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Exam

Longstanding Questions on Economic Substance Penalties Resurface Amidst Rising Tide of Cases

By George A. Hani and Jeffrey M. Tebbs*

Nearly 15 years have elapsed since Congress codified the economic substance doctrine ("ESD") through the enactment of Code Sec. 7701(o).[1] To date, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") have not issued regulations interpreting Code Sec. 7701(o) and the associated strict liability penalty. Initially, this approach was sustainable, as the IRS had instituted procedural safeguards that limited the circumstances in which examiners were permitted to assert the codified ESD. However, in recent months, the IRS has relaxed those administrative guardrails and started to assert the codified doctrine in several high-profile disputes, including cases in which taxpayers have challenged the validity of regulations issued to implement the Tax Cuts and Jobs Act.[2] The renewed vigor with which the IRS is applying Code Sec. 7701(o) is placing significant strain on the text of the statute.

In the absence of binding guidance, this column analyzes longstanding questions about the proper operation of the economic substance penalty. In particular, we critically evaluate the standard for determining when the 20-percent penalty may be enhanced to 40 percent for inadequate disclosure.[3] In addition, we consider what constitutes a failure to satisfy a "similar rule of law," other than the economic substance doctrine, for which the strict liability penalty may be imposed.[4] For each issue, we identify practical considerations for the planning, compliance, and controversy settings.

I. The Treasury Department's Decision to Refrain from Issuing Economic Substance Regulations

In the years immediately following the codification of the economic substance doctrine, the IRS issued a pair of non-binding Notices articulating the Service's views on certain aspects of the codified doctrine and the new strict liability penalty.[5] However, Treasury and the IRS refrained from proposing any binding regulations that would address numerous questions unanswered by the statutory text, notwithstanding detailed requests from tax practitioners.[6] The non-binding guidance itself was far from comprehensive. Notably, the IRS announced in

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Notice 2010-62 that it did not intend to issue any general guidance identifying the types of transactions to which the codified ESD was relevant.[7]

II. The Judiciary's Limited Opportunities to Interpret the Codified ESD

During this same period, the courts have provided minimal judicial guidance on the codified ESD and the associated penalty. The lack of case law is the result of the natural progression through the judicial system of transactions that pre-dated the codified ESD and the restrictions the IRS initially imposed on asserting the doctrine.

Code Sec. 7701(o) and the associated penalty apply only to transactions entered into after the date of enactment, March 30, 2010.[8] Given the extended process before a given transaction is subject to judicial review, including selection for audit, completion of an examination, review by the IRS Independent Office of Appeals (if any), and the initiation of litigation, nearly all judicial decisions since 2010 have involved transactions that occurred before the effective date for Code Sec. 7701(o). The highest profile cases, involving foreign tax credit claims arising from Structured Trust Advantaged Repackaged Securities ("STARS") transactions, involved transactions evaluated under the common law economic substance doctrine.[9] Transactions subject to the codified ESD have only recently started to trickle through the judicial system.[10]

Second, immediately following the enactment of Code Sec. 7701(o), the IRS established significant administrative guardrails to prevent examiners from asserting the codified ESD without adequate oversight and coordination. Within months of enactment, the Large and Mid Size Business Division ("LMSB"), the predecessor to today's Large Business & International Division ("LB&I"), issued a directive requiring LMSB examiners to receive approval from the applicable Director of Field Operations ("DFO") before proposing the economic substance penalty under Code Sec. 6662(b)(6).[11] In July 2011, LB&I issued a supplemental directive, reiterating that DFO approval was required before an examiner could assert the ESD penalty and confirming that DFO approval was required for any proposal to impose the doctrine itself.[12]

The 2011 directive established a rigorous four-step process for LB&I examiners to follow to determine whether the application of the codified ESD was appropriate. This included a mandatory review of 18 factors that "tend to show that application of the economic substance doctrine to a transaction is likely not appropriate." If a review of the facts and circumstances tended to show that the application of the ESD may have been appropriate, the examiner was then required to answer seven detailed "inquiries," any of which could have prevented the examiner from requesting DFO approval. For example, if another judicial doctrine, such as the substance-over-form doctrine or the step transaction doctrine, more appropriately addressed the noncompliance, the examiner was required to apply that doctrine rather than the codified ESD. If the examiner ultimately overcame the procedural hurdles and sought DFO review, the DFO was required to consult with IRS counsel before rendering a decision.

In 2012, the Office of Chief Counsel issued a directive, subsequently incorporated into the Chief Counsel Directives Manual, establishing coordination procedures for the economic substance doctrine and related penalties.[13] At the examination stage, consultation with the Office of Chief Counsel was not required but was available upon request from the field. However, litigation of the codified ESD and associated penalty "require[d] National Office review before briefs or motions are filed with the Tax Court and defense or suit letters are sent to the Department of Justice."[14]

Collectively, these administrative guardrails restricted the Service's assertion of the codified doctrine, and by extension, the strict liability penalty. Combined with any *in terrorem* effect on taxpayer behavior from codifying the doctrine and enacting a strict liability penalty, fewer than 15 judicial decisions involving the application of Code Sec. 7701(o) have been rendered through June 2024.

