TECHNICAL EXPLANATION OF THE "AMT RELIEF ACT OF 2007" AS INTRODUCED IN THE HOUSE OF REPRESENTATIVES ON DECEMBER 11, 2007

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CONTENTS

Page

INTRODUCTION 1

TITLE I – INDIVIDUAL TAX RELIEF 2

A. Extend Alternative Minimum Tax Relief for Individuals (secs. 101 and 102 of the bill and secs. 26 and 55 of the Code) 2
B. Provide Alternative Minimum Tax Credit Relief for Individuals (sec. 103 of the bill and sec. 53 of the Code) 4
C. Modify Refundable Child Credit Threshold (sec. 104 of the bill and sec. 24(d) of the Code) 7

TITLE II – REVENUE PROVISIONS 8

A. Modify Tax Treatment of Offshore Nonqualified Deferred Compensation (sec. 201 of the bill and new sec. 457A of the Code) 8
B. Economic Substance 19
   1. Clarification of the economic substance doctrine (sec. 211 of the bill and new sec. 7701(p) of the Code) 19
   2. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 212 of the bill and secs. 6662, 6664, and 6676 of the Code) 27
C. Delay Implementation of Worldwide Interest Allocation (sec. 221 of the bill and sec. 864(f) of the Code) 34
D. Increase in Penalty for Failure to File Partnership Returns (sec. 222 of the bill and sec. 6698 of the Code) 38
E. Impose Penalty for Failure to File S Corporation Returns (sec. 223 of the bill and new sec. 6699 of the Code) 39
F. Increase Minimum Failure to File Penalty (sec. 224 of the bill and sec. 6651 of the Code) 40
G. Modify Corporate Estimated Tax Payments (sec. 225 of the bill) 41

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the AMT Relief Act of 2007, as introduced in the House of Representatives on December 11, 2007.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the "AMT Relief Act of 2007" as Introduced in the House of Representatives on December 11, 2007,* (JCX-113-07), December 12, 2007. This document can also be found on our website at www.house.gov/jct.

TITLE I – INDIVIDUAL TAX RELIEF

A. Extend Alternative Minimum Tax Relief for Individuals (secs. 101 and 102 of the bill and secs. 26 and 55 of the Code)

Present Law

Present law imposes an alternative minimum tax ("AMT") on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The present exemption amount is: (1) $62,550 ($45,000 in taxable years beginning after 2006) in the case of married individuals filing a joint return and surviving spouses; (2) $42,500 ($33,750 in taxable years beginning after 2006) in the case of other unmarried individuals; (3) $31,275 ($22,500 in taxable years beginning after 2006) in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit).

For taxable years beginning before 2007, the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2006, the nonrefundable personal credits (other than the adoption credit, child credit and saver's credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and saver's credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.[2]

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[2] The rule applicable to the adoption credit and child credit is subject to the EGTRRA sunset.

Explanation of Provision

The bill provides that the individual AMT exemption amount for taxable years beginning in 2007 is (1) $66,250, in the case of married individuals filing a joint return and surviving spouses; (2) $44,350 in the case of other unmarried individuals; and (3) $33,125 in the case of married individuals filing separate returns.

For taxable years beginning in 2007, the provision allows an individual to offset the entire regular tax liability and alternative minimum tax liability by the nonrefundable personal credits.

Effective Date

The provision is effective for taxable years beginning in 2007.

B. Provide Alternative Minimum Tax Credit Relief for Individuals (sec. 103 of the bill and sec. 53 of the Code)

Present Law

In general

Present law imposes an alternative minimum tax ("AMT") on an individual taxpayer to the extent the taxpayer's tentative minimum tax liability exceeds his or her regular income tax liability. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is the amount by which the alternative minimum taxable income ("AMTI") exceeds an exemption amount.

An individual's AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The individual AMT attributable to deferral adjustments generates a minimum tax credit that is allowable to the extent the regular tax (reduced by other nonrefundable credits) exceeds the tentative minimum tax in a future taxable year. Unused minimum tax credits are carried forward indefinitely.

AMT treatment of incentive stock options

One of the adjustments in computing AMTI is the tax treatment of the exercise of an incentive stock option. An incentive stock option is an option granted by a corporation in connection with an individual's employment, so long as the option meets certain specified requirements.[3] Under the regular tax, the exercise of an incentive stock option is tax-free if the stock is not disposed of within one year of exercise of the option or within two years of the grant of the option.[4] The individual then computes the long-term capital gain or loss on the sale of the stock using the amount paid for the stock as the cost basis. If the holding period requirements are not satisfied, the individual generally takes into account at the exercise of the option an amount of ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the amount paid for the stock. The cost basis of the stock is increased by the amount taken into account.[5]

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[3] Sec. 422.

[4] Sec. 421.

[5] If the stock is sold at a loss before the required holding periods are met, the amount taken into account may not exceed the amount realized on the sale over the adjusted basis of the stock. If the stock is sold after the taxable year in which the option was exercised but before the required holding periods are met, the required inclusion is made in the year the stock is sold.

Under the individual alternative minimum tax, the exercise of an incentive stock option is treated as the exercise of an option other than an incentive stock option. Under this treatment, generally the individual takes into account as ordinary income for purposes of computing AMTI the excess of the fair market value of the stock at the date of exercise over the amount paid for the stock.[6] When the stock is later sold, for purposes of computing capital gain or loss for purposes of AMTI, the adjusted basis of the stock includes the amount taken into account as AMTI.

