

CC-2012-008

April 3, 2012

Subject: Coordination Procedures for the
Economic Substance Doctrine and
Related Penalties

Cancel Date: Upon incorporation
into CCDM

Purpose

This notice provides: (1) instructions regarding Counsel's role during an examination that involves the application of the economic substance doctrine under the common law or section 7701(o) ("codified economic substance doctrine"), including any penalties related to the codified economic substance doctrine under section 6662, 6662A, or 6676; (2) instructions for reviewing a statutory notice of deficiency or a notice of final partnership administrative adjustment if a Business Operating Division concludes that a transaction lacks economic substance; and (3) coordination procedures for litigating the common law economic substance doctrine or the codified economic substance doctrine and a related penalty.

Background

Section 7701(o)

Section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, added section 7701(o) to codify the economic substance doctrine and provided related amendments to the penalty provisions under sections 6662, 6662A, 6664, and 6676. These changes are effective for transactions entered into on or after March 31, 2010.

Section 7701(o)(1) provides a conjunctive test whereby a transaction is treated as having economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. Section 7701(o)(5)(B) provides that the codified economic substance doctrine only applies to an individual if that individual entered into a transaction in

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connection with a trade or business or an activity engaged in for the production of income.

Section 6662(b)(6) was added to impose an accuracy-related penalty on any portion of an underpayment attributable to any disallowance of claimed tax benefits because of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirement of any similar rule of law (collectively a section 6662(b)(6) transaction). Section 6662(i) increases the accuracy-related penalty from 20% to 40% for any portion of an underpayment that is attributable to a “nondisclosed noneconomic substance transaction,” which is any portion of a section 6662(b)(6) transaction with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return or a statement attached to the return. For guidance regarding the adequate disclosure requirement, see Notice 2010-62, 2010-2 C.B. 411, and Announcement 2010-75, 2010-2 C.B. 428.

Pursuant to section 6664(c) and (d), the reasonable cause exception does not apply to any portion of an underpayment (subject to penalty under section 6662 or 6663) or reportable transaction understatement (subject to penalty under section 6662A) attributable to one or more section 6662(b)(6) transactions. Similarly, section 6676 now provides that any excessive amount of a claim for refund or credit attributable to any section 6662(b)(6) transaction shall not be treated as having a reasonable basis.

Service Implementation Procedures

On September 14, 2010, the Large and Mid-Size Business Division (now the Large Business & International Division) issued a directive requiring that the appropriate Director of Field Operations review and approve any proposal by examination to impose the codified economic substance doctrine and a related penalty. LMSB-20-0910-024. LB&I issued a second directive on July 15, 2011, which provides a series of inquiries that LB&I examiners and their managers must develop and analyze before seeking approval from the DFO to raise the codified economic substance doctrine. LB&I-4-0711-015. In addition, the July 15, 2011 LB&I Directive provides that, until further guidance is issued, the related penalty provisions 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.

Counsel Coordination Procedures

Before applying the common law economic substance doctrine or the codified economic substance doctrine to a transaction, the Service should consider all of the substantive arguments and technical analysis that are reasonably relevant to the proper tax treatment of the transaction. Neither the common law economic substance doctrine nor the codified economic substance doctrine changes how the Service analyzes the tax treatment of a transaction under the Internal Revenue Code, regulations, published guidance, and case law. To this end, section 7701(o)(5)(C) expressly states that the

determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if the economic substance doctrine was never codified. To ensure that the common law economic substance doctrine and the codified economic substance doctrine and related penalties are only raised in appropriate cases, the procedures described below must be followed.¹

1. Examination

Counsel should provide assistance timely regarding the common law economic substance doctrine or the codified economic substance doctrine and related penalties upon request by the Service during the ordinary course of an examination, including examinations of claims for refund and administrative adjustment requests. In advising the Service, all coordination as required by the CCDM and procedures established within the relevant Division or Associate Offices should be followed. When advising the Service in an examination regarding whether the codified economic substance doctrine and related penalties are appropriate, Counsel should consider the factors outlined in the LB&I Directives (even if the case originates from an Operating Division other than LB&I) and the application of appropriate case law. Although the LB&I Directives apply to the codified economic substance doctrine, advice regarding the common law economic substance doctrine similarly should consider the factors as outlined in the LB&I Directives and the application of appropriate case law.