III. Recent Growth in Cases Under Code Sec. 7701(o)

Recent changes in the Service's approach to Code Sec. 7701(o) are expected to turn the slow dribble of case law into a steady stream. In April 2022, LB&I issued an interim guidance memorandum relaxing LB&I's historic policy of restraint with the codified ESD.[15] In particular, LB&I eliminated the requirement that its examiners obtain executive approval from the DFO before asserting the codified ESD and the related penalty. Instead of executive approval, an LB&I examiner now requires only the approval of an immediate supervisor. If the issue is "novel" or "significant" or "will require significant resources to address," then the examiner must also consult with "local field Counsel."[16] With a single exception, the guidance memorandum deletes the list of factors that tend to show

that it would not be appropriate to apply the codified ESD to a transaction.[17] Finally, the guidance memorandum now allows examiners to assert the codified ESD in addition to other judicial doctrines.[18]

Following LB&I's interim guidance memorandum, IRS officials have commented that the Service intends to assert the codified ESD with greater frequency.[19] Those statements are corroborated by recent petitions in the Tax Court, which show that the Service has asserted the codified ESD in response to high-profile challenges to the validity of key regulations under the Tax Cuts and Jobs Act.[20] In June 2024, the IRS announced that it would apply the codified economic substance doctrine "to challenge inappropriate basis adjustments" claimed by taxpayers in three types of transactions involving related party partnerships.[21] The expanding catalog of pending economic substance cases will require courts to resolve numerous questions about the operation and scope of the associated penalties.

IV. Overview of the Economic Substance Doctrine Penalty

When codifying the economic substance doctrine at Code Sec. 7701(o), Congress imposed a new "strict liability penalty"[22] at Code Sec. 6662(b)(6).[23] Specifically, a 20-percent penalty applies to the portion of any underpayment attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law."[24] The penalty rate increases to 40 percent for any underpayment "attributable to one or more nondisclosed noneconomic substance transactions."[25] A transaction is a "nondisclosed noneconomic substance transaction" if "the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return."[26] The 2010 legislation amended Code Sec. 6676 to extend the strict liability penalty to refund claims, with the penalty in the refund context limited to 20 percent.[27]

No exceptions to the penalty are available.[28] Congress modified the rules under Code Sec. 6664 to preclude the reasonable cause and good faith exception from being available for any underpayment attributable to a transaction lacking economic substance.[29] Objective defenses are not available either. For example, the substantial authority exception available for the "substantial understatement" penalty in Code Sec. 6662(b)(2) does not extend to the economic substance penalty.[30] Although the economic substance penalty is a strict liability penalty, LB&I has acknowledged that Code Sec. 6751(b) requires the penalty to be timely approved in writing by the immediate supervisor of the person who initially determines the penalty applies.[31]

Congress provided rules coordinating with other penalty provisions. For example, the Code Sec. 6662(b)(6) penalty does not apply to any portion of an underpayment on which a fraud penalty under Code Sec. 6663 is imposed.[32] Similarly, if the enhanced 40-percent penalty for nondisclosed noneconomic substance transactions applies, the reportable transaction penalty (Code Sec. 6662A) will not also apply.[33]

V. Key Unanswered Questions on Penalties Under the Codified Economic Substance Doctrine

A. Adequate Disclosure

Recent developments have refocused attention on the lack of regulations addressing what constitutes inadequate disclosure for purposes of increasing the economic substance penalty to 40 percent under Code Sec. 6662(i). For example, in a recent Tax Court petition, the taxpayer averred that it disclosed the disputed transaction on Schedule UTP (*Uncertain Tax Position Statement*) before it was contacted by the IRS regarding examination of its tax return, but the IRS nevertheless concluded that the taxpayer's disclosure was inadequate and imposed the enhanced 40-percent penalty.[34]

1. Historic IRS Position on Disclosure of "Noneconomic Substance Transactions"

In a 2010 Notice issued shortly after enactment of Code Sec. 7701(o), the IRS announced its position that "disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS, consistent with the instructions and other guidance associated with those subsequent forms, publications, or other guidance."[35] Shortly following the 2010 Notice, the IRS announced that it would treat a complete and accurate disclosure of a tax position on Schedule UTP as satisfying the disclosure requirements of Code Sec. 6662(i).[36] If these items of subregulatory guidance had been followed by implementing regulations, the economic substance disclosure rules would generally have been aligned with existing disclosure rules for relief from substantial understatement penalties.[37]