The adjustment relating to incentive stock options is a deferral adjustment and therefore generates an AMT credit in the year the stock is sold.[7]

Allowance of long-term unused credits

Under present law, an individual's minimum tax credit allowable for any taxable year beginning after December 31, 2006, and beginning before January 1, 2013, is not less than the "AMT refundable credit amount". The "AMT refundable credit amount" is the greater of (1) the lesser of $5,000 or the long-term unused minimum tax credit, or (2) 20 percent of the long-term unused minimum tax credit. The long-term unused minimum tax credit for any taxable year means the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the 3rd taxable year immediately preceding the taxable year (assuming the credits are used on a first-in, first-out basis). In the case of an individual whose adjusted gross income for a taxable year exceeds the threshold amount (within the meaning of section 151(d)(3)(C)), the AMT refundable credit amount is reduced by the applicable percentage (within the meaning of section 151(d)(3)(B)). The additional credit allowable by reason of this provision is refundable.

Explanation of Provision

The provision generally allows the long-term unused minimum tax credit over two years and eliminates the AGI phase-out. Thus, if an individual has a long-term unused minimum tax credit of $1 million for 2007, the AMT refundable credit amount for 2007 is $500,000 (50 percent of the $1 million long-term unused credit amount for 2007) and the AMT refundable credit amount for 2008 is also $500,000 (the $500,000 amount of the AMT refundable credit amount for 2007 but not in excess of the $500,000 long-term unused minimum tax credit for 2008).

The bill provides that any underpayment of tax outstanding on the date of enactment which is attributable to the application of the minimum tax adjustment for incentive stock

[6] If the stock is sold in the same taxable year the option is exercised, no adjustment in computing AMTI is required.

[7] If the stock is sold for less than the amount paid for the stock, the loss may not be allowed in full in computing AMTI by reason of the $3,000 limit on the deductibility of net capital losses. Thus, the excess of the regular tax over the tentative minimum tax may not reflect the full amount of the loss.

options (including any interest or penalty relating thereto) is abated. No credit is allowed with respect to any amount abated.

The bill provides that any interest and penalty paid before the date of enactment with respect to the application of the minimum adjustment for incentive stock options is treated as an amount of adjusted net minimum tax for the taxable year of the underpayment to which the interest or penalty relates for purposes of the minimum tax credit.

Effective Date

The provision generally applies to taxable years beginning after December 31, 2006.

The provision relating to the abatement of interest and penalties takes effect on date of enactment.

C. Modify Refundable Child Credit Threshold (sec. 104 of the bill and sec. 24(d) of the Code)

Present Law

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000 through 2010, and $500 thereafter. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The credit is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against the regular tax and the alternative minimum tax. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). The threshold dollar amount is $11,750 (2007), and is indexed for inflation.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit ("EIC").

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Explanation of Provision

The provision modifies the earned income formula for the determination of the refundable child credit to apply to 15 percent of earned income in excess of $8,500 for taxable years beginning in 2008.

Effective Date

The provision is effective for taxable years beginning in 2008.

TITLE II – REVENUE PROVISIONS

A. Modify Tax Treatment of Offshore Nonqualified Deferred Compensation (sec. 201 of the bill and new sec. 457A of the Code)

Present Law

In general

Under present law, the determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the person earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[8] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)), and the requirements of section 409A.

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation generally is includible in income by a cash-basis taxpayer when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

An arrangement generally is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[9] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor; for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts generally are not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

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[8] See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd, per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[9] Treas. Reg. sec. 1.83-3(e). This definition, in part, reflects previous IRS rulings on nonqualified deferred compensation.

As discussed above, if the arrangement is unfunded, then the compensation generally is includible in income by a cash-basis taxpayer when it is actually or constructively received under section 451.[10] Income is constructively received when it is credited to a person's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Prior to the enactment of section 409A, arrangements had developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion under the constructive receipt doctrine (which applies to unfunded arrangements). One such arrangement is a "rabbi trust." A rabbi trust is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy. In the case of a rabbi trust, these terms have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[11] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

Section 409A

Reason for enactment

The Congress enacted section 409A[12] because it was concerned that many nonqualified deferred compensation arrangements had developed which allowed improper deferral of income. Executives often used arrangements that allowed deferral of income, but also provided security of future payment and control over amounts deferred. For example, nonqualified deferred compensation arrangements often contained provisions that allowed participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision). In addition, Congress was aware that since the concept of a rabbi trust was developed, techniques had been used that attempted to protect the assets from creditors despite the terms of the trust. For example, the trust or fund would be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

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[10] Treas. Reg. secs. 1.451-1 and 1.451-2.

[11] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence, the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[12] Section 409A was added to the Code by sec. 885 of the American Job Creation Act of 2004, Pub. L. No. 108-357.

Prior to the enactment of section 409A, while the general tax principles governing deferred compensation were well established, the determination whether a particular arrangement effectively allowed deferral of income was generally made on a facts and circumstances basis. There was limited specific guidance with respect to common deferral arrangements. The Congress believed that it was appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted and to provide a clear set of rules that would apply to these arrangements. The Congress believed that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. The Congress also believed that certain arrangements, such as offshore trusts, which effectively protect assets from creditors of the employer, should be treated as funded and not result in deferral of income inclusion to the extent the amounts are vested.

