

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF REVENUE PROVISIONS  
CONTAINED IN THE PRESIDENT'S  
FISCAL YEAR 2010 BUDGET PROPOSAL**

**PART TWO: BUSINESS TAX PROVISIONS**

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the business tax provisions that are included in the President's fiscal year 2010 budget proposal, as submitted to the Congress on May 7, 2009.<sup>2</sup> The document generally follows the order in which the provisions are set forth in the table providing estimates of the revenue effects of all the revenue proposals contained in the President's budget proposals.<sup>3</sup> For each provision, there is a description of present law and the proposal (including effective date), a reference to relevant prior budget proposals or recent significant legislative action, and an analysis of policy issues related to the proposal.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Two: Business Tax Provisions* (JCS-3-09), September 2009. For part one of the document, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part One: Individual Income Tax and Estate and Gift Tax Provisions* (JCS-2-09), September 2009. Subsequent parts of the document will describe international and other tax provisions.

The staff of the Joint Committee on Taxation has provided estimates of the revenue effects of each of the provisions described herein. See, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury*, May 2009, (JCX-28-09), June 11, 2009.

<sup>2</sup> See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010: Analytical Perspectives* (H. Doc. 111-3, Vol. III), pp. 265-273. See also Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, May 2009.

<sup>3</sup> See Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury*, (JCX-28-09), June 11, 2009.

## I. TAX INCENTIVES AND OTHER TAX REDUCTIONS

### A. Increase in Limitations on Expensing of Certain Depreciable Business Assets

#### Present Law

A taxpayer that satisfies limitations on annual investment may elect under section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions.<sup>4</sup> For taxable years beginning in 2009, the maximum amount that a taxpayer may expense is \$250,000 of the cost of qualifying property placed in service for the taxable year. The \$250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000.<sup>5</sup> For taxable years beginning in 2010, the maximum amount that a taxpayer may expense is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. The \$125,000 and \$500,000 amounts are indexed for inflation. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2011 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.<sup>6</sup>

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<sup>4</sup> Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

<sup>5</sup> The temporary \$250,000 and \$800,000 amounts were enacted in the Economic Stimulus Act of 2008, Pub. L. No. 110-185, and extended for taxable years beginning in 2009 by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5.

<sup>6</sup> Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

For taxable years beginning in 2011 and thereafter, other rules apply.<sup>7</sup>

### **Description of Proposal**

The proposal increases permanently the amount a taxpayer may deduct under section 179. The proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2010, is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. In addition, off-the-shelf computer software is treated as qualifying property. Further, a taxpayer is permitted to make or revoke an election for a taxable year under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year.

Effective date.—The proposal is effective for taxable years beginning after 2010.

### **Analysis**

The proposal lowers the after-tax cost of capital expenditures made by businesses within a certain size range by permitting the immediate depreciation of the full amount of the capital expenditure (i.e., expensing), rather than depreciation of the expenditure over the recovery period. With a lower cost of capital, it is argued that eligible businesses will invest in more equipment and employ more workers, thus serving to stimulate economic growth among businesses taxable in the United States.

Expensing of capital investments is the appropriate treatment if the objective is to tax consumption, because expensing effectively eliminates tax on the returns to investment, subject to certain assumptions.<sup>8</sup> If the objective is to tax income, then depreciation deductions should coincide with the economic depreciation of the asset in order to measure economic income accurately. A depreciation system more generous than economic depreciation, but less generous

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<sup>7</sup> Under the rules in effect for taxable years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner (sec. 179(c)(2)).

<sup>8</sup> To see this, consider an investment of \$100 that yields a \$10 return in the following year, i.e., a 10-percent pre-tax return. If the tax rate is 50 percent, expensing of the \$100 investment yields a \$50 reduction in tax liability, meaning the after-tax cost to the taxpayer for the \$100 investment is \$50. The \$10 return in the following year results in a \$5 tax, and thus a \$5 after-tax return. Thus, the after-tax return on the investment is 10 percent (5 divided by 50), the same as the pre-tax return. To fully effect consumption tax treatment, other modifications would need to be made, such as not imposing capital gains taxes with respect to sales of business equity interests and fully integrating the corporate and individual tax systems. Additionally, no business interest expense deductions could be permitted or negative effective tax rates would result. Finally, even with the changes above, any property taxes imposed at the State or local level would cause there to remain a positive effective tax rate on the return to investment.

than full expensing, results in an effective tax rate on the income from capital that is less than the statutory tax rate.

In addition to promoting investment, advocates of expensing assert that increased expensing eliminates depreciation recordkeeping requirements with respect to expensed property. Under the proposal, Federal income tax accounting could be simplified by increasing the portion of capital costs that are expensed in one taxable year and concomitantly reducing those that are recovered through depreciation over the recovery period. It could be argued that the simplification benefit of expensing is not fully realized, however, so long as property is partially depreciated, or so long as some but not all of the taxpayer's property that is eligible for cost recovery is expensed; the taxpayer must still keep records for that property that is subject to depreciation over a period of years.

The proposal increases the present-law \$200,000 phaseout threshold amount to \$500,000, which has the effect of generally permitting larger businesses to obtain the tax benefit of expensing. Some may argue that this result is inconsistent with the idea of limiting expensing to small businesses, as under the present-law provision. They might alternatively argue that in an income tax system, expanding the availability of expensing is not appropriate because it results in less accurate measurement of economic income. On the other hand, it could be argued that there is no rationale for limiting expensing to businesses below a particular size or with capital expenditures below a certain level.

An advantage of making the increase in the expensing amounts permanent is that it reduces uncertainty with respect to the tax treatment of future investment, thus permitting taxpayers to plan capital expenditures with greater focus on the underlying economics of the investments, and less focus on tax-motivated timing of investment. Removing tax-motivated distortions in the timing of investment may promote more efficient allocation of economic resources. On the other hand, legislative changes to the expensing rules (principally temporary increases in the amount that can be expensed) have been frequent in the past decade, and there is nothing to suggest that additional legislative changes would not be made to the expensing rules, whether the current expensing rules were permanent or temporary. Additionally, to the extent that the rationale for the original increase in the amounts that may be expensed was to provide a counter-cyclical short-term economic stimulus, it can be argued that it is important that such provisions in fact be temporary. If there is uncertainty that a provision providing temporary tax relief may not ultimately be temporary, it can be argued that the stimulative effect of the provision is compromised because the taxpayer need not act within the originally specified time frame of the provision in order to get the tax benefits from the provision.

#### **Prior Action**

A similar proposal was included in the President's budget proposals for fiscal years 2007, 2008, and 2009.

## **B. Qualified Small Business Stock**

### **Present Law**

#### **In general**

Individuals may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for more than five years.<sup>9</sup> The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>10</sup> A percentage of the excluded gain is an alternative minimum tax preference;<sup>11</sup> the portion of the gain includible in alternative minimum taxable income (“AMTI”) is taxed at a maximum rate of 28 percent under the AMT.

Thus, under present law, gain from the sale of qualified small business stock is taxed at effective rates of 14 percent under the regular tax<sup>12</sup> and under the AMT (i) 14.98 percent for dispositions before January 1, 2011; (ii) 19.88 percent for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and (iii) 17.92 percent under for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.<sup>13</sup>

The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer’s basis in the stock or (2) \$10 million. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet certain active trade or business requirements.

#### **Special rules for certain stock issued in 2009 and 2010**

For stock issued after February 17, 2009, and before January 1, 2011, the percentage exclusion for qualified small business stock sold by an individual is increased to 75 percent.

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<sup>9</sup> Sec. 1202.

<sup>10</sup> Sec. 1(h).

<sup>11</sup> Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010.

<sup>12</sup> The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>13</sup> The amount of gain included in AMTI is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.



As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at maximum effective rates of seven percent under the regular tax<sup>14</sup> and 12.88 percent under the AMT.<sup>15</sup>

### **Description of Proposal**

Under the proposal all gain from the sale or exchange of qualified small business stock is excluded from gross income. The AMT preference is eliminated. Additional documentation is required.

Effective date.—The proposal is effective for qualified small business stock issued after February 17, 2009.

### **Analysis**

For analysis of this proposal, as well as capital gains in general, see Analysis under “Dividends and Capital Gains Tax Rate Structure” in Part One of the Description of Revenue Provisions.<sup>16</sup>

### **Prior Action**

The American Recovery and Reinvestment Tax Act of 2009 provided the rule described under present law relating to stock issued after February 17, 2009, and before January 1, 2011.

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<sup>14</sup> The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

<sup>15</sup> The 46 percent of gain included in AMTI is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

<sup>16</sup> Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2010 Budget Proposal; Part One: Individual Income Tax and Estate and Gift Tax Provisions* (JCS-2-09), September 2009.

## C. Make the Research Credit Permanent

### Present Law

#### General rule

A taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.<sup>17</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit is also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the university basic research credit.<sup>18</sup>

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the university basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2009.<sup>19</sup>

#### Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that

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<sup>17</sup> Sec. 41.

<sup>18</sup> Sec. 41(e).

<sup>19</sup> Sec. 41(h).

period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.<sup>20</sup>

In computing the credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer.<sup>21</sup> Under regulations prescribed by the Secretary, special rules apply for computing the credit when a major portion of a trade or business (or unit thereof) changes hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage.<sup>22</sup>

### **Alternative incremental research credit regime**

Taxpayers are allowed to elect an alternative incremental research credit regime.<sup>23</sup> If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year

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<sup>20</sup> The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

<sup>21</sup> Sec. 41(f)(1).

<sup>22</sup> Sec. 41(f)(3).

<sup>23</sup> Sec. 41(c)(4).

research expenses exceed a base amount computed by using a fixed-base percentage of two percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above are increased to three percent, four percent, and five percent, respectively.<sup>24</sup>

An election to be subject to this alternative incremental credit regime can be made for any taxable year beginning after June 30, 1996, and before January 1, 2009. Such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury. The alternative incremental credit regime is not available for taxable years beginning after December 31, 2008.

### **Alternative simplified credit**

Generally, for amounts paid or incurred after 2006, taxpayers may elect to claim an alternative simplified credit for qualified research expenses.<sup>25</sup> The alternative simplified research credit is equal to 12 percent (14 percent for taxable years beginning after December 31, 2008) of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes January 1, 2007. The transition rule applies only to the taxable year which includes that date.

### **Eligible expenses**

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).<sup>26</sup> Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or

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<sup>24</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>25</sup> A special transition rule applies for fiscal year 2006-2007 taxpayers.

<sup>26</sup> Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of present-law section 174 (described below) but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.<sup>27</sup> In addition, research does not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control.<sup>28</sup> Research does not qualify for the credit if it is conducted outside the United States, Puerto Rico, or any U.S. possession.

### **Relation to deduction**

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.<sup>29</sup> However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.<sup>30</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>31</sup>

### **Description of Proposal**

The proposal makes the research credit permanent.

Effective date.—The proposal is effective for amounts paid or incurred after December 31, 2009.

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<sup>27</sup> Sec. 41(d)(3).

<sup>28</sup> Sec. 41(d)(4).

<sup>29</sup> Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

<sup>30</sup> Sec. 280C(c).