2. Recent IRS Developments on Adequate Disclosure

In the ensuing 14 years, Treasury and the IRS never issued proposed, temporary, or final regulations prescribing the form or content for adequate disclosure of a "noneconomic substance transaction." IRS Notices "do not have the force of law, are merely statements of the Commissioner's position, and are entitled to no special deference[.]"[38] In November 2022, the Office of Chief Counsel acknowledged that the disclosure requirements described in Notice 2010-62 are not binding on taxpayers.[39]

Specifically, in written advice to LB&I Area Counsel, the Office of Associate Chief Counsel (Procedure & Administration) observed that "[t]here are no regulations that require taxpayers to file a Form 8275 to disclose non-economic substance transactions to defend against section 6662(i) penalties," and the IRS "cannot contend" that any subregulatory pronouncement "imposes an obligation for taxpayers to file a Form 8275 because that position would not adhere to" the Treasury Department's policy on the tax regulatory process. In the particular case under review, the taxpayer had completely described the "material facts" of a micro-captive insurance transaction on Form 8886 but had not filed Form 8275. The advice concludes that the timely filed Form 8886 likely satisfied the disclosure requirements in Code Sec. 6662(i). The advice does not identify what facts were "material" to the transaction. In articulating the standard for disclosure in Code Sec. 6662(i), the Office of Chief Counsel relied on "case law interpreting similar disclosure requirements" for other penalty provisions and opined that a taxpayer must "disclose enough relevant data concerning the treatment of the item to alert the Commissioner to potential controversy."[40]

3. Determining Adequate Disclosure in the Absence of Binding Guidance

a) Disclosure may be adequate without a separate attachment. The 2022 Chief Counsel Advice came to the seemingly obvious conclusion that Form 8275 is not required for adequate disclosure. Indeed, the text of the statute states a taxpayer may adequately disclose the relevant facts on the face of the return. Code Sec. 6662(i)(2) provides that the enhanced penalty only applies if "the relevant facts affecting the tax treatment are not adequately disclosed *in the return* nor in a statement attached to the return." (Emphasis added.) The legislative history for Code Sec. 6662(i) reiterates the statutory language providing that disclosure on the return may be adequate.[41] That statutory language reflects a departure from prior proposals for an economic substance doctrine penalty. Legislative proposals between 2003 and 2007 would have characterized disclosure as adequate only if the disclosure satisfied the requirements of the reportable transaction regulations under Code Sec. 6011.[42] Those reportable transaction regulations mandate a disclosure statement on a prescribed form (Form 8886).[43] The version of Code Sec. 6662(i) adopted by Congress abandoned that approach.

It is therefore clear that taxpayers are entitled to disclose the relevant facts affecting the tax treatment of a transaction on the return itself or any statement attached to return, whether that is a form designated by Notice 2010-62 (*i.e.*, Form 8275 (*Disclosure Statement*) or Form 8275-R (*Regulation Disclosure Statement*)) or a different form, such as Schedule UTP (*Uncertain Tax Positions*) or Form 8886 (*Reportable Transaction Disclosure*).

b) Adequate disclosure should not require the taxpayer to identify a transaction as subject to potential challenge, nor should it require the taxpayer to describe the legal reasons the transaction may lead to a potential dispute. The statutory text does not clarify what constitutes disclosure of "relevant facts affecting the tax treatment" of the transaction. In the absence of binding regulations, case law interpreting similar statutory language should be considered, albeit with consideration for the specific policy context of different sections of the Code.

(i) Relief from understatement penalty under former Code Sec. 6661. Former Code Sec. 6661 provided for a penalty equal to 25 percent of the amount of any underpayment. Former Code Sec. 6661(b)(2)(B)(ii) completely relieved that penalty for "any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return."[44] Treasury and the IRS issued regulations under Code Sec. 6661 requiring disclosure on Form 8275, but several cases were decided under the language of the statute, for tax years before those regulations were effective.[45] In general, those cases rely upon the legislative history for Code Sec. 6661 to conclude that the facts disclosed by the taxpayer need to be sufficient for the IRS to identify a potential dispute, assuming the IRS actually examined the information provided on the return.[46]

For example, in *Pan American Life Insurance Company*,[47] the Fifth Circuit Court of Appeals vacated a substantial understatement penalty under former Code Sec. 6661, concluding that the taxpayer had adequately disclosed the relevant facts for the position that it was taxable as a "stock" life insurance company rather than a "mutual" life insurance company. The taxpayer had marked a box on Form 1120L (*U.S. Life Insurance Company Income*

Tax Return) indicating that it was a "stock" insurer, while attaching audited financial statements that referred to the entity as a "mutual" insurer. The court rejected the IRS position that the taxpayer was required to invite attention to the "inconsistency" by providing an explanation in a written statement attached to the return.[48]

