

Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties

LB&I; Control No: LB&I-4-0711-015;

Impacted IRM 20.1.1, 20.1.5

July 15, 2011

LB&I; DIRECTIVE FOR INDUSTRY DIRECTORS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PRE-FILING AND TECHNICAL GUIDANCE
DIRECTOR, INTERNATIONAL BUSINESS COMPLIANCE
DIRECTOR, INTERNATIONAL INDIVIDUAL COMPLIANCE

FROM:Heather C. Maloy /s/ Heather C. Maloy
Commissioner, Large Business & International Division

SUBJECT: Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties

BACKGROUND

Section 1409(a) of the Health Care and Education Reconciliation Act of 2010 (the “2010 Act”) codified a conjunctive economic substance test in new section 7701(o). The new statute defines the economic substance doctrine as the common law doctrine under which certain tax benefits are not allowable if the transaction does not have economic substance or lacks a business purpose and states that “[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [the legislation] had never been enacted.”

The statute further states that “[i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”

As a result, enactment of section 7701(o) resolved the longstanding conflict among various circuit courts of appeal regarding how the doctrine should be applied by codifying a two-part conjunctive test.

In addition, the 2010 Act added section 6662(b)(6), which imposes a strict liability penalty of 20 percent (40 percent for undisclosed transactions) of any underpayment attributable to the disallowance of claimed tax benefits by reason of the application of the economic substance doctrine or failing to meet the requirements of any similar rule of law. Amendments to section 6664 make clear that the “reasonable cause” exception is not applicable to this penalty, and a corresponding amendment to section 6676 provides that a strict liability penalty also applies to refund claims, although in that case the penalty is limited to 20 percent.

Section 7701(o) and the related strict liability accuracy-related penalty apply to transactions entered into after March 30, 2010, which was the date of enactment of the 2010 Act.

PURPOSE OF GUIDANCE

On September 14, 2010, an LB&I Directive, LMSB-20-0910-024, was issued relating to the codification of the economic substance doctrine in the 2010 Act. This directive stated that to ensure consistent administration of the strict liability penalty related to the application of the doctrine, any proposal to impose the doctrine, and thus the penalty, at the examination level must be reviewed and approved by the appropriate Director of Field Operations (DFO).

The purpose of this LB&I Directive is to instruct examiners and their managers how to determine when it is appropriate to seek the approval of the DFO in order to raise the economic substance doctrine. Once an examiner determines that raising the doctrine may be appropriate, this directive sets forth a series of inquiries the examiner must develop and analyze in order to seek approval for the ultimate application of the doctrine in the examination.

In addition, this LB&I Directive provides that, until further guidance is issued, the penalties provided in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other “similar rule of law” or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

This LB&I Directive has four steps. First, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate. Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate. Third, if an examiner determines that the application of the

doctrine may be appropriate, the guidance provides a series of inquiries an examiner must make before seeking approval to apply the doctrine. Fourth, if an examiner and his or her manager and territory manager determine that application of the economic substance doctrine is merited, guidance is provided on how to request DFO approval.

Generally, in applying this LB&I Directive, when a transaction involves a series of interconnected steps with a common objective, the term “transaction” refers to all of the steps taken together. However, in certain circumstances, it may be appropriate to apply this guidance separately to one or more steps that are included within a series of arguably interconnected steps. This may be appropriate in situations 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. If an examiner wants to apply this guidance separately to one or more steps with a common objective, the examiner is required to seek guidance from their manager and consult with their local counsel before doing so.

An examiner should notify a taxpayer that the examiner is considering whether to apply the economic substance doctrine to a particular transaction as soon as possible, but not later than when the examiner begins the analysis in the steps described below.

STEP 1: DOCTRINE LIKELY NOT APPROPRIATE

The following facts and circumstances tend to show that application of the economic substance doctrine to a transaction is likely not appropriate. If some of the factors described in this section of the LB&I Directive apply to the transaction, and an examiner continues to believe that the application of the doctrine is appropriate, the examiner should continue to analyze the transaction using the guidance set forth in Steps 2-4.

- Transaction is not promoted/developed/administered by tax department or outside advisors
- Transaction is not highly structured
- Transaction contains no unnecessary steps
- Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives
- Transaction is at arm’s length with unrelated third parties
- Transaction creates a meaningful economic change on a present value basis (pre-tax)
- Taxpayer’s potential for gain or loss is not artificially limited
- Transaction does not accelerate a loss or duplicate a deduction
- Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)
- Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction
- Transaction does not involve a tax-indifferent counterparty that recognizes substantial income

- Transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years
- Transaction has credible business purpose apart from federal tax benefits
- Transaction has meaningful potential for profit apart from tax benefits
- Transaction has significant risk of loss
- Tax benefit is not artificially generated by the transaction
- Transaction is not pre-packaged
- Transaction is not outside the taxpayer's ordinary business operations.

In addition, it is likely not appropriate to raise the economic substance doctrine if the transaction being considered is related to the following circumstances.

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

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.

STEP 2: DOCTRINE MAY BE APPROPRIATE

The following facts and circumstances tend to show that application of the economic substance doctrine may be appropriate.

Transaction is promoted/developed/administered by tax department or outside advisors

Transaction is highly structured

Transaction includes unnecessary steps

Transaction is not at arm's length with unrelated third parties

Transaction creates no meaningful economic change on a present value basis (pre-tax)

Taxpayer's potential for gain or loss is artificially limited

Transaction accelerates a loss or duplicates a deduction

Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)

Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction

Transaction involves a tax-indifferent counterparty that recognizes substantial income

Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years

Transaction has no credible business purpose apart from federal tax benefits

Transaction has no meaningful potential for profit apart from tax benefits

Transaction has no significant risk of loss

Tax benefit is artificially generated by the transaction

Transaction is pre-packaged

Transaction is outside the taxpayer's ordinary business operations.

STEP 3: DEVELOPMENT OF CASE FOR APPROVAL

If after applying the guidance set forth above an examiner believes that the application of the economic substance doctrine may be appropriate, the examiner must answer the following series of inquiries before seeking the approval of his or her appropriate DFO to apply the doctrine.

1. Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
2. Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
3. Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
4. Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.
5. Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an

examiner should seek the advice of the examiner's manager in consultation with local counsel.

6. Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.
7. In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

STEP 4: DFO APPROVAL

If an examiner completes the inquiries described above and as a result concludes that it is appropriate to seek approval for the application of the economic substance doctrine, the examiner, in consultation with his or her manager and territory manager, should describe for the appropriate DFO in writing how the analysis described in the guidance above was completed. The DFO in considering an examiner's request for approval should review the written material provided and consult with Counsel before a decision is made. If the DFO believes it is appropriate to approve the request, the DFO should provide the taxpayer an opportunity to explain their position, either in writing or in person (at the DFO's discretion), addressing whether the doctrine should be applied to a particular transaction. Once the DFO has made a final decision, that decision should be conveyed to the examiner in writing.

This LB&I Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

cc: Deputy Commissioner (Operations)

Deputy Commissioner (International)

Division Counsel (LB&I;)

Page Last Reviewed or Updated: 27-Jan-2015