<sup>31</sup> Sec. 280C(c)(3).

## Analysis

### Overview

Technological development is an important component of economic growth. However, while an individual business may find it profitable to undertake some research, it may not find it profitable to invest in research as much as it otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from being used by competitors. In general, businesses acting in their own self-interest will not necessarily invest in research to the extent that would be consistent with the best interests of the overall economy. This is because costly scientific and technological advances made by one firm may be cheaply copied by its competitors. Research is one of the areas where there is a consensus among economists that government intervention in the marketplace may improve overall economic efficiency.<sup>32</sup> However, this does not mean that increased tax benefits or more government spending for research always will improve economic efficiency. It is possible to decrease economic efficiency by spending too much on research. However, there is evidence that the current level of research undertaken in the United States, and worldwide, is too little to maximize society's well-being.<sup>33</sup> Nevertheless, even if there were agreement that additional subsidies for research are warranted as a general matter, misallocation of research dollars across competing sectors of the economy could diminish economic efficiency. It is difficult to determine whether, at the present levels and allocation of government subsidies for research, further government spending on research or additional tax benefits for research would increase or decrease overall economic efficiency.

If it is believed that too little research is being undertaken, a tax subsidy is one method of offsetting the private-market bias against research, so that research projects undertaken approach the optimal level. Among the other policies employed by the Federal government to increase the aggregate level of research activities are direct spending and grants, favorable anti-trust rules, and patent protection. The effect of tax policy on research activity is largely uncertain because there is relatively little consensus regarding magnitude of the responsiveness of research to changes in taxes and other factors affecting its price. To the extent that research activities are responsive to the price of research activities, the research and experimentation tax credit should

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<sup>32</sup> This conclusion does not depend upon whether the basic tax regime is an income tax or a consumption tax.

<sup>33</sup> See Zvi Griliches, "The Search for R&D Spillovers," *Scandinavian Journal of Economics*, vol. XCIV, (1992), M. Ishaq Nadiri, "Innovations and Technological Spillovers," National Bureau of Economic Research, Working Paper No. 4423, 1993, and Bronwyn Hall, "The Private and Social Returns to Research and Development," in Bruce Smith and Claude Barfield, editors, *Technology, R&D and the Economy*, (Washington, D.C.: Brookings Institution Press), 1996, pp. 1-14. These papers suggest that the rate of return to privately funded research expenditures is high compared to that in physical capital and the social rate of return exceeds the private rate of return. Griliches concludes, "in spite of [many] difficulties, there has been a significant number of reasonably well-done studies all pointing in the same direction: R&D spillovers are present, their magnitude may be quite large, and social rates of return remain significantly above private rates." Griliches, p. S43. Charles I. Jones and John C. Williams, "Measuring the Social Return to R&D," *Quarterly Journal of Economics*, 113, November 1998, also conclude that "advanced economies like the United States substantially under invest in R&D" (p. 1120).

increase research activities beyond what they otherwise would be. However, the present law research credit contains certain complexities and compliance costs.

### **Scope of research activities in the United States and abroad**

In the United States, private for-profit enterprises and individuals, non-profit organizations, and the public sector undertake research activities. Total expenditures on research and development in the United States are large, representing 2.6 percent of gross domestic product in 2005 and 2006.<sup>34</sup> This rate of expenditure on research and development exceeds that of the European Union and the average of all countries that are members of the Organisation for Economic Co-operation and Development (“OECD”), but is less than that of Japan. See Figure 1, below. In 2005, expenditures on research and development in the United States represented 42.2 percent of all expenditures on research and development undertaken by OECD countries, were 40 percent greater than the total expenditures on research and development undertaken in the European Union, and were more than two and one half times such expenditures in Japan.<sup>35</sup> Expenditures on research and development in the United States have grown at an average real rate of 3.69 percent over the period 1995-2005. This rate of growth has exceeded that of France (1.52 percent), the United Kingdom (1.86 percent), Japan (2.46 percent), Italy (2.50 percent), and Germany (2.57 percent), but is less than that of Canada (4.95 percent), Spain (7.34 percent), and Ireland (7.40 percent).<sup>36</sup>

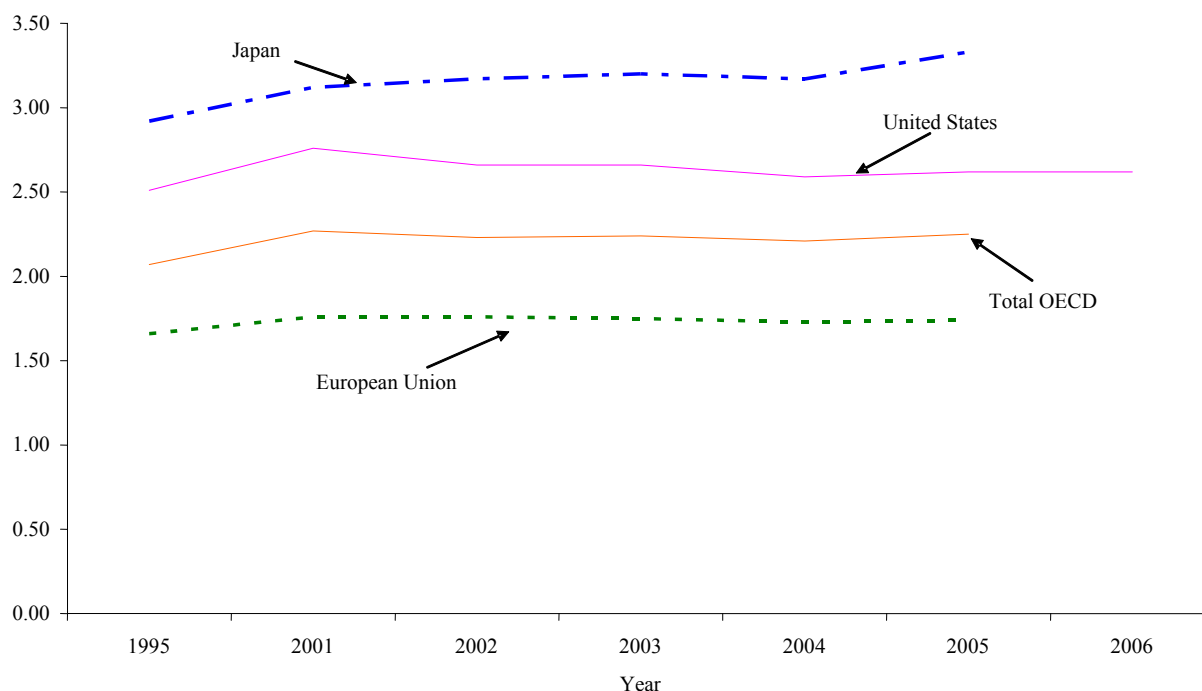
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<sup>34</sup> Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Scoreboard, 2007*, (Paris: Organisation for Economic Co-operation and Development), 2007. This data represents outlays by private persons and by governments. The figures reported in this paragraph and Figure 1 do not include the value of tax expenditures, if any. The OECD calculates that the United States spent approximately \$344 billion on research and development in 2006. Organisation for Economic Co-operation and Development, *Main Science and Technology Indicators, 2007*, vol. 2, (Paris: Organisation for Economic Co-operation and Development), 2007.

<sup>35</sup> OECD, *Science, Technology and Industry Scoreboard, 2007*. While the OECD attempts to present these data on a standardized basis the cross-country comparisons are not perfect. For example, the United States reporting for research spending generally does not include capital expenditure outlays devoted to research while the reporting of some other countries does include capital expenditures.

<sup>36</sup> OECD, *Main Science and Technology Indicators, 2007*, vol. 2. The annual real rate of growth of expenditures on research and development for the period 1995-2005 in the European Union and in all OECD countries at 2.94 percent and 3.61 percent, respectively. All reported growth rates are calculated in terms of U.S. dollars equivalents converted at purchasing power parity.

**Figure 1.—Gross Domestic Expenditure on R&D as a Percentage of GDP, United States, Japan, the European Union, and the OECD, 1995-2005**



Source: OECD, Main Science and Technology Indicators, 2007, vols. 1 & 2.

A number of countries, in addition to the United States, provide tax benefits to taxpayers who undertake research activities. The OECD has attempted to quantify the relative value of such tax benefits in different countries by creating an index that measures the total value of tax benefits accorded research activities relative to simply permitting the expensing of all qualifying research expenditures. Table 1, below, reports the value of this index for selected countries. A value of zero would result if the only tax benefit a country offered to research activities was the expensing of all qualifying research expenditures. Negative values reflect tax benefits less generous than expensing. Positive values reflect tax benefits more generous than expensing. For example, in 2008 in the United States qualifying taxpayers could expense research expenditures and, in certain circumstances claim the research and experimentation tax credit. The resulting index number for the United States is 0.07.<sup>37</sup>

<sup>37</sup> Organisation for Economic Co-operation and Development, *OECD Science, Technology and Industry Outlook, 2008*. (Paris: Organisation for Economic Co-operation and Development), 2008. The index is calculated as one minus the so-called “B-index.” The B-index is equal to the after-tax cost of an expenditure of one dollar on qualifying research, divided by one minus the taxpayer marginal tax rate. Alternatively, the B-index represents the present value of pre-tax income that it is necessary to earn to finance the research activity and earn a positive after-tax profit. In practice, construction of the B-index and the index number reported in Table 1 requires a number of simplifying assumptions. As a consequence, the relative position of the tax benefits of various countries reported in the table is only suggestive.



**Table 1.–Index Number of Tax Benefits for Research Activities  
in Selected Countries, 2008**

Country	Index Number <sup>1</sup>
Germany	-0.03
Italy	-0.02
Ireland	0.05
United States	0.07
United Kingdom	0.11
Japan	0.12
Canada	0.18
France	0.37
Spain	0.39

<sup>1</sup> Index number reported is only that for “large firms.” Some countries have additional tax benefits for research activities of “small” firms.

Source: OECD, OECD Science, Technology and Industry Outlook, 2008.

### **Scope of tax expenditures on research activities**

The tax expenditure related to the research and experimentation tax credit was estimated to be \$4.9 billion for 2008. The related tax expenditure for expensing of research and development expenditures was estimated to be \$3.1 billion for 2008 growing to \$7.8 billion for 2012.<sup>38</sup> As noted above, the Federal Government also directly subsidizes research activities. Direct government outlays for research have substantially exceeded the annual estimated value of the tax expenditure provided by either the research and experimentation tax credit or the expensing of research and development expenditures. For example, in fiscal 2008, the National Science Foundation gross outlays for research and related activities were \$4.6 billion, the Department of Defense’s budget for research, development, test and evaluation were \$84.7 billion, the Department of Energy’s science gross outlays were \$3.9 billion, and the Department of Health and Human Services’ budget for the National Institutes of health was \$28.9 billion.<sup>39</sup> However, such direct government outlays generally are for directed research on projects selected by the government. The research credit provides a subsidy to any qualified project of an eligible

<sup>38</sup> Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012* (JCS-2-08), October 31, 2008, p. 24.

<sup>39</sup> Office of Management and Budget, *Appendix, Budget of the United States Government, Fiscal Year 2010*, pp. 1141, 293, 295, 297, 413, and 469.

taxpayer with no application to a grant-making agency required. Projects are chosen based on the taxpayer's assessment of future profit potential.

