“(B) the treatment of any member of a foreign controlled group of entities as the common parent of such group if such treatment is appropriate taking into account the economic relationships among such entities.”.

(b) Effective Date.—The amendment made by this section shall apply to payments made after the date of the enactment of this Act.

SEC. 452. CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.

(a) In General.—Section 7701 of the Internal Revenue Code of 1986 is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

“(o) Clarification of Economic Substance Doctrine.—

“(1) Application of doctrine.—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—
“(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and

“(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

“(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—

“(A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

“(B) TREATMENT OF FEES AND FOREIGN TAXES.—Fees and other trans-
action expenses and foreign taxes shall be taken into account as expenses in determining pre-tax profit under subparagraph (A).

“(3) State and local tax benefits.—For purposes of paragraph (1), 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.

“(4) Financial accounting benefits.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

“(5) Definitions and special rules.—For purposes of this subsection—

“(A) Economic substance doctrine.—The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the trans-
action does not have economic substance or lacks a business purpose.

“(B) Exception for personal transactions of individuals.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

“(C) Other common law doctrines not affected.—Except as specifically provided in this subsection, the provisions of this subsection shall not be construed as altering or supplanting any other rule of law, and the requirements of this subsection shall be construed as being in addition to any such other rule of law.

“(D) Determination of application of doctrine not affected.—The determination of whether the economic substance doctrine is relevant to a transaction (or series of transactions) shall be made in the same
manner as if this subsection had never been enacted.

“(6) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.”.

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into after the date of the enactment of this Act.

SEC. 453. PENALTIES FOR UNDERPAYMENTS.

(a) PENALTY FOR UNDERPAYMENTS ATTRIBUTABLE TO TRANSACTIONS LACKING ECONOMIC SUBSTANCE.—

(1) IN GENERAL.—Subsection (b) of section 6662 of the Internal Revenue Code of 1986 is amended by inserting after paragraph (5) the following new paragraph:

“(6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.”.