

111TH CONGRESS }
2d Session }

HOUSE OF REPRESENTATIVES

{ REPORT
111-443 }

THE RECONCILIATION ACT OF 2010

R E P O R T

OF THE

COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES

TO ACCOMPANY

H.R. 4872

A BILL TO PROVIDE FOR RECONCILIATION PURSUANT TO SECTION 202 OF THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2010

together with
MINORITY VIEWS



VOLUME I
DIVISION I

MARCH 17, 2010.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

55-104

WASHINGTON : 2010

COMMITTEE ON THE BUDGET

JOHN M. SPRATT, JR., South Carolina, *Chairman*

ALLYSON Y. SCHWARTZ, Pennsylvania	PAUL RYAN, Wisconsin, <i>Ranking Minority Member</i>
MARCY KAPTUR, Ohio	JEB HENSARLING, Texas
XAVIER BECERRA, California	SCOTT GARRETT, New Jersey
LLOYD DOGGETT, Texas	MARIO DIAZ-BALART, Florida
EARL BLUMENAUER, Oregon	MICHAEL K. SIMPSON, Idaho
MARION BERRY, Arkansas	PATRICK T. McHENRY, North Carolina
ALLEN BOYD, Florida	CONNIE MACK, Florida
JAMES P. McGOVERN, Massachusetts	JOHN CAMPBELL, California
NIKI TSONGAS, Massachusetts	JIM JORDAN, Ohio
BOB ETHERIDGE, North Carolina	CYNTHIA M. LUMMIS, Wyoming
BETTY McCOLLUM, Minnesota	STEVE AUSTRIA, Ohio
JOHN A. YARMUTH, Kentucky	ROBERT B. ADERHOLT, Alabama
ROBERT E. ANDREWS, New Jersey	DEVIN NUNES, California
ROSA L. DeLAURO, Connecticut,	GREGG HARPER, Mississippi
CHET EDWARDS, Texas	ROBERT E. LATTA, Ohio
ROBERT C. "BOBBY" SCOTT, Virginia	
JAMES R. LANGEVIN, Rhode Island	
RICK LARSEN, Washington	
TIMOTHY H. BISHOP, New York	
GWEN MOORE, Wisconsin	
GERALD E. CONNOLLY, Virginia	
KURT SCHRADER, Oregon	
DENNIS MOORE, Kansas	

PROFESSIONAL STAFF

THOMAS S. KAHN, *Staff Director and Chief Counsel*
AUSTIN SMYTHE, *Minority Staff Director*

CONTENTS

VOLUME I

	Page
Introduction	1
Division I—Committee on Ways and Means: Health Care Reform	5

THE RECONCILIATION ACT OF 2010

PROVIDING FOR RECONCILIATION PURSUANT TO SECTION 202 OF THE
CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2010

MARCH 17, 2010.—Committed to the Committee of the Whole House on the State
of the Union and ordered to be printed

Mr. SPRATT, from the Committee on the Budget,
submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany H.R. 4872]

The Committee on the Budget, to whom reconciliation recommendations were submitted pursuant to section 202 of Senate Concurrent Resolution 13, the Concurrent Resolution on the Budget for Fiscal Year 2010, having considered the same, report the bill without recommendation.

BUDGET COMMITTEE INTRODUCTION

OVERVIEW

The reconciliation bill reported by the Budget Committee includes provisions for health care reform and for investing in education. The need for health care reform is clear. By most measures, we have the best medical care system in the world, but it is also by a wide margin the world's most expensive, and it is not readily accessible to millions of Americans. The rising cost of health care is not sustainable, not only in household and business budgets, but in the federal budget as well.

Making higher education more affordable and accessible without adding to the deficit is also an important goal. A productive economy requires affordable, accessible, high-quality education and the higher education provisions included in the reconciliation bill will help advance that goal.

The reconciliation process has been used 22 times in prior years. During the previous Administration and the previous Congressional majority, reconciliation was used in 2001 to pass tax cuts that worsened the bottom line by \$1.35 trillion over ten years. In 2003, a second round of tax cuts passed under reconciliation added \$350 billion to the deficit. By contrast, the use of reconciliation in this year's budget process requires that reconciliation legislation reduce the deficit, not add to it.

Reconciliation has been used in the recent past to invest in education in a fiscally responsible way—the College Cost Reduction and Access Act of 2007 passed using reconciliation procedures. The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) gave recently separated workers the choice to temporarily continue employer-provided health coverage. When reconciliation was used in the Balanced Budget Act of 1997, the Children's Health Insurance Program (CHIP), Medicare Payment Advisory Commission (MedPAC), and Medicare Advantage were created. The use of reconciliation in the current budget process lies well within those past practices.