Tables 2 and 3 present data for 2006 on those corporations that claimed the research tax credit by industry and asset size, respectively. Over 17,000 corporations (counting both C corporations and S corporations) claimed more than \$7.6 billion of research tax credits in 2006.<sup>40</sup> Corporations whose primary activity is manufacturing account for just more than one-half of all corporations claiming a research tax credit. These manufacturers claimed more than 70 percent of all credits. Firms with assets of \$50 million or more account for almost 17 percent of all corporations claiming a credit but represent more than 80 percent of the credits claimed. Nevertheless, as Table 3 documents, a large number of small firms are engaged in research and were able to claim the research tax credit. C corporations claimed almost \$7.3 billion of these credits and, furthermore, nearly all of this \$7.3 billion was the result of the firm's own research. Only \$137 million in research credits flowed through to C corporations from ownership interests in partnerships and other pass-through entities.

For comparison, individuals claimed \$388 million in research tax credits on their individual income tax returns in 2006. This \$388 million includes credits that flowed through to the individual from pass-through entities such as partnerships and S corporations as well those credits generated by sole proprietorships.

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<sup>40</sup> The \$7.6 billion figure reported for 2006 is not directly comparable with the Joint Committee on Taxation Staff's \$4.8 billion tax expenditure estimate for 2006 (Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005, p. 30). The tax expenditure estimate accounts for the present-law requirement that deductions for research expenditures be reduced by research credits claimed. Also, the \$7.6 billion figure does not reflect the actual tax reduction achieved by taxpayers claiming research credits in 2006 as the actual tax reduction will depend upon whether the taxpayer had operating losses, was subject to the alternative minimum tax, or other aspects specific to each taxpayer's situation. In addition, at the time the Joint Committee on Taxation staff made its tax expenditure estimate, the law provided that the research credit would expire after December 31, 2005.

**Table 2.—Percentage Distribution of Corporations Claiming Research Tax Credit  
and Percentage of Credit Claimed by Sector, 2006**

<b>Industry</b>	<b>Percent of Corporations Claiming Credit</b>	<b>Percent of Total R &amp; E Credit</b>
Manufacturing	50.7	71.6
Professional, Scientific, and Technical Services	23.4	10.0
Information	6.6	9.8
Wholesale Trade	8.6	3.5
Finance and Insurance	1.7	1.7
Holding Companies	2.8	1.1
Retail Trade	1.8	0.6
Health Care and Social Services	0.8	0.4
Utilities	0.3	0.4
Administrative and Support and Waste Management and Remediation Services	1.1	0.2
Mining	0.2	0.2
Transportation and Warehousing	0.5	0.1
Construction	0.4	0.1
Agriculture, Forestry, Fishing, and Hunting	0.5	(1)
Real Estate and Rental and Leasing	0.4	(1)
Arts, Entertainment, and Recreation	0.2	(1)
Educational Services	0.1	(1)
Other Services	(2)	(2)
Accommodation and Food Services	(2)	(2)
Wholesale and Retail Trade not Allocable	(2)	(2)
Not Allocable	(2)	(2)

<sup>1</sup> Less than 0.1 percent.

<sup>2</sup> Data undisclosed to protect taxpayer confidentiality.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

**Table 3.—Percentage Distribution of Corporations Claiming Research Tax Credit and of Credit Claimed by Corporation Size, 2006**

Asset Size (\$)	Percent of Firms Claiming Credit	Percent of Credit Claimed
0	2.1	0.9
1 to 99,999	5.0	(1)
100,000 to 249,999	1.6	(1)
250,000 to 499,999	4.5	0.1
500,000 to 999,999	9.1	0.3
1,000,000 to 9,999,999	39.9	5.4
10,000,000 to 49,999,999	20.9	12.4
50,000,000 +	16.9	80.7

Note: Totals may not add to 100 percent due to rounding.

<sup>1</sup> Less than 0.1 percent.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service, Statistics of Income data.

**Flat versus incremental tax credits**

For a tax credit to be effective in increasing a taxpayer’s research expenditures, it is not necessary to provide that credit for all the taxpayer’s research expenditures (i.e., a flat credit). By limiting the credit to expenditures above a base amount, incremental tax credits attempt to target the tax incentives where they will have the most effect on taxpayer behavior.

Suppose, for example, a taxpayer is considering two potential research projects: Project A will generate cash flow with a present value of \$105 and Project B will generate cash flow with a present value of \$95. Suppose that the research cost of investing in each of these projects is \$100. Without any tax incentives, the taxpayer will find it profitable to invest in Project A and will not invest in Project B.

Consider now the situation where a 10-percent flat credit applies to all research expenditures incurred. In the case of Project A, the credit effectively reduces the cost to \$90. This increases profitability, but does not change behavior with respect to that project, since it would have been undertaken in any event. However, because the cost of Project B also is reduced to \$90, this previously neglected project (with a present value of \$95) would now be profitable. Thus, the tax credit would affect behavior only with respect to this marginal project.

Incremental credits attempt not to reward projects that would have been undertaken in any event but to target incentives to marginal projects. To the extent this is possible, incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures. In the example above, if an incremental

credit were properly targeted, the government could spend the same \$20 in credit dollars and induce the taxpayer to undertake a marginal project so long as its expected cash flow exceeded \$80. Unfortunately, it is nearly impossible as a practical matter to determine which particular projects would be undertaken without a credit and to provide credits only to other projects. In practice, almost all incremental credit proposals rely on some measure of the taxpayer's previous experience as a proxy for a taxpayer's total qualified expenditures in the absence of a credit. This is referred to as the credit's base amount. Tax credits are provided only for amounts above this base amount.

Since a taxpayer's calculated base amount is only an approximation of what would have been spent in the absence of a credit, in practice, the credit may be less effective per dollar of revenue cost than it otherwise might be in increasing expenditures. If the calculated base amount is too low, the credit is awarded to projects that would have been undertaken even in the absence of a credit. If, on the other hand, the calculated base amount is too high, then there is no incentive for projects that actually are on the margin.

Nevertheless, the incentive effects of incremental credits per dollar of revenue loss can be many times larger than those of a flat credit. However, in comparing a flat credit to an incremental credit, there are other factors that also deserve consideration. A flat credit generally has lower administrative and compliance costs than does an incremental credit. Probably more important, however, is the potential misallocation of resources and unfair competition that could result as firms with qualified expenditures determined to be above their base amount receive credit dollars, while other firms with qualified expenditures considered below their base amount receive no credit.

### **Fixed base versus moving base credit**

With the addition of the alternative simplified credit, taxpayers effectively have the choice of three different research credit structures for general research expenditures.<sup>41</sup> Each of the credit structures is an "incremental" credit. However, the base is determined differently in each case. The regular credit and the expired alternative incremental credit are examples of "fixed base" credits. With a fixed base credit, the incremental amount of qualified research expenditures is determined without reference to the qualified research expenditures of a prior year. The alternative simplified credit is a "moving base" credit. With a moving base credit, the incremental amount of qualified research expenditures for a given year is determined by reference to one or more prior year's qualified research expenditures. The distinction can be important because, in general, an incremental tax credit with a base amount equal to a moving average of previous years' qualified expenditures is considered to have an effective rate of credit substantially below its statutory rate. On the other hand, an incremental tax credit with a base amount determined as a fixed base generally is considered to have an effective rate of credit equal to its statutory rate.

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<sup>41</sup> A taxpayer election into one of these structures is permanent unless revoked by the Secretary. However, historically, permission to revoke an election has routinely been granted by the Secretary, effectively making the choice an annual election.

To see how a moving base creates a reduction in the effective rate of credit, consider the structure of the alternative simplified credit. The base of the credit is equal to 50 percent of the previous three years' average of qualified research expenditures. Assume a taxpayer has been claiming the alternative simplified credit and is considering increasing his qualified research expenditures this year. A \$1 increase in qualified expenditures in the current year will earn the taxpayer 14 cents in credit in the current year but it will also increase the taxpayer's base amount by 16.7 cents (50 percent of \$1 divided by three) in each of the next three years. If the taxpayer returns to his previous level of research funding over the subsequent three years, the taxpayer will receive two and one-third cents less in credit than he otherwise would have. Assuming a nominal discount rate of 10 percent, the present value of the one year of credit increased by 14 cents followed by three years of credits reduced by two and one-third cents is equal to 8.19 cents. That is, the effective credit rate on a \$1 dollar increase in qualified expenditures is 8.19 percent.

An additional feature of the moving average base calculation of the alternative simplified credit is that it is not always an incremental credit. If the taxpayer never alters his or her research expenditures, the alternative simplified credit is the equivalent of a flat rate credit with an effective credit value equal to one half of the statutory credit rate. Assume a taxpayer spends \$100 per year annually on qualified research expenses. This taxpayer will have an annual base amount of \$50, with the result that the taxpayer will have \$50 of credit eligible expenditures on which the taxpayer may claim \$7 of tax credit (14 percent of \$50). For this taxpayer, the 14-percent credit above the defined moving average base amount is equivalent to a seven-percent credit on the taxpayer's \$100 of annual qualifying research expenditures.

The moving average base calculation of the alternative simplified credit also can permit taxpayers to claim credit for research expenditures while they decrease their research expenditures. Assume as before that the taxpayer has spent \$100 annually on qualified research expenses, but decides to reduce research expenses in the next year to \$75 and in the subsequent year to \$50, after which the taxpayer plans to maintain research expenditures at \$50 per year. In the year of the first reduction, the taxpayer would have \$25 of qualifying expenditures (the taxpayer's prior three-year average base is \$100) and could claim a credit of \$3.50 (14 percent of the \$75 current year expenditure less half of three year average base). In the subsequent four years, the taxpayer could claim a credit of \$0.58, \$1.75, \$2.92, and \$3.50.<sup>42</sup> Of course, it is also the case that a taxpayer may claim credit as he or she reduces research expenditures under a fixed base credit as long as the taxpayer's level of qualifying expenditures is greater than the fixed base.

Some have also observed that a moving base credit can create incentives for taxpayers to "cycle" or bunch their qualified research expenditures. For example, assume a taxpayer who is claiming the alternative simplified credit has had qualified research expenditures of \$100 per year for the past three years and is planning on maintaining qualified research expenditures at \$100 per year for the next three years. The taxpayer's base would be \$50 for each of the next three years and the taxpayer could claim \$7 of credit per year. If, however, the taxpayer could

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<sup>42</sup> In the subsequent four years, 50 percent of the prior three years' expenditures equals \$45.83, \$37.50, \$29.17, and \$25.00. In each year, the taxpayer's expenditure of \$50 exceeds 50 percent of the prior three years' expenditures.

bunch expenditures so that the taxpayer incurred only \$50 of qualified research next year, followed by \$150 in the second year and \$100 in the third, the taxpayer could claim no credit next year but \$15.17 in the second year and \$7 dollars in the third. While the example demonstrates a benefit to cycling, as the majority of qualified research expenditures consist of salaries to scientists, engineers, and other skilled labor, the potential for cycling most likely would be limited in practice.

