DESCRIPTION OF THE REVENUE PROVISIONS OF H.R. 3200, THE "AMERICA'S AFFORDABLE HEALTH CHOICES ACT OF 2009"

Scheduled for Markup
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on July 16, 2009

Prepared by the Staff
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JCX-30-09

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on July 16, 2009, relating to the revenue provisions in H.R. 3200, the America's Affordable Health Choices Act of 2009. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the revenue provisions of the America's Affordable Health Choices Act of 2009.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Revenue Provisions of H.R. 3200, the "America's Affordable Health Choices Act of 2009"* (JCX-30-09), July 14, 2009. This document can also be found on our website at www.jct.gov.

I. REFORM PROPOSALS

A. Tax on Individuals Without Acceptable Health Care Coverage

Present Law

Federal law does not require individuals to have health insurance. Massachusetts is the only State that imposes a tax penalty on certain individuals who do not meet a State health insurance requirement. All adult residents of Massachusetts are required to have health insurance that meets "minimum creditable coverage" standards if it is deemed "affordable" at their income level under a schedule set by the board of the Massachusetts Connector.[2] Individuals are required to report their insurance status on State income tax forms.[3] Individuals can file hardship exemptions from the requirement. Persons for whom there are no affordable insurance options available are not subject to the requirement for insurance coverage.

Under Massachusetts law, for taxable year 2007, an individual without insurance and who was not exempt from the requirement did not qualify for a State income tax personal exemption. For taxable years beginning on or after January 1, 2008, a penalty is levied for each month an individual is without insurance. The penalty consists of an amount up to 50 percent of the lowest premium available to the individual through the Connector. The penalty is reported and paid by the individual with the individual's Massachusetts State income tax return at the same time and in the same manner as State income taxes. Failure to pay the penalty results in the same interest and penalties as apply to unpaid income tax.[4]

Description of Proposal

Maintenance of health insurance coverage

An individual (or a husband and wife in the case of a joint return) who does not maintain coverage under acceptable health insurance for themselves and each of their qualifying children[5]

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[2] Massachusetts Revenue regulation 830 CMR 111M.2.1(3).

[3] Massachusetts Revenue regulation 830 CMR 111M.2.1(4).

[4] Massachusetts Revenue regulation 830 CMR 111M.2.1(5).

[5] Under section 152(c), a child generally is a qualifying child of a taxpayer if the child satisfies each of five tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; (3) the child has not yet attained a specified age; (4) the child has not provided over one-half of their own support for the calendar year in which the taxable year of the taxpayer begins; and (5) the qualifying child has not filed a joint return (other than for a claim of refund) with their spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child. The specified relationship is that the child is the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. With respect to the specified age, a child must be under age 19 (or under age 24 in the case of a full-time student). However, no age limit applies with respect to individuals who are totally and permanently disabled within the meaning of section 22(e)(3) at any time during the calendar year. Other rules may apply.

is subject to an additional tax. The tax is equal to the lesser of (a) the national average premium for single or family coverage, as applicable, or (b) two percent of the excess of the taxpayer's adjusted gross income ("AGI") over the threshold amount of income required for income tax return filing for that taxpayer under section 6012(a)(1). Any individual who is a bona fide resident of a possession of the United States (as determined under section 937(a)) (and any qualifying child residing with the individual) is treated as maintaining acceptable coverage. This tax is in addition to both the regular income tax and the alternative minimum tax.

Under the proposal, acceptable coverage includes coverage under a qualified health plan, a grandfathered plan, Medicare, Medicaid, Tricare (and other Armed Services coverage), Veterans Administration coverage[6] and other coverage approved by the Secretary of the Treasury in coordination with the Health Choices Commissioner.[7]

A qualified health plan generally is a health plan that covers at least an essential benefits package and that includes certain specified limits on required cost sharing, no annual or lifetime limit on covered health care items or services, certain specified minimum services, and certain requirements as to network adequacy as determined by the Health Choices Commissioner.[8] A grandfathered plan generally is a health insurance plan purchased in the individual market in which the taxpayer was enrolled prior to date of enactment and the terms or conditions of which are not changed subsequent to the date of enactment other than to reflect area changes.[9] Certain group coverage in effect on the date of enactment also qualifies as grandfathered coverage, but only for the five year period following the date of enactment.

Exceptions

The additional tax applies to United States citizens and resident aliens.[10] The additional tax does not apply for non-resident aliens or U.S. citizens and residents who satisfy the definition

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[6] Veterans Administration coverage is acceptable coverage only if the coverage is not less than a level specified by the Secretary of the Treasury and the Secretary of Veteran's Affairs, in coordination with the Health Choices Commissioner, based on the individual's priority for services.

[7] Under the non- revenue provisions of the proposal, a new independent agency is established called the Health Choices Administration which is headed by a Health Choices Commissioner. The Health Choices Commissioner would establish qualified plan standards, establish and operate the health insurance Exchange, administer the Individual Affordability Credits and perform other functions.

[8] These requirements are detailed in the non-revenue provisions of the proposal.

[9] The definition of grandfathered plan is set forth in the non-revenue provisions of the proposal. No new enrollment is permitted in grandfathered plans (other than dependents of individuals already enrolled).

[10] Under section 7701(b)(1)(A), an alien is considered a resident of the United States if the individual: (1) is a lawful permanent U.S. resident (the "green card test") at any time during the relevant year; (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time − during a three-year period, 183 or more days weighted toward the present year (the "substantial presence test"); or (3) makes a "first-year election" to be treated as a resident of the United States (a numerical formula under which an alien may pass the substantial presence test one year earlier than under normal rules).

of a qualified individual, as defined by section 911(d). The additional tax does not apply if the maintenance of acceptable coverage would result in a hardship to the individual. The additional tax does not apply if the person's income is below the threshold for filing a Federal income tax return.[11] The additional tax also does not apply to any individual (or any qualifying child of the individual) if the individual has in effect an exemption which certifies that the individual is a member of a religious sect described in section 1402(g)(1) and an adherent of established tenets of such sect or division described in section 1402(g)(1).[12] For taxpayers who maintain insurance for only part of the year, their annual tax is calculated and then pro-rated for the duration of time when insurance was not maintained. Lastly, the additional tax does not apply to an individual if the individual is properly claimed as a dependent on the income tax return of another taxpayer for the taxable year. However, parents or guardians claiming qualified children as dependents on their Federal income tax returns are required to maintain coverage for these dependents.

Delegation of regulatory authority

The proposal delegates authority to the Secretary of the Treasury to issue regulations or other guidance as necessary to carry out the purposes of the proposal. The proposal specifically directs the Secretary to issue guidance to provide an exemption from the tax for de minimis lapses of acceptable coverage and a process for applying for a waiver of the requirement to maintain coverage in cases of hardship (due to cost, or otherwise). In developing guidance in these two specific areas, the Secretary of the Treasury is also directed to coordinate with the Health Choices Commissioner.

Reporting

The new additional tax for failure to maintain health insurance is accompanied by new reporting requirements for employers, health insurers and individuals. Any employer providing acceptable coverage is required to provide information to the Department of Treasury and the primary insured individual. The return is required to contain the name, address and taxpayer identification numbers of all individuals receiving insurance under the policy by January 31 of the year following the calendar year the insurance was provided. Failure to file the required information return or to include complete and correct information on the required return is subject to the failure to file correct information returns penalty of section 6721.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2012.

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[11] Generally, in 2009, the filing threshold separately is $9,350 for a single person or a married person filing separately and is $18,700 for married filing jointly. IR-2008-117, Oct. 16, 2008.

[12] Sections 1402(g) and 3127 (incorporating section 1402(g) by reference) provide a process for individuals (and employers for themselves and their employees) to file for an exemption from the self-employment tax and Federal Insurance Contributions Act ("FICA") tax if they are members of a recognized religious sect that has established tenets or teachings by which individuals are conscientiously opposed to the acceptance of any private or public insurance which makes payments in the event of death, disability, old age, retirement or makes payments toward the cost of, or provides services for, medical care.

