



IRS Limits Strict Penalty on Tax-Motivated Deals Not Challenged under Economic Substance Statute

The IRS issued guidance in Notice 2014-58 regarding the statutory economic substance doctrine and related penalties. Although the notice contains little new guidance, this article considers the signals the notice might be sending about how the IRS plans to interpret the statutory definition of transaction and to apply the related strict liability penalty provision.

On October 10, 2014, the IRS released Notice 2014-58¹ amplifying Notice 2010-62² to provide additional guidance on the statutory economic substance doctrine of section 7701(o) and related penalty amendments. The 2014 notice addresses the meaning of “transaction” for purposes of section 7701(o) and the meaning of “similar rule of law” for applying the non-economic substance penalty to various penalty provisions.

Although the IRS’s new economic substance notice adds little new guidance, it signals how the IRS plans to interpret the statutory definition of transaction and to apply the related strict liability penalty provision. First, the notice confirms the IRS will apply a facts-and-circumstances test in determining whether to look at the steps of a transaction as a whole instead of applying the rules to only the tax-motivated steps. Second, the IRS will not take an expansive view of the strict liability accuracy-related penalty for transactions that lack economic substance but are not disallowed by the IRS under the economic substance provision. Thus, if the IRS does not raise the economic substance provision of section 7701(o) to disallow a claimed benefit, but rather relies on another judicial doctrine such as step-transaction or substance-over-form doctrine, the IRS will not impose the section 6662(b)(6) penalty.

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¹ 2014-11 I.R.B. 746.

² 2010-40 I.R.B. 411.

Background

The courts have developed several judicial doctrines to disallow tax benefits from tax-motivated transactions satisfying the literal requirements of specific tax provisions. One of these is the economic substance doctrine. Because the courts did not apply the doctrine in a uniform manner, Congress codified the economic substance doctrine in section 7701(o)³ for transactions entered into after March 30, 2010.

Under section 7701(o), a transaction has economic substance if the taxpayer has, apart from federal income tax effects, (1) an economic position changed by the transaction in a meaningful way, and (2) a substantial purpose for entering into the transaction.

Defining Transaction

Section 7701(o)(5)(D) states that a transaction “includes a series of transactions.” The term “transaction” is defined in regulations as including “all of the factual elements relevant to the expected treatment of any investment, entity, plan, or arrangement,” as well as any series of steps carried out as a part of a plan.⁴ According to the 2014 notice, the IRS will generally use the reportable transaction definition of “transaction” to apply the codified economic substance doctrine.

The 2014 notice elaborates by imposing a facts-and-circumstances test to determine when a plan’s steps are aggregated or disaggregated in defining a transaction. Generally, when a plan that generated a tax benefit involved a series of interconnected steps with a common object, the transaction is considered to include all those steps taken together—an aggregation approach. Thus, every step in the series will be considered when analyzing whether the transaction as a whole lacks economic substance.

On the other hand, in some situations the IRS will use a disaggregation approach: It will apply the economic substance doctrine only to the individual steps in a transaction that are tax-motivated and unnecessary to

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

³ Section 1409 of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152.

⁴ Section 1.6011-4(b)(1).

accomplish the non-tax goals. The disaggregation approach has been asserted by the IRS and the Justice Department in litigation, but not always successfully.

The legislative history of section 7701(o) provides that the codified provision does not alter a court's ability to "aggregate, disaggregate, or otherwise recharacterize a transaction" when applying the economic substance doctrine.⁵ The legislative history cites *Coltec Industries, Inc. v. United States*,⁶ which took a disaggregation approach. However, the disaggregation approach was not followed in *Shell Petroleum Inc. v. United States*.⁷ The statute does not require a disaggregation approach, and it is unclear how the courts will react in those cases in which the government raises the disaggregation approach in the future.

Penalties

Section 6662(b)(6) imposes an accuracy-related penalty when any claimed tax benefit is disallowed because a transaction either lacks economic substance within the meaning of section 7701(o), or fails to meet the requirements of any similar rule of law. This 20 percent penalty on any portion of an underpayment is increased to 40 percent if the transaction is not adequately disclosed by the taxpayer.

Section 6662(b)(6) is a strict liability provision; taxpayers cannot invoke the reasonable cause exceptions under sections 6664(c) and 6664(d) to avoid the penalty. In addition, if any portion of a claim for refund or credit is denied because the claim is attributable to a non-economic substance transaction—i.e., disallowed under a "similar rule" provision—then the taxpayer will be treated as not having a reasonable basis with respect to that amount and will be subject to a 20 percent penalty.

Taxpayers and tax practitioners have been concerned about which judicial doctrines are within the scope of "any similar rule of law" for purposes of this penalty. In a 2011 Large Business and International ("LB&I") directive,⁸ LB&I professionals were instructed that, until further notice, the

⁵ House Budget Report No. 111-443(i) at 296-7; Joint Committee on Taxation Report for the Revenue Reconciliation Act of 2010, JCX-18-10, at 153.

⁶ 454 F.3d 1340 (Fed Cir. 2006).

⁷ 102 A.F.T.R. 2008-5008 (D.C. Tex 2008), 2008-2 U.S.T.C. ¶ 50,422.

⁸ LB&I 4-0711015 (July 15, 2011).

penalty should only be imposed for failure to meet the economic substance provisions of section 7701(o); the penalty was not to be imposed because of the application of any similar rule of law or judicial doctrine such as the step transaction, substance over form, or sham transaction doctrines. The directive stated, however, that it was not an official pronouncement of law, and could not be used, cited, or relied upon.

The 2014 notice clarifies that “any similar rule of law” means a rule or doctrine that applies the same factors and analysis 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. The notice differs from the directive by stating that the penalty could apply to a transaction disallowed because of the sham transaction doctrine if the factors and analysis applied were the same as those under section 7701(o). Moreover, the notice provides that if the IRS does not raise section 7701(o) to disallow the claimed tax benefit but disallows it using other judicial doctrines, such as substance over form or step transaction doctrine, the IRS will not treat the transaction as failing to meet the requirements of a similar rule of law for penalty purposes.⁹ Accordingly, if a taxpayer’s claimed benefits are disallowed under a judicial doctrine not considered a similar rule of law, the strict liability aspect of section 6662(b)(6) would not apply. The taxpayer may seek relief for reasonable cause under section 6664(c) (or section 6664(d) if applicable) or establish a reasonable basis for purposes of section 6676.

The notice is effective for transactions entered into after March 30, 2010, so it supplants the advice in the directive as to what is “any similar rule of law.”

Conclusion

The notice provides little new guidance on what constitutes a transaction for purposes of section 7701(o). Although the notice takes a different

⁹ At a D.C. Bar luncheon on January 22, 2015, Treasury tax legislative counsel Thomas West stated that a “sham transaction” is a similar rule of law for purposes of the penalty only if the same two-prong test, the transaction has to have economic substance and a substantial business purpose, and was not intended to include the sham transaction doctrine. 2015 TNT 15-2 (Jan. 22, 2015) (Doc 2015-1685).

position from the directive and includes “sham transaction doctrine” within what constitutes “any similar rule of law” for purposes of section 6662(b)(6), it is generally ameliorative. Importantly, taxpayers may rely on the notice to assert that for purposes of section 6662(b)(6) and related penalty provisions, other judicial doctrines (such as substance over form and step transaction) that do not rely on the same factors and analysis as section 7701(o) do not fall within a similar law or rule.



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