### **The responsiveness of research expenditures to tax incentives**

Like any other commodity, the amount of research expenditures that a firm wishes to incur generally is expected to respond positively to a reduction in the price paid by the firm. Economists often refer to this responsiveness in terms of price elasticity, which is measured as the ratio of the percentage change in quantity to a percentage change in price. For example, if demand for a product increases by five percent as a result of a 10-percent decline in price paid by the purchaser, that commodity is said to have a price elasticity of demand of 0.5.<sup>43</sup> One way of reducing the price paid by a buyer for a commodity is to grant a tax credit upon purchase. A tax credit of 10 percent (if it is refundable or immediately usable by the taxpayer against current tax liability) is equivalent to a 10-percent price reduction. If the commodity granted a 10-percent tax credit has an elasticity of 0.5, the amount consumed will increase by five percent. Thus, if a flat research tax credit were provided at a 10-percent rate, and research expenditures had a price elasticity of 0.5, the credit would increase aggregate research spending by five percent.<sup>44</sup>

While all published studies report that the research credit induced increases in research spending, early evidence generally indicated that the price elasticity for research is substantially less than one. For example, one early survey of the literature reached the following conclusion:

In summary, most of the models have estimated long-run price elasticities of demand for R&D on the order of -0.2 and -0.5. . . . However, all of the measurements are prone to aggregation problems and measurement errors in explanatory variables.<sup>45</sup>

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<sup>43</sup> For simplicity, this analysis assumes that the product in question can be supplied at the same cost despite any increase in demand (i.e., the supply is perfectly elastic). This assumption may not be valid, particularly over short periods of time, and particularly when the commodity—such as research scientists and engineers—is in short supply.

<sup>44</sup> It is important to note that not all research expenditures need be subject to a price reduction to have this effect. Only the expenditures that would not have been undertaken otherwise—so called marginal research expenditures—need be subject to the credit to have a positive incentive effect.

<sup>45</sup> Charles River Associates, “An Assessment of Options for Restructuring the R&D Tax Credit to Reduce Dilution of its Marginal Incentive” (final report prepared for the National Science Foundation), February, 1985, p. G-14. The negative coefficient in the text reflects that a decrease in price results in an increase in research expenditures. Often, such elasticities are reported without the negative coefficient, it being understood that there is an inverse relationship between changes in the “price” of research and changes in research expenditures.

In a 1983 study, the Treasury Department used an elasticity of 0.92 as its upper range estimate of the price elasticity of R&D, but noted that the author of the unpublished study from which this estimate was taken conceded

If it took time for taxpayers to learn about the credit and what sort of expenditures qualified, taxpayers may have only gradually adjusted their behavior. Such a learning curve might explain a modest measured behavioral effect. A more recent survey of the literature on the effect of the tax credit suggests a stronger behavioral response, although most analysts agree that there is substantial uncertainty in these estimates.

[W]ork using US firm-level data all reaches the same conclusion: the tax price elasticity of total R&D spending during the 1980s is on the order of unity, maybe higher. . . . Thus there is little doubt about the story that the firm-level publicly reported R&D data tell: the R&D tax credit produces roughly a dollar-for-dollar increase in reported R&D spending on the margin.<sup>46</sup>

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that the estimate might be biased upward. See Department of the Treasury, “The Impact of Section 861-8 Regulation on Research and Development,” p. 23. As stated in the text, although there is uncertainty, most analysts believe the elasticity is considerable smaller. For example, the General Accounting Office (now called the Government Accountability Office) summarizes: “These studies, the best available evidence, indicate that spending on R&E is not very responsive to price reductions. Most of the elasticity estimates fall in the range of 0.2 and 0.5. . . . Since it is commonly recognized that all of the estimates are subject to error, we used a range of elasticity estimates to compute a range of estimates of the credit’s impact.” See *The Research Tax Credit Has Stimulated Some Additional Research Spending* (GAO/GGD-89-114), September 1989, p. 23. Similarly, Edwin Mansfield concludes: “While our knowledge of the price elasticity of demand for R&D is far from adequate, the best available estimates suggest that it is rather low, perhaps about 0.3,” in Edwin Mansfield, “The R&D Tax Credit and Other Technology Policy Issues,” *American Economic Review*, Vol. 76, no. 2, May 1986, p. 191.

<sup>46</sup> Bronwyn Hall and John Van Reenen, “How effective are fiscal incentives for R&D? A review of the evidence,” *Research Policy*, vol. 29, 2000, p. 462. This survey reports that more recent empirical analyses have estimated higher elasticity estimates. One recent empirical analysis of the research credit has estimated a short-run price elasticity of 0.8 and a long-run price elasticity of 2.0. The author of this study notes that the long-run estimate should be viewed with caution for several technical reasons. In addition, the data utilized for the study cover the period 1980 through 1991, containing only two years under the revised credit structure. This makes it empirically difficult to distinguish short-run and long-run effects, particularly as it may take firms some time to appreciate fully the incentive structure of the revised credit. See Bronwyn H. Hall, “R&D Tax Policy During the 1980s: Success or Failure?” in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 7, (Cambridge: The MIT Press, 1993), pp. 1-35. Another recent study examined the post-1986 growth of research expenditures by 40 U.S.-based multinationals and found price elasticities between 1.2 and 1.8. However, including an additional 76 firms, that had initially been excluded because they had been involved in merger activity, the estimated elasticities fell by half. See James R. Hines, Jr., “On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s” in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation*, (Chicago: University of Chicago Press 1993). Also see M. Ishaq Nadiri and Theofanis P. Mamuneas, “R&D Tax Incentives and Manufacturing-Sector R&D Expenditures,” in James M. Poterba, ed., *Borderline Case: International Tax Policy, Corporate Research and Development, and Investment*, (Washington, D.C.: National Academy Press), 1997. While their study concludes that one dollar of research tax credit produces 95 cents of research, they note that time series empirical work is clouded by poor measures of the price deflators used to convert nominal research expenditures to real expenditures.

Other research suggests that many of the elasticity studies may overstate the efficiency of subsidies to research. Most R&D spending is for wages and the supply of qualified scientists is small, particularly in the short run. Subsidies may raise the wages of scientists, and hence research spending, without increasing actual research. See Austan Goolsbee, “Does Government R&D Policy Mainly Benefit Scientists and Engineers?,” *American Economic Review*, vol. 88, May, 1998, pp. 298-302.



However this survey notes that most of this evidence is not drawn directly from tax data. For example, effective marginal tax credit rates are inferred from publicly reported financial data and may not reflect limitations imposed by operating losses or the AMT. The study notes that because most studies rely on “reported research expenditures” that a “relabelling problem” may exist whereby a preferential tax treatment for an activity gives firms an incentive to classify expenditures as qualifying expenditures. If this occurs, reported expenditures increase in response to the tax incentive by more than the underlying real economic activity. Thus, reported estimates may overestimate the true response of research spending to the tax credit.<sup>47</sup>

Apparently there have been no specific studies of the effectiveness of the university basic research tax credit.

### **Other policy issues related to the research and experimentation credit**

Perhaps the greatest criticism of the research and experimentation tax credit among taxpayers regards its temporary nature. Research projects frequently span years. If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure. A credit of longer duration may more successfully induce additional research than would a temporary credit, even if the temporary credit is periodically renewed.

An incremental credit does not provide an incentive for all firms undertaking qualified research expenditures. Many firms have current-year qualified expenditures below the base amount. These firms receive no tax credit and have an effective rate of credit of zero. Although there is no revenue cost associated with firms with qualified expenditures below the base amount, there may be a distortion in the allocation of resources as a result of these uneven incentives.

If a firm has no current tax liability, or if the firm is subject to the AMT or the general business credit limitation, the research credit must be carried forward for use against future-year tax liabilities. The inability to use a tax credit immediately reduces its present value according to the length of time between when it actually is earned and the time it actually is used to reduce tax liability.<sup>48</sup>

Except for energy research, firms with research expenditures substantially in excess of their base amount are subject to the 50-percent base amount limitation. In general, although these firms received the largest amount of credit when measured as a percentage of their total qualified research expenses, their marginal effective rate of credit was exactly one half of the statutory credit rate of 20 percent (i.e., firms subject to the base limitation effectively are governed by a 10-percent credit rate).

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<sup>47</sup> Hall and Van Reenen, “How effective are fiscal incentives for R&D? A review of the evidence,” p. 463.

<sup>48</sup> As with any tax credit that is carried forward, its full incentive effect could be restored, absent other limitations, by allowing the credit to accumulate interest that is paid by the Treasury to the taxpayer when the credit ultimately is utilized.

Although the statutory rate of the research credit was 20 percent, it is likely that the average effective marginal rate may be substantially below 20 percent. Reasonable assumptions about the frequency that firms were subject to various limitations discussed above yield estimates of an average effective rate of credit between 25 and 40 percent below the statutory rate, i.e., between 12 and 15 percent.<sup>49</sup>

Since sales growth over a long time frame will rarely track research growth, it can be expected that over time each firm's base will drift from the firm's actual current qualified research expenditures. Therefore, if the research credit were made permanent, increasingly over time there would be a larger number of firms either substantially above or below their calculated base. This could gradually create an undesirable situation where many firms would receive no credit and have no reasonable prospect of ever receiving a credit, while other firms would receive large credits (despite the 50-percent base amount limitation). Thus, over time, it can be expected that, for those firms eligible for the credit, the average effective marginal rate of credit would decline while the revenue cost to the Federal government increased.

As explained above, because costly scientific and technological advances made by one firm may often be cheaply copied by its competitors, research is one of the areas where there is a consensus among economists that government intervention in the marketplace, such as the subsidy of the research tax credit, can improve overall economic efficiency. This rationale suggests that the problem of a socially inadequate amount of research is not more likely in some industries than in other industries, but rather it is an economy-wide problem. The basic economic rationale argues that a subsidy to reduce the cost of research should be equally applied across all sectors. As described above, the Energy Policy Act of 2005 provided that energy-related research receive a greater tax subsidy than other research. Some argue that it makes the tax subsidy to research inefficient by biasing the choice of research projects. They argue that an energy-related research project could be funded by the taxpayer in lieu of some other project that would offer a higher rate of return absent the more favorable tax credit for the energy-related project. Proponents of the differential treatment for energy-related research argue that broader policy concerns such as promoting energy independence justify creating a bias in favor of energy related research.

### **Complexity and the research tax credit**

Administrative and compliance burdens result from the research tax credit. The Government Accountability Office ("GAO") has testified that the research tax credit had been difficult for the IRS to administer. The GAO reported that the IRS states that it is required to make difficult technical judgments in audits concerning whether research was directed to produce truly innovative products or processes. While the IRS employs engineers in such audits, the companies engaged in the research typically employ personnel with greater technical expertise and, as would be expected, personnel with greater expertise regarding the intended application of the specific research conducted by the company under audit. Such audits create a

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<sup>49</sup> For a more complete discussion of this point, see Joint Committee on Taxation, *Description and Analysis of Tax Provisions Expiring in 1992* (JCS-2-92), January 27, 1992, pp. 65-66.

burden for both the IRS and taxpayers. The credit generally requires taxpayers to maintain records more detailed than those necessary to support the deduction of research expenses under section 174.<sup>50</sup> An executive in a large technology company has identified the research credit as one of the most significant areas of complexity for his firm. He summarizes the problem as follows.

