

Part III - Administrative, Procedural, and Miscellaneous

Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010

Notice 2010-62

PURPOSE

This notice provides interim guidance regarding the codification of the economic substance doctrine under section 7701(o) and the related amendments to the penalties under sections 6662, 6662A, 6664, and 6676 by section 1409 of the Health Care and Education Reconciliation Act of 2010 (Act), Pub. L. No. 111-152. The notice applies with respect to transactions entered into on or after March 31, 2010, which is the effective date for the amendments made by section 1409 of the Act.

BACKGROUND

Section 1409 of the Act added new section 7701(o) to the Code. Section 7701(o)(1) provides that, in the case of any transaction to which the economic substance doctrine is relevant, the transaction shall be treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the

transaction. Section 7701(o)(5)(A) states that the term “economic substance doctrine” means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

Section 7701(o)(5)(C) states that the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if section 7701(o) had never been enacted. With respect to individuals, however, section 7701(o)(5)(B) states that the two-prong analysis in section 7701(o)(1) shall apply only to a transaction entered into in connection with a trade or business or an activity engaged in for the production of income. In addition, section 7701(o)(5)(D) states that the term “transaction” as used in section 7701(o) includes a series of transactions.

Section 7701(o)(2)(A) provides that a transaction’s potential for profit shall be taken into account in determining whether the requirements of section 7701(o)(1) are met only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the claimed net tax benefits. For purposes of computing pre-tax profit, section 7701(o)(2)(B) provides that the Secretary shall issue regulations treating foreign taxes as a pre-tax expense in appropriate cases.

The Act also added section 6662(b)(6), which provides that the accuracy-related penalty imposed under section 6662(a) applies to any underpayment attributable to any disallowance of a claimed tax benefit because of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet any similar rule of law (collectively a section 6662(b)(6) transaction). The Act also added section 6662(i),

which increases the accuracy-related penalty from 20 to 40 percent for any portion of an underpayment attributable to one or more section 6662(b)(6) transactions with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return or in a statement attached to the return. Furthermore, new section 6662(i)(3) provides that certain amended returns or any supplement to a return shall not be taken into consideration for purposes of section 6662(i).

The Act amended section 6664(c) so that the reasonable cause exception for underpayments found in section 6664(c)(1) shall not apply to any portion of any underpayment attributable to a section 6662(b)(6) transaction. The Act similarly amended section 6664(d) so that the reasonable cause exception found in section 6664(d)(1) shall not apply to any reportable transaction understatement (within the meaning of section 6662A(b)) attributable to a section 6662(b)(6) transaction. The Act also amended section 6676 so that any excessive amount (within the meaning of section 6676(b)) attributable to any section 6662(b)(6) transaction shall not be treated as having a reasonable basis.

APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE WITH RESPECT TO TRANSACTIONS ENTERED INTO AFTER THE EFFECTIVE DATE OF THE ACT

A. Application of the Conjunctive Test

For transactions entered into on or after March 31, 2010, to which the economic substance doctrine is relevant, section 7701(o)(1) mandates the use of a conjunctive two-prong test to determine whether a transaction shall be treated as having economic substance. The first prong, found in section 7701(o)(1)(A), requires that the transaction

change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position. The second prong, found in section 7701(o)(1)(B), requires that the taxpayer have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

The IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1). Accordingly, in determining whether a transaction sufficiently affects the taxpayer's economic position to satisfy the requirements of section 7701(o)(1)(A), the IRS will apply cases under the common-law economic substance doctrine (as identified in section 7701(o)(5)(A)) pertaining to whether the tax benefits of a transaction are not allowable because the transaction does not satisfy the economic substance prong of the economic substance doctrine. Similarly, in determining whether a transaction has a sufficient nontax purpose to satisfy the requirements of section 7701(o)(1)(B), the IRS will apply cases under the common-law economic substance doctrine pertaining to whether the tax benefits of a transaction are not allowable because the transaction lacks a business purpose.