B. Election to Satisfy Health Coverage Participation Requirements

Present Law

The Code does not provide a tax credit for any employer that provides health coverage for its employees. The cost to an employer of providing health coverage for its employees is generally deductible as an ordinary and necessary business expense for employee compensation.[13] In addition, the value of employer provided health insurance is not subject to employer paid Federal Insurance Contributions Act ("FICA") tax.

The Code generally provides that employees are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan. [14] In addition, medical care provided under an accident or health plan for employees, their spouses, and their dependents is excluded from gross income of the employee.[15] Employees participating in a cafeteria plan may be able to pay their share of premiums on a pre-tax basis through salary reduction.[16] Such salary reduction contributions are treated as employer contributions and thus also are excluded from gross income.

The Employee Retirement Income Security Act of 1974 ("ERISA")[17] preempts State law relating to certain employee benefit plans, including employer-sponsored health plans. While ERISA specifically provides that its preemption rule does not exempt or relieve any person from any State law which regulates insurance, ERISA also provides that an employee benefit plan is not deemed to be engaged in the business of insurance for purposes of any State law regulating insurance companies or insurance contracts. As a result of this ERISA preemption, self-insured employer-sponsored health plans need not provide benefits that are mandated under State insurance law.

While ERISA does not require an employer to offer health benefits, it does require compliance if an employer chooses to offer health benefits, such as compliance with plan fiduciary standards, reporting and disclosure requirements, and procedures for appealing denied benefit claims. ERISA was amended (as well as the Public Health Service Act and the Internal Revenue Code) in the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA")[18] and the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"),[19] adding other

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[13] Sec. 162. However see special rules in section 419 and 419A for the deductibility of contributions to welfare benefit plans with respect to medical benefits for employees and their dependents.

[14] Sec. 106.

[15] Sec. 105(b).

[16] Sec. 125.

[17] Pub. L. No. 93-406.

[18] Pub. L. No. 99-272.

[19] Pub. L. No. 104-191.

Federal requirements for health plans, including rules for health care continuation coverage, limitations on exclusions from coverage based on preexisting conditions, and a few benefit requirements such as minimum hospital stay requirements for mothers following the birth of a child.

The Code imposes an excise tax on group health plans that fail to meet HIPAA and COBRA requirements. The excise tax generally is equal to $100 per day per failure during the period of noncompliance and generally is imposed on the employer sponsoring the plan.[20]

Under Medicaid, states may establish "premium assistance" programs, which pay a Medicaid beneficiary's share of premiums for employer-sponsored health coverage. Besides being available to the beneficiary through his or her employer, the coverage must be comprehensive and cost-effective for the State. A 2007 analysis showed that 12 states had Medicaid premium assistance programs as authorized under current law.[21]

Description of Proposal

Elections

Under the proposal, employers are required to make an affirmative election regarding whether to offer health benefit plans to employees. Those employers electing to offer health benefit plans are required to have their plans meet certain minimum coverage requirements. Employers choosing not to offer health benefit plans, or offering plans that do not meet the proposal's qualification requirements, are subject to a payroll tax.[22]

The Secretary of the Treasury will prescribe rules for employer elections regarding coverage, including rules for the time, manner and form of elections, and the treatment of affiliated groups of employers, separate lines of business, and full versus part time employees.[23] Employers are required to provide verification of their compliance with the proposal's health coverage participation requirement to the Health Choices Commissioner and to the Secretaries of Labor, Health and Human Services ("HHS"), and the Treasury.

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[20] Secs. 4980B and 4980D.

[21] U.S. Department of Health and Human Services, Center for Medicare and Medicaid Services, "The State Children's Health Insurance Program," Powerpoint Presentation, March 5, 2007, p. 14.

[22] There is an exception for certain small employers. Employers with annual payrolls not exceeding $250,000 during the preceding calendar year are not subject to the tax. Employers with annual payrolls between $250,000 and $400,000 during the preceding calendar year are subject to a reduced rate.

[23] Employers electing to offer health benefit plans are to be treated as having established and maintained a group health plan for purposes of ERISA and the Public Health Service Act ("PHSA") (42 U.S.C. 6A) and the proposal's health coverage participation requirements are deemed to be part of the terms and conditions of the employer-provided plan.

Parallel provisions for this election (including termination of the election) are provided in ERISA and the Public Health Service Act ("PHSA").[24] The Secretary of the Treasury shares authority for providing rules for employers making this election, and authority to terminate the election, with the Secretaries of Labor and HHS.

Aggregation Rules

For affiliated groups of employers, the identity of the employer is generally determined by applying the employer aggregation rules in section 414(b), (c), (m), and (o).[25] The same election must apply to all employers in the aggregated group. Employers are able to make separate elections for employees in separate lines of business, or for full time employees and part time employees.

Contribution requirements

Employers that offer health benefit plans are required to offer[26] individual and family coverage under a qualified health benefit plan (or certain grandfathered health insurance plans)[27] and to make contributions to help discharge the coverage costs of employees enrolled in the employer-provided plan.[28] For full time employees, the contribution amount is required to be at least 72.5 percent of the lowest cost plan offered by the employer which meets the requirements

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[24] 42 U.S.C. 6A.

[25] Section 414(b) provides that, for specified employee benefit purposes, all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer. There is a similar rule in section 414(c) under which all employees of trades or businesses (whether or not incorporated) which are under common control are treated under regulations as employed by a single employer, and, in section 414(m), under which employees of an affiliated service group (as defined in that section) are treated as employed by a single employer. Section 414(o) authorizes the Treasury to issue regulations to prevent avoidance of the requirements under section 414(m).

[26] The Health Choices Commissioner (in coordination with the Secretaries of Labor, Health and Human Services, and the Treasury) has the authority to set standards for determining whether employers, in the course of offering coverage, are undertaking any actions to affect the risk pool within the Health Insurance exchange by inducing employees to enroll in Exchange-participating health plans rather than in employer-provided plans. An employer found to be violating these standards is treated as not meeting the coverage requirements.

[27] For a plan to be a "qualified health benefits plan" it needs to meet certain minimum coverage requirements, but it need not be offered through the Health Insurance Exchange.

[28] Beginning in the fifth year after enactment of the proposal, employers are required to make contributions to the Health Insurance Exchange for employees who decline employer-provided coverage and instead enroll in an Exchange-participating plan. The contribution amount is equal to eight percent of the average wages paid by the employer to its employee during the time the employee was enrolled in the non-employer provided plan. Employers with annual payrolls between $250,000 and $400,000 during the preceding calendar year are subject to a reduced rate. Employer contributions are paid to the Health Choices Commissioner and deposited into the Health Insurance Exchange Trust Fund. The contributions are not tied to a particular employee (i.e., the contribution does not subsidize an employee's premium liability). This contribution requirement parallels the payroll tax equal to eight percent of wages that applies to nonelecting employers.

of the essential benefits package[29] (65 percent for eligible employees electing family coverage). For part time employees, the contribution amount is a fraction of the minimum contributions made for full time employees, with such fraction being equal to a ratio of the average weekly hours worked by the employee compared to the minimum weekly hours specified by the Health Choices Commissioner. An employer cannot satisfy the minimum contribution requirement through a salary reduction arrangement with the employee.

Noncompliance with coverage requirements

Employers who elect to provide coverage but whose health benefit plans fail to meet the proposal's minimum health coverage participation requirement are subject to an excise tax of $100 per day for each employee to whom the failure applies.[30] The excise tax does not apply to (1) periods during which an employer used reasonable diligence but did not discover any failures, and (2) failures that are corrected within 30 days of discovery (but only if such failures are due to reasonable cause and not willful neglect). Excise taxes imposed on employers for unintentional failures (i.e., due to reasonable cause and not to willful neglect) are limited to the lesser of: 10 percent of the aggregate amount paid or incurred by the employer during the preceding taxable year for group health plans, or $500,000. There are parallel civil penalties provided in ERISA and PHSA.[31] The excise tax with respect to any failure is reduced (but not below zero) by the amount of any civil penalty collected under these parallel provisions. The Secretary is also able to terminate an employer's election (and thus subject the employer to the payroll tax imposed on employers that do not offer coverage) if it is determined that the employer was substantially noncompliant with health coverage participation requirements.