Tax incentives such as the R&D tax credit ... typically pose compliance challenges, because they incorporate tax-only concepts that may be only tenuously linked to financial accounting principles or to the classifications used by the company's operational units. ... [I]s what the company calls "research and development" the same as the "qualified research" eligible for the R&D tax credit under I.R.C. Section 41? The extent of any deviation in those terms is in large part the measure of the compliance costs associated with the tax credit.<sup>51</sup>

In addition to compliance challenges, with the addition of the alternative simplified credit, taxpayers now have three research credit structures to choose from, not including the energy research credit and the university basic research credit. The presence of multiple research credit options creates increased complexity by requiring taxpayers to make multiple calculations to determine which credit structure will result in the most favorable tax treatment.

### **Prior Action**

The President's budget proposals for fiscal years 2003 through 2006 contained an identical proposal. The President's budget proposal for fiscal year 2007 contained a similar proposal, but did not extend or make permanent the energy research credit. The President's budget proposal for fiscal years 2008 and 2009 contained an identical proposal.

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<sup>50</sup> Natwar M. Gandhi, Associate Director Tax Policy and Administration Issues, General Government Division, U.S. General Accounting Office, "Testimony before the Subcommittee on Taxation and Internal Revenue Service Oversight," Committee on Finance, United States Senate, April 3, 1995.

<sup>51</sup> David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company," *National Tax Journal*, vol. 50, September 1997, pp. 487-493.

## D. Expand Net Operating Loss Carryback

### Present Law

Under present law, a net operating loss (“NOL”) generally means the amount by which a taxpayer’s business deductions exceed its gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.<sup>52</sup> NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.<sup>53</sup>

The alternative minimum tax (“AMT”) rules provide that a taxpayer’s NOL deduction cannot reduce the taxpayer’s alternative minimum taxable income (“AMTI”) by more than 90 percent of the AMTI.

Different rules apply with respect to NOLs arising in certain special circumstances. A three-year carryback applies with respect to NOLs--(1) arising from casualty or theft losses of individuals, or (2) attributable to federally declared disasters (as defined in section 165(h)(3)(C)(i)) for taxpayers engaged in a farming business or a small business.<sup>54</sup> A five-year carryback applies to NOLs--(1) arising from a farming loss (regardless of whether the loss was incurred in a federally declared disaster area),<sup>55</sup> (2) attributable to qualified Gulf Opportunity Zone losses and qualified Disaster Recovery Assistance losses,<sup>56</sup> or (3) resulting from qualified disaster losses.<sup>57</sup> A five-year carryback also applies to NOLs of taxpayers that qualify as eligible small businesses either with respect to the taxpayer’s NOL for any tax year ending in 2008 or beginning in 2008.<sup>58</sup> Special rules also apply, for example, to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

In addition, in the case of a life insurance company, present law allows a deduction for the operations loss carryovers and carrybacks to the taxable year, in lieu of the deduction for net operating losses allowed to other corporations.<sup>59</sup> A life insurance company is permitted to treat a

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<sup>52</sup> Sec. 172(b)(1)(A).

<sup>53</sup> Sec. 172(b)(2).

<sup>54</sup> Sec. 172(b)(1)(F).

<sup>55</sup> Sec. 172(b)(1)(G).

<sup>56</sup> Sec. 1400N(k). See also Pub. L. No. 110-343, Div. C, Sec. 702, which applies Code Sec. 1400N for the temporary tax relief for areas damaged by 2008 Midwestern storms, tornados, and flooding, as specifically outlined in Pub. L. No. 110-343, Div. C, Secs. 702(a)-(c) and 702(d)(1)-(7).

<sup>57</sup> Sec. 172(b)(1)(J). See also Pub. L. No. 110-343, Div. C, Sec. 712.

<sup>58</sup> Sec. 172(b)(1)(H) as amended by Sec. 1211 of the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5).

<sup>59</sup> Secs. 810, 805(a)(5).

loss from operations (as defined under section 810(c)) for any taxable year as an operations loss carryback to each of the three taxable years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.<sup>60</sup> Special rules apply to new life insurance companies.

## **Description of Proposal**

### **Administration proposal**

The Administration does not specify a proposal, but instead proposes to work with Congress to make an extended NOL carryback period available to more taxpayers.

For purposes of estimating the budget effects of the Administration's proposal with respect to extending the NOL carryback period, the 2009 Senate proposal was used.<sup>61</sup>

### **2009 Senate proposal**<sup>62</sup>

The proposal provides an election to increase the present-law carryback period for an applicable 2008 or 2009 NOL from two years to any whole number of years elected by the taxpayer which is more than two and less than six.<sup>63</sup> An applicable NOL is the taxpayer's NOL for any taxable year ending in 2008 or 2009, or at the taxpayer's election, the NOL for any taxable year beginning in 2008 or 2009.

The proposal also suspends the 90-percent limitation on the use of any AMT NOL deduction attributable to the carryback of NOLs from taxable years ending in 2008 or 2009, as well as NOL carryovers to such taxable years. This provision applies to taxable years beginning in 2008 or 2009 if a taxpayer has made an election to determine its applicable NOL using a taxable year beginning in 2008 or 2009.

For life insurance companies, the provision provides an election to increase the present-law carryback period for an applicable loss from operations from three years to four or five years. An applicable loss from operations is the taxpayer's loss from operations for any taxable year ending in 2008 or 2009, or if a taxpayer elects, the loss from operations for any taxable year beginning in 2008 or 2009.

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<sup>60</sup> Sec. 810(b)(1).

<sup>61</sup> See Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury*, (JCX-28-09), June 11, 2009.

<sup>62</sup> See Conference Report, H. Rep. No. 111-16, to H.R. 1.

<sup>63</sup> For all elections under this provision, the common parent of a group of corporations filing a consolidated return makes the election, which is binding on members of the consolidated group.

The provision does not apply to: (1) any taxpayer if (a) the Federal government acquires, at any time,<sup>64</sup> an equity interest in the taxpayer pursuant to the Emergency Economic Stabilization Act of 2008, or (b) the Federal government acquires, at any time, any warrant (or other right) to acquire any equity interest with respect to the taxpayer pursuant to such Act; (2) the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation; and (3) any taxpayer that in 2008 or 2009<sup>65</sup> is a member of the same affiliated group (as defined in section 1504 without regard to subsection (b) thereof) as a taxpayer to which the provision does not otherwise apply.

Effective date.—The proposal is generally effective for NOLs arising in taxable years ending after December 31, 2007. The modification to the AMT NOL deduction applies to taxable years ending after 1997.<sup>66</sup> The modification with respect to operation loss deductions of life insurance companies applies to losses from operations arising in taxable years ending after December 31, 2007.

For an NOL or loss from operations for a taxable year ending before the enactment of the proposal, the proposal includes the following transition rules: (1) any election to waive the carryback period under either sections 172(b)(3) or 810(b)(3) with respect to such loss may be revoked before the applicable date; (2) any election to increase the carryback period under this provision is treated as timely made if made before the applicable date; and (3) any application for a tentative carryback adjustment under section 6411(a) with respect to such loss is treated as timely filed if filed before the applicable date. For purposes of the transition rules, the applicable date is the date which is 60 days after the date of the enactment of the provision.

### **Analysis**

NOLs may be carried back to prior years resulting in the refund of taxes paid in such prior years. This allows companies to smooth out fluctuations in earnings and taxes and to provide comparable tax payments over several years to companies with more stable net income. To allow for optimal smoothing of income across the business cycle, the carryback and carryforward period should be long enough to encompass the business cycle. NOL carrybacks may encourage investment, by sharing the risk of losses from investment with the government and by providing cash in the form of refund of prior taxes paid to fund investment. The accelerated refund of prior taxes paid increases current cash flow available to taxpayers relative to cash flow absent this provision. The business community generally and many specific

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<sup>64</sup> For example, if the Federal government acquires an equity interest in the taxpayer during 2010, or in later years, the taxpayer is not entitled to the extended carryback rules under this provision. If the carryback has previously been claimed, amended filings may be necessary to reflect this disallowance.

<sup>65</sup> For example, a taxpayer with an NOL generated in 2008 or 2009 that in 2010 joins an affiliated group with a member in which the Federal government has an equity interest pursuant to the Emergency Economic Stabilization Act of 2008 may not utilize the extended carryback rules under this provision with regard to the 2008 or 2009 NOL. The taxpayer is required to amend prior filings to reflect the permitted carryback period.

<sup>66</sup> NOL deductions from as early as taxable years ending after 1997 may be carried forward to 2008 and utilize the provision suspending the 90 percent limitation on AMT NOL deductions.

taxpayers have indicated that increased current cash flow would allow them to fund payroll obligations, other business expenses, and necessary capital improvement projects.

However, an indefinite carryback period is not practically feasible because of the potential revenue losses to the government, especially during an economic downturn. Nonetheless, economists generally agree that the NOL carryback period should be sufficiently long (generally at least the length of the business cycle) to allow for income smoothing and investment-risk reduction.<sup>67</sup>

During an economic downturn, the ability to carry back a NOL may be particularly important for taxpayers that have historically generated taxable income, but are currently experiencing losses. Rather than waiting to offset the current losses against future taxable income, the NOL carryback provisions may enable a taxpayer to obtain cash immediately. Thus, in an economy with restrictive credit, extending the NOL carryback period beyond the current two-year period may provide a relatively low cost source of funds for companies facing borrowing constraints (i.e., providing liquidity). This cash flow, in turn, could boost investment and thereby stimulate economic growth.

Some have questioned the efficacy of extending the NOL carryback period to stimulate investment. The Congressional Budget Office (“CBO”) has noted that it is unlikely that the effects of changes in NOL carrybacks and carryovers, by themselves, significantly impact investment in the short term.<sup>68</sup> The CBO has estimated that a dollar of NOL carryback translates into a GDP increase between \$0 and \$0.40; whereas a dollar increase in Federal government purchases increases GDP by between \$1.00 and \$2.50 and a targeted temporary decrease in individual taxes increases GDP by between \$0.50 and \$1.70.<sup>69</sup> Moreover, companies may be inclined to retain cash if sufficiently attractive investment opportunities are not available or if their economic outlook supports holding cash rather than investing it.

Others have commented that extending the NOL carryback period does little to stimulate additional investment, but instead serves to reward prior investment and production.<sup>70</sup> They argue that because much of the loss is attributable to depreciation deductions on capital investments made in prior years, such deductions would have taken place without the additional benefit of an extended carryback period.

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<sup>67</sup> See, e.g., Congressional Research Service (“CRS”), “Net Operating Losses: Proposed Extension of Carryback Period,” May 29, 2009, wherein CRS notes that since World War II, the average business cycle is approximately six years.

<sup>68</sup> Congressional Budget Office, “Options for Responding to Short-Term Economic Weakness,” January 24, 2008.

<sup>69</sup> U.S. Congress, House Committee on the Budget, “The State of the Economy and Issues in Developing an Effective Policy Response, The Economic Outlook and Budget Challenges,” 111th Cong., January 27, 2009.

