



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR ALL LB&I AND SB/SE EXAMINATION EMPLOYEES

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SUBJECT: Interim Guidance Memorandum on Economic Substance
Doctrine and Related Penalties

Purpose: This memorandum is issued to communicate updated guidance for examiners and managers on the Economic Substance Doctrine and Related Penalties.

This guidance supersedes the instructions in [IRM 4.46.4.12.9](#), Economic Substance Doctrine; [IRM Exhibit 4.46.4-4](#), Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties; [IRM 20.1.5.13.2](#), Penalty Administration, and will be added to [IRM 4.10.13](#), Examination of Returns, Certain Technical Issues.

Background: Previously, executive approval was required to raise the economic substance doctrine argument under Internal Revenue Code (IRC) 7701(o) (for LB&I), and executive approval was required to assert the economic substance penalty under IRC 6662(b)(6) and 6662(i) (for LB&I and SB/SE). The changes set forth herein align this penalty with other assessable penalties which do not require executive approval. The changes herein do not remove the requirement that the penalties must be timely

approved in writing by the immediate supervisor of the person who initially determines the penalty under IRC 6751(b).

Procedural Change: See Attachments 1 through 3 for updated information for managers and examiners who are considering raising the economic substance doctrine and asserting the related penalty. Executive level approval is not required to raise the economic substance doctrine argument or assert related penalties.

Effective Date and Effect on Other Documents: This guidance is effective immediately and will be incorporated into the impacted IRMs listed above within two years from the date of this memorandum.

Mandatory review by Area Counsel of any statutory notice of deficiency asserting the economic substance doctrine under IRC 7701(o), Clarification of Economic Substance Doctrine, and the related penalty under IRC 6662(b)(6), Imposition of Accuracy-Related Penalty on Underpayments, and IRC 6662(i), Increase in Penalty in Case of Nondisclosed Noneconomic Substance Transactions, under [IRM 4.8.9.9.2.1](#) remain in effect.

Attachments (3)

Attachment 1 - IRM 4.46.4.12.9 and Exhibit 4.46.4-4

1) On March 30, 2010, the Health Care and Education Reconciliation Act of 2010 was enacted. This law amended the Internal Revenue Code to codify the Economic Substance Doctrine under IRC 7701(o). It also amended penalty provisions under [IRC 6662](#), [IRC 6662A](#), [IRC 6664](#) and [IRC 6676](#).

(2) IRC 6662 was amended to add a new penalty to be applied to any underpayment attributable to transactions lacking economic substance. The penalty under IRC 6662(b)(6) applies a 20 percent penalty on noneconomic substance transactions. IRC 6662(i) increases the penalty to 40 percent if the relevant facts affecting the tax treatment are not adequately disclosed. The penalty is applicable for transactions entered into after March 30, 2010.

(3) See Exhibit 4.46.4-4 for guidance on the economic substance doctrine and related penalties.

(4) See Notice 2014-58 for additional guidance regarding penalties associated with the Economic Substance Doctrine.

Exhibit 4.46.4-4

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

Background: IRC 7701(o) 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. It 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.”

IRC 7701(o) resolves the longstanding conflict among various circuit courts of appeal regarding how the doctrine should be applied by codifying a two-part conjunctive test. The statute states that “in the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be 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 such transaction.”

IRC 6662(b)(6) imposes a strict liability penalty of 20 percent (40 percent for undisclosed transactions under IRC 6662(i)) 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 IRC 6664 make clear that the “reasonable cause” exception is not applicable to this penalty, and a corresponding amendment to IRC 6676 provides that a strict liability penalty also applies to refund claims, although in that case the penalty is limited to 20 percent. Even though the 20 and 40 percent penalties are strict liability penalties, such penalties must be timely approved in writing by the immediate supervisor of the person who initially determines the penalty applies in order to comply with IRC 6751(b). See [IRM 20.1.1.2.3](#) (Approval Prerequisite to Penalty Assessments); [IRM 20.1.1.2.3.1](#) (Timing of Supervisory Approval); [IRM 20.1.7.3.1](#) and [IRM 20.1.10.2](#) (Supervisory Approval for Penalty Assessment); [20.1.5.2.3](#) (Supervisory Approval of Penalties – IRC 6751 Procedural Requirements); [20.1.5.2.3.1](#) (Documenting Supervisory Approval of Penalties); [IRM 4.46.4.12](#) (LB&I Penalty Consideration); [4.46.4](#) (LB&I Examination Process, Executing the Examination). IRC 7701(o) and the related strict liability accuracy-related penalty apply to transactions entered into after March 30, 2010. Examiners should follow all existing examination procedures regarding issue identification, development, resolution, and related documentation requirements.

PURPOSE OF GUIDANCE

The purpose of this guidance is to instruct examiners and their managers on how to determine when it is appropriate to raise the economic substance doctrine, (the codified economic substance doctrine under IRC 7701(o) or the common law economic substance doctrine) and related penalties. Before applying the codified economic substance doctrine or the common law economic substance doctrine to a transaction, Exam should consider all substantive arguments and technical analysis that are reasonably relevant to the proper tax treatment of the transaction. If after such consideration an examiner and their manager believe that the application of the codified economic substance doctrine or the common law economic substance doctrine may be appropriate, the examiner must consult with local field Counsel before proceeding if the issue/case is novel and/or significant or the issue has required or will require significant resources to address.

