

PUBLICATION

IRS Guidance: Application of the Codified Economic Substance Doctrine

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On July 15, 2011, the Internal Revenue Service (IRS) issued Directive LB&I-4-0711-015 (Directive), which instructs the Service's examiners and managers how to determine whether and when it is appropriate to seek approval to raise the economic substance doctrine under Section 7701(o) and its associated penalties under Section 6662(b)(6) of the Internal Revenue Code. Although the Directive cannot be used or cited as an official pronouncement of law, it does provide taxpayers with a glimpse of when and how the IRS will apply the Doctrine to transactions.

Background

Section 7701(o) imposes a two-prong test to determine whether a transaction has economic substance. Those tests are: (i) the transaction changes in a meaningful way the taxpayers' economic position (apart from the federal income tax effects), and (ii) the taxpayer has a substantial purpose (apart from the federal income tax effects) for entering into the transaction. Although the IRS issued interim guidance on applying Section 7701(o) in Notice 2010-62 (as discussed in our [November 30, 2010 Tax Alert](#)), taxpayers and practitioners were left with more questions than answers when it came to applying the economic substance doctrine.

When and How the Doctrine Applies

According to the new Directive, the following factors indicate economic substance is lacking if the transaction:

- Is promoted/developed/administered by tax department or outside advisors;
- Is highly structured;
- Contains unnecessary steps;
- Generates targeted tax incentives and is, in form and substance, inconsistent with Congressional intent in providing the incentives;
- Is not at arm's length with unrelated third parties;
- Does not create a meaningful economic change on a present value basis (pre-tax);
- Accelerates a loss or duplicates a deduction;
- Generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset);
- Involves a tax-indifferent counterparty that recognizes substantial income;
- Results in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years;
- Has no credible business purpose apart from federal tax benefits;
- Has no meaningful potential for profit apart from tax benefits;
- Has no significant risk of loss;
- Artificially generates tax benefits;
- Is pre-packaged; or
- Is outside the taxpayer's ordinary business operation.

Economic substance is also lacking according to the Directive if the taxpayer:

- Has potential for gain or loss that is artificially limited; or
- Holds offsetting positions that largely reduce or eliminate the economic risk of the transaction.

In addition, the Directive provides that the economic substance doctrine should not be raised if a transaction relates to the following:

- 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; and
- The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of Section 482 and other applicable concepts are satisfied.

The Directive instructs examiners to take into account factors such as whether the transaction involves a statutory or regulatory election, is the subject of a detailed statutory or regulatory scheme, is the subject of judicial or administrative precedent, or involves tax credits designed to encourage the transaction. The Directive also advises examiners to consider whether another judicial doctrine (such as the step transaction doctrine) or a recharacterization of the transaction applies instead of the economic substance doctrine.

If, after making the inquiries above, an examiner determines that the applicability of the economic substance doctrine is proper, a written request must be made to the Director of Field Operations seeking approval to apply the economic substance doctrine to the transaction.

Summary

Although the Directive may not be cited or used as an official pronouncement of law, it should be seen as a positive development for taxpayers whether or not they are audited by the Service's Large Business & International Division. The Directive should limit the use of the economic substance doctrine and its associated penalties, and should give taxpayers some measure of comfort that this doctrine will not be used by Service examiners in a manner inconsistent with past practices. In addition, the Directive's requirement that a taxpayer be notified prior to an examiner's analysis of whether the economic substance doctrine is applicable should hopefully provide the taxpayer ample time to prepare arguments accordingly.

If you wish to discuss the Directive or the economic substance doctrine codified under Section 7701(o), please contact an attorney in the Firm's Tax Department.