<sup>70</sup> Aviva Aron-Dine, “Net Operating Loss Measure Under Consideration in Senate has Low Bang-for-the-Buck as Stimulus,” Center on Budget and Policy Priorities, February 26, 2008.

**Prior Action**

No similar proposals have been included in recent budget proposals of the President.



## **E. Restructure Transportation Infrastructure Assistance to New York City**

### **Present Law**

#### **In general**

Present law includes a number of incentives to invest in property located in the New York Liberty Zone (“NYLZ”), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.<sup>71</sup>

#### **Special depreciation allowance for qualified New York Liberty Zone property**

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.<sup>72</sup> To qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

For property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System (“MACRS”)<sup>73</sup> apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property<sup>74</sup> and (2) property eligible for the additional first-year depreciation deduction under

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<sup>71</sup> In addition to the NYLZ provisions described above, the following NYLZ provisions expired in 2006: five-year recovery period for depreciation of certain leasehold improvements, increase in expensing under Sec. 179, and extended replacement period for nonrecognition of gain under Sec. 1033.

<sup>72</sup> The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

<sup>73</sup> A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

<sup>74</sup> Qualified NYLZ leasehold improvement property is defined as qualified leasehold improvement property located in the NYLZ, placed in service after September 10, 2001 and before January 1, 2007, and for which no written binding contract was in effect before September 11, 2001 (Sec. 1400L(c)(2)). Leasehold improvements that do not satisfy the requirements to be treated as “qualified NYLZ leasehold improvement property” maybe eligible for the 30 percent additional first-year depreciation deduction (if all other requirements are met).

section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation deduction). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase<sup>75</sup> by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For nonresidential real property and residential rental property to qualify, it must be placed in service on or before December 31, 2009, rather than December 31, 2006. Property does not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.<sup>76</sup>

Nonresidential real property and residential rental property is eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006<sup>77</sup> (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

### **Description of Proposal**

#### **Repeal of certain NYLZ incentives**

The proposal repeals the NYLZ incentive for the additional first-year depreciation allowance of 30 percent for nonresidential real property and residential rental property.

Effective date.—The proposal is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law.

#### **Credit for certain payments of New York State and New York City**

The proposal provides a Federal tax credit to New York State and New York City for expenditures relating to construction or improvement of transportation infrastructure in or connecting to the NYLZ. The amount of the credit in each year, 2010 through 2019, may not exceed the lesser of (1) \$200 million per year (divided equally between the State and the City), until a cumulative total of \$2 billion is reached, or (2) expenditures for the calendar year by the

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<sup>75</sup> For purposes of this provision, purchase is defined as under Sec. 179(d).

<sup>76</sup> Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

<sup>77</sup> December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

State or City, respectively, relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. Any amount of unused credit below the \$200 million annual limit is carried forward to the following year, including years after 2019, and expenditures that exceed the \$200 million annual limit are carried forward and subtracted from the \$200 million annual limit in the following year.

The credit would be allowable against any payment by the State or City to the Federal government required under a provision of the Internal Revenue Code other than the provisions relating to payments of excise taxes, FICA, SECA, or OASDI amounts. For example, the credit is allowable against payments of Federal income tax withheld with respect to State or City employees.

Treasury guidance is to be provided to ensure that the expenditures satisfy the intended purposes. The amount of the credit is treated as State and local funds for purposes of any Federal program.

Effective date.—The proposal is effective for calendar years after 2009.

### **Analysis**

The proposal is based on the premise that some of the tax benefits provided by the present-law incentive provisions will not be usable in the form in which they were originally provided, and that they should be replaced with other benefits that would have a greater impact on the recovery and continued development in the NYLZ. The proposal reflects a preference for subsidizing transportation infrastructure rather than buildings and other private property. Even to the extent that the incentive provisions can be used by taxpayers in their present-law form, they are unnecessary to spur investment in the NYLZ because, it is argued, investment would occur in the area even without special tax incentives.

On the other hand, the effectiveness of the present-law NYLZ incentives may not yet be determinable because insufficient time has passed since they were enacted. Furthermore, repeal of the provisions prior to their scheduled expiration could be unfair to any taxpayers who have begun, in reliance upon the incentive provisions, to implement long-term plans the status of which requires them to continue with planned investments despite the absence of a written binding contract. Opponents may also object to the replacement of a benefit for private taxpayers with a cash grant to governmental entities, or the replacement of an incentive for investment in private property with an incentive for investment in public infrastructure. Further, it could be argued that the transportation infrastructure might be built without the incentive provided under the proposal, just as investment in the NYLZ is taking place without regard to tax incentives.

The proposal could be criticized as creating an inefficient method for delivering a Federal transportation infrastructure subsidy to New York State and New York City. Further, because neither New York City nor New York State is subject to Federal income tax itself, administration of the Federal tax law is made needlessly complex by the creation of a credit against payment of withheld income tax of these governmental entities' employees. Providing a transportation

infrastructure subsidy as a direct grant outside of the tax law would be more consistent with simplification of the tax law and administrative efficiency.

**Prior Action**

A similar proposal was included in the President's fiscal year 2006, 2007, 2008, and 2009 budget proposals. These prior proposals included the repeal of certain other NYLZ incentives not previously expired.

## II. REVENUE RAISING PROPOSALS

### A. Codify Economic Substance Doctrine

#### 1. Codify 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, the IRS, and litigants. Although these doctrines serve an important role in the administration of the tax system, they can be seen as providing a further, possibly less predictable, interpretive element to an objective, rule-based system of taxation.

##### Economic substance doctrine

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.<sup>78</sup> Courts applying this doctrine 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

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<sup>78</sup> See, e.g., *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); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 189 (1997), *cert. denied* 526 U.S. 1017 (1999).

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.<sup>79</sup>

### Business purpose and other related doctrines

Closely related doctrines also applied by the courts (sometimes interchangeably with the economic substance doctrine) include the “business purpose,” “sham transaction,” “substance over form” and “step-transaction” doctrines.<sup>80</sup> The business purpose doctrine, often considered together with the economic substance 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.<sup>81</sup> In general, the “sham transaction,” “substance over form” and “step transaction” doctrines examine in a more objective manner the actual effect of the transactions undertaken by the taxpayer.<sup>82</sup>

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<sup>79</sup> *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

<sup>80</sup> See, e.g., Joseph Bankman, “The Economic Substance Doctrine,” 74 *S. Cal. L. Rev.* 5, 12 (2000-2001) (“...the economic substance doctrine to some extent incorporates other common law doctrines[,]” and “the differences between the doctrines are apt to be smaller than first imagined.”); Jeffrey C. Glickman and Clark R. Calhoun, “The ‘States’ of the Federal Common Law Tax Doctrines,” 61 *Tax Lawyer* 4 (Summer 2008) (describes the step-transaction as a subset or extension of the substance over form doctrine, and notes the overlapping nature of all of the related anti-avoidance doctrines; Kevin M. Keyes and Russell S. Light, “Developments in the Economic Substance Doctrine,” 20 *Journal of Taxation of Investments* 284 (2003) (“A transaction may be challenged through any one of several doctrines, including the business purpose doctrine, the substance over form doctrine, the sham transaction doctrine, and the economic substance doctrine. Clear delineation or bright-line differentiation between these doctrines is not to be found”).

Some have, nevertheless, articulated differences among the doctrines. For example, it has been said, that although the doctrines are all categories of the “substance over form” doctrine, the “economic substance” doctrine applies “where there is no substance other than the creation of unintended tax benefits.” Donald L. Korb, “The Economic Substance Doctrine in the Current Tax Shelter Environment” (Jan. 25, 2005) reprinted at 2005 *TNT* 16-2; see also *Rogers v. United States*, 281 F.3d 1108 (10th Cir. 2002), denying a bad debt deduction on the ground that the asserted transaction was not a loan but a redemption, and stating that although more than one doctrine may apply to a transaction, the doctrines are different from one another (citing *inter alia* Department of the Treasury, “The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals” (1999) (“Treasury Department White Paper”); see Yoram Keinen, 508 *T.M.* “The Economic Substance Doctrine” secs. III F. and III G., at pp. A-33-36, concluding that “the economic substance doctrine is strongly related to the other four common law doctrines....[I]n the majority of cases involving the economic substance doctrine, the courts applied more than one common law doctrine in their decisions.”

<sup>81</sup> See *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

<sup>82</sup> 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 Corp. v. United States*, 2007-1 USTC ¶150,130 (M.D.N.C. 2007), *aff’d* 523 F.3d 461 (4th Cir. 2008). Another variation of

## Application by the courts

### Elements of the economic substance doctrine

There is a lack of uniformity regarding the proper tests to use when applying the economic substance doctrine.<sup>83</sup> 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.<sup>84</sup> A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.<sup>85</sup> 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.<sup>86</sup>

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the substance over form doctrines is known as the “step-transaction” doctrine. See, e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935). Application of this doctrine may result in ignoring one or more of the various separate steps in the structure of a transaction, or collapsing all into one transaction. The courts apply one of three tests in evaluating a series of transactional steps: the binding commitment test (see, e.g., *Commissioner v. Gordon*, 391 U.S. 83 (1968)); the end result test (see, e.g., *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969)); or the mutual interdependence test (see, e.g., *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), *aff’d per curiam* 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950)). Binding commitment requires a finding that the parties committed at the outset to honor a specific result, and is the least frequently invoked. End result analysis looks at the result and determines whether the steps would have permitted any other result, while mutual interdependence considers whether the steps are so interdependent that they would be fruitless unless all occur. These latter two tests have as their gravamen a requirement to examine the economic substance of the steps when viewed together.

<sup>83</sup> “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).

<sup>84</sup> 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 the taxpayers are believed to have had a profit motive, the transaction was disregarded because it did not in fact have any realistic possibility of profit and funding was never at risk).

<sup>85</sup> 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 outside 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), July 22, 1999, at p. 182.

<sup>86</sup> 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

One decision by the Court of Federal Claims questioned the continuing viability of the doctrine, even suggesting that “the use of the economic substance doctrine to trump mere compliance with the Code would violate the separation of powers.”<sup>87</sup> That court also applied the doctrine to find that the particular transaction at issue in the case did not lack economic substance.<sup>88</sup> However, the Court of Appeals for the Federal Circuit (“Federal Circuit Court”) overruled that decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in question violated that doctrine.<sup>89</sup> 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.”<sup>90</sup>

### 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.<sup>91</sup> Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.<sup>92</sup> In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a

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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’.”)

<sup>87</sup> *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128).

<sup>88</sup> *Ibid.*

<sup>89</sup> *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).

<sup>90</sup> The Federal Circuit Court further 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.

<sup>91</sup> 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).

<sup>92</sup> 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).



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.<sup>93</sup> 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.<sup>94</sup> 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.<sup>95</sup> 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.<sup>96</sup>

#### Foreign taxes

Determining the pre-tax profit potential of a transaction under the economic substance doctrine raises special issues when the transaction includes foreign taxes, which give rise to foreign tax credits. In such cases, the IRS and Treasury Department have sought to treat foreign taxes as expenses in calculating pre-tax profit potential, while taxpayers have contended that foreign taxes should be disregarded for this purpose, as discussed below. The courts have not always agreed with the government's treatment, as discussed below.