The Concurrent Resolution on the Budget for Fiscal Year 2010, S. Con. Res. 13, included two reconciliation instructions as part of Section 202—one for legislation on health care reform and the second for legislation investing in education.

Under the Budget Act, a concurrent resolution on the budget can include reconciliation instructions to authorizing committees. These reconciliation instructions provide a specified dollar amount of budgetary change to be accomplished by reconciliation, but the decisions about the policies to be included in the reconciliation legislation are left to the authorizing committees themselves.

The Budget Act assigns the Budget Committee the role of packaging the reconciliation bills sent to us by the authorizing committees and transmitting them to the House "without any substantive revision."

Division I of this year's reconciliation bill consists of legislative language on health care reform submitted to the Budget Committee in October by the Ways and Means Committee. Division II of the bill consists of legislative language on health care reform submitted to the Budget Committee by the Education and Labor Committee. Division III consists of legislative language on investing in education submitted to the Budget Committee by the Education and Labor Committee. The recommendations that were submitted to the Budget Committee in October were in compliance with the savings required by Section 202 of the budget resolution.

The Energy and Commerce Committee did not submit recommendations to the Budget Committee in response to the reconciliation instruction.

As noted in the following material, after reporting the reconciliation legislation to the House, the Budget Committee approved a number of non-binding motions expressing support for certain

being made in order by the Rules Committee when it grants a rule for floor consideration of this reconciliation bill.

DIVISION I

LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC, October 15, 2009.

Hon. JOHN SPRATT,
*Chairman, Committee on the Budget, Cannon HOB, Washington,
DC.*

DEAR CHAIRMAN SPRATT: On July 16, 2009, the Committee on Ways and Means ordered favorably reported to the House, an Amendment in the Nature of a Substitute to H.R. 3200 by a recorded vote of 23 to 18. Pursuant to section 202(c) of Senate Concurrent Resolution 13, I am hereby transmitting the Amendment in the Nature of a Substitute to you as fulfillment of the Committee on Ways and Means budget reconciliation instructions.

Enclosed please find a copy of our Committee's report on H.R. 3200, including legislative language, explanatory report language, estimates from the Joint Committee on Taxation and additional views. Please feel free to contact me if you have any questions.

Sincerely,

CHARLES B. RANGEL
*Chairman,
Committee on Ways and Means.*

Enclosure.

AMERICA'S AFFORDABLE HEALTH CHOICES ACT OF 2009

OCTOBER 14, 2009.—Committed to the Committee of the Whole House on the State
of the Union and ordered to be printed

Mr. RANGEL, from the Committee on Ways and Means,
submitted the following

R E P O R T

together with

DISSENTING AND ADDITIONAL VIEWS

[To accompany H.R. 3200]

The Committee on Ways and Means, to whom was referred the bill (H.R. 3200) to provide affordable, quality health care for all Americans and reduce the growth in health care spending, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause (other than title VII of division B and division C) and insert the following:

SECTION 1. SHORT TITLE; TABLE OF DIVISIONS, TITLES, AND SUBTITLES.

(a) **SHORT TITLE.**—This Act may be cited as the “America’s Affordable Health Choices Act of 2009”.

(b) **TABLE OF DIVISIONS, TITLES, AND SUBTITLES.**—This Act is divided into divisions, titles, and subtitles as follows:

DIVISION A—AFFORDABLE HEALTH CARE CHOICES

TITLE I—PROTECTIONS AND STANDARDS FOR QUALIFIED HEALTH BENEFITS PLANS

Subtitle A—General Standards

Subtitle B—Standards Guaranteeing Access to Affordable Coverage

Subtitle C—Standards Guaranteeing Access to Essential Benefits

Subtitle D—Additional Consumer Protections

Subtitle E—Governance

Subtitle F—Relation to other requirements; Miscellaneous

Subtitle G—Early Investments

TITLE II—HEALTH INSURANCE EXCHANGE AND RELATED PROVISIONS

Subtitle A—Health Insurance Exchange

Subtitle B—Public health insurance option

Subtitle C—Individual Affordability Credits

TITLE III—SHARED RESPONSIBILITY

Subtitle A—Individual responsibility

companies 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 provision, 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 provision, 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 provision is effective for payments made after the date of enactment.

J. Codification of Economic Substance Doctrine (sec. 452 of the bill and sec. 7701 of the Code)

PRESENT LAW

In general

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

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of a

(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)).

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, the IRS, and litigants. 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.¹⁰⁶

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:

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.¹⁰⁷

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.¹⁰⁸

¹⁰⁶ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'd* 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 interchangeably 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).