General requirements of section 409A

In general.–Under section 409A, all amounts deferred by a service provider under a nonqualified deferred compensation plan[13] for all taxable years are currently includible in gross income of the service provider to the extent such amounts are not subject to a substantial risk of forfeiture[14] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Section 409A does not limit the amount that may be deferred under a nonqualified deferred compensation plan. The Secretary of the Treasury is authorized to prescribe regulations as are necessary or appropriate to carry out the purposes of section 409A. The Secretary of the Treasury published final regulations under section 409A on April 17, 2007.[15]

Under these regulations, the term “service provider” includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in section 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, or qualified personal service corporation (as defined in section 448(d)(2)) for any taxable year in which such individual or entity accounts for gross income from the performance

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[13] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

[14] The rights of a person to compensation are subject to a substantial risk of forfeiture if the person’s rights to such compensation are conditioned upon the performance of substantial services by any individual.

[15] On October 22, 2007, the IRS announced that during 2008, taxpayers are not required to comply with the final regulations. Instead, taxpayers must operate a plan in compliance with section 409A and the otherwise applicable guidance. To the extent an issue is not addressed, a reasonable, good faith interpretation of the statute must be used. Notice 2007-86.

of services under the cash receipts and disbursements method of accounting.[16] Section 409A does not apply to a service provider that provides significant services to at least two service recipients that are not related to each other or the service provider. This exclusion does not apply to a service provider who is an employee or a director of a corporation (or similar position in the case of an entity that is not a corporation).[17] In addition, the exclusion does not apply to an entity that operates as the manager of a hedge fund or private equity fund. This is because the exclusion does not apply to the extent that a service provider provides management services to a service recipient. Management services for this purpose means services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets, such as a hedge fund.[18]

Permissible distribution events.–Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary of the Treasury), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary of the Treasury), occurrence of an unforeseeable emergency, or if the service provider becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary of the Treasury, may not permit acceleration of a distribution. In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees[19] of publicly-traded corporations.

Elections.–Section 409A requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the service provider's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. The time and form of distributions must be specified at the time of initial deferral. A plan may allow changes in the time and form of distributions subject to certain requirements.

Back-to-back arrangements.–Back-to-back service recipients (i.e., situations under which an entity receives services from a service provider such as an employee, and the entity in turn

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[16] Treas. Reg. sec. 1.409A-1(f)(1).

[17] Treas. Reg. sec. 1.409A-1(f)(2).

[18] Treas. Reg. sec. 1.409A-1(f)(2)(iv).

[19] Key employees are defined in section 416(i) and generally include officers (limited to 50 employees) having annual compensation greater than $145,000 (for 2007), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

provides services to a client) that involve back-to-back nonqualified deferred compensation arrangements (i.e., the fees payable by the client are deferred at both the entity level and the employee level) are subject to special rules under section 409A. For example, the final regulations generally permit the deferral agreement between the entity and its client to treat as a permissible distribution event those events that are specified as distribution events in the deferral agreement between the entity and its employee. Thus, if separation from employment is a specified distribution event between the entity and the employee, the employee's separation generally is a permissible distribution event for the deferral agreement between the entity and its client.[20]

Offshore funding arrangements.–Section 409A requires current income inclusion in the case of certain offshore funding of nonqualified deferred compensation. Under section 409A, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary of the Treasury) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property.

Interest at the underpayment rate plus one percentage point is imposed on the underpayments of tax that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income also is subject to an additional 20-percent tax.

The special funding rule does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The Secretary of the Treasury has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Definition of substantial risk of forfeiture

Under the Treasury regulations, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned upon either the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, provided that the possibility of forfeiture is substantial.[21]

[20] Treas. Reg. sec. 1.409A-3(i)(6).

[21] Treas. Reg. sec. 1.409A-1(d)(1).

Definition of nonqualified deferred compensation

Under section 409A, a nonqualified deferred compensation plan generally includes any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) and an eligible deferred compensation plan (sec. 457(b)) is a qualified employer plan.

The Treasury regulations also provide that certain other types of plans are not considered deferred compensation, and thus are not subject to section 409A. For example, if a service recipient transfers property to a service provider, there is no deferral of compensation merely because the value of the property is either not includible in income under section 83 by reason of the property being substantially nonvested or is includible in income because of a valid section 83(b) election.[22] Special rules apply in the case of stock options.[23] Another exception applies to amounts that are not deferred beyond a short period of time after the amount is no longer subject to a substantial risk of forfeiture.[24] Under this exception, there generally is no deferral for purposes of section 409A if the service provider actually or constructively receives the amount on or before the last day of the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of: (1) the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or (2) the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

Special rules apply in the case of stock appreciation rights ("SARs").[25] Under the final Treasury regulations, a SAR is a right to compensation based on the appreciation in value of a specified number of shares of service recipient stock occurring between the date of grant and the date of exercise of such right. The final regulations generally provide that a SAR does not result in a deferral of compensation for purposes of section 409A (and thus is not subject to section 409A) if the compensation payable under the SAR is not greater than the excess of the fair market value of the underlying stock on the date the SAR is exercised over the fair market value of the underlying stock on the date the SAR is granted.[26]

The Treasury regulations provide exclusions from the definition of nonqualified deferred compensation in the case of services performed by individuals who participate in certain foreign plans, including plans covered by an applicable treaty and broad-based foreign retirement

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[22] Treas. Reg. Sec. 1.409A-1(b)(6).

[23] Treas. Reg. Sec. 1.409A-1(b)(5).

[24] Treas. Reg. sec. 1.409A-1(b)(4).

[25] Treas. Reg. sec. 1.409A-1(b)(5).

[26] Treas. Reg. sec. 1.409A-1(b)(5)(i)(B).

plans.[27] In the case of a U.S. citizen or lawful permanent alien, nonqualified deferred compensation plan does not include a broad-based foreign retirement plan, but only with respect to the portion of the plan that provides for nonelective deferral of foreign earned income and subject to limitations on the annual amount deferred under the plan or the annual amount payable under the plan. In general, foreign earned income refers to amounts received by an individual from sources within a foreign country that constitutes earned income attributable to services.