Multi-agency coordination

The Health Choices Commissioner and the Secretaries of Labor, Health and Human Services, and the Treasury are required to execute an interagency memorandum of understanding to ensure coordination with respect to regulations, rulings, interpretations, and enforcement of the proposal and the parallel provisions in ERISA and PHSA. The Secretaries of Labor and of Health and Human Services are required to conduct periodic audits of employers in order to discover noncompliance with health coverage participation requirements. The Secretaries of

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[29] The essential benefits package includes certain specified limits on required cost sharing, bans annual or life time limits on covered health care items or services and certain specified minimum services, and imposes certain requirements as to network adequacy as determined by the Health Choices Commissioner.

[30] Under the proposal, there is created within the Treasury of the United States a trust fund known as the "Health Insurance Exchange Trust Fund" which consists of such amount as may be appropriated or credited to the trust fund. Under the proposal, an amount equal to these excise taxes received from non compliant employers is automatically appropriated to, and thus used to fund, the new Health Insurance Exchange Trust Fund.

[31] The proposal permits the penalties to be assessed through an excise tax or through a civil penalty under ERISA or PHSA. Penalties for any particular failure are not to be duplicated, however. The Secretary of Labor or Health and Human Services, as appropriate, is required to give advance written notification of failure to employers prior to the assessment of a penalty. The Secretary of Health and Human Services is able to bring civil actions in Federal court to collect civil penalties assessed under PHSA.

Labor, Health and Human Services, and the Treasury, and the Health Choices Commissioner are all informed of audit results.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2012.

C. Responsibilities of Nonelecting Employers

In general

Under the Federal Insurance Contributions Act ("FICA"), separate taxes are imposed on every employer and employee with respect to wages paid by the employer to the employee.[32] These two taxes are commonly referred to as the employer's and the employee's share of FICA. The employee's share of FICA is collected by means of payroll withholding by the employee's employer.

For both the employer and the employee's share of FICA, the tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death;[33] and (2) Medicare hospital insurance ("HI").[34] The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($106,800 for 2009). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

For purposes of the employer's and employee's share of FICA, wages generally means all remuneration for employment including the cash value of all remuneration paid in a medium other than cash. However, the general definition of wages is subject to a number of special rules and exceptions.[35]

Employment for FICA purposes generally means any service of whatever nature performed by an employee for the employer (irrespective of the citizenship or residence of either) within the United States. In the case of service outside the United States, employment also includes service performed by a United States citizen or resident as an employee for an American employer. As in the case of the definition of wages, the definition of employment is also subject to a number of exceptions and special rules.[36] An American employer is defined as an employer which is: (1) the United States or any instrumentality thereof; (2) an individual who is a resident of the United States; (3) a partnership, if at least two-thirds of the partners are

[32] Secs. 3101-3128 (FICA). Sections 3501-3510 provide additional rules.

[33] Pursuant to sec. 201(a) and (b) of the Social Security Act, 42 USC 401(a) and (b), these OASDI payroll taxes fund the Federal Old and Survivor Insurance Trust Fund and the Federal Disability Trust Fund, respectively. For each fiscal year, an amount equal to the OASDI payroll taxes collected is appropriated for these trust funds.

[34] Pursuant to Sec. 1817 of the Social Security Act, 42 USC 1395i, the HI payroll taxes fund the Federal Hospital Insurance Trust Fund. For each fiscal year, an amount equal to the HI payroll taxes collected is appropriated for this trust fund.

[35] Sec. 3121(a).

[36] Sec. 3121(b). For example, employment for FICA purposes includes certain service with respect to American vessels or aircrafts and also includes service that is designated as employment under an agreement entered into under section 233 of the Social Security Act.

United States residents; (4) a trust, if all of the trustees are United States residents; or (5) a corporation organized under the laws of the United States or any of the States.[37]

Description of Proposal

Employers that elect not to provide health benefit plans to their employees are subject to an additional payroll tax equal to eight percent of wages (as defined in section 3121 for purposes of FICA).[38] The proposal's definitions of the terms wages, employment, and employer, are generally the same as under present FICA provisions. The proposal, however, differs from present law in several respects. First, the tax is imposed as a result of a voluntary election by the employer not to offer an eligible health plan and not to make the required contribution toward each employee's premium for the plan. Second, as is currently the case for HI, there is no taxable wage base for purposes of the new payroll tax. Third, the definition of employment includes services performed by certain foreign agricultural workers, aliens performing services pursuant to certain nonimmigrant visas, and government workers, among others who are carved out of the definition under current law.

Employers are permitted to make separate elections for separate lines of business, or full-time employees and part-time employees (or vice-versa). The new payroll tax applies only to wages paid to employees who are not offered health benefits by their employers.

There is an exception for certain small employers. Employers with annual payrolls not exceeding $250,000 during the preceding calendar year are not subject to the tax. Employers with annual payrolls between $250,000 and $400,000 during the preceding calendar year are subject to a reduced rate, as follows: two percent if the annual payroll does not exceed $300,000; 4 percent if the annual payroll exceeds $300,000 but does not exceed $350,000; and six percent if the annual payroll exceeds 350,000 but does not exceed $400,000. Annual payroll is defined as the aggregate wages (as defined in section 3121(a)) paid by the employer with respect to employment (as defined in section 3121(b)).

A parallel payroll tax, including the exception for small employers, applies to railroad carriers.

Territories and possessions of the United States are not treated as States for purposes of the new payroll tax.

Effective Date

The proposal is effective for all tax years beginning after December 31, 2012.

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[37] Sec. 3121(h).

[38] Under the proposal, there is created within the Treasury of the United States a trust fund known as the "Health Insurance Exchange Trust Fund" which consists of such amount as may be appropriated or credited to the trust fund. Under the proposal, an amount equal to these payroll taxes received from employers electing to not provide health benefits is automatically appropriated to, and thus used to fund, the new Health Insurance Exchange Trust Fund.

D. Credit For Small Business Employee Health Coverage Expenses

Present law

Deduction of employer contributions for health coverage for employees

The Code does not provide a tax credit for any employer that provides health coverage for its employees. The cost to an employer of providing health coverage for its employees is generally deductible as an ordinary and necessary business expense for employee compensation.[39] In addition, the value of employer provided health insurance is not subject to employer paid Federal Insurance Contributions Act ("FICA") tax.

Employer contributions for health coverage

The Code generally provides that employees are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan.[40] In addition, medical care provided under an accident or health plan for employees, their spouses, and their dependents is excluded from gross income of the employee.[41] Employees participating in a cafeteria plan may be able to pay their share of premiums on a pre-tax basis through salary reduction.[42] Such salary reduction contributions are treated as employer contributions and thus also are excluded from gross income.

Description of Proposal

General rule

The proposal generally provides a tax credit for a qualified small employer for up to 50 percent of its qualified health coverage expenses for the taxable year. Qualified employee health coverage expenses are, with respect to any employer for any taxable year, the aggregate amount paid or incurred by the employer for coverage of any qualified employee of the employer (including any family coverage which covers the employee) under qualified health coverage. However, for this purpose, "amounts paid by the employer" do not include amounts based on a salary reduction election made by an employee under a cafeteria plan (although such amounts are generally treated as an employer contribution under the Code). The credit is a general business credit, eligible to be carried back for one year and carried forward for 20 years.

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[39] Sec. 162. However see special rules in section 419 and 419A for the deductibility of contributions to welfare benefit plans with respect to medical benefits for employees and their dependents.

[40] Sec. 106

[41] Sec. 105(b)

[42] Sec. 125.

Qualified small employer

A qualified small employer for purposes of the proposal is an employer with no more than 25 qualified employees employed during the employer's taxable year, and whose average annual employee compensation does not exceed $40,000. However, the full amount of the credit (50 percent of qualified health coverage expenses) is available only to an employer with no more than 10 qualified employees and whose average annual employee compensation does not exceed $20,000. Average annual employee compensation is determined by dividing the total aggregate compensation for the taxable year of all qualified employees by number of qualified employees.

Under the proposal, an employee is a qualified employee of an employer for a taxable year if the employee receives at least $5,000 of compensation from the employer during the taxable year. Self-employed individuals, including partners and sole proprietors, are treated as employees with respect to a business or partnership that generates net earnings for self employment for the individual but only if the business or partnership also has common law employees who are qualified employees.