If the tax treatment of a transaction is the subject of one or more favorable private letter rulings or determination letters issued to the taxpayer, the appropriate course of action is to request that the Associate Chief Counsel office with jurisdiction over the transaction review and, if appropriate, revoke the applicable rulings or letters. If revocation is appropriate, the Service should receive confirmation of the revocation before proposing an adjustment to the transaction that applies the economic substance doctrine. Section 11 or 13 of Rev. Proc. 2012-1, 2012-1 I.R.B. 1 (or subsequent guidance), provides the revocation procedures. These procedures must be followed even when the private letter ruling or determination letter does not address the economic substance doctrine. Under Notice 2010-62, the Service will not issue a private letter ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o). Section 3.02(1) of Rev. Proc. 2012-3, 2012-1 I.R.B. 113, also includes this prohibition.

2. Statutory Notices of Deficiency and Notices of Final Partnership Administrative Adjustment

As part of the review of a proposed statutory notice of deficiency or a proposed notice of final partnership administrative adjustment that concludes that a transaction lacks economic substance under the common law or section 7701(o), attorneys shall coordinate with Division Counsel headquarters and the Office of the Associate Chief

¹ The procedures in this notice do not create any substantive or procedural rights for taxpayers, and the failure to follow any of these procedures in whole, or in part, does not invalidate any otherwise valid notice of deficiency or other Service action.

Counsel (Procedure and Administration). The Office of the Associate Chief Counsel (Procedure and Administration) will further coordinate National Office review with all other Associate Chief Counsel offices with jurisdiction over the substantive issues underlying the transaction.

3. Litigation

Before raising the common law economic substance doctrine or the codified economic substance doctrine and any related penalty as a new issue in a Tax Court case or in a defense or suit letter to the Department of Justice, attorneys shall coordinate with Division Counsel headquarters and the Office of the Associate Chief Counsel (Procedure and Administration). In this regard, all defense or suit letters that raise the common law economic substance doctrine or the codified economic substance doctrine are required to be classified Standard. The Office of the Associate Chief Counsel (Procedure and Administration) will further coordinate National Office review with all other Associate Chief Counsel offices with jurisdiction over the substantive issues underlying the transaction. If the tax treatment of that transaction is the subject of one or more favorable private letter rulings or determination letters issued to the taxpayer, the appropriate course of action is to request that the Associate Chief Counsel office with jurisdiction over the transaction review and, if appropriate, revoke the applicable rulings or letters. If revocation is appropriate, attorneys should receive confirmation of the revocation before raising the common law economic substance doctrine or the codified economic substance doctrine and related penalty as a new issue. Section 11 or 13 of Rev. Proc. 2012-1, 2012-1 I.R.B. 1 (or subsequent guidance), provides the revocation procedures. These procedures must be followed even when the private letter ruling or determination letter does not address the economic substance doctrine.

The common law economic substance doctrine and the codified economic substance doctrine and related penalties are issues that require National Office review before briefs or motions are filed with the Tax Court and defense or suit letters are sent to the Department of Justice. CCDM Exhibits 31.1.1-1 and 35.11.1-1 will be amended to include the common law economic substance doctrine and the codified economic substance doctrine and related penalties as issues that require National Office review. See CCDM 31.1.1.2.3 and 34.5.1.1.2.4.

For cases involving the application of the common law economic substance doctrine or the codified economic substance doctrine that are currently in litigation when this notice is released, the briefs, motions, defense or suit letters, and other court filings that are due after the date this notice is released, April 3, 2012, must be coordinated with the National Office in accordance with this notice.

4. Administrative Pronouncements

Division or Associate Offices with subject matter jurisdiction over administrative pronouncements (e.g., Appeals Settlement Guidelines or Coordinated Issue Papers) shall review appropriate administrative pronouncements to ensure that any discussion of the economic substance doctrine is consistent with the statute, the LB&I Directives,