Timing of the service recipient's deduction

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[28] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the service provider is deductible by the service recipient for the taxable year in which the amount is includible in the service provider's income.[29] Thus, for example, in the case of an unfunded nonqualified deferred compensation plan, a deduction to the taxable service recipient is deferred until the deferred compensation is actually paid or made available to the service provider.

Section 457

Special income recognition rules apply in the case of a participant in a deferred compensation plan that is sponsored by a State or local government or an organization that is exempt from Federal income tax under section 501(a). Section 457 provides for different income inclusion rules for two basic types of deferred compensation arrangements: (1) arrangements that limit the amount of compensation that may be deferred (generally, $15,500 in 2007) and that meet certain other requirements specified in section 457(b) (referred to as a "section 457(b) plan" or an "eligible deferred compensation plan"); and (2) arrangements that do

[27] Treas. Reg. sec. 1.409A-1(a)(3).

[28] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

[29] In the case of a publicly held corporation, no deduction is allowed for a taxable year for remuneration with respect to a covered employee to the extent that the remuneration exceeds $1 million. Code sec. 162(m). The Code defines the term "covered employee" in part by reference to Federal securities law. In light of changes to Federal securities law, the Internal Revenue Service interprets the term covered employee as the principal executive officer of the taxpayer as of the close of the taxable year or the 3 most highly compensated employees of the taxpayer for the taxable year whose compensation must be disclosed to the taxpayer's shareholders (other than the principal executive officer or the principal financial officer). Notice 2007-49, 2007-25 I.R.B. 1429. For purposes of the deduction limit, remuneration generally includes all remuneration for which a deduction is otherwise allowable, although commission-based compensation and certain performance-based compensation are not subject to the limit. Remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of the compensation is deferred until after termination of employment.

not satisfy the requirements of section 457(b) (referred to as a "section 457(f) plan" or an "ineligible deferred compensation plan"). Section 457 does not provide a limit on the amount of compensation that may be deferred under a section 457(f) plan.

A participant in a section 457(b) plan does not recognize income with respect to the participant's interest in such plan until the time of actual distribution (or, if earlier, the time the participant's interest is made available to the participant, but only in the case of a section 457(b) plan maintained by a tax-exempt sponsor other than a State or local government). In contrast, a participant in a section 457(f) plan must include amounts deferred under such a plan in gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation.

Explanation of Provision

In general

Under the provision, any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income by the service provider when there is no substantial risk of forfeiture of the service provider's rights to such compensation. The provision applies in addition to the requirements of section 409A (or any other provision of the Code or general tax law principle) with respect to nonqualified deferred compensation.

Nonqualified deferred compensation

For purposes of the provision, the term nonqualified deferred compensation plan is defined in the same manner as for purposes of section 409A. As under section 409A, the term nonqualified deferred compensation includes earnings with respect to previously deferred amounts. Earnings are treated in the same manner as the amount deferred to which the earnings relate.

Under the provision, nonqualified deferred compensation includes any arrangement under which compensation is based on the increase in value of a specified number of equity units of the service recipient. Thus, stock appreciation rights (SARs) are treated as nonqualified deferred compensation under the provision, regardless of the exercise price of the SAR. It is not intended that the term nonqualified deferred compensation plan include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future. The provision is not intended to change the tax treatment of incentive stock options meeting the requirements of 422 or options granted under an employee stock purchase plan meeting the requirements of section 423. Similarly, nonqualified deferred compensation for purposes of the provision does not include a transfer of property to which section 83 is applicable (such as a transfer of restricted stock), provided that the arrangement does not include a deferral feature.

Compensation is not treated as deferred for purposes of the provision if the service provider receives payment of the compensation not later than 12 months after the end of the taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture.

Nonqualified entity

The term nonqualified entity includes certain foreign corporations and certain partnerships (either domestic or foreign). A foreign corporation is a nonqualified entity unless substantially all of such income is effectively connected with the conduct of a United States trade or business or is subject to a comprehensive foreign income tax. A partnership is a nonqualified entity unless substantially all of such income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive income tax and organizations which are exempt from U.S. income tax.

The term comprehensive foreign income tax means with respect to a foreign person, the income tax of a foreign country if (1) such person is eligible for the benefits of a comprehensive income tax treaty between such foreign county and the United States, or (2) such person demonstrates to the satisfaction of the Secretary of the Treasury that such foreign country has a comprehensive income tax. A comprehensive foreign income tax does not include any tax unless the tax includes rules for the deductibility of deferred compensation which are similar to the rules under the Code.

In the case of a foreign corporation with income that is taxable under section 882, the provision does not apply to compensation which, had such compensation been paid in cash on the date that such compensation ceased to be subject to a substantial risk of forfeiture, would have been deductible by such foreign corporation against such income.

Additional rules

For purposes of the provision, compensation of a service provider is subject to a substantial risk of forfeiture only if such person's right to the compensation is conditioned upon the future performance of substantial services by any person. Thus, compensation is subject to a substantial risk of forfeiture only if entitlement to the compensation is conditioned on the performance of substantial future services and the possibility of forfeiture is substantial. Substantial risk of forfeiture does not include a condition related to a purpose of the compensation (other than future performance of substantial services), regardless of whether the possibility of forfeiture is substantial.