The case law interpreting former Code Sec. 6661 does not establish a precise dividing line between adequate and inadequate disclosure. The Seventh Circuit Court of Appeals observed that "the mere declaration of a deduction does not entitle taxpayer to a reduced penalty for understatement of tax."[49] The Eighth Circuit Court of Appeals described the standard as requiring that "the tax return must at least provide sufficient information to enable the Commissioner to identify the potential controversy involved."[50] However, identifying a potential controversy does not necessarily require identifying particular legal theories or Code sections. In *Elliott*,[51] the Tax Court held a taxpayer adequately disclosed relevant facts for purposes of relief from accuracy-related penalties, notwithstanding that the taxpayer abandoned its position that a specific Code section permitted the deduction claimed. The court observed that "[t]he test of adequate disclosure does not rest solely on whether a taxpayer has identified the correct section of the Code to support a reported deduction."

In considering case law interpreting the disclosure standards in other provisions of the Code, it is important to recall that the enhanced penalty under Code Sec. 6662(i) is unique, and the interpretation of adequate disclosure in related contexts does not inexorably lead to the same conclusion for the economic substance penalty. In contrast to mandatory disclosure rules, taxpayers are not required to disclose "noneconomic substance transactions."[52] Unlike the understatement penalty in former Code Sec. 6661, taxpayers that voluntarily disclose "noneconomic substance transactions" are not entitled to comprehensive penalty relief.[53] Instead, adequate disclosure merely prevents the enhancement of the penalty from 20 to 40 percent. Given this fundamental difference (disclosure of a noneconomic substance transaction lessens but does not eliminate the penalty), Congress likely did not intend for the standard to be equally stringent.

(ii) Relief from extended statute of limitations under Code Sec. 6501. In that vein, "adequate" disclosure has been interpreted more leniently in a more closely analogous policy context. Specifically, Code Sec. 6501(e) extends the statute of limitation for assessment if a taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated on the return. However, in determining the amount omitted from gross income, an omitted amount is not taken into account if "such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of the item."[54] The Supreme Court has explained that Congress extended the statute of limitations in this circumstance, because the omission of income puts "the Commissioner ... at a special disadvantage in detecting errors."[55]

Case law under Code Sec. 6501(e) considers disclosure to be adequate if the tax return (or an attachment) provides an "adequate clue" that an error exists on the return.[56] The "clue" must enable the IRS to identify and investigate the item, but "[t]he clue does not have to be a detailed revelation of each and every underlying fact."[57] For example, in *Benderoff*,[58] the Eighth Circuit Court of Appeals held that a balance sheet included with a corporate information return constituted adequate disclosure, because it provided "the Commissioner an adequate clue that there has been a distribution of shareholder's undistributed taxable income" from an S corporation. Because the distributions were adequately disclosed within the meaning of Code Sec. 6501(e), the extended statute of limitations did not apply.[59]

The legislative history for the economic substance penalty is silent on the purpose of the penalty enhancement for inadequate disclosure. However, the structure of the penalty scheme sheds light on the Congressional purpose. The IRS is generally at a disadvantage in detecting a transaction lacking economic substance, where the form typically diverges from the substance (or lack thereof). Congress intended to discourage "transaction[s] lacking economic substance" with the 20-percent penalty under Code Sec. 6662(b)(6), and it sought to eliminate the Service's special disadvantage in detecting such transactions with the additional 20-percent enhancement for inadequate disclosure in Code Sec. 6662(i). Viewed through this lens, the "adequate clue" standard is the appropriate benchmark.

c) Practical considerations. With fewer guardrails to limit the assertion of the codified economic substance doctrine, decisions regarding disclosure have risen dramatically in importance. Providing robust disclosure on Form 8275, describing in detail any potential weakness in a taxpayer's reporting position, would certainly minimize the chance of a penalty enhancement under Code Sec. 6662(i). On the other hand, such disclosures may attract excessive scrutiny from the Service, turning the taxpayer into a target for extensive audit, and bring the 20-percent strict liability penalty to the table, even for a transaction that is not reasonably susceptible to successful challenge under Code Sec. 7701(o).

Given the current environment, taxpayers may consider prophylactically amending prior-year tax returns

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to supplement existing disclosures on an original return. Code Sec. 6662(i)(3) allows taxpayers to amend their tax returns to provide supplemental disclosure. An amendment that is limited to furnishing a disclosure statement typically would not affect federal taxable income and therefore may not require burdensome amendment of state income tax returns.

Any amendment that occurs after the taxpayer is "first contacted" by the Service regarding an examination of the return will not be taken into account for purposes of evaluating the adequacy of the taxpayer's disclosure. While it is true that the IRS permits certain eligible LB&I taxpayers to supplement disclosure *via* qualified amended return in the first 30 days after the opening of an audit, that administrative policy applies only to the accuracy-related penalties described in Code Secs. 6662(b)(1) and 6662(b)(2).[60] The applicable revenue procedure does not extend that administrative grace to the economic substance penalty under Code Sec. 6662(b)(6) or its enhancement in Code Sec. 6662(i).