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<sup>93</sup> 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").

<sup>94</sup> 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).

<sup>95</sup> See, e.g., *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).

<sup>96</sup> 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 28, 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.

In 1998, the IRS and Treasury Department indicated that they would issue regulations that would curb abuse of the foreign tax credit regime.<sup>97</sup> Under the contemplated regulations, foreign taxes would be treated as an expense in determining economic profit. In addition, the regulations would deny foreign tax credits with respect to “abusive arrangements” involving withholding taxes or cross-border tax arbitrage transactions. However, the effort was abandoned in 2004, when the IRS announced it would not issue the regulations described in 1998.<sup>98</sup>

In between these events, separate Federal courts of appeal rejected the government’s contentions with respect to the economic substance of two similar, structured transactions that involved the generation of losses from the buying and selling of American Depository Receipts of foreign corporations.<sup>99</sup> The availability of foreign tax credits was critical to the economic viability of these transactions for the taxpayers involved. Nevertheless, the courts held that foreign taxes were not an appropriate factor to consider in the evaluation of the profit potential of the transactions and that profit potential should be tested instead by reference to pre-foreign-tax income.

In 2008, the IRS and Treasury Department issued temporary and proposed regulations intended to curb abuses of the foreign tax credit regime as a result of highly structured transactions, referred to as “structured passive investment arrangements.”<sup>100</sup> These arrangements take different forms, but the basic goal is to create a foreign tax liability in cases in which, absent the additional structuring, the underlying business transaction would result in significantly less, or even no, foreign taxes. The parties exploit differences between U.S. and foreign law to permit a person to claim a foreign tax credit for the purported foreign tax payments while also allowing the foreign counterparty to claim a duplicative foreign tax benefit.

The regulations treat foreign payments attributable to such arrangements as noncompulsory payments, and thus deny foreign tax credits for such amounts. The preamble to the temporary regulations states that for periods prior to the effective date of the regulations,<sup>101</sup> the IRS will continue to utilize all available tools under current law to challenge the claimed U.S. tax results of these arrangements, including the economic substance doctrine.

#### 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,

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<sup>97</sup> Notice 98-5, 1998-1 C.B. 334, *withdrawn*, Notice 2004-19, 2004-1 C.B. 606.

<sup>98</sup> Notice 2004-19, 2004-1 C.B. 606.

<sup>99</sup> *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Indus. Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001).

<sup>100</sup> T.D. 9416, 2008-2 C.B. 1142 (temporary regulations); 73 Fed. Reg. 40,792 (July 16, 2008) (proposed regulations).

<sup>101</sup> The regulations are generally effective for taxable years ending on or after July 16, 2008.

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. In some cases, the courts have concluded that a particular type of transaction did not satisfy the economic substance doctrine.<sup>102</sup> 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.<sup>103</sup>

### **Description of Proposal**<sup>104</sup>

The proposal clarifies that a transaction satisfies the economic substance doctrine only if (i) it changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (other than a Federal tax purpose) for entering into the transaction. The proposal also clarifies that a transaction will not be treated as having economic substance solely by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction. The proposal allows the Treasury Department to publish regulations to carry out the purposes of the proposal.

Effective date.—The proposal applies to transactions entered into after the date of enactment.

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<sup>102</sup> 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).

<sup>103</sup> See, e.g., *TIFD- III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

<sup>104</sup> The description appears in the Department of Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009 (referred to herein as the "Administration proposal"), at p. 25. As noted in the Analysis section, *infra*, this description does not delineate certain potential aspects of the proposal. Based on conversations with Treasury Department staff, this proposal and the companion penalty and interest proposals may contain a number of elements substantially similar to the provisions of H.R. 2419 (Food and Energy Security Act of 2007), secs. 12521-12523, 110th Congress (Engrossed Amendment as Accepted by the Senate) (herein referred to as "H.R. 2419") which mirrors the economic substance provisions of S. 2242 (Heartland, Habitat, Harvest and Horticulture Act of 2007) (secs. 511- 513), 110th Congress (Placed on Senate Calendar on October 25, 2007). For purposes of the estimated budgetary effects, the staff of the Joint Committee on Taxation has assumed the proposal and the companion penalty and interest disallowance proposals are the same as H.R. 2419 (and S. 2242). Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009* (JCX-28-09), June 11, 2009, at p. 5.

## Analysis

### Two-prong test

The proposal would adopt a conjunctive, “two prong” test—requiring the taxpayer to have both a substantial purpose (other than a Federal tax purpose) and a meaningful change in economic position (apart from Federal tax effects), to satisfy the economic substance doctrine.

Whether such a two-prong test<sup>105</sup> would have an effect on the outcome of particular cases is a subject of debate. On the one hand, in those jurisdictions that have stated that only one prong must be satisfied under the economic substance doctrine, it might be inferred that the outcomes in some cases, otherwise favorable to the taxpayer, could be less favorable under the proposal.

On the other hand, the application of the economic substance doctrine is dependent upon facts and circumstances of particular cases and arguably is ultimately subjective. Thus, it is unclear whether the application of this two-prong test would ultimately be less favorable to a particular taxpayer. Under present law, for example, different courts (e.g., lower courts and appeals courts) have reached opposite outcomes in the same case.<sup>106</sup> Courts in different jurisdictions have also reached different conclusions in similar cases.<sup>107</sup> Courts also may apply inconsistent analyses and differing degrees of factual examination, with the result that a holding in one case may or may not be considered appropriate authority for another case if the facts are differently developed or analyzed. Commentators addressing similar prior legislative proposals have suggested that regardless of which “set” of tests is used, the factors ultimately involve a

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<sup>105</sup> The proposal includes as part of the two-prong test a rule relating to profit potential (discuss further below) where taxpayers invoke such a potential to satisfy the test.

<sup>106</sup> See, e.g., *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) (lower court found economic substance; appeals court vacated and remanded); *Dow Chem. Co. v. United States*, 250 F.Supp. 2d 748 (E.D. Mich. 2003), *rev'd* 435 F.3d 594 (6th Cir. 2006), *cert. denied* 549 U.S. 1205 (2007) (lower court found economic substance, appeals court reversed); *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621 (D. Md. 2004), *rev'd and remanded*, 436 F.3d 431(4th Cir. 2006) (lower court found economic substance, appeals court reversed and remanded); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) (IRS won in the lower court but was reversed on appeal); *IES Indus. Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001) (IRS won in the lower court but was reversed on appeal); *UPS of America v. Commissioner*, 251 F.3d 1014 (11th Cir. 2001) (IRS won in the lower court but was reversed on appeal).

<sup>107</sup> Different conclusions have been reached in the case of the so-called “son-of- boss” transactions involving claimed basis due to the assertion that certain obligations are not “liabilities.” Compare *Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008) (taxpayer prevails on economic substance) with *Stobie Creek Investments, LLC v. United States*, 82 Fed. Cl. 636 (2008); *Jade Trading LLC, et. al. v. United States*, 80 Fed. Cl. 11 (2007); *Maguire Partners-Master Investments, LLC v. United States*, 2009-1 USTC ¶50,215 (C.D. Cal. 2009); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9 (April 9, 2009) (IRS prevails in all, on varying grounds including economic substance).

facts and circumstances balancing, and have noted that the proposals do not explicitly state that any particular outcome under present law is intended to be reversed.<sup>108</sup>

### Subjective inquiry

A dominant issue in connection with the conjunctive two-prong test arises from the elevation of the substantial non-Federal-tax purpose to an absolute requirement. This subjective requirement has led commentators on similar prior proposals to question whether tax-planning methods that have not been considered questionable, but that are used solely for tax purposes, might be challenged.<sup>109</sup>

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<sup>108</sup> See, e.g., New York State Bar Association Tax Section Report No. 1032, “Summary Report on the Provisions of Recent Senate Bills that would Codify the Economic Substance Doctrine,” Doc 2003-12678, at p. 4 (May 21, 2003), 2003 *TNT* 102-19, noting “We doubt whether a court says that it is using a conjunctive or a disjunctive test, without more, would affect the outcome in many cases. It would be helpful in understanding the statute if the drafters could identify some cases where the courts have gotten it wrong that would be changed by the legislation”; Monte Jackel, “Farming for Economic Substance: Codification Fails to Bear Fruit” 119 *Tax Notes* 59, 68-74 (April 7, 2008); Charles I. Kingson, “Economic Substance vs. The Supreme Court” (letter to the editor) 117 *Tax Notes* 269 (Oct. 15, 2007) (criticizing as inconsistent and incomplete the economic substance analysis applied in specific Supreme Court and other cases, and noting that codification proposals do not expressly overrule any of these cases); Kevin M. Keyes and Russell S. Light, “Developments in the Economic Substance Doctrine,” 20 *Journal of Taxation of Investments* 284, 314 (2003), commenting on an earlier similar proposal in the Care Act of 2003: “The clarification which the proposal purports to provide, whether the economic substance test is a disjunctive or conjunctive one, is not one that likely would affect the outcome of any particular case, particularly where the stated business purposes are vigorously tested and evaluated.” A number of commentators have urged that various decisions under existing law have overlooked or inadequately described important aspects of tax motivation or of actual economic effect. The commentators express varying views regarding the appropriate analysis and outcome that should apply to particular fact situations. Some contend that taxpayer purpose should not ultimately govern the outcome, but that the critical inquiry should rather focus on whether the elements of risk and reward, or other objective economic elements, justify the claimed tax benefits. See and compare, e.g., Charles I. Kingson, “Economic Substance vs. The Supreme Court” (letter to the editor) 117 *Tax Notes* 269 (Oct. 15, 2007), and “The Confusion Over Tax Ownership,” 93 *Tax Notes* 409 (October 15, 2001); David P. Hariton, “When and How Should the Economic Substance Doctrine Be Applied?” 60 *Tax L. Rev.* 29 (Fall 2006), and “Sorting Out the Tangle of Economic Substance” 52 *Tax Lawyer* 235 (1999); Joseph Bankman, “The Economic Substance Doctrine” 74 *S. Cal. L. Rev.* 5 (2000-2001); Sandra Favelukes O’Neil, “Let’s Try Again: Reformulating the Economic Substance Doctrine,” 121 *Tax Notes* 1053 (December 1, 2008). Some others have suggested that purpose is appropriate to consider separately. See, e.g., Martin J. McMahon, Jr., “Beyond a GAAR: Retrofitting The Code to Rein in 21<sup>st</sup> Century Tax Shelters” 98 *Tax Notes* 1721 (March 17, 2003); see also, Terrill A. Hyde and Glen Arlen Kohl, “The Shelter Problem Is Too Serious Not to Change the Law” 2003 *TNT* 130-44 (July 8, 2003) (suggesting codification of business purpose test rules though not denominated as “economic substance” clarification).