For a common law employee, compensation means wages for purposes of income tax withholding plus elective deferrals within the meaning of section 402(g) and compensation deferred under an eligible deferred compensation plan under section 457. For a self-employed individual, compensation means net earnings from self employment, prior to subtracting any elective contributions. These definitions of compensation[43] are used to determine both whether an individual is a qualified employee and to determine average annual employee compensation.

Qualified health coverage and expenses

Qualified health coverage includes two elements. First, the coverage must be "acceptable coverage" as defined for purposes of the individual responsibility requirement for obtaining health coverage. Second, the coverage must be provided by the employer pursuant to its election to satisfy the employer responsibility requirement by offering coverage, and the employer's contribution toward the cost of the coverage must be at least the minimum required for that purpose.[44] The credit is only available for qualified health expenses paid or incurred by the employer for the purchase of health care coverage.

Phase out of the credit

If an employer's average annual employee compensation exceeds $20,000, the credit phases out from the maximum available credit of 50 percent. The percentage is reduced by one

[43] The proposal specifies that compensation has the same meaning as the definition of compensation for simple plans under section 408(p)(6)(A).

[44] Under the proposal, for employers that elect to provide coverage rather than pay an additional payroll tax, employers are required to make contributions to help discharge the coverage costs of employees enrolled in the employer-provided plan. For example, for full-time employees, the contribution amount is required to be at least 72.5 percent of the lowest cost plan meeting the requirements of the essential benefits package (reduced to 65 percent for eligible employees electing family coverage).

percentage point for each $400 by which average annual employee compensation exceeds $20,000. For example, a firm with an average wage of $24,000 is entitled to a 40-percent credit. Simultaneously, the credit would be phased out for employers with more than 10 qualified employees by reducing the credit by an amount which bears the same ratio to the amount of the credit as the number of qualified employees of the employer in excess of 10 bears to 15. For example, if a firm has 16 qualified employees, the 50-percent credit is reduced by 40 percent to a 30-percent credit.[45]

Special rules

The employer would be determined by applying the employer aggregations rules in section 414(b), (c), (m), and (o).[46] The credit is not available with respect to qualified employee health coverage expenses for any employee if the employee's compensation for the taxable year exceeds $80,000. Under the proposal, the employer generally is allowed a deduction under section 162 for qualified employee health coverage expenses equal to total health coverage expenses minus the dollar amount of the credit. The $5,000 compensation threshold for identifying qualified employees, the $20,000 average annual compensation limit, and the $80,000 compensation amount are indexed for changes in the Consumer Price Index. However, in each case, if the resulting amount is not a multiple of $50, the amount is rounded down to the next lowest multiple of $50.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2012.

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[45] [1 - (16-10)/15]*50 percent = 30 percent

[46] Section 414(b) provides that, for specified employee benefit purposes, all employees of all corporations which are members of a controlled group of corporations are treated as employed by a single employer. There is a similar rule in section 414(c) under which all employees of trades or businesses (whether or not incorporated) which are under common control are treated under regulations as employed by a single employer, and, in section 414(m), under which employees of an affiliated service group (as defined in that section) are treated as employed by a single employer. Section 414(o) authorizes the Treasury to issue regulations to prevent avoidance of the requirements section 414(m).

E. Disclosures to Carry Out Health Insurance Exchange Subsidies

Present Law

Section 6103 provides that returns and return information are confidential and may not be disclosed by the Internal Revenue Service ("IRS"), other Federal employees, State employees, and certain others having access to such information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances. For example, section 6103 provides for the disclosure of certain return information for purposes of establishing the appropriate amount of any Medicare Part B Premium Subsidy Adjustment.[47]

Section 6103(p)(4) requires, as a condition of receiving returns and return information, that Federal and State agencies (and certain other recipients) provide safeguards as prescribed by the Secretary of the Treasury by regulation to be necessary or appropriate to protect the confidentiality of returns or return information.[48] Unauthorized disclosure of a return or return information is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.[49] The unauthorized inspection of a return or return information is punishable by a fine not exceeding $1,000 or imprisonment of not more than one year, or both, together with the costs of prosecution.[50] An action for civil damages also may be brought for unauthorized disclosure.[51]

Description of Proposal

The bill creates within the Health Choices Administration a National Health Insurance Exchange ("Exchange") to facilitate the purchase of health insurance. A State has the option of forming its own health insurance exchange at the State level that must be approved for operation by the Federal government ("approved State Exchange"). The bill provides for "affordability credits," administered by the exchanges, which subsidize the purchase of health insurance through the exchanges and the cost of paying for medical care. The affordability credits generally are available on a sliding scale for persons and families with incomes between Medicaid eligibility and 400 percent of the poverty level. To ensure the appropriate level of subsidy, the proposal allows for the disclosure of certain return information to the Exchange, or approved State Exchange to administer the affordability credits.

Upon receipt of a valid written request from the Health Choices Commissioner or the head of the approved State Exchange, the IRS is authorized to disclose limited return information

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[47] Sec. 6103(l)(20).

[48] Sec. 6103(p)(4)(D).

[49] Sec. 7213.

[50] Sec. 7213A.

[51] Sec. 7431.

of any taxpayer whose income is relevant in determining the amount of the affordability credit(s). Such return information is limited to (1) taxpayer identity information, (2) filing status, (3) modified adjusted gross income, (4) the number of dependents of the taxpayer, (5) such other information as is prescribed by the Secretary by regulation as might indicate that the taxpayer is eligible for such affordability credit(s) (and the amount thereof), and (6) the taxable year with respect to which the preceding information relates or, if applicable, the fact that such information is not available.

The return information disclosed is to be used by officers and employees of the Health Choices Administration, or approved State Exchange, only for the purposes of and to the extent necessary in establishing and verifying the appropriate amount of any affordability credit and providing for the repayment of any such credit that was in excess of the appropriate amount.

The general rule of confidentiality applies to the information disclosed, as well as the safeguard requirements, penalties, and civil damage remedies for unauthorized disclosure or inspection.

Effective Date

The proposal is effective on the date of enactment.

F. Disclosures to Facilitate Identification of Individuals Likely to be Ineligible for Low-Income Subsidies Under the Medicare Prescription Drug Program to Assist Social Security Administration's Outreach to Eligible Individuals

Present Law

Outreach efforts to increase awareness of the availability of Part D subsidies for low-income individuals

Under Medicare Part D (the prescription drug program), beneficiaries with incomes and assets below certain levels may be eligible for Low Income Subsidy ("LIS") benefits. Section 1144 of the Social Security Act requires the Commissioner of Social Security to conduct outreach efforts to inform potential LIS beneficiaries about the additional premium and cost-sharing subsidies. The Social Security Administration ("SSA"), from its own records and other non-tax records available to SSA, is able to determine a potential pool of LIS beneficiaries, but such pool includes many persons ineligible for the LIS benefits due to excess income or resources.

For example, prior to the beginning of the Part D program, SSA identified and conducted outreach to 18.6 million potentially eligible individuals; of these, 6.2 million applied by March 2007 and 2.2 million were found to be eligible. The Centers for Medicare and Medicaid Services ("CMS") believes that some of the remaining 12.4 million that did not apply could be eligible for LIS benefits. SSA has contacted these individuals a number of times, but has had limited success identifying additional potentially eligible individuals and securing applications from them.

Confidentiality of returns and return information

Section 6103 provides that returns and return information are confidential and may not be disclosed by the Internal Revenue Service ("IRS"), other Federal employees, State employees, and certain others having access to such information except as provided in the Internal Revenue Code (the "Code"). Section 6103 contains a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances.