¹⁰⁷ *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

¹⁰⁸ See *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

*Application by the courts**Elements of the doctrine*

There is a lack of uniformity regarding the proper application of the economic substance doctrine.¹⁰⁹ 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.¹¹⁰ A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.¹¹¹ A third approach regards economic substance 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.¹¹²

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.¹¹³ 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.”¹¹⁴

¹⁰⁹The 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).

¹¹⁰See, 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).

¹¹¹See, 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 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.

¹¹²See, 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.’”)

¹¹³*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).

¹¹⁴The 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 Fed-

Continued

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.¹¹⁵ Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.¹¹⁶ 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.¹¹⁷ 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.¹¹⁸ 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.¹¹⁹ 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.¹²⁰

eral 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.

¹¹⁵ 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).

¹¹⁶ 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).

¹¹⁷ 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").

¹¹⁸ 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).

¹¹⁹ 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).

¹²⁰ 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* (JCX–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*,

Tax-indifferent parties

A number of cases have involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax indifferent party from the transaction. Courts have sometimes concluded that a particular type of transaction did not satisfy the economic substance doctrine.¹²¹ 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.¹²²

REASONS FOR CHANCE

Tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining the overall integrity of the tax system.

A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. The Committee recognizes that the IRS has achieved a number of recent successes in litigation. The Committee believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences.

EXPLANATION OF PROVISION

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, in the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.¹²³ 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

902 F.2d 159, 163 (2d Cir. 1990), to argue that financial accounting benefits arising from tax savings constitute a good business purpose.

¹²¹ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *affg* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

¹²² See, e.g., *TIFD-III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

¹²³ 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.

change current law standards in determining when to utilize an economic substance analysis.¹²⁴

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. Among¹²⁵ these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;¹²⁶ (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;¹²⁷ (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;¹²⁸ 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.¹²⁹ Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.¹³⁰ 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.¹³¹

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-

¹²⁴If 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.

¹²⁵The examples are illustrative and not exclusive.

¹²⁶See, 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).

¹²⁷See, 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).

¹²⁸See, e.g., *Rev. Proc. 2009-3 2009-11R.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).

¹²⁹See, 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 C.B. 1; *Commissioner v. Bollinger*, 485 U.S. 340 (1988); see also sec. 7701(1).

¹³⁰See, 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).

¹³¹As 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., *TFD-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).

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.¹³²

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 purpose¹³³ 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.¹³⁴

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.¹³⁵ 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 a non-Federal-income-tax purpose if the origin of

¹³²See, e.g., *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied 127 S. Ct. 1261 (Mem.) (2007) (“the first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities. . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale.”) 454 F.3d 1340, 1358 (Fed. Cir. 2006). See also *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48; *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (“A given result at the end of a straight path is not made a different result because reached by following a devious path.”).

¹³³For 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.

¹³⁴The 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.

¹³⁵See, 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.]

such financial accounting benefit is a reduction of Federal income tax.¹³⁶

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.¹³⁷ 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 alter 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.

K. Penalties for Underpayments Attributable to Transactions Lacking Economic Substance (sec. 453 of the bill and sec. 6662 and sec. 6664 of the Code)

PRESENT LAW

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of

¹³⁶ 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 F.3d 737 (6th Cir. 2003).

¹³⁷ Thus, a “reasonable possibility of profit” alone will not be sufficient to establish that a transaction has economic substance.

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.¹³⁸ Except in the case of tax shelters,¹³⁹ 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.¹⁴⁰ The relevant regulations for a tax shelter 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.¹⁴¹ For transactions other than tax shelters, the relevant regulations provide a facts and circumstances test, the most important factor generally being the extent of the taxpayer’s effort to assess the proper tax liability. If a taxpayer relies on an opinion, reliance is not reasonable if the taxpayer knows or should have known that the advisor lacked knowledge in the relevant aspects of Federal tax law, or if the taxpayer fails to disclose a fact that it knows or should have known is relevant. Certain additional requirements apply with respect to the advice.¹⁴²

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

¹³⁸ Sec. 6662.

¹³⁹ 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).

¹⁴⁰ Sec. 6664(c).