<sup>109</sup> See, e.g., New York State Bar Association Tax Section Report No. 1032, “Summary Report on the Provisions of Recent Senate Bills that would Codify the Economic Substance Doctrine,” Doc 2003-12678, at p. 4 (May 21, 2003), 2003 *TNT* 102-19; American Bar Association Section of Taxation, “Proposed Codification of the Economic Substance Doctrine (Apr. 12, 2007) 2007 *TNT* 72-22; Peter L. Faber, “Practitioner to Congress: Don’t Codify Economic Substance,” 2002 *TNT* 206-60 (Oct. 22, 2002). Even apart from any legislative proposal, some have previously requested additional guidance following certain judicial decisions. See, e.g., ABA Tax Section, *Recommendations for IRS 2007-08 Guidance Priority List* (June 18, 2007), requesting “guidance on the effect of *Coltec Industries, Inc. v. United States*, 454 F. 3d 1340 (Fed. Cir. 2006) on routine business transactions that involve additional restructuring in order to obtain more favorable tax consequences.” Compare 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”).

Proponents of prior similar proposals contend, however, that the two-prong test applies only when the economic substance doctrine is considered relevant, and that the existing judicial framework for determining the types of cases in which to apply the economic substance doctrine is expected to continue to operate under the proposal.<sup>110</sup> For example, the statutory language of S. 2242 states that the codified definition of economic substance is to be used “[i]n any case in which a court determines that the economic substance doctrine is relevant ...”<sup>111</sup> Moreover, the legislative history of S. 2242 and prior similar proposals contain language indicating that the provision does not change current law standards in determining when to utilize an economic substance analysis.<sup>112</sup>

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<sup>110</sup> See Samuel C. Thompson Jr. and Robert Allen Clary II, “Coming in From the ‘Cold’: the Case of ESD Codification,” 99 *Tax Notes* 1270 (May 26, 2003).

<sup>111</sup> S. 2242 sec. 511(a) adds new section 7701(p) to the Code. S. 2242 was introduced and placed on the Senate Legislative Calendar on October 25, 2007, however the bill was never voted on by the Senate. On the same day, the Committee on Finance submitted its report providing detail about the economic substance provisions and other provisions in the bill. Another Senate bill containing the same economic substance provisions was passed in the Senate on December 14, 2007. That bill is H.R. 2419 (Food and Energy Security Act of 2007) (Engrossed Amendment as Accepted by the Senate) (herein “H.R. 2419”). The Committee on Finance did not prepare a report to accompany this bill so this document will generally reference S. 2242 and H.R. 2419. A different version of H.R. 2419 (called Food, Conservation and Energy Act of 2008) ultimately was passed by both houses without the economic substance provisions.

<sup>112</sup> S. Rep. No. 110-206, 110th Cong., 1st Sess., at pp. 92-93 (2007). See Joint Committee on Taxation, *Technical Explanation of the “AMT Relief Act of 2007” as Introduced in the House of Representatives on December 11, 2007* (JCX-113-07), December 12, 2007 at pp. 23-24.

Specifically, the legislative history of S. 2242 provides:

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<sup>127</sup> these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;<sup>128</sup> (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;<sup>129</sup> (3) the choice to enter a transaction or series of transactions that constitute a corporate reorganization or reorganization under subchapter C;<sup>130</sup> 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.<sup>131</sup> Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.<sup>132</sup>

Notes:

<sup>127</sup> The examples are illustrative and not exclusive.

<sup>128</sup> See, e.g., *John Kelly 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).

<sup>129</sup> 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. 349 (1988) (agency principles applied to title-holding corporation under all the facts and circumstances).

<sup>130</sup> See, e.g., Rev. Proc. 2007-3, 2007-1 I.R.B. 108, secs. 3.01(33), (34), and (36) (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); compare *Gregory v. Helvering*, 239 U.S. 465 (1935).

<sup>131</sup> 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).

<sup>132</sup> See, e.g., *Frank Lyon v. Commissioner*, 435 U.S. 561 (1968); *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).

The legislative history also states that "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. Thus, the provision does not change current law standards used by courts in determining when to utilize an economic substance analysis."<sup>113</sup>

Although the Administration proposal does not contain statements similar to those in the legislative history to S. 2242, it is likely that similar assumptions are implicit in the proposal.

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<sup>113</sup> S. Rep. No. 110-206, at p. 92.

## Profit potential

The proposal provides that a transaction will not be treated as having economic substance by reason of a profit potential unless the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction. Legislative history accompanying prior similar provisions indicates that this phrasing is intended to preclude a finding that a mere “reasonable possibility of profit,” without regard to its relative amount, could be sufficient to satisfy a profit potential test.<sup>114</sup> However, it is not clear what level of profit would be “substantial” in relation to net Federal income tax benefits on any particular facts, or how to determine the appropriate discount rate to compute present value.

In other contexts, some have questioned the utility of such a comparison given the existence of explicit statutory tax benefits that would affect the level of pre-tax profit expected from tax-benefitted transactions when compared to a non-tax-benefitted market rate.<sup>115</sup> Assuming the proposal follows the approach of S. 2242, the intent of the proposal would appear to be to apply the new test only in cases to which the economic substance doctrine is considered relevant, and the taxpayer relies upon profit potential as a non-Federal tax purpose. Thus, the test may not be intended to affect cases where, as the legislative history to S. 2242 stated, “the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions.”<sup>116</sup>

The language regarding the profit potential test does not address many types of transactions that may not specify a readily calculable profit potential as their business purpose—for example, various types of financing transactions or corporate restructurings.

## **Distinguishing economic substance from other tax issues**

There may be uncertainty regarding the extent of overlap or intersection of the “economic substance” doctrine with other grounds on which claimed tax benefits may be disallowed. Courts have denied claimed tax benefits by finding that the economics and the expectations of the parties were not in conformity with the claimed tax structure. In some cases, for example, courts have found a failure of “economic substance” as such, but in other cases they have found also, or instead, that the claimed structure failed to meet either the specific rules of the statute and valid regulations,<sup>117</sup> or failed to satisfy the interpretive doctrines surrounding technical

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<sup>114</sup> See, e.g., S. Rep. No. 110-206, at p.95 n. 104.

<sup>115</sup> See, e.g., Alvin C. Warren, Jr., “The Requirement of Economic Profit in Tax Motivated Transactions,” 59 *Taxes* 985 (1981).

<sup>116</sup> S. Rep. No. 110-206, at p. 92.

<sup>117</sup> See, e.g., Monte A. Jackel and Robert J. Crnkovich, “Son-of-Boss Revisited,” 123 *Tax Notes* 1481 (June 22, 2009), summarizing various grounds and conclusions courts have applied in addressing so-called “son-of-boss” transactions that the IRS challenged as invalidly creating artificial basis, including the validity or application of Treasury regulations, the meaning of the term “liabilities” under section 752 of the Code, and the economic substance doctrine.



statutory requirements, such as whether a transaction constituted a tax-free corporate restructuring,<sup>118</sup> whether an investment constituted debt or equity,<sup>119</sup> whether a sale, lease, option, or other transaction occurred,<sup>120</sup> or whether the tax incidence of a transaction should fall upon the party asserted or rather upon a different party.<sup>121</sup>

Given the many common law “doctrines” that have been applied to various cases, and the fact that some cases have explicitly held that there is both a failure of economic substance and a failure under the statute or regulations, taxpayers may contend that their transaction has failed for reasons that do not include “economic substance” if this could be advantageous. However, similar prior proposals have indicated that there is no intent to modify the development or application of any other rule of law, nor to preclude the IRS from asserting other challenges to a transaction at the same time it asserts an economic substance challenge.<sup>122</sup> Thus, it would seem that the IRS would not be constrained in raising multiple challenges to a particular transaction.<sup>123</sup>

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<sup>118</sup> See, e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935) (contribution of assets to newly formed subsidiary followed by spin off and liquidation of subsidiary did not qualify as a tax-free “spin-off” due to lack of corporate restructuring business purpose); *Tribune Co. v. Commissioner*, 125 T.C. 110 (2005) (structured transaction failed to qualify as tax-free “B” reorganization because transferor’s control over cash represented disallowed non-stock consideration).

<sup>119</sup> *TIFD- III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006). Taxpayers might contend under the proposal that even if a court recharacterizes a financing, for example, as debt rather than equity, and therefore denies the desired tax benefits, a financing (if respected in some form) nevertheless changes the taxpayer’s economic position in that some relationship is established with investors, and nevertheless has a non-tax business purpose, to obtain funds. Hence they might contend that such a transaction should not fail the literal language of the proposed codification.

<sup>120</sup> See, e.g., *Schering-Plough Corporation v. United States*, No. 05-2575 (D.N.J. August 28, 2009), 2009 TNT 167-3 (finding that a transaction was a loan, not a sale, and also failed “economic substance”); *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008), finding a “sale-in-lease-out” transaction to satisfy the present-law economic substance doctrine but not to constitute a sale or lease; *BB&T Corporation v. United States*, 2007-1 USTC ¶50,130 (M.D.N.C. 2007), *aff’d* 523 F.3d 461 (4th Cir. 2008). See also, *Enbridge Energy Co. v. United States*, 553 F. Supp. 2d 716 (S.D. Tex. 2008) (transaction was a sale of stock not assets).

<sup>121</sup> See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331(1945) (a sale of property that had been distributed to shareholders in a corporate liquidation was recharacterized as made by the distributing corporate entity, not by the shareholders); *Haas v. Commissioner*, 248 F. 2d 487 (2d Cir. 1957) (losses were attributable to corporation, not shareholders who purported to form a joint venture with corporation).

<sup>122</sup> S. Rep. No. 110-206, at p. 95: “In addition, the provision shall not be construed as altering or supplanting any other 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 doctrine, Code provision, or regulations or guidance thereunder.”

<sup>123</sup> The New York State Bar Association Tax Section has suggested that if “economic substance” is to be referred to in the Code, then the Code could as well explicitly recognize other judicial doctrines. This group opposes both the codification of the economic substance doctrine and the imposition of any new penalty on economic substance cases. Specifically the group says: “...[I]nstead of attempting to codify the amorphous and flexible rules of the economic substance doctrine, if Congress believes that aggressive tax advisers and taxpayers in structuring transactions are not giving proper weight to that doctrine or to other common law principles, or that (contrary to our view) courts have been unduly hesitant to apply common law rules, consideration should be given to adding a code provision along the following lines: A literal application of any provision in this Title shall not be

Still, if economic substance as such is not explicitly stated as one of the grounds for disallowance of tax benefits, the application of the companion penalty provision may be in doubt.<sup>124</sup>

### **Judicial flexibility**

Some contend that, as to the economic substance doctrine itself, a codification with standards, plus the expression of legislative intent not to modify the scope of existing application, might inadvertently limit judicial flexibility so as to constrain the IRS from developing new case law that is more favorable to the IRS.<sup>125</sup> Likewise this codification might inadvertently constrain taxpayers from seeking to do the same in their own favor. It has been urged that a better approach simply would be to continue to rely on courts to determine what situations are within the interpreted intent of the statute without requiring a special, codified analysis in the case of one particular doctrine that might be applied.<sup>126</sup> On the other hand,

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respected if such application would produce results that are inappropriate under the economic substance, business purpose, sham transaction, step-transaction or other common law principles as developed and interpreted by the courts.” New York State Bar Association Tax Section Report No. 1032, “