For example, the Code provides for the disclosure of returns and return information to the SSA for several nontax administration purposes. For purposes of administering the Social Security Act, section 6103(l)(1)(A) authorizes the disclosure to SSA of returns and return information relating to self-employment taxes, Federal Insurance Contributions Act taxes, and taxes withheld at the source on wages.[52] Section 6103(l)(5) provides for the disclosure to SSA of

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[52] Documents which may be disclosed under this provision include but are not limited to:

- Schedule C, Form 1040, *Profit (or Loss) from Business or Profession*
- Schedule E, Form 1040, *Supplemental Income Schedule-Part III, Income or Loss from Partnerships*
- Schedule F, Form 1040, *Farm Income and Expenses*
- Schedule SE, Form 1040, *Computation of Social Security Self-Employment Tax*
- Form 1065, *U.S. Partnership Return of Income*
- Form 941, *Employer's Quarterly Federal Tax Return*

certain information returns for purposes of carrying out an effective return processing program, the Combined Annual Wage Reporting Program, and for providing mortality status of individuals for certain epidemiological and similar research.[53] In addition, the Code provides for the disclosure of certain return information for purposes of establishing the appropriate amount of any Medicare Part B Premium Subsidy Adjustment.[54]

A December 2008 Treasury study conducted jointly with SSA found that certain income information in IRS's possession, and, through imputation, some asset information, could be used to narrow the pool of potentially eligible LIS beneficiaries identified by SSA, thereby allowing SSA to better target its outreach efforts. Specifically, tax information could be used to screen out some individuals whose income or resources make them likely to be ineligible for LIS benefits.[55]

Description of Proposal

Under the proposal, upon written request from the Commissioner of Social Security, officers and employees of SSA will have access to the following information (including information available under sections 6103(l)(1) and (l)(5)) with respect to any individual identified by the Commissioner of Social Security:

1. return information for the applicable year from returns with respect to wages and payments of retirement income,

2. unearned income information and income information of the taxpayer from partnerships, trusts, estates, and subchapter S corporations for the applicable year,

3. if the individual filed an income tax return for the applicable year, the filing status, number of dependents, income from farming, and income from self employment on such return, and

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- Form 942, *Employer's Quarterly Tax Return for Household Employees* or portions Schedule H, Form 1040
- Form 943, *Employer's Annual Tax Return for Agricultural Employees*
- Form W-2, *Wage and Tax Statement*.

See Internal Revenue Service, Internal Revenue Manual, sec. 11.3.29.3 - Administration of the Social Security Act - Social Security Administration (05-27-2005).

[53] The information returns that may be disclosed under section 6103(l)(5) are those filed under Part III, Subchapter A, Chapter 61 of the Code. These include, primarily, Form W-2, Form W-3; and Form 1099-R. See, Internal Revenue Service, Internal Revenue Manual, sec. 11.3.29.3.2 - Disclosure of Information Returns to Social Security Administration (05-27-2005).

[54] Sec. 6103(l)(20).

[55] Department of the Treasury, Office of Tax Analysis, *Value of IRS Information for Determining Eligibility for the Low Income Subsidy Program (LIS) of the Medicare Prescription Drug Program (Medicare Part D)*, December 2008 at 1 and 3.

4. if the taxpayer’s return status was married filing separately, the social security number of the taxpayer’s spouse;

5. if the taxpayer filed a joint return, the social security number, unearned income information, and income information from partnerships, trusts, estates, and Subchapter S corporations of the taxpayer’s spouse;

6. such other return information relating to the taxpayer (and, in the case of a joint return, the taxpayer’s spouse) as is prescribed by the Secretary by regulation as might indicate that the taxpayer is likely to be ineligible for a low-income prescription drug subsidy under section 1860D-14 of the Social Security Act.

For purposes of the proposal, “applicable year” means the most recent taxable year for which information is available in the IRS’s taxpayer information records. Under the proposal, SSA may only request tax information with respect to individuals SSA has identified, through the use of all other reasonably available information, as likely to be eligible for a low-income prescription drug subsidy under section 1860D-14 of the Social Security Act and who have not applied for such subsidy. In the case of an identified individual who filed a married-filing separately return and whose spouse was not identified by SSA as likely to be eligible for a low-income prescription drug subsidy, SSA may make a separate request for information related to such spouse.

The information disclosed under the proposal can only be used by SSA for purposes of identifying those individuals likely to be ineligible for a low-income prescription drug subsidy for purposes of its outreach efforts under section 1144 of the Social Security Act.

Effective Date

The proposal is effective 12 months after the date of enactment.

G. Comparative Effectiveness Research Trust Fund; Financing for Trust Fund

Present law

No provision.

Description of Proposal

In general

The proposal establishes the Health Care Comparative Effectiveness Research Trust Fund (''CERTF'') under the Internal Revenue Code (the ''Code'') to carry out the proposal's provisions relating to comparative effectiveness research.

The following amounts are appropriated to the CERTF: $90,000,000 for fiscal year 2010; $100,000,000 for fiscal year 2011; and $110,000,000 for fiscal year 2012. For each fiscal year beginning with fiscal year 2013, the amount appropriated to the CERTF is (1) an amount equal to the net revenues received in the Treasury from the fees imposed on health insurance and self-insured plans under proposed Code sections 4375, 4376 and 4377 for such fiscal year, and (2) amounts determined by the Secretary of Health and Human Services to be equivalent to the fair share per capita amount for the fiscal year multiplied by the average number of individuals entitled to benefits under Medicare part A, or enrolled under Medicare part B, for such fiscal year. The amount transferred under (2) is limited to $90,000,000. Net revenues means the amount, as estimated by the Secretary of the Treasury, equaling the excess of the fees received in the Treasury on account of the new fee on health insurance and self-insured plans under proposed Code sections 4375, 4376 and 4377, over the decrease in tax imposed by chapter one of the Code relating to the fees imposed by such sections.

The amounts appropriated for fiscal years 2011 through 2013, as well as the amounts transferred under (2), above, are to be transferred from the Federal Hospital Insurance Trust Fund and from the Federal Supplementary Medical Insurance Trust Fund, and from the Medicare Prescription Drug Account within such Trust Fund, in proportion to the total expenditures during such year that are made under Medicare for the respective trust fund or account.

The fair share per capita amount is an amount computed by the Secretary of Health and Human Services for such fiscal year that will result in revenues to the CERTF of $375,000,000 for the fiscal year. If the Secretary is unable to compute the fair share per capita amount for a fiscal year, a default amount is used. The default amount is $2 for fiscal year 2013. For a subsequent year, the default amount is equal to the default amount for the preceding fiscal year increased by the annual percentage increase in the medical care component of the consumer price index for the 12-month period ending with April of the preceding fiscal year. Beginning not later than December 31, 2011, the Secretary of Health and Human Services must submit to Congress an annual recommendation for a fair share per capita amount for purposes of funding the CERTF.

At least the following amounts in the CERTF must be available to carry out the activities of the Comparative Effectiveness Research Commission established under the bill: $7,000,000 for fiscal year 2010; $9,000,000 for fiscal year 2011; and $10,000,000 for each fiscal year beginning with 2012

Financing CERTF from fees on health plans

As discussed above, the CERTF is funded in part from fees imposed on health plans under proposed Code sections 4375 through 4377. Under the proposal, a fee is imposed on each specified health insurance policy equal to the fair share per capita amount multiplied by the average number of lives covered under the policy. The issuer of the policy is liable for payment of the fee. A specified health insurance policy includes any accident or health insurance policy[56] issued with respect to individuals residing in the United States.[57] An arrangement under which fixed payments of premiums are received as consideration for a person's agreement to provide or arrange for the provision of accident or health coverage to residents of the United States, regardless of how such coverage is provided or arranged to be provided, is treated as a specified health insurance policy. The person agreeing to provide or arrange for the provision of coverage is treated as the issuer.

In the case of an applicable self-insured health plan, a fee is imposed equal to the fair share per capita amount multiplied by the average number of lives covered under the plan. The plan sponsor is liable for payment of the fee. For purposes of the provision, the plan sponsor is: the employer in the case of a plan established or maintained by a single employer or the employee organization in the case of a plan established or maintained by an employee organization. In the case of (1) a plan established or maintained by two or more employers or jointly by one of more employers and one or more employee organizations, (2) a multiple employer welfare arrangement, or (3) a voluntary employees' beneficiary association described in Code section 501(c)(9), the plan sponsor is the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan. In the case of a rural electric cooperative or a rural telephone cooperative, the plan sponsor is the cooperative or association.