To the extent provided in regulations prescribed by the Secretary, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an investment asset, such compensation is treated as subject to a substantial risk of forfeiture until the date of such disposition. Investment asset means any single asset (other than an investment fund or similar entity) (1) acquired directly by an investment fund or similar entity, (2) with respect to which such entity does not (nor does any person related to such entity) participate in the active management of such asset (or if such asset is an interest in an entity, in the active management of the assets of such entity), and (3) substantially all of any gain on the disposition of which (other than the nonqualified deferred compensation) is allocated to investors of such entity. The rule is intended to apply to compensation contingent on the disposition of a single asset held as a long-term investment, provided that the service provider does not actively manage the asset (other than the decision to purchase or sell the investment). If the asset is an interest in an entity (such as a company that produces products or services), the rule does not apply if the service provider actively participates in the management of the entity. Active management is intended to include participation in the day-to-day activities of the asset, but does not include the election of a director or other voting rights exercised by shareholders. The rule is intended to apply solely to compensation arrangements relating to passive investments in a single asset. For example, the rule is intended to apply to an arrangement that the manager receive 20 percent of the proceeds from the disposition of XYZ operating corporation if the service provider does not actively participate in the management of the corporation. The rule does not apply to the disposition of a foreign subsidiary which holds a variety of assets the investment of which is managed by the service provider.

Under the provision, if the amount of any deferred compensation is not ascertainable at the time that such compensation is otherwise required to be taken into account into income under the provision, the amount is taken into account when such amount becomes ascertainable. This rule applies in lieu of the general rule of the provision, under which deferred compensation is taken into account in income when such compensation is no longer subject to a substantial risk of forfeiture. In addition, the income tax with respect to such amount is increased by the sum of (1) an interest charge, and (2) an amount equal to 20 percent of such compensation. The interest charge is equal to the interest at the rate applicable to underpayments of tax plus one percentage point imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Treasury regulations

It is intended that the Secretary of the Treasury issue regulations as to when an amount is unascertainable for purposes of the provision. It is intended that an amount of deferred compensation is unascertainable at the time the amount is no longer subject to a substantial risk of forfeiture if the amount varies depending on the satisfaction of an objective condition. For example, if a deferred amount varies depending on the satisfaction of an objective condition at the time the amount is no longer subject to substantial risk of forfeiture (e.g., 20 percent of the amount is paid if a certain threshold is achieved, 100 percent is paid if a higher threshold is achieved, and 200 percent is paid if a still higher threshold is achieved), the amount deferred is unascertainable.

The Secretary of the Treasury is also authorized to issue such regulations as may be necessary or appropriate to carry out the purposes of the provision, including regulations disregarding a substantial risk of forfeiture as necessary to carry out such purposes.

Under the provision, aggregation rules similar to those that apply under section 409A apply for purposes of determining whether a plan sponsor is a nonqualified entity. It is intended, however, that such aggregation rules are limited by the Secretary to operate in accordance with the purposes of the provision. For example, it is intended that the aggregation rules do not result in the application of the provision to employees of a U.S. subsidiary C corporation that is wholly owned by a nonqualified entity when the U.S. subsidiary sponsors the nonqualified deferred compensation plan in which the employees of the subsidiary participate. This is because the subsidiary is subject to the timing rule with respect to its deduction of its employees' nonqualified deferred compensation.

Effective Date

The provision is effective with respect to amounts deferred which are attributable to services performed after December 31, 2007. In the case of an amount deferred which is attributable to services performed on or before December 31, 2007, to the extent such amount is not includible in gross income in a taxable year beginning before 2017, then such amount is includible in gross income in the later of (1) the last taxable year beginning before 2017, or (2) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. Earnings on amounts deferred which are attributable to services performed on or before December 31, 2007, are subject to the provision only to the extent that the amounts to which such earnings relate are subject to the provision.

No later than 60 days after date of enactment, the Secretary shall issue guidance providing a limited period of time during which a nonqualified deferred compensation arrangement attributable to services performed on or before December 31, 2007, may, without violating the requirements of section 409A(a), be amended to conform the date of distribution to the date the amounts are required to be included in income. If the taxpayer is also a service recipient and maintains one or more nonqualified deferred compensation arrangements for its service providers under which any amount is attributable to services performed on or before December 31, 2007, the guidance shall permit such arrangements to be amended to conform the dates of distribution under the arrangement to the date amounts are required to be included in income of the taxpayer under the provision. An amendment made pursuant to the Treasury guidance will not be treated as a material modification of the arrangement for purposes of section 409A.

B. Economic Substance

1. Clarification of the economic substance doctrine (sec. 211 of the bill and new sec. 7701(p) of the Code)

Present Law

In general

The Code provides detailed rules specifying the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss, and deduction. These rules permit both taxpayers and the government to compute taxable income with reasonable accuracy and predictability. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, they can be seen as at odds with an objective, "rule-based" system of taxation.

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[30]

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations − notwithstanding that the purported activity actually occurred. The Tax Court has described the doctrine as follows:

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[30] *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied,* 526 U.S. 1017 (1999). Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine." *See, e.g.*, *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions). Certain "substance over form" cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed. *See, e.g., Klamath Strategic Investment Fund, LLC v. United States,* 472 F. Supp. 2d 885 (E.D. Texas 2007); *TIFD- III-E, Inc. v. United States*, 459 F. 3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, __F. Supp. 2d __, 2007-1 USTC P 50,130 (M.D.N.C. 2007).

