

# WNTS *Insight*

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## The codified economic substance doctrine: Making decisions in an uncertain world

Taxpayer transactions entered into after March 30, 2010, are subject to the codified economic substance doctrine and related penalties. With adequate disclosure, those penalties effectively can be capped at 20 percent rather than 40 percent. Accordingly, as taxpayers prepare and file returns reflecting 2010 transactions, they should consider whether the economic substance doctrine could be considered relevant to their transaction and, if so, determine how to disclose the transaction.

### *Background*

In March 2010 the economic substance doctrine was codified -- as code section 7701(o) -- as part of the Health Care and Education Affordability Reconciliation Act of 2010. Section 7701(o) provides that for transactions entered into after March 30, 2010, when the economic substance doctrine is relevant, a transaction will be treated as having economic substance only if (1) it changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and (2) the taxpayer has a substantial purpose (other than to obtain federal income tax benefits) for entering into the transaction.

If a transaction does not satisfy this two-pronged standard, section 6662(b)(6) imposes a 20-percent accuracy-related penalty to any underpayment attributable to any disallowance of a claimed tax benefit because the transaction fails to satisfy the newly codified economic substance doctrine or any similar rule of law. Under section 6662(i), that penalty increases to 40 percent when the relevant facts affecting the tax treatment of the transaction are not "adequately disclosed" on the return or in a statement attached to the return. Because the reasonable cause exception under



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section 6664(c)(1) does not apply to this penalty, it is considered a strict liability penalty.

## *Determining whether the doctrine is relevant*

Neither section 7701(o) nor initial guidance on the codified economic substance doctrine provides concrete guidance on when the doctrine is relevant. Section 7701(o) provides that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." In Notice 2010-62, the IRS stated it will continue to analyze when the economic substance doctrine applies in the same fashion as it did prior to the enactment of section 7701(o).

Notice 2010-62 also states that "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." Finally, Notice 2010-62 states that the IRS did not intend to issue general administrative guidance on the types of transactions to which the economic substance doctrine applied. The lack of administrative guidance has left taxpayers uncertain as to how the IRS may view specific transactions.

On July 15, 2011, the IRS issued an LB&I Directive providing guidance to examiners and their managers on when it is appropriate to seek the approval of the appropriate Director of Field Operations in order to raise the economic substance doctrine. The Directive also provides examiners guidance on additional development and analysis required to seek approval for the application of the doctrine in an examination. Although taxpayers may not rely on the Directive, it provides taxpayers with insight on how the IRS will analyze transactions with regard to which the economic substance doctrine may be implicated.

The LB&I Directive outlines a four-step process. The first three steps provide insight to a taxpayer evaluating its transactions.

The first step requires an examiner to evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate. The Directive provides 18 (fairly predictable) facts and circumstances that tend to show that application of the economic substance doctrine is not relevant (i.e., taxpayer-favorable factors). Some of these factors include a transaction that is not promoted, is not highly structured, contains no unnecessary steps, does not accelerate a loss or duplicate a deduction, is at arm's length with unrelated third parties, is not pre-packaged, has meaningful potential for profit apart from the tax benefit, has a credible business purpose, and is not outside the taxpayer's ordinary business operations.

In the second step, the examiner is to evaluate whether the circumstances in the case are those under which the application of the economic substance doctrine may be appropriate. The Directive provides 17 (fairly predictable) factors that tend to show that application of the economic substance doctrine may be relevant (i.e., taxpayer-unfavorable factors). Many of these unfavorable factors are simply the opposite of favorable factors, including a transaction that is promoted, is highly structured, contains unnecessary steps, accelerates a loss or duplicates a deduction, is not at arm's length with unrelated third parties, is pre-packaged, has no meaningful potential for profit apart from the tax benefit, has no credible business purpose, and is outside the taxpayer's ordinary business operations.

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If, after applying the favorable and unfavorable factors, the examiner determines that the application of the doctrine may be appropriate, the third step requires evaluation of additional factors and approval of the examiner's manager in consultation with local counsel. The directive sets forth seven questions to be considered in this process. Those questions provide meaningful insight into situations in which it appears that the IRS may be more reluctant to assert application of the codified economic substance doctrine -- i.e., the transaction is pursuant to a statutory or regulatory election, precedent exists that upholds the transaction or rejects the application of the economic substance doctrine to the transaction, the transaction involves a tax credit designed by Congress to encourage the transaction, and the transaction is subject to a detailed statutory or regulatory scheme with which the transaction complies.

**Observation:** Given the magnitude of the potential penalty, taxpayers will want to identify all transactions with regard to which the economic substance doctrine might be implicated. In evaluating whether the economic substance doctrine is relevant to a transaction entered into after March 30, 2010, a taxpayer may want to consider the factors outlined in the Directive. Taxpayers, however, should remember that the Directive does not provide authority upon which they may rely.

## *Making adequate disclosure*

Guidance issued to date identifies three potential mechanisms to meet the adequate disclosure requirements of section 6662(i). The taxpayer may make disclosure on Form 8275 or 8275-R, Schedule UTP, or consistent with Rev. Proc. 94-69.

Notice 2010-62 provided initial guidance on meeting the disclosure requirement necessary to avoid the 40-percent penalty under section 6662(i). As described in the Notice, the disclosure requirement is satisfied if the taxpayer discloses on Form 8275 or 8275-R "the relevant facts affecting the tax treatment of the transaction" on a timely filed original return, including extensions, or on a qualified amended return. Notice 2010-62 also states that disclosures made within the 15-day audit window under Rev. Proc. 94-69 will be taken into account in determining adequate disclosure. Subsequently, Announcement 2010-75, released with Schedule UTP, states that a complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP will be treated as a disclosure on Form 8275 or 8275-R and that the IRS would treat such a disclosure as satisfying the disclosure requirements of section 6662(i).

Notice 2010-62 warns taxpayers that if the transaction determined to lack economic substance is a reportable transaction, the adequate disclosure requirement of section 6662(i)(2) is satisfied only if the taxpayer complies with the disclosure requirements discussed above and satisfies the disclosure requirements under the section 6011 regulations (e.g., Form 8886).

If a taxpayer determines that the economic substance doctrine may be relevant to a transaction and disclosure is necessary, the taxpayer will need to consider what information must be included in the disclosure. The guidance issued to date focuses on how to make the required disclosure rather than the content required to meet the "adequate disclosure" threshold.

As a result, taxpayers must look to the instructions for the various forms for guidance. For example, the instructions for Form 8275 state that the disclosure must include "information that reasonably can be expected to apprise the IRS of the identity of the item, its amount, and the nature of the controversy or potential

controversy." While similar, the instructions for the concise description on Schedule UTP require the description to be "reasonably expected to apprise the IRS of the identity of the tax position and the nature of the issue."

There are other differences as well. For example, Part I of Schedule UTP requires taxpayers to identify the primary code sections. The instructions, however, are silent as to whether taxpayers should include section 7701(o) or only the code sections relating to the underlying transaction. Form 8275 does not have this explicit requirement, but does require the taxpayer to identify the amount involved, whereas Schedule UTP requires taxpayers only to rank the issues.

**Observation:** It is noteworthy that the Schedule UTP instructions provide no guidance on satisfying the adequate disclosure requirement of section 6662(i). Where the IRS has been silent on matters such as whether section 7701(o) must be identified in either the concise statement or on Part I, taxpayers will want to consider carefully what to include. Given the magnitude of the potential penalty and the uncertainty on what will constitute adequate disclosure, taxpayers may want to consider disclosing more rather than less.

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