Under the proposal, an applicable self-insured health plan is any plan providing accident or health coverage if any portion of such coverage is provided other than through an insurance policy if such plan is established or maintained (1) by one or more employers for the benefit of their employees or former employees, (2) by one or more employee organizations for the benefit of their members or former members, (3) jointly by one or more employers and one or more employee organizations for the benefit of employees or former employees, (4) by a voluntary

[56] A specified health insurance policy does not include insurance if substantially all of the coverage provided under such policy consists of excepted benefits described in section 9832(c) of the Code. Examples of excepted benefits described in section 9832(c) are coverage for only accident, or disability insurance, or any combination thereof; liability insurance, including general liability insurance and automobile liability insurance; workers' compensation or similar insurance; automobile medical payment insurance; coverage for on-site medical clinics; limited scope dental or vision benefits; benefits for long term care , nursing home care, community based care, or any combination thereof; coverage only for a specified disease or illness; Hospital indemnity or other fixed indemnity insurance; and Medicare supplemental coverage.

[57] Under the proposal, the United States includes any possession of the United States.

employees' beneficiary association described in section 501(c)(9) of the Code, (5) by any organization described in section 501(c)(6) of the Code, or (6) in the case of a plan not previously described, by a multiple employer welfare arrangement (as defined in section 3(40) of the Employee Retirement Income Security Act of 1974 (''ERISA'')), a rural electric cooperative (as defined in section 3(40) of ERISA), or a rural telephone cooperative association (as defined in section 3(40)(B)(v) of ERISA).

Governmental entities are not exempt from the fees imposed under the provision except in the case of certain exempt governmental programs. Exempt governmental programs include Medicare, Medicaid, SCHIP, and any program established by Federal law for proving medical care (other than through insurance policies) to members of the Armed Forces, veterans, or members of Indian tribes.

No amount collected from the fee on health insurance and self insurance plans is covered over to any possession of the United States. For purposes of the procedure and administration rules under the Code, the fee imposed under the provision is treated as a tax.

Effective Date

The fee on health insurance and self-insured plans is effective with respect to policies and plans for portions of policy or plan years beginning on or after October 1, 2012.

II. OTHER REVENUE PROVISIONS

A. Surcharge on High-Income Individuals

Present Law

In general

An individual who is a citizen or resident of the United States is subject to the income tax on his or her taxable income.[58] An individual computes taxable income by reducing gross income by the sum of (i) the deductions allowable in computing adjusted gross income, (ii) the standard deduction (or itemized deductions, at the election of the taxpayer), and (iii) the deduction for personal exemptions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. Lower rates apply to net capital gain and qualified dividend income. A taxpayer may also be subject to an alternative minimum tax. A taxpayer may reduce his or her income tax liability by certain tax credits.

Gross income

Gross income means "income from whatever source derived" other than certain items excluded from gross income. Sources of gross income generally include, among other things, compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[59] trusts or estates.[60] Exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain allowable deductions from gross income. These deductions are known as "above-the line" deductions. These deductions include trade or business deductions (other than certain deductions

[58] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

[59] In general, partnerships and S corporations are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of these entities is passed through and taxed to the owners at the individual level.

[60] In general, estates and most trusts pay tax on income at the entity level, unless the income is distributed or required to be distributed under governing law or under the terms of the governing instrument. These entities determine their tax liability using a special tax rate schedule and may be subject to the alternative minimum tax. Other trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

for services performed as an employee), losses from the sale or exchange of property, deductions attributable to rents and royalties, contributions to pensions and other retirement plans, moving expenses, and alimony payments.

Many deductions are not allowable in computing adjusted gross income. These deductions generally are referred to as "itemized deductions". The principal itemized deductions are the deductions for interest on a personal residence and investment interest, taxes, charitable contributions, nonbusiness casualty and theft losses, investment expenses, medical and dental expenses, and certain employee expenses. An individual who does not elect to deduct itemized deductions is allowed a standard deduction, which also is not allowable in computing adjusted gross income.

Description of Proposal

The proposal imposes a tax at the rates of 1 percent, 1.5 percent, and 5.4 percent on certain income of high-income individuals. In the case of a joint return or return of a surviving spouse, the 1 percent rate applies to so much of the taxpayer's modified adjusted gross income as exceeds $350,000 but does not exceed $500,000; the 1.5 percent rate applies to so much of the taxpayer's modified adjusted gross income as exceeds $500,000 but does not exceed $1,000,000; and the 5.4 percent rate applies to so much of the modified adjusted gross income as exceeds $1,000.000. In the case of a married individual filing a separate return, the dollar amounts are 50 percent of the above dollar amounts. In the case of unmarried individuals, heads of households and trusts and estates, the dollar amounts are 80 percent of the above dollar amounts. The dollar amounts are indexed for inflation for taxable years beginning after December 31, 2011.

The proposal directs the Director of the Office of Management and Budget ("OMB") to determine before December 1, 2012 whether the Federal health reform savings under division B of this act for the period beginning October 1, 2009 and ending before October 1, 2019, exceed the savings estimated by the Congressional Budget Office ("CBO"). If these savings do not exceed $150 billion dollars, then the 1 percent and 1.5 percent rates will become 2 percent and 3 percent, respectively, for taxable years beginning after December 31, 2012. If the Director of OMB determines these savings exceed the CBO estimate by more than $150 billion dollars for the period, then the 1 percent and 1.5 percent rates shall not increase after December 31, 2012. If Director of OMB determines these savings exceed the CBO estimate by more than $175 billion dollars for the period, then neither the 1 percent nor 1.5 percent rates shall apply after December 31, 2012.

Modified adjusted gross income is the taxpayer's adjusted gross income reduced by the deduction allowed for investment interest expense.

In the case of a nonresident alien, only amounts taken into account in computing taxable income are taken into account in computing this tax.

In the case of a taxpayer with an amount excluded under section 911 (relating to income earned outside the United States), the dollar amounts applicable to the taxpayer are reduced by the amount of the exclusion (net of disallowed deductions and exclusions).

Charitable trusts are not subject to the tax.

No credits are allowed against this tax and this tax is not taken into account in computing alternative minimum tax liability.

Effective Date

The proposal applies to taxable years beginning after December 31, 2010.

B. Delay in Application of Worldwide Allocation of Interest

Present Law

In general

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.[61] 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.[62] 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

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

[62] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations (certain electing domestic corporations that have income from the active conduct of a trade or business in Puerto Rico or another U.S. possession) 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."[63] A financial corporation includes 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.[64] 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.[65]

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")[66] 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 that the foreign assets of the worldwide affiliated group bears to the total assets of

[63] Treas. Reg. sec. 1.861-11T(d)(4).

[64] Sec. 864(e)(5)(C).

[65] Sec. 864(e)(5)(D).

[66] Pub. L. No. 108-357, sec. 401.

the worldwide affiliated group,[67] 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 principles of worldwide interest allocation were applied separately to the foreign members of the group.[68]

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,[69] 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.

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 provide 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.[70] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

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

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[67] 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.

[68] 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.

[69] 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.

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

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

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, 2010, 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.[71] The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2010, in which a worldwide affiliated group includes a financial corporation. Once either election is made, it applies to the common parent and all other members of the worldwide affiliated group or to all members of the financial institution group, as applicable, for the taxable year for which the election is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

Phase-in rule

HERA also provided a special phase-in rule in the case of the first taxable year to which the worldwide interest allocation rules apply. For that year, the amount of the taxpayer's taxable income from foreign sources is reduced by 70 percent of the excess of (i) the amount of its taxable income from foreign sources as calculated using the worldwide interest allocation rules over (ii) the amount of its taxable income from foreign sources as calculated using the present-law interest allocation rules. For that year, the amount of the taxpayer's taxable income from domestic sources is increased by a corresponding amount. Any foreign tax credits disallowed by virtue of this reduction in foreign-source taxable income may be carried back or forward under the normal rules for carrybacks and carryforwards of excess foreign tax credits.

Description of Proposal

The proposal delays the effective date of worldwide interest allocation rules for nine years, until taxable years beginning after December 31, 2019. The required dates for making the worldwide affiliated group election and the financial institution group election are changed accordingly.

The proposal also eliminates the special phase-in rule that applies in the case of the first taxable year to which the worldwide interest allocation rules apply.