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[31]

Business purpose doctrine

A common law doctrine that often is considered together with the economic substance doctrine is the business purpose doctrine. The business purpose doctrine involves a subjective inquiry into the motives of the taxpayer − that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[32]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[33] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[34] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.[35] A third approach regards economic substance

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[31] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[32] *See ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[33] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

[34] *See, e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[35] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States,* 253 F.3d 350, 353 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test],. . . a transaction will be characterized as a sham if 'it is not motivated by any economic purpose out of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test)."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied

and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[36]

Recently, the Court of Federal Claims questioned the continuing viability of the doctrine. That court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers" though that court also found that the particular case did not lack economic substance. The Court of Appeals for the Federal Circuit ("Federal Circuit Court") overruled the Court of Federal Claims decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in question violated that doctrine.[37] The Federal Circuit Court stated that "[w]hile the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, [footnote omitted], a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."[38]

<u>Non-tax economic benefits</u>

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to satisfy economic substance. Some courts have denied tax benefits on the grounds that a stated business benefit of a particular structure was not in fact obtained by that structure.[39] Several courts have denied tax benefits on the grounds that the

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interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

[36] *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[37] *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *vacated and remanded,* 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied,* 127 S. Ct. 1261 (Mem.) (2007).

[38] The Federal Circuit Court stated that "when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." The Federal Circuit Court quoted a decision of its predecessor court, stating that "*Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance." The Court also stated that "while the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of a transaction in assessing its economic substance." *Coltec Industries, Inc. v. United States*, 454 F.3d at 1355, 1356.

[39] *See, e.g., Coltec Industries v. United States,* 454 F.3d 1340 (Fed. Cir. 2006). The court analyzed the transfer to a subsidiary of a note purporting to provide high stock basis in exchange for a purported assumption of liabilities, and held these transactions unnecessary to accomplish any business purpose of using a subsidiary to manage asbestos liabilities. The court also held that the purported

subject transactions lacked profit potential.[40] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[41] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[42] In these cases, in assessing whether a reasonable possibility of profit exists, it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least one court has concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.[43] However, based on court decisions that recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.[44]

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business purpose of adding a barrier to veil-piercing claims by third parties was not accomplished by the transaction. 454 F.3d at 1358-1360 (Fed. Cir. 2006).

[40] *See, e.g., Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

[41] *See, e.g., Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating that "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[42] *See, e.g., Rice's Toyota World v. Commissioner,* 752 F. 2d 89, 94 (4th Cir. 1985) (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 781 (5th Cir. 2001) (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001).

[43] *See American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001); *aff'd* 326 F.3d.737 (6th Cir. 2003).

[44] *See, e.g.,* Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JSC-3-03) February, 2003 ("Enron Report"), Volume III at C-93, 289. Enron Corporation relied on *Frank Lyon Co. v. United States*, 435 U.S. 561, 577-78 (1978), and *Newman v. Commissioner*, 902 F.2d 159, 163 (2d Cir. 1990), to argue that financial accounting benefits arising from tax savings constitute a good business purpose.

Tax-indifferent parties

A number of cases have involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax indifferent party from the transaction. Courts have sometimes concluded that a particular type of transaction did not satisfy the economic substance doctrine.[45] In other cases, courts have indicated that the substance of the transaction did not support the form of income allocations asserted by the taxpayer, and have questioned whether asserted business purpose or other standards were met.[46]

Explanation of Provision

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, in the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only 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.[47] The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if the provision had never been enacted. Thus, the provision does not change current law standards in determining when to utilize an economic substance analysis.[48]

The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on

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[45] *See, e.g.*, *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied,* 526 U.S. 1017 (1999).

[46] *See, e.g., TIFD- III-E, Inc. v. United States,* 459 F.3d 220 (2d Cir. 2006).

[47] In applying these tests, any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

[48] If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision. *See, e.g.,* Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

comparative tax advantages. Among[49] these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;[50] (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;[51] (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;[52] and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[53] Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[54] As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions can be a question of facts and circumstances. Also, the fact that a transaction does meet the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.[55]

The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities

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[49] The examples are illustrative and not exclusive.

[50] *See, e.g.*, *John Kelley Co. v. Commissioner,* 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).

[51] *See, e.g.*, *Sam Siegel v. Commissioner,* 45. T.C. 566 (1966), *acq.* 1966-2 C.B. 3. *But see Commissioner v. Bollinger,* 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under the facts and circumstances).

[52] *See, e.g. Rev. Proc. 2007-3 2007-1 I.R.B. 108, Secs 3.01(33), (34), and (36)* (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); *compare Gregory v. Helvering*. 293 U.S. 465 (1935).

[53] *See, e.g., National Carbide v. Commissioner,* 336 U.S. 422 (1949), *Moline Properties v. Commissioner,* 319 U.S. 435 (1943); *compare, e.g. Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1; *Commissioner v. Bolllinger,* 485 U.S. 340 (1988); *see also* sec. 7701(l).

[54] *See, e.g., Frank Lyon v. Commissioner*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305, *aff'd*, 671 F. 2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982); *Coltec Industries v. United States,* 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied,* 127 S. Ct. 1261 (Mem) (2007).

