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One Elk Street, Albany, New York 12207 • 518.463.3200 • www.nysba.org

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599 Lexington Avenue  
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New York, NY 10022  
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January 5, 2011

The Honorable Michael Mundaca  
Assistant Secretary (Tax Policy)  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

The Honorable William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

The Honorable Douglas H. Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

## Re: Report on Codification of the Economic Substance Doctrine

I am pleased to transmit Report No. 1228 of the New York State Bar Association Tax Section concerning codification of the economic substance doctrine ("ESD").

Among other things, where the ESD is "relevant," Section 7701(o) mandates a conjunctive test for economic substance and sets forth a statutory standard for profit potential. To encourage taxpayer compliance with Section 7701(o), Section 6662 was amended to impose a 20 percent strict-liability penalty (increased to 40 percent absent adequate disclosure) on understatements attributable to tax benefits denied under Section 7701(o) or any "similar rule of law" (the "ESD Penalty").

On September 13, 2010, the Treasury Department and the Internal Revenue Service issued Notice 2010-62, which offers some guidance, but includes a statement that the government does "not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply." We believe, however, that the

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potential imposition of the ESD Penalty is reason to articulate certain basic principles, including that certain common law formulations related to the ESD, and sometimes used alternatively in the case law, are nevertheless distinct. We believe these distinctions are important to provide the Service and courts clear and uniformly applicable guidelines, permitting a finding against the taxpayer in appropriate cases without implicating the ESD Penalty, while allowing imposition of the ESD Penalty (by application of the two-prong test described in the statute) in cases for which it was intended. We therefore encourage Treasury and the Service to issue guidance clarifying, among other things, that certain existing legal doctrines do not fall under the statutory definition of the ESD, and we believe that this can be done without limiting the government's or the courts' ability to continue to develop the ESD on a case by case basis in the future.

Furthermore, to provide taxpayers and field-level agents of the Service with as much direction as possible, we believe that Treasury and the Service should also issue guidance clarifying to the extent feasible other specific aspects of Section 7701(o), such as in respect of the profit potential test. We believe this is desirable from the standpoint of both the government and taxpayers as potential litigants, as well as in respect of the principle that a fair and efficient tax system should allow taxpayers to conduct their affairs with reasonable knowledge of what the tax laws are, especially where the consequences of being wrong include an automatic, strict-liability penalty. Section 7701(o) and the ESD Penalty provisions contain certain newly articulated concepts and the wording is in certain places unclear and confusing.

The following is a brief summary of our recommendations for guidance:

- Guidance clarifying that, for purposes of Section 7701(o), the ESD refers only to judicial rules of statutory construction that deny the tax benefits of a transaction if a court has analyzed both the economic substance and business or non-tax purpose of such a transaction (or at least has referred to the applicability of such a two-prong test) and found it lacked either or both. Specifically excluded would be other doctrines, such as substance over form, step transaction and adequate business purpose (in the sense where it is used separately from the ESD).
- Similarly, guidance clarifying the meaning of the phrase "any similar rule of law" in Section 6662(b)(6), to the effect that a rule of law is not a similar rule of law if it is not based on an analysis of both the economic substance and non-tax purpose of the transaction in question (regardless of whether the court expressly found that either or both was lacking), and coordinating the ESD Penalty with the precise scope of the ESD along the lines suggested above.
- Guidance enunciating a few principles identifying broad categories of transactions to which the ESD (as defined in Section 7701(o)(5)(A)) is not "relevant." In particular, these principles would confirm that the ESD is not relevant to (i) any tax elections granted to taxpayers under the Code or the Treasury

Regulations, and (ii) where the circumstances of the transaction are such that the tax benefits are "clearly consistent" with the provisions and purposes of the Code or Regulations.

- Given how important the test for potential pre-tax profit of Section 7701(o) is likely to be, guidance as to the proper application of the present value concepts under the provision, including how to determine what discount rate or rates are to be used.
- If feasible, guidance under Section 7701(o)(2) addressing (i) which expenses (*e.g.*, actual or imputed financing costs) should be taken into account under the provision, and under what circumstances; and (ii) the application of Section 7701(o)(2) to transactions whose economics are based (in part or largely) on tax benefits arising from specific incentives granted by Congress.
- Guidance that either confirms that foreign income taxes should not be treated as "expenses" for purposes of the Profit Potential Test or details the limited situations in which they should be.
- Although current LB&I practice providing that the ESD Penalty is not assertable without the express review and consent of an IRS District Counsel is a laudable first step, at least until the courts, Treasury or the IRS provide further clarification, the ESD Penalty should not be assertable without express review and consent of the IRS Chief Counsel.
- Guidance aligning the disclosure requirements of Section 6662(i) with the administration of the substantial understatement penalty of Section 6662(b)(6).

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Peter H. Blessing", with a long, sweeping flourish extending to the right.

Peter H. Blessing  
Chair

Hon. Michael Mundaca, Hon. Douglas H. Shulman, Hon. William J. Wilkins  
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cc: William D. Alexander  
Associate Chief Counsel (Corporate)  
Internal Revenue Service

Deborah A. Butler  
Associate Chief Counsel (Practice and Procedure)  
Internal Revenue Service

Heather Maloy  
Commissioner, Large and Mid-Size Business Division  
Internal Revenue Service

Emily S. McMahon  
Deputy Assistant Secretary (Tax Policy)  
Department of the Treasury

Steven T. Miller  
Deputy Commissioner for Services and Enforcement  
Internal Revenue Service

Clarissa C. Potter  
Deputy Chief Counsel (Technical)  
Internal Revenue Service

Lon B. Smith  
National Counsel to the Chief Counsel for Special Projects  
Internal Revenue Service

Christopher B. Sterner  
Deputy Chief Counsel (Operational)  
Internal Revenue Service

Jeffrey Van Hove  
Acting Tax Legislative Counsel  
Department of the Treasury

Kathryn Zuba  
Special Counsel  
Office of Associate Chief Counsel (Practice and Procedure)