[71] As originally enacted under AJCA, the worldwide interest allocation rules were effective for taxable years beginning after December 31, 2008. However, the Housing and Economic Recovery Act of 2008 ("HERA") delayed the implementation of the worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. Pub. L. No. 110-289, sec. 3093.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2010.

C. Limit on Treaty Benefits for Certain Deductable Payments

Present Law

In general

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to net-basis U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax ("U.S. withholding tax") generally is collected by means of withholding by the person making the payment. U.S. withholding tax may be reduced or eliminated under an applicable tax treaty, subject to the conditions discussed below.

Tax treaties

A foreign corporation may not benefit from a provision of a U.S. tax treaty with a foreign country that eliminates or reduces U.S. withholding tax unless the foreign corporation is both a resident of such foreign country and qualifies under any limitation-on-benefits provision contained in the U.S. tax treaty with such foreign country. In general, a foreign corporation is a resident of a foreign country under a U.S. tax treaty with that foreign country if it is liable to tax in that country by reason of its domicile, residence, citizenship, place of management, place of incorporation, or other criterion of a similar nature.[72]

Limitation-on-benefits provisions generally

Limitation-on-benefits provisions in income tax treaties are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents. Treaty shopping is said to occur when an entity that is resident in a country with respect to which there is no relevant tax treaty in force (or there is such a treaty in force but the taxpayer desires better benefits than those offered under that treaty) becomes resident in a treaty country or conducts a transaction in such a country for the purpose of qualifying for treaty benefits. For example, treaty shopping by a third-country resident may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a related treaty-country resident by having that treaty

[72] United States Model Income Tax Convention of November 15, 2006, Art. 4, par. 1.

country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made.

U.S. tax treaties contain a variety of limitation-on-benefits provisions due to the continued and recently accelerated development of limitation-on-benefits concepts, and the negotiated nature of tax treaties in general. Although many older U.S. tax treaties may lack limitation-on-benefits provisions[73] or lack the refinements now thought essential to such provisions, the U.S. model income tax treaty, as most recently revised in 2006 ("U.S. model treaty"),[74] and the newer U.S. treaties include limitation-on-benefits provisions that limit treaty benefits to resident taxpayers that meet certain detailed requirements intended to minimize these abuses. Present Treasury Department policy, which has been repeatedly ratified by the Senate, is broadly to revise older treaties by tightening limitation-on-benefits provisions to prevent treaty shopping.

The limitation-on-benefits rules included in U.S. income tax treaties and protocols signed since 2001 generally correspond with the limitation-on-benefits provisions of the U.S. model treaty. Certain features of the limitation-on-benefits provisions in recent treaties and protocols, however, differ from the rules in the U.S. model treaty, and some recent treaties and protocols include additional limitation-on-benefits rules not included in the U.S. model treaty. Some of the additions and differences make limitation-on-benefits provisions more restrictive than the rules in the U.S. model treaty, and others make the provisions less restrictive.

The U.S. model treaty limitation-on-benefits provision

The limitation-on-benefits rules of the U.S. model treaty include three provisions under which a resident of a treaty country may qualify for treaty benefits. First, a treaty-country resident may qualify for all treaty benefits if it has any one of several listed attributes. Second, a treaty-country resident that does not have one of the listed attributes may qualify for treaty benefits for income items that are derived from the other treaty country and that are related to a trade or business carried on in the residence country. Third, a treaty-country resident that would not be eligible for treaty benefits under either of the preceding two provisions may qualify for treaty benefits at the discretion of the competent authority of the other treaty country. These three provisions are described in more detail below.

Listed attributes qualifying a treaty-country resident for treaty benefits

A treaty-country resident may qualify for treaty benefits under the U.S. model treaty if it has one of the following attributes: it is (1) an individual; (2) a contracting state or a political subdivision or a local authority of the contracting state; (3) a company that satisfies either a public trading or ownership test described below; (4) a pension fund or other tax-exempt

[73] U.S. income tax treaties with Greece, Hungary, Pakistan, the Philippines, Poland, and Romania are examples of such treaties, each of which entered into force more than 25 years ago. The United States recently concluded negotiations for a new income tax treaty with Hungary that contains a modern limitation-on-benefits provision; the U.S. Senate must still ratify that treaty before it may enter into force.

[74] United States Model Income Tax Convention of November 15, 2006, Art. 22.

organization (if, in the case of a pension fund, more than 50 percent of the fund's beneficiaries, members, or participants are individuals resident in either treaty country); or (5) a person other than an individual that satisfies the ownership and base erosion test described below.

Public trading and ownership tests.−A company satisfies the public trading test if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges and either its principal class of shares is primarily traded on one or more recognized stock exchanges located in the treaty country in which the company is a resident or the company's primary place of management and control is in its country of residence. A company may satisfy the ownership test if at least 50 percent of the aggregate vote and value of the company's shares (and at least 50 percent of any disproportionate class of the company's shares) is owned directly or indirectly by five or fewer companies entitled to benefits under the public trading test described above. This ownership test may be satisfied by indirect ownership only if each intermediate owner is a resident of either treaty country.

Ownership and base erosion test.−A resident of a treaty country satisfies the ownership prong of the ownership and base erosion test if on at least half the days of the taxable year, persons that are residents of that country and that are entitled to treaty benefits as individuals, governments, companies that satisfy the public trading test, or pension funds or other tax-exempt organizations own, directly or indirectly, stock representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the resident for whom treaty benefit eligibility is being tested. This ownership requirement may be satisfied by indirect ownership only if each intermediate owner is a resident of the country of residence of the person for which entitlement to treaty benefits is being tested. A resident of a treaty country satisfies the base erosion prong of the ownership and base erosion test if less than 50 percent of the person's gross income for the taxable year, as determined in the person's country of residence, is paid or accrued, directly or indirectly, in the form of deductible payments to persons who are not residents of either treaty country entitled to treaty benefits as individuals, governments, companies that satisfy the public trading test, or pension funds or other tax-exempt organizations (other than arm's-length payments in the ordinary course of business for services or tangible property).

Items of income derived from an active trade or business

Under the U.S. model treaty, a resident of a treaty country that is not eligible for all treaty benefits under any of the rules described above may be entitled to treaty benefits with respect to a particular item of income derived from the other treaty country. A resident is entitled to treaty benefits for such an income item if the resident is engaged in the active conduct of a trade or business in its country of residence (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer) and the income derived from the other treaty country is derived in connection with, or is incidental to, that trade or business. If a resident of a treaty country derives an item of income from a trade or business activity that it conducts in the other treaty country, or derives an income item arising in that other country from a related person, the income item eligibility rule just described is considered satisfied for that income item only if the trade or business activity carried on by the resident in its country of residence is substantial in relation to the trade or business activity carried on by the resident or the related person in the other country. The determination whether a trade or business activity is substantial is based on all the facts and circumstances.

Discretionary grant of benefits by competent authority

A resident of a treaty country not otherwise eligible for treaty benefits under the U.S. model treaty may be eligible for the benefits of the treaty generally or eligible for the benefits with respect to a specific item of income, based on a determination by the competent authority of the other treaty country. The competent authority may grant such benefits if it determines that the establishment, acquisition, or maintenance of the person for whom treaty benefits eligibility is being tested, and the conduct of that person's operations, did not have as one of its principal purposes the obtaining of benefits under the treaty.

Description of Proposal

The proposal limits tax treaty benefits with respect to U.S. withholding tax imposed on deductible related-party payments. Under the proposal, the amount of U.S. withholding tax imposed on deductible related-party payments may not be reduced under any U.S. income tax treaty unless such withholding tax would have been reduced under a U.S. income tax treaty if the payment were made directly to the "foreign parent corporation" of the payee. A payment is a deductible related-party payment if it is made directly or indirectly by any entity to any other entity, it is allowable as a deduction for U.S. tax purposes, and both entities are members of the same "foreign controlled group of entities."