Note: Novel or significant issues include, but are not limited to, issues of importance to tax administration, such as a case of first impression; one affecting large numbers of taxpayers or an industry; or one falling within an operating division’s major strategic goal.

Reminder: In SB/SE, when a local Area Counsel contact has not been designated or a formal advice memorandum is required, examiners must send a written request for advice through the Appeals/Counsel liaison in Technical Services (see IRM 4.2.3.3.1, Assistance Available from Area Counsel, and IRM 4.8.8.12.1.2, Advice from Area Counsel).

Local field Counsel will coordinate, as required by the Chief Counsel Directives Manual (CCDM) or other applicable Chief Counsel Directive, with Division Counsel and the appropriate Associate Chief Counsel Office(s) to analyze whether assertion of the doctrine is warranted. After considering the facts received from Exam, local field Counsel will provide the examiner and their manager with Counsel's legal advice analyzing the transaction and advising the examiner on asserting the doctrine. After receiving and considering Counsel's advice, Exam will decide whether to apply the economic substance doctrine. Local field Counsel will continue to provide assistance and advice, as needed.

Exception: If the issue/transaction involves a Compliance Initiative Project (CIP), Campaign, or other coordinated project, the examiner should contact the CIP analyst or the Campaign or coordinated project lead with any questions about whether to apply the economic substance doctrine. If necessary, the analyst/lead will coordinate with Counsel to request a review of the facts and circumstances of the CIP/Campaign/Project issue to determine if the assertion of the doctrine is warranted. Once a decision is made, the analyst/lead will communicate that decision to examiners. On any other case, if the facts and circumstances are the same, examiners, managers, and local Counsel attorneys do not need to coordinate with or within Counsel on the assertion of the doctrine due to Counsel's previously provided advice.

APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

To determine whether raising the doctrine may be appropriate, the examiner should consider all of the following and seek advice from local field Counsel on application of the doctrine to the transaction in the examination.

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

- 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 operation.

Notwithstanding existence of the above facts and circumstances, the economic substance doctrine may not be appropriate if the transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives.

CONSIDERATION OF OTHER JUDICIAL DOCTRINES

The economic substance doctrine may be applied in addition to other judicial doctrines (e.g., substance over form or step transaction) either as a primary argument or as an alternative position to those judicial doctrines depending on the facts and circumstances of the case. Likewise, if 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) addresses the noncompliance that is being examined, then recharacterization should be applied and the economic substance doctrine may be considered as either a primary or alternative position based on the facts and circumstances of the case.

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

Attachment 2 – IRM 20.1.5.13.2

Penalty Administration

1. Each operating division will be responsible for developing procedures to administer the IRC 6662(b)(6) and IRC 6662(i) penalties. At a minimum, each operating division's procedures will include the following:
 - A. A requirement of timely written approval by the immediate supervisor of the person who initially determines the penalty as required by IRC 6751(b).
 - B. Documentation of the supervisory approval must be maintained in the case file as prescribed in various IRM sections such as IRM 20.1.5.2.3.1, Documenting Supervisory Approval of Penalties.
2. Refer to [IRM 4.46.4.12.9](#), Economic Substance Doctrine for additional information.
3. Each operating division's procedures will be cited for cross-referencing in [IRM 20.1.5](#).
4. When closing the case from the group, the examiner will do the following:
 - A. Identify the adjustment in the report relating to the IRC 6662(b)(6) or 6662(i) (if applicable) penalty and provide the penalty computation in the workpapers.
 - B. Complete and attach [Form 3198](#) or [Form 3198–A](#) to identify the IRC section(s) and penalty amount for CCP.
 - C. Use the appropriate closing record and enter PRN 780 for the 20 percent penalty or PRN 781 for the 40 percent penalty and the positive penalty amount to assess the penalty. See [IRM 20.1.5.4.2](#).

Attachment 3 – IRM 4.10.13

Economic Substance Doctrine

1) On March 30, 2010, the Health Care and Education Reconciliation Act of 2010 was enacted. This law amended the Internal Revenue Code to codify the Economic Substance Doctrine under IRC 7701(o). It also amended penalty provisions under IRC 6662, IRC 6662A, IRC 6664 and IRC 6676.

(2) IRC 6662 was amended to add a new penalty to be applied to any underpayment attributable to transactions lacking economic substance. The penalty under IRC 6662(b)(6) applies a 20 percent penalty on noneconomic substance transactions. IRC 6662(i) increases the penalty to 40 percent if the relevant facts affecting the tax treatment are not adequately disclosed. The penalty is applicable for transactions entered into after March 30, 2010.

(3) For guidance on applying the economic substance doctrine and related penalties, see [IRM Exhibit 4.46.4-4](#), Guidance for Managers and Examiners on the Economic Substance Doctrine and Related Penalties, and [IRM 20.1.5.13](#), IRC 6662(b)(6), Penalty for Underpayments Attributable to a Transaction Lacking Economic Substance.

(4) See Notice 2014-58 for additional guidance regarding penalties associated with the Economic Substance Doctrine.