

September 14, 2010

**DIRECTIVE FOR INDUSTRY DIRECTORS**

DIRECTOR, FIELD SPECIALISTS  
DIRECTOR, PRE-FILING AND TECHNICAL GUIDANCE  
DIRECTOR, INTERNATIONAL COMPLIANCE, STRATEGY  
AND POLICY

**FROM:** Heather C. Maloy /s/ Heather C. Maloy  
Commissioner, Large and Mid Size Business Division

**SUBJECT:** Codification of Economic Substance Doctrine and Related Penalties

**BACKGROUND**

Section 1409 of the Health Care and Education Reconciliation Act of 2010 (Act), Pub. L. No. 111-152, added section 7701(o) to codify the economic substance doctrine and amended penalty provisions under sections 6662, 6662A, 6664, and 6676.

Under section 7701(o), a transaction is treated as having economic substance only if it passes a conjunctive, two prong test. The test requires that (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and; (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

The Act also added section 6662(b)(6), which provides that the accuracy-related penalty imposed under section 6662(a) applies to any underpayment attributable to any disallowance of a claimed tax benefit because of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet any similar rule of law (collectively a section 6662(b)(6) transaction). The Act also added section 6662(i), which increases the accuracy-related penalty from 20 to 40 percent for any portion of an underpayment attributable to one or more section 6662(b)(6) transactions with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return or in a statement attached to the return. Furthermore, new section 6662(i)(3) provides that certain amended returns or any supplement to a return shall not be taken into consideration for purposes of section 6662(i).

The Act amended section 6664(c) so that the reasonable cause exception for underpayments found in section 6664(c)(1) shall not apply to any portion of any underpayment attributable to a section 6662(b)(6) transaction. The Act similarly amended section 6664(d) so that the reasonable cause exception found in section 6664(d)(1) shall not apply to any reportable transaction understatement (within the

meaning of section 6662A(b)) attributable to a section 6662(b)(6) transaction. The Act also amended section 6676 so that any excessive amount (within the meaning of section 6676(b)) attributable to any section 6662(b)(6) transaction shall not be treated as having a reasonable basis.

These changes are effective for transactions entered into on or after March 31, 2010.

For more detailed information regarding the application of these changes, see Notice 2010-62, released September 13, 2010 (IRB 2010-40, dated October 4, 2010).

## **EXAMINATION GUIDANCE**

To ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6), any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.

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

cc: Deputy Commissioner (Operations)  
Deputy Commissioner (International)