For purposes of the proposal, a foreign controlled group of entities is a "controlled group of corporations" as defined in section 1563(a)(1), modified as described below, in which the common parent company is a foreign corporation. Such common parent company is referred to as the "foreign parent corporation". A controlled group of corporations consists of a chain or chains of corporations connected through direct stock ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations. For purposes of the proposal, the relevant ownership threshold is lowered from "at least 80 percent" to "more than 50 percent," certain members of the controlled group of corporations that would otherwise be treated as excluded members are not treated as excluded members,[75] and insurance companies

[75] Under section 1563(b)(2), a corporation which is a member of a controlled group of corporations on December 31 of a taxable year is treated as an excluded member of the group for the taxable year that includes such December 31 if such corporation —

(A) is a member of the group for less than one-half the number of days in such taxable year which precedes such December 31;

(B) is exempt from taxation under section 501(a) for such taxable year;

(C) is a foreign corporation subject to tax under section 881 for such taxable year;

(D) is an insurance company subject to taxation under section 801; or

(E) is a franchised corporation (as defined in section 1563(f)(4)).

are not treated as members of a separate controlled group of corporations. In addition, a partnership or other noncorporate entity is treated as a member of a controlled group of corporations if such entity is controlled by members of the group.

The Secretary may prescribe regulations that are necessary or appropriate to carry out the purposes of the proposal, including regulations providing for the treatment of two or more persons as members of a foreign controlled group of entities if such persons would be the common parent of such group if treated as one corporation, and regulations providing for the treatment of any member of a foreign controlled group of entities as the common parent of that group if such treatment is appropriate taking into account the economic relationships among the group entities.

For example, under the proposal, a deductible payment made by a U.S. entity to a foreign entity with a foreign parent corporation that is resident in a country with respect to which the United States does not have an income tax treaty is always subject to the statutory U.S. withholding tax rate of 30 percent, irrespective of whether the payee qualifies for benefits under a tax treaty. If, instead, the foreign parent corporation is a resident of a country with respect to which the United States does have an income tax treaty that would reduce the withholding tax rate on a payment made directly to the foreign parent corporation (regardless of the amount of such reduction), and the payment would qualify for benefits under that treaty if the payment were made directly to the foreign parent corporation, then the payee entity will continue to be eligible for the reduced withholding tax rate under the U.S. income tax treaty with the payee entity's residence country (even if such reduced treaty rate is lower than the rate that would be imposed on a hypothetical direct payment to the foreign parent corporation).

Effective Date

The proposal is effective for payments made after the date of enactment.

D. Codification of Economic Substance Doctrine

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 a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. These 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.

One common-law doctrine applied over the years 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.[76]

Economic substance doctrine

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

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[76] *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); *Klamath Strategic Investment Fund, LLC v. United States,* 472 F. Supp. 2d 885 (E.D. Texas 2007), *aff'd* 568 F.3d 537 (5th Cir. 2009); *Coltec Industries, Inc. v. United States,* 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied,* 127 S. Ct. 1261 (Mem.) (2007).

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., TIFD- III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd* 523 F.3d 461 (4th Cir. 2008).

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.[77]

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 an inquiry into the subjective 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 activities with non-tax objectives have been combined with unrelated activities having only tax-avoidance objectives, in order to disallow the tax benefits of the overall transaction.[78]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[79] 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.[80] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.[81] A third approach regards economic substance

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

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

[79] "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).

[80] *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."). *See also, Klamath Strategic Investment Fund v. United States*, 568 F. 3d 537, (5th Cir. 2009)(even if taxpayers may have had a profit motive, a transaction was disregarded where it did not in fact have any realistic possibility of profit and funding was never at risk).

[81] *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, 358 (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 interchangeably. For a more detailed discussion of the sham transaction

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.[82]

One decision by 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 transaction at issue in the 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.[83] 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."[84]

Nontax economic benefits

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has 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.[85] Several courts have denied tax benefits on

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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.

[82] *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'.")

[83] *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).

[84] 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.

[85] *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 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).

the grounds that the subject transactions lacked profit potential.[86] 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.[87] 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.[88] 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 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.[89] 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.[90]

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

[86] *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).

[87] *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").

[88] *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).

[89] *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).

[90] *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.

the transaction. Courts have sometimes concluded that a particular type of transaction did not satisfy the economic substance doctrine.[91] In other cases, courts have indicated that the substance of a 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.[92]

Description of Proposal

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.[93] 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.[94]

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 comparative tax advantages. Among[95] these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;[96] (2) a U.S. person's choice between

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[91] *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).

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

[93] 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.

[94] 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.

[95] The examples are illustrative and not exclusive.

[96] *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).

utilizing a foreign corporation or a domestic corporation to make a foreign investment;[97] (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;[98] 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.[99] Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[100] 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.[101]

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 with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.[102]

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[97] *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).

[98] *See, e.g. Rev. Proc. 2009-3 2009-1 I.R.B. 108, Secs. 3.01(38), (39), and (41)* (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).

[99] *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. Bollinger,* 485 U.S. 340 (1988); *see also* sec. 7701(l).

[100] *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); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd,* 523 F.3d 461 (4th Cir. 2008).

[101] 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*, 2007-1 USTC P 50,130 (M.D.N,C, 2007) *aff'd*, 523 F.3d 461 (4th Cir. 2008); *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); *aff'd*, 568 F. 3d 537 (5th Cir. 2009); *Santa Monica Pictures LLC v. Commissioner,* 89 T.C.M. 1157 (2005).

[102] *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

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[103] for entering into such transaction, in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the Federal circuit courts 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.[104]

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."[105] For purposes of this 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

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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.").

[103] For purposes of 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.

[104] The provision defines "economic substance doctrine" as the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Thus, the definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both.

[105] *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]

a non-Federal-income-tax purpose if the origin of such financial accounting benefit is a reduction of Federal income tax.[106]

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.[107] 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

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.

Effective Date

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

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[106] 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).

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

1. Penalty for understatements attributable to transactions lacking economic substance

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.[108] Except in the case of tax shelters,[109] 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.[110] 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.[111]

Listed transactions and reportable avoidance transactions

In general

A separate accuracy-related penalty under section 6662A applies to any "listed transaction" and to any other "reportable transaction" that is not a listed transactions, if a significant purpose of such transaction is the avoidance or evasion of Federal income tax[112]

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[108] Sec. 6662.

[109] 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).

[110] Sec. 6664(c).

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

[112] Sec. 6662A(b)(2).

(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 other reportable transactions are allowed to be described by the Treasury department under section 6011 as transactions that must be reported, and section 6707A(c) 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.[113] 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.[114]

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.[115] 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 were 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. A "reasonable belief" must be based on the facts and law as they exist at the time that the return in question is filed, and not take into account the possibility that a return would not be audited. Moreover, reliance on professional advice may support a "reasonable belief" only in certain circumstances.[116]

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.[117] 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.[118] The IRS Commissioner is authorized to do this only if the

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

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

[115] Sec. 6662A(a).

[116] Section 6664(d)(3)(B) would not allow a reasonable belief to be based on a "disqualified opinion" or on an opinion from a "disqualified tax advisor".

[117] Sec. 6662A(c).

[118] Sec. 6664(d).

failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[119]

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).[120]

<u>Determination of the understatement amount</u>

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);[121] 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.[122]

<u>Strengthened reasonable cause exception</u>

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;[123] (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than

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[119] Sec. 6707A(d).

[120] Sec. 6707A(e).

[121] 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).

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

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

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.[124]

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[125] 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[126] 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.[127] Participation in the "management" of a transaction means involvement in the decision-making process regarding any

[124] Sec. 6664(d).

[125] 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).

[126] 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.

[127] 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 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). See Notice 2005-12, 2005-1 C.B. 494 regarding disqualified compensation arrangements.

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.[128]

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

[128] Sec. 6667.

Description of Proposal

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),[129] or failing to meet the requirements of any similar rule of law.[130] 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). Thus, 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 fails to meet the requirements of any similar rule of law. 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.[131] 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.[132]

As described above, 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)). In addition, 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 person. A specified person is defined as (i) any person required to file periodic or other

[129] 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."

[130] 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.

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

[132] 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.

reports under section 13 of the Securities and Exchange Act of 1934, and (ii) any corporation with gross receipts in excess of $100 million for the taxable year involved.[133]

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),[134] the rules of section 6662(d) still apply, but are changed in the case of a specified person (as defined above). In the case of such a person, it is no longer 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 person 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 transactions entered into after the date of enactment.

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

[134] 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.