

Additional Guidance Under the Codified Economic Substance Doctrine and Related Penalties

Notice 2014-58

PURPOSE

This notice amplifies Notice 2010-62, 2010-40 I.R.B. 411, by providing additional guidance regarding the codification of the economic substance doctrine and the related penalty amendments. Specifically, this notice provides guidance regarding: (1) the definition of “transaction” for purposes of applying the codified economic substance doctrine under section 7701(o), and (2) the meaning of “similar rule of law” as described in the accuracy-related penalty under section 6662(b)(6). This notice is also relevant with respect to the availability of the reasonable cause exceptions under sections 6664(c) and (d) and the reasonable basis exception under section 6676 because those exceptions are inapplicable to transactions described in section 6662(b)(6).

BACKGROUND

The economic substance doctrine is a judicial doctrine that was codified in section 7701(o) by section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152. Section 7701(o)(5)(A) defines "economic substance

doctrine" as the common-law doctrine that disallows tax benefits under subtitle A of the Internal Revenue Code if the transaction that produces those benefits lacks economic substance or a business purpose. Under section 7701(o)(1), a transaction has economic substance 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.

Section 7701(o)(5)(D) provides that "[t]he term 'transaction' includes a series of transactions." The legislative history explained:

The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the [economic substance] doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.

H.R. Rep. No. 111-443(I), at 296-297, P.L. 111-152, Health Care and Education Reconciliation Act of 2010. Although section 7701(o) does not provide a definition of "transaction," the term has been defined in the analogous context of reportable transactions. Specifically, Treas. Reg. § 1.6011-4(b)(1) provides that, for purposes of the reportable transaction disclosure regime, the term "transaction" includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement and also includes any series of steps carried out as part of a plan.

Section 6662(b)(6) imposes a penalty on an underpayment attributable to tax benefits that were disallowed because a transaction lacks economic substance (within

the meaning of section 7701(o)) or fails to meet the requirements of any similar rule of law. Neither section 7701(o) nor section 6662 defines “similar rule of law.” However, the legislative history explained, with respect to a “similar rule of law,” that the “penalty would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision [section 7701(o)] for an economic substance analysis, even if a different term is used to describe the doctrine.” H.R. Rep. 111-443(I), at 304.

Sections 6664(c)(2) and (d)(2) provide that the reasonable cause and good faith exception to a section 6662 or 6662A penalty does not apply to the portion of an underpayment or reportable transaction understatement attributable to one or more transactions described in section 6662(b)(6). For purposes of the penalty for an erroneous claim for refund or credit of an excessive amount, section 6676(c) provides that any excessive amount (within the meaning of section 6676(b)) that is attributable to any transaction described in section 6662(b)(6) is not treated as having a reasonable basis.

DISCUSSION

A. Transaction

For purposes of determining whether the codified economic substance doctrine applies, “transaction” generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan’s steps are aggregated or disaggregated when defining a transaction.

Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the “transaction” includes all of the steps taken together – an aggregation approach. This means that every step in the series will be considered when analyzing whether the “transaction” as a whole lacks economic substance. However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the “transaction” may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals – a disaggregation approach.

Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered on a case-by-case basis, depending on the facts and circumstances of each individual case. For example, if transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

B. Similar Rule of Law

For purposes of section 6662(b)(6), “similar rule of law” means a rule or doctrine that disallows the tax benefits under subtitle A of the Code related to a transaction because:

(1) the transaction does not change a taxpayer’s economic position in a meaningful way (apart from Federal income tax effects); or

(2) the taxpayer did not have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

In other words, “similar rule of law” means a rule or doctrine that applies the same factors and analysis that is required under section 7701(o) for an economic substance analysis, even if a different term or terms (for example, “sham transaction doctrine”) are used to describe the rule or doctrine. See H.R. Rep. 111-443, at 304.

The IRS will not apply a penalty under section 6662(b)(6) (or otherwise argue that a transaction is described in section 6662(b)(6)) unless it also raises section 7701(o) to support the underlying adjustments. If the IRS does not raise section 7701(o) to disallow the claimed tax benefits and instead relies upon other judicial doctrines (e.g., the substance over form or step transaction doctrines) to support the underlying adjustments, the IRS will not apply a section 6662(b)(6) penalty (or otherwise argue that a transaction is described in section 6662(b)(6)) because the IRS will not treat the transaction as failing to meet the requirements of a similar rule of law. Code sections and Treasury regulations, other than section 7701(o) and the regulations under that section, that disallow tax benefits are not similar rules of law for purposes of section 6662(b)(6).

EFFECT ON OTHER DOCUMENTS

Notice 2010-62, 2010-40 I.R.B. 411, is amplified.

EFFECTIVE DATE

This notice is effective for transactions entered into after March 30, 2010.

CONTACT INFORMATION

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