If the time has elapsed to include an initial disclosure or supplement an existing disclosure, taxpayers should defend the adequacy of their disclosures based on the statutory text and legislative history, without regard to Notice 2010-62, which lacks the force of law. Although the Office of Chief Counsel now acknowledges that filing Form 8275 is not required for a taxpayer to adequately inform the IRS of a transaction for purposes of Code Sec. 6662(i), taxpayers may nevertheless encounter examiners who assert or imply that disclosure is presumptively inadequate if not furnished in a narrative statement attached to the return. Taxpayers should not reflexively accept an examiner's expansive view of the disclosure standard in Code Sec. 6662(i). To the extent case law in related contexts is relevant, precedent for the understatement penalty under former section 6661 provides that a taxpayer is not required to highlight a transaction or articulate legal weaknesses in its position, as long as the return provides sufficient data to alert the IRS to a possible dispute, assuming the IRS reviewed the information provided. A more moderate standard—disclosure of an "adequate clue"—applies to determine when the IRS has been placed at a special disadvantage in detecting an item of omitted income, and a similar principle naturally extends to Code Sec. 6662(i), the imposition of which may only be appropriate when the IRS has been placed at a disadvantage in detecting a transaction lacking economic substance.

Looking forward, taxpayers should closely monitor pending cases on the scope of the codified ESD. In an October 2023 decision in *Liberty Global, Inc.*, the district court concluded that every transaction is subject to the conjunctive test in Code Sec. 7701(o)(1), and "[t]here is no 'threshold' inquiry separate from the statutory factors" of objective economic effect and substantial business purpose."[61] This conclusion—that the codified ESD does not require an initial determination that the doctrine is "relevant" to a given transaction—is wrong as a matter of law, and the taxpayer has appealed that decision to the Tenth Circuit.[62] However, if the Department of Justice ("DOJ") prevails on appeal, taxpayers should expect to see the codified ESD asserted for transactions never previously contemplated as within the ambit of the doctrine. Developments in *Liberty Global* and similar cases in the litigation pipeline may further complicate the extent to which disclosure is advisable for a given transaction.

B. Extension of the Economic Substance Penalty to Disallowance Under a "Similar Rule of Law"

Code Sec. 6662(b)(6) imposes a 20-percent penalty on an understatement of income tax attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) *or failing to meet the requirements of any similar rule of law*." (Emphasis added.) The legislative history explains that the phrase "similar rule of law" was intended to describe a judicial doctrine involving the conjunctive test in Code Sec. 7701(o) (that is, objective economic effect and substantial non-tax business purpose). The phrase "similar rule of law" was not intended to extend to other "soft" doctrines, such as the substance over form doctrine or the step transaction doctrine.

The summary of the legislation produced by the staff of the Joint Committee of Taxation, immediately prior to enactment of the economic substance penalty, explains that "[i]t is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine."[63] The report of the House Budget Committee dated March 17, 2010, describing a bill will the same relevant statutory language, stated that "[f]or example, 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 for an economic substance analysis, even if a different term is used to describe the doctrine."[64]

Consistent with the legislative history, the IRS announced in Notice 2014-58 that it would not apply

the penalty to transactions for which the "underlying adjustments" were based on "other judicial doctrines (*e.g.*, the substance over form or step transaction doctrines)." Although an IRS Notice does not bind taxpayers, the Notice should bind the IRS, similar to a revenue ruling.[65] Even in the absence of the Notice, the legislative history is clear that Congress intended to address circumstances in which a court analyzed the same factors as Code Sec. 7701(o)(1) but applied a different label to its analysis (*e.g.*, "sham in substance").

With the recent decision to eliminate executive approval before assertion of Code Sec. 7701(o), there may be temptation for exam teams to access the strict liability penalty by labeling challenges under other judicial doctrines as assertions of the codified ESD. IRS policy prohibits the use of penalties as a "bargaining point" in resolving a taxpayer's other tax adjustments.[66] Taxpayers should be prepared to rebut such attempts, which would violate the statutory limits on the economic substance penalty and inappropriately deprive taxpayers of standard defenses to accuracy-related penalties.