[55] As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the Code, or does not have economic substance, *see e.g.*, *TIFD- III-E, Inc. v. United States,* 459 F.3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, __F. Supp.__, 2007-1 USTC P 50,130 (M.D.N,C, 2007); *Tribune Company and Subsidiaries v. Commissioner*, 125 T.C. 110 (2005) ; *H.J. Heinz Company and Subsidiaries v. United States,* 76 Fed. Cl. 570 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007); *Long Term Capital Holdings LP v. United States,* 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd,* 150 Fed. Appx. 40 (2d Cir. 2005); *Klamath Strategic Investment Fund, LLC v. United States,* 472 F. Supp. 2d 885 (E.D. Texas 2007); *Santa Monica Pictures LLC v. Commissioner,* 89 T.C.M. 1157 (2005).

with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax motivated benefits.[56]

Conjunctive analysis

The provision clarifies that the economic substance doctrine involves a conjunctive analysis − there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer must have a substantial non-Federal-income-tax purpose[57] for entering into such transaction, in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-Federal-tax business purpose

Under the provision, a taxpayer's non-Federal-income-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial."[58] For purposes of this

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[56] *See, e.g., Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007) ("the first asserted business purpose focuses on the wrong transaction--the creation of Garrison as a separate subsidiary to manage asbestos liabilities. . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale…") 454 F.3d 1340, 1358 (Fed. Cir. 2006). *See also ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48; *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

[57] A purpose of reducing non-Federal taxes is not a non-Federal-tax business purpose if (i) the transaction will effect a reduction in both Federal and non-Federal taxes because of similarities between Federal tax law and the law of the other jurisdiction and (ii) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non-Federal taxes.

[58] *See, e.g.,* Treas. Reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

> Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

analysis, any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect. Also, a purpose of achieving a favorable accounting treatment for financial reporting purposes shall not be taken into account as a non-Federal-income-tax purpose if the transaction results in a Federal income tax benefit.[59]

Profit potential

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-tax purpose for entering into such transaction. The provision does not require or establish a specified minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[60] Fees and other transaction expenses and foreign taxes shall be taken into account as expenses in determining pre-tax profit.

Personal transactions of individuals

In the case of an individual, the provision applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

Other rules

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. Such regulations may include exemptions from the application of the provision.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, the provision shall not be construed as altering or supplanting any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and the provision shall be construed as being additive to any such other rule of law.

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[59] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. *See, e.g.*, *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'") (citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)); *aff'd,* 326 F3d 737 (6th Cir. 2003).

[60] Thus, a "reasonable possibility of profit" alone will not be sufficient to establish that a transaction has economic substance.

Effective Date

The provision applies to transactions entered into after the date of enactment.

2. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 212 of the bill and secs. 6662, 6664, and 6676 of the Code)

Present Law

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[61] Except in the case of tax shelters,[62] the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[63] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[64]

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[61] Sec. 6662.

[62] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[63] Sec. 6664(c).

[64] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

Listed transactions and reportable avoidance transactions

In general

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Both listed transactions and reportable transactions are allowed to be described by the Treasury department under section 6707A(c), which imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[65] A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[66]

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[67] The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[68] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[69] The IRS Commissioner is authorized to do this only if the

[65] Sec. 6707A(c)(1).

[66] Sec. 6707A(c)(2).

[67] Sec. 6662A(a).

[68] Sec. 6662A(c).

[69] Sec. 6664(d).

failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[70]

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[71]

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);[72] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.[73]

Strengthened reasonable cause exception

A penalty is not imposed with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011;[74] (2) that there is or was substantial authority for such

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[70] Sec. 6707A(d).

[71] Sec. 6707A(e).

[72] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income. Sec. 6662A(b).

[73] Sec. 6662A(e)(3).

[74] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.[75]

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor" or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor[76] and who participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates; (2) is compensated directly or indirectly[77] by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state,or local government body.[78] Participation in the

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[75] Sec. 6664(d).

[76] The term "material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case). Sec. 6111(b)(1).

[77] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[78] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion,or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee

"management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

To the extent a penalty on an understatement is imposed under section 6662A, that same amount of understatement is not also subject to the accuracy-related penalty under section 6662(a) or to the valuation misstatement penalties under section 6662(e) or 6662(h). However, such amount of understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1) and for purposes of identifying an underpayment under the section 6663 fraud penalty.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Erroneous claim for refund or credit

If a claim for refund or credit with respect to income tax (other than a claim relating to the earned income tax credit) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim is subject to a penalty in an amount equal to 20 percent of the excessive amount.[79]

The term "excessive amount" means the amount by which the amount of the claim for refund for any taxable year exceeds the amount of such claim allowable for the taxable year.

This penalty does not apply to any portion of a the excessive amount of a claim for refund or credit which is subject to a penalty imposed under the accuracy related or fraud penalty

arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

[79] Sec. 6667.

provisions (including the general accuracy related penalty, or the penalty with respect to listed and reportable transactions, described above).

Explanation of Provision

The provision imposes a new, stronger penalty under section 6662 for an understatement attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new section 7701(p), [80] or failing to meet the requirements of any similar rule of law.[81] 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. Except as provided in regulations, an amended return or supplement to a return is not taken into account if filed after the taxpayer has been contacted for audit or such other date as is specified by the Secretary. No exceptions (including the reasonable cause rules) to the penalty are available (i.e., the penalty is a strict-liability penalty). Under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or is not respected as described below. Similarly, a claim for refund that is excessive under section 6676 due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is subject to the 20 percent penalty under that section, and the reasonable basis exception is not available.

The penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed.[82] The new 20 percent penalty (and 40 percent penalty for nondisclosed transactions) is also added to the penalties to which section 6662A will not also apply.[83]

Under the provision, the reasonable cause and good faith exception of present law section 6664(c)(1) does not apply to any portion of an underpayment which is attributable to a transaction lacking economic substance, as defined in section 7701(p), or failing to meet the requirements of any similar rule of law, or to any tax shelter (as defined in present law section 6662(d)(2)(C)). The reasonable cause and good faith exception of present law section 6664(c)(1) also does not apply to any underpayment in which the taxpayer is a specified large corporation

[80] That provision generally provides that in any case in which a court determines that the economic substance doctrine is relevant, a transaction has economic substance only 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. Specific other rules also apply. See "Description of Proposal" for the immediately preceding provision, "Clarification of the economic substance doctrine."

