of the ES Doctrine is not likely to be appropriate.

(b) Second, the agent must evaluate whether the circumstances in the case are those in which the application of the ES Doctrine *is appropriate*. There are 17 nonexclusive factors where the application of the ES Doctrine may be appropriate.

The factors to be considered in analyzing the application/nonapplication of the ES Doctrine are virtually identical. The focus is on transactions that are "highly structured," that are promoted by outside advisors, that are not at arm's length with unrelated parties, that generate no meaningful economic change (pre-tax), and that accelerate or generate losses or deductions. A significant income tax deferral is not a factor required to be considered in the analysis. Although the factors are highly subjective, there is no guidance provided to the agents about how to make the required assessments.

(c) Third, assuming that the agent believes the application of the ES Doctrine may be appropriate, the directive sets forth a list of inquiries that must be made before the agent can seek approval to apply the ES Doctrine. These inquiries go to the question whether sustaining the transaction or tax benefits meets an expressed Congressional purpose.

(d) Finally, if the agent, the agent's manager, and the territory manager determine that application of the ES Doctrine is appropriate in a particular case, the directive instructs the agent how to prepare the submission to the DFO for approval.

What Should You Take Away from this Directive.

Although the guidance is relatively simplistic on its face, there are a number of important takeaways:

- The agent is supposed to notify the taxpayer that the agent is considering the application of the ES Doctrine *no later than* when the agent begins the four-step analysis set forth above. There is no provision in the directive for the taxpayer to submit its position to the agent, in writing or otherwise, at the time it is notified that the inquiry has commenced.

- Where the transaction involves a specific statutory or regulatory election, or is subject to a detailed statutory or regulatory scheme, the agent is directed not to pursue the application of the ES Doctrine without the approval of his or her manager and the manager is required to consult with counsel.
- If precedent (judicial or administrative) exists rejecting the application of the economic substance doctrine to transactions similar to the instant case, both the agent's manager and counsel must be involved in the analysis process and give specific approval to proceed.
- Tax credit transactions are carved out and an agent appears to be required to seek manager and counsel approval before proceeding to develop the case.
- An agent is not permitted to unilaterally assert that the ES Doctrine and its penalty provisions apply in a particular case. Rather, the directive requires a tripartite consideration and analysis of the application of the ES Doctrine among the agent, his or her manager, and their territory manager before the case can be submitted to the DFO. Further, the submission to the DFO is required to be in writing.
- The DFO is required to review the written justification *and* to consult with counsel before a decision regarding the assertion of the ES Doctrine is made.
- Once the DFO believes that it is appropriate to approve the agent's request to apply the ES Doctrine and its penalties, the directive recommends that the DFO provide the taxpayer the opportunity to explain its position, either in writing or in person (at the discretion of the DFO), whether the ES Doctrine should be applied to the particular case. The decision of the DFO is required to be transmitted to the agent in writing. The memo to the DFO and the written response from the DFO will create a record that can be accessed by the taxpayer and may be useful in a later Appeals consideration of the penalty or in litigation.

One thing that is clear from the Directive is that IRS counsel will be assuming a much more active involvement in prospective ES Doctrine cases and at a very early point in the process. Where the transaction involves a specific statutory or regulatory election or scheme, or significant tax credits, the Directive virtually requires that the agent seek the involvement of counsel before proceeding to the analysis portion of the four-step process. One implication from this step in the process is that the decisions to seek the ES Doctrine penalties will be made largely by counsel.

Finally, the Directive provides that, until further guidance is issued, the penalties provided in Code Sections 6662(b)(6) (the no-fault 20 percent accuracy-related penalty), 6662(i) (the 40 percent nondisclosed noneconomic substance transaction penalty), and 6676 (the penalty applicable to refund claims based on a noneconomic substance transaction) are limited to the application of the codified economic substance doctrine and may not be imposed based on the application of any other "similar rule of law" or judicial doctrine (e.g., the step transaction doctrine, substance-over-form doctrine, or sham transaction doctrine). Most commentators believe that this limitation on the application of the ES Doctrine is a very positive development that eliminates much uncertainty about how the IRS might wield its new weapon.

The attorneys at Cozen O'Connor have experience in dealing with the tax issues involved in the application of the ES Doctrine, as codified in 2010 and in its prior common law forms, to a variety of transactions and investment vehicles. If you would like to discuss the impact of these rules, please contact any of the attorneys in our Tax Group listed below.

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