VI. Conclusion

As the IRS and DOJ wield the codified economic substance doctrine in a growing number of controversies, and the judicial approach to the breadth of the doctrine remains in flux, taxpayers should revisit whether their existing approach to disclosure remains fit for purpose. Taxpayers under active examination should expect aggressive assertion of the economic substance penalty and its enhancement. Taxpayers should be prepared to hold the IRS to its commitment in Notice 2014-58, rooted firmly in the legislative history, that the Service will not apply the economic substance penalty to transactions for which the underlying adjustments are based on common law doctrines with distinct criteria (*e.g.*, the step transaction doctrine). In the current regulatory vacuum, with no binding guidance, taxpayers should also prepare to defend the adequacy of their disclosures under the plain text of Code Sec. 6662(i) and relevant precedent. Both issues represent questions of first impression, which will finally be presented to the judicial system as the codified economic substance doctrine enters its adolescence.

ENDNOTES

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[1] *Health Care and Education Reconciliation Act of 2010*, Pub. L. No. 111-152, § 1409, 124 Stat. 1070 (Mar. 30, 2010). Unless otherwise noted, all references to "sections" are to the Internal Revenue Code of 1986 (the "Code"). All references to "regulations," "Treasury Regulations §," and "Treas. Reg. §" are to the Income Tax Regulations implementing the Code.

[2] *See* discussion *infra* Part III.

[3] Code Secs. 6662(b)(6) and 6662(i).

[4] Code Sec. 6662(b)(6).

[5] *See* Notice 2010-62, *Interim Guidance under the Codification of the Economic Substance Doctrine and Related Provisions in the Health Care and Education Reconciliation Act of 2010*, IRB 2010-40, 411 (Oct. 4, 2010); Notice 2014-58, *Additional Guidance under the Codified Economic Substance Doctrine and Related Penalties*, IRB 2014-44, 746 (Oct. 27, 2014).

[6] *See, e.g.*, AM. BAR ASS'N SECTION OF TAX'N, REQUEST FOR GUIDANCE ON IMPLEMENTATION OF ECONOMIC SUBSTANCE LEGISLATION (Jan. 18, 2011); N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE, RPT. NO. 1228 (Jan. 5, 2011).

[7] *See* Notice 2010-62, IRB 2010-40 at 412 ("The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."); Code Sec. 7701(o)(1) (flush language); Code Sec. 7701(o)(5)(C).

[8] Pub. L. No. 111-152, § 1409(e); *see also* IRS PMTA 2010-55 (Aug. 24, 2010) (addressing the effective date for enhanced penalty for underpayments attributable to nondisclosed noneconomic substance transactions).

[9] *See Wells Fargo & Co.*, CA-8, 2020-1 USTC ¶50,133, 957 F3d 840; *Santander Holdings USA, Inc.*, CA-1, 2017-1 USTC ¶50,101, 844 F3d 15, 21 n.9; *Salem Financial, Inc.*, CA-FC, 2015-1 USTC ¶50,304, 786 F3d 932, 943 n.4; *Bank of New York (Mellon) Corporation*, CA-2, 2015-2 USTC ¶50,473, 801 F3d 104, 115 n.7.

[10] *See, e.g., Chemoil Corp.*, 132 AFTR 2d 2023-5965 (S.D.N.Y. Sept. 26, 2023); *Alternative Carbon Res., LLC*, CA-FC, 2019-2 USTC ¶70,356, 939 F3d 1320 (2019).

[11] LMSB Directive, Codification of Economic Substance Doctrine and Related Penalties, LMSB-4-0910-024 (Sep. 14, 2010).

[12] LB&I Directive, Guidance for Examiners and Managers of the Codified Economic Substance Doctrine and Related Penalties, LB&I-4-0711-015 (Jul. 15, 2011).

[13] IRS CC-2012-008, Coordination Procedures for the Economic Substance Doctrine and Related Penalties (Apr. 3, 2012); IRS CC-2014-005, Updated Requirements for National Office Coordination (May 20, 2014)

[14] IRC CC-2012-008, at 4; CCDM Exhibits 31.1.1-1 (Jul. 19, 2023) and 35.11.1-1 (Aug. 2, 2023).

[15] *See* LB&I Directive, Interim Guidance Memorandum on Economic Substance Doctrine and Related Penalties, LB&I-04-0422-0014 (Apr. 22, 2022). That memorandum is now incorporated into the Internal Revenue Manual. IRM 4.46.4.12.9 (Economic Substance Doctrine) (Sep. 6, 2023).

[16] If required by the Chief Counsel Directives Manual, local field counsel will coordinate with "Division Counsel" and the appropriate Associate Chief Counsel offices.

[17] The memorandum retains the statement that "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." *Id.* at 4.

[18] *Id.*

[19] For example, in October 2022, at the American Bar Association Section of Taxation meeting, the IRS Associate Chief Counsel (International) stated that the IRS may "look to bring up the economic substance doctrine to a greater extent than in the past." Andrew Velarde, *Government's Use of Economic Substance Doctrine May Increase*, TAX NOTES (Oct. 24, 2022).