¹⁴¹ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

¹⁴² See Treas. Reg. Sec. 1.6664-4(c). In addition to the requirements applicable to taxpayers under the regulations, advisors may be subject to potential penalties under section 6694 (applicable to return preparers), and to monetary penalties and other sanctions under Circular 230 (which provides rules governing persons practicing before the IRS). Under Circular 230, if a transaction is a “covered transaction” (a term that includes listed transactions and certain non-listed reportable transactions) a “more likely than not” confidence level is required for written tax advice that may be relied upon by a taxpayer for the purpose of avoiding penalties, and certain other standards must also be met. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.35. For other tax advice, Circular 230 generally requires a lower “realistic possibility” confidence level or a “non-frivolous” confidence level coupled with advising the client of any opportunity to avoid the accuracy related penalty under section 6662 by adequate disclosure. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.34.

that is not a listed transaction, if a significant purpose of such transaction is the avoidance or evasion of Federal income tax¹⁴³ (“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 to adequately 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.¹⁴⁴ 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.¹⁴⁵

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.¹⁴⁶ The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (“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.¹⁴⁷

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.¹⁴⁸ 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.¹⁴⁹ The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.¹⁵⁰

¹⁴³ Sec. 6662A(b)(2).

¹⁴⁴ Sec. 6707A(c)(1).

¹⁴⁵ Sec. 6707A(c)(2).

¹⁴⁶ Sec. 6662A(a).

¹⁴⁷ 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”.

¹⁴⁸ Sec. 6662A(c).

¹⁴⁹ Sec. 6664(d).

¹⁵⁰ Sec. 6707A(d).

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).¹⁵¹

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);¹⁵² 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.¹⁵³

Strengthened reasonable cause exception

A penalty is not imposed under section 6662A 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;¹⁵⁴ (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 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

¹⁵¹Sec. 6707A(e).

¹⁵²For 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).

¹⁵³Sec. 6662A(e)(3).

¹⁵⁴See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.¹⁵⁵

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 advisor¹⁵⁶ 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 indirectly¹⁵⁷ 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.¹⁵⁸ Participation in the management of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the promotion or sale of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations,

¹⁵⁵ Sec. 6664(d).

¹⁵⁶ 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).

¹⁵⁷ 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.

¹⁵⁸ 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.

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 section 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.¹⁵⁹

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 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).

REASONS FOR CHANGE

The Committee believes that a stronger penalty under section 6662 should be imposed on understatements attributable to non-economic substance and similar transactions, to improve compliance by deterring taxpayers from entering such transactions. The Committee is concerned that under present law there is a potential to avoid penalties in such cases (based for example on certain levels of tax advice), and that the potential that a taxpayer in such cases may pay only the tax due plus interest is not a sufficient deterrent. The Committee therefore believes it is appropriate to impose a new strict liability penalty in such cases. The Committee also believes that a similar strict liability standard should apply to tax shelter transactions.

In addition, the Committee believes that for large corporations, and for persons required to file reports under section 13 of the Securities Exchange Act of 1934, any position for which a reasonable cause and good faith defense to penalties is still available should satisfy a confidence level of being at least more likely than not to prevail, and the same level of confidence should be required of such

¹⁵⁹ Sec. 6676.

taxpayers in determining whether there is a substantial understatement of income tax.

EXPLANATION OF PROVISION

The provision imposes a new, stronger penalty under section 6662 for an understatement attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new section 7701(p),¹⁶⁰ or failing to meet the requirements of any similar rule of law.¹⁶¹ 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.¹⁶² 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.¹⁶³

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 reports under section 13 of the Securities and Exchange Act

¹⁶⁰ 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 "Explanation of Provision" for the immediately preceding provision, "Codification of the economic substance doctrine."

¹⁶¹ 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.

¹⁶² I.e., section 6662(b) of present law applies to the new penalty as well.

¹⁶³ 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.

of 1934, and (ii) any corporation with gross receipts in excess of \$100 million for the taxable year involved.¹⁶⁴

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),¹⁶⁵ 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.

L. Certain Health Related Benefits Applicable to Spouses and Dependents Extended to Eligible Designated Beneficiaries (sec. 461 of the bill and secs. 105, 106, 162, 501, 3121, 3306, and 3401 of the Code)

PRESENT LAW

Definition of dependent for exclusion for employer-provided 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 for employees, their spouses, and their dependents under an accident or health plan.¹⁶⁶ In addition, any reimbursements under the accident or health plan for medical care expenses for employees, their spouses, and their dependents generally are excluded from gross income.¹⁶⁷ For purposes of these exclusions, dependents are determined under section 152, but without regard to section 152(b)(1), (b)(2), and (d)(1)(B). Section 152 defines a dependent as a qualifying child or qualifying relative.

Under section 152(c), a child generally is a qualifying child of a taxpayer if the child satisfies each of five tests for the taxable year: (1) the child has the same principal place of abode as the taxpayer for more than one-half of 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

¹⁶⁴ For purposes of this rule, all persons treated as a single employer under section 52(a) are treated as one person.

¹⁶⁵ 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.

¹⁶⁶ Sec. 106 and proposed Treas. Reg. sec. 1.106-1.

¹⁶⁷ Sec. 105(b).