The IRS will challenge taxpayers who seek to rely on prior case law under the common-law economic substance doctrine for the proposition that a transaction will be treated as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary). For all transactions subject to section 1409 of the Act that otherwise would have been subject to a common-law economic substance analysis that treated a

transaction as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary) the IRS will apply a two-prong conjunctive test consistent with section 7701(o).

B. Determination of Economic Substance Transactions

Section 7701(o)(5)(C) provides that the determination of whether a transaction is subject to the economic substance doctrine shall be made in the same manner as if section 7701(o) had never been enacted. In addition, section 7701(o)(1) only applies in the case of any transaction to which the economic substance doctrine is relevant.

Consistent with these provisions, the IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o). If authorities, prior to the enactment of section 7701(o), provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable. The IRS anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop. Consistent with section 7701(o)(5)(C), codification of the economic substance doctrine should not affect the ongoing development of authorities on this issue. The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.

C. Calculating Net Present Value of the Reasonably Expected Pre-tax Profit.

In determining whether the requirements of section 7701(o)(1)(A) and (B) are met, the IRS will take into account the taxpayer's profit motive only if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected for Federal income tax purposes. In performing this calculation, the IRS will apply existing relevant case law and other published guidance.

D. Treatment of Foreign Taxes as Expenses in Appropriate Cases.

Section 7701(o)(2)(B) provides that the Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. The Treasury Department and the IRS intend to issue regulations pursuant to section 7701(o)(2)(B). In the interim, the enactment of the provision does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases.

ACCURACY-RELATED PENALTIES

Unless the transaction is a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), the adequate disclosure requirements of section 6662(i) will be satisfied if a taxpayer adequately discloses on a timely filed original return (determined with regard to extensions) or a qualified amended return (as defined under Treas. Reg. § 1.6664-2(c)(3)) the relevant facts affecting the tax treatment of the transaction. If a disclosure would be considered adequate for purposes of section 6662(d)(2)(B) (without regard to section 6662(d)(2)(C)) prior to the enactment of section 1409 of the Act, then it

will be deemed to be adequate for purposes of section 6662(i). The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS consistent with the instructions and other guidance associated with those subsequent forms, publications, or other guidance. Disclosures made consistent with the terms of Rev. Proc. 94-69 also will be taken into account for purposes of section 6662(i). If a transaction lacking economic substance is a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), the adequate disclosure requirement under section 6662(i)(2) will be satisfied only if the taxpayer meets the disclosure requirements described earlier in this paragraph and the disclosure requirements under the section 6011 regulations. Similarly, a taxpayer will not meet the disclosure requirements for a reportable transaction under the section 6011 regulations by only attaching Form 8275 or 8275-R to an original or qualified amended return.

EFFECT ON OTHER DOCUMENTS

The IRS will not issue a private letter ruling or determination letter pursuant to section 3.02 (1) of Rev. Proc. 2010-3, 2010-1 I.R.B. 110 (or subsequent guidance), regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o). Accordingly, Rev. Proc. 2010-3 is modified.

REQUEST FOR COMMENTS

The IRS is interested in comments concerning the disclosure requirements set forth in this notice with regard to section 6662(i), especially with regard to the interplay

between Rev. Proc. 94-69, proposed Schedule UTP, and the LMSB compliance assurance process (CAP) program. Interested parties are invited to submit comments on this notice by December 3, 2010. Comments should be submitted to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2010-62), Room 5205, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand-delivered Monday through Friday between the hours of 8:00 a.m. to 4:00 p.m. to: CC:PA:LPD:PR (Notice 2010-62), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Comments may also be submitted electronically via the following e-mail address: Notice.Comments@irs.counsel.treas.gov. Please include Notice 2010-62 in the subject line of any electronic submissions.

EFFECTIVE DATE

This notice is effective with respect to transactions entered into on or after March 31, 2010.

CONTACT INFORMATION

The principal author of this notice is James G. Hartford of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact James G. Hartford at (202) 622-7950 (not a toll-free call). For further information with respect to the treatment of foreign taxes as expenses, contact Suzanne M. Walsh at (202) 622-3850 (not a toll-free call).