[20] *See, e.g., Siemens USA Holdings, Inc.*, Tax Court No. 3898-24 (ESD asserted in response to taxpayer challenge to the validity of Reg. §1.245A-5T); *Liberty Global, Inc.*, No. 1:22-cv-02622 (same) DC-CO, 2022-1 USTC ¶50,134 (2022); *Abbott Labs*, Tax Court No. 20227-23 (ESD asserted in response to taxpayer challenge to the validity of the GILTI disqualified basis regulations).

[21] *See* IRS, *New IRS, Treasury guidance focuses on 'basis shifting transactions used by partnerships*, FS-2024-21 (Jun. 17, 2024); Rev. Rul. 2024-14, IRB 2024-28. In October 2023, the District Court

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for the District of Colorado held that Code Sec. 7701(o) does not require a determination that the economic substance doctrine is "relevant" to a transaction before applying the conjunctive test of objective economic effect and substantial business purpose. *See Liberty Global, Inc.*, No. 1:20-cv-03501-RBJ, 2023 WL 8062792 (Oct. 31, 2023). The taxpayer has appealed that decision to the Tenth Circuit. In the unlikely event that the Tenth Circuit affirms the district court on this question of law, it would likely further expand the universe of circumstances in which the IRS asserts the codified ESD.

22 J. Comm. Tax'n, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act,"* at 152-53 (Mar. 21, 2010) ("JCX-18-10"), at 155.

23 Pub. L. No. 111-152, § 1409(b)(1).

24 Code Sec. 6662(b)(6).

25 Code Sec. 6662(i)(1).

26 Pub. L. No. 111-152, § 1409(b)(2); Code Sec. 6662(i)(2).

27 Pub. L. No. 111-152, § 1409(d); Code Sec. 6676(c); JCX-18-10, at 156.

28 JCX-18-10, at 156.

29 Pub. L. No. 111-152, § 1409(c); Code Sec. 6664(c)(2).

30 Code Sec. 6662(d)(2)(B).

31 2022 LB&I Directive, at 2. This would appear to be a concession that, although it is a strict liability penalty, it is not "automatically calculated by electronic means" and therefore is not exempt by reason of Code Sec. 6751(b)(2). *See also S.S. Patel*, 120 TCM 211, Dec. 61,754(M), TC Memo. 2020-133 (analyzing timeliness of supervisory approval for assertion of economic substance penalties); *J.R. Oropeza*, 155 TC 132, 155 TC No. 9, Dec. 61,763 (2020) (same). Existing judicial precedent is divided on the stage at which supervisory approval is required. *See* Preamble to NPRM, 88 FR 21,564 (Apr. 11, 2023). Also in April 2023, LB&I issued a memorandum clarifying that an LB&I case manager is a "higher-level official" who may approve the initial determination of penalties for purposes of satisfying the Code Sec. 6751(b)(1) requirement of supervisory approval. LB&I, Interim Guidance for Approval of Penalties under Code Sec. 6751(b)(1) for LB&I Examiners, LB&I-04-0423-0004 (Apr. 27, 2023).

32 Code Sec. 6662(b) (flush language).

33 Code Sec. 6662A(e)(2)(B).

34 *Siemens USA Holdings Inc.*, *supra* note 21, Pet. ¶¶ 16(a), 20, 64.

35 Notice 2010-62, 2010-40 IRB at 412. The IRS has not prescribed any other form of disclosure for purposes of Code Sec. 6662(i). *See* Rev. Proc. 2023-40, IRB 2023-51, 1553, § 1 (Dec. 18, 2023) (revenue procedure identifying circumstances for adequate disclosure for substantial understatement penalty "does not apply with respect to any other penalty provisions (including but not limited to … the Code Sec. 6662(i) increased accuracy-related penalty in the case of nondisclosed noneconomic substance transactions …).").

36 Announcement 2010-75, 2010-41 IRB 428 (Coordination with Forms 8275 and 8886).

37 *See* Reg. §§1.6662-4(f) (establishing method for making adequate disclosure for relief for substantial understatement penalty).

38 *Phillips Petroleum Co.*, 101 TC 78, 99, Dec. 49,178, n.17 (1993); *see also* U.S. Dep't of the Treasury, Policy Statement on the Tax Regulatory Process, at 2, n.1 (Mar. 5, 2019) ("Subregulatory guidance [such as a notice] is not intended to affect taxpayer rights or obligations independent from underlying statutes or regulations. Unlike statutes and regulations, subregulatory guidance does not have the force and effect of law.").

39 I.R.S. Chief Couns. Adv. 2022-44-010 (Nov. 4, 2022).

40 *Id.* (citations omitted).

41 JCX-18-10, at 155 ("The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return.)."); H.R. Rep. No. 111-443(I), at 304 (2010) ("The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return).").