[81] For 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.

[82] *I.e.*, section 6662(b) of present law applies to the new penalty as well.

[83] As under present law, the penalties under section 6662 (including the new penalty) do not apply to any portion of an underpayment on which a fraud penalty is imposed.

(defined as any corporation with gross receipts in excess of $100 million for the taxable year involved).[84]

In the case of a substantial understatement of income tax (which is a separate type of understatement under new section 6662(b) than an understatement attributable to a transaction lacking economic substance or failing to meet the requirements of any similar rule of law),[85] the rules of section 6662(d) still apply, but are changed in the case of a specified large corporation (as defined above). In the case of such a corporation, it is no longer be the case that a substantial understatement is reduced if there is or was substantial authority for the taxpayer's treatment, or if the relevant facts were disclosed and there is a reasonable basis for the taxpayer's tax treatment. Under the provision, a substantial understatement of a specified large corporation can be reduced only by that portion attributable to any item with respect to which the taxpayer had a reasonable belief that the tax treatment by the taxpayer is more likely than not the proper treatment.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

[84] For purposes of this rule, all persons treated as a single employer under section 52(a) are treated as one person.

[85] The rules and exceptions of section 6662(d) do not apply to any understatement attributable to a transaction that lacks economic substance or fails to meet the requirements of any similar rule of law.

C. Delay Implementation of Worldwide Interest Allocation sec. 221 of the bill and sec. 864(f) of the Code)

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[86] For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income. The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

Generally, the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[87] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same

[86] However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

[87] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity that is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Worldwide interest allocation

In general

The American Jobs Creation Act of 2004 ("AJCA")[88] modified the interest expense allocation rules described above (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election (the "worldwide affiliated group election") under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[89] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the

[88] Pub. L. No. 108-357, sec. 401 (2004).

[89] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account.

principles of worldwide interest allocation were applied separately to the foreign members of the group.[90]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[91] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group, as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

Financial institution group election

Taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The rules also provides a one-time "financial institution group" election that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[92] For these purposes, items of income or gain from a transaction or series of

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[90] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[91] Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

[92] See Treas. Reg. sec. 1.904-4(e)(2).

transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, anti-abuse rules are provided under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. Regulatory authority is provided with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of these rules, to prevent assets or interest expense from being taken into account more than once, or to address changes in members of any group (through acquisitions or otherwise) treated as affiliated under these rules.

Effective date of worldwide interest allocation under AJCA

The worldwide interest allocation rules are effective for taxable years beginning after December 31, 2008.

Explanation of Provision

The provision delays by eight years the implementation of the worldwide interest allocation rules added by AJCA. Thus, the worldwide interest allocation rules are effective for taxable years beginning after December 31, 2017.

Effective Date

The provision is effective on the date of enactment.

D. Increase in Penalty for Failure to File Partnership Returns (sec. 222 of the bill and sec. 6698 of the Code)

Present Law

A partnership generally is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under present law, a partnership is required to file a tax return for each taxable year. The partnership's tax return is required to include the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual. In addition to applicable criminal penalties, present law imposes a civil penalty for the failure to timely file a partnership return. The penalty is $50 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of five months.

Explanation of Provision

The provision increases the present-law failure to file penalty for partnership returns to $100 per partner times the number of shareholders in the partnership during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months.

Effective Date

The provision applies to returns required to be filed after the date of enactment.

E. Impose Penalty for Failure to File S Corporation Returns (sec. 223 of the bill and new sec. 6699 of the Code)

Present Law

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns.

Under present law, S corporations are required to file a tax return for each taxable year. The S corporation's tax return is required to include the following: the names and addresses of all persons owning stock in the corporation at any time during the taxable year; the number of shares of stock owned by each shareholder at all times during the taxable year; the amount of money and other property distributed by the corporation during the taxable year to each shareholder and the date of such distribution; each shareholder's pro rata share of each item of the corporation for the taxable year; and such other information as the Secretary may require.

Explanation of Provision

The provision imposes a monthly penalty for any failure to timely file an S corporation return or any failure to provide the information required to be shown on such a return. The penalty is $100 times the number of shareholders in the S corporation during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months.

Effective Date

The provision applies to returns required to be filed after the date of enactment.

F. Increase Minimum Failure to File Penalty (sec. 224 of the bill and sec. 6651 of the Code)

Present Law

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.[93] An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.[94]

In the case of a failure to file a tax return within 60 days of the due date, present law imposes a minimum penalty equal to the lesser of $100 or 100 percent of the amount of tax required to be shown on the return.

Explanation of Provision

The provision increases the minimum penalty for a failure to file a tax return within 60 days of the due date to the lesser of $150 or 100 percent of the amount of tax required to be shown on the return.

Effective Date

The provision is effective for tax returns required to be filed on or after January 1, 2008.

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[93] Sec. 6651(a)(1).

[94] Sec. 6651(b)(1).

G. Modify Corporate Estimated Tax Payments (sec. 225 of the bill)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Under present law, in the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 115.00 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Explanation of Provision

The provision increases the otherwise applicable percentage for payments due in July, August, and September, 2012 (115.00 percent) by 52½ percentage points.

Effective Date

The provision is effective on the date of enactment.