42 *See* S. Rep. No. 110-206, at 99 (Oct. 25, 2007); S. Rep. No. 109-336, at 145 (Sept. 15, 2006); H.R. Rep. No. 109-455, at 230 (May 9, 2006); H.R. Rep. No. 108-755, at 670 (Oct. 7, 2004).

43 Reg. §25.6011-4(d).

44 Former I.R.C. § 6661(b)(2)(B)(ii) (1986).

45 *See* T.D. 8381, 56 FR 67,492 (Dec. 31, 1991).

46 The Senate Report that preceded enactment of Code Sec. 6661 stated "disclosure will be made if the taxpayer discloses facts sufficient to enable the Internal Revenue Service to identify the potential controversy, if it analyzed that information" S. Rep. No. 97-494, at 272 (1982).

47 CA-5, 99-1 USTC ¶50,543, 174 F3d 694, 697.

48 Similarly, in *E. Fellouzis*, DC-FL, 95-1 USTC ¶50,287, 896 FSupp 1166 (1995), a jury concluded that an individual taxpayer adequately disclosed his basis for charitable income tax deductions with respect to donations of art, by attaching appraisals to his tax return. Following trial, the district court rejected the government's motion for judgment as a matter of law on the issue of adequate disclosure.

49 *A.J. Accardo*, CA-7, 91-2 USTC ¶50,405, 942 F2d 444, 453 (brief description of deduction on return was insufficient to disclose potential controversy over deductibility of legal fees incurred in defense of RICO prosecution).

50 *E.A. Reinke Est.*, CA-8, 95-1 USTC ¶50,064, 46 F3d 760, 765 (listing amounts as "capital gains" or "rents" or "royalties" was insufficient to "disclose to the Commissioner the possible issue whether those amounts constituted capital gains or ordinary income, or provide the facts relevant to such a determination.").

51 73 TCM 3197, 3201, Dec. 52,121(M), TC Memo. 1997-294 (1997).

52 *Compare* Reg. §25.6011-4 (mandatory disclosure of listed transactions) *with* Code Sec. 6662(i) (voluntary disclosure prevents enhancement of penalty).

53 *See* Rochelle L. Hodes, *The Case for a Different Kind of Disclosure Regime*, Tax Notes (Aug. 30, 2010).

54 Code Sec. 6501(e)(1)(B)(iii).

55 *Colony, Inc.*, SCt, 58-2 USTC ¶9593, 357 US 28, 36, 78 SCt 1033.

56 *G.E. Quick's Trust*, 54 TC 1336, 1347, Dec. 30,187 (1970), *aff'd*, CA-8, 71-1 USTC ¶9489, 444 F2d 90 ("The touchstone in cases of this type is whether respondent has been furnished with a 'clue' to the existence of the error.").

57 *See Univ. Country Club, Inc.*, 64 TC 460, 470, Dec. 33,277 (1975), *acq.*, IRS Announcement Relating to: *Univ. Country Club*, 1976 WL 175537 (Dec. 31, 1976).

58 CA-8, 68-2 USTC ¶9486, 398 F2d 132, 137.

59 *V.C. Benderoff*, CA-8, 68-2 USTC ¶9486, 398 F2d at 137-38.

60 Rev. Proc. 2022-39, IRB 2022-49, 507 (Dec. 5, 2022).

61 *See Liberty Global, Inc.*, No. 1:20-cv-03501-RBJ, 2023 WL 8062792, *5 (Oct. 31, 2023).

62 *See* Code Sec. 7701(o)(1) (flush language); Code Sec. 7701(o)(5)(C); *see also* Brief of National Foreign Trade Council, Inc. as Amicus Curiae in Support of Appellant, *Liberty Global, Inc.*, CA-8, No. 23-01410.

63 JCX-18-10, at 155, n.359.

64 H.R. Rep. No. 111-443(I), at 304, n.161.

65 *See G. McLendon Est.*, CA-5, 98-1 USTC ¶60,303, 135 F3d 1017, 1025 ("because [the taxpayer] was entitled to rely" on a published revenue ruling, "the Tax Court was not at liberty to disregard it"); *G.A. Rauenhorst*, 119 TC 157, 171-73, Dec. 54,899 (2002) (although court is not "bound by the Commissioner's revenue rulings," the IRS is bound, and such rulings operate as a "concession" by the IRS to the taxpayer); *cf.* IRM 32.1.1.2.2 (Aug. 2, 2018) ("The Office of Chief Counsel ordinarily should not take any position in litigation that would yield a result that would be harsher to the taxpayer than what the taxpayer would be allowed under the proposed regulations.").

66 *See* IRS Policy Statement 20-1, Penalties are Used to Enhance Voluntary Compliance, Internal Revenue Manual ("IRM"), IRM 1.2.1.12.1 (Jun. 29, 2004). ("Penalties are not a 'bargaining point' in resolving the taxpayer's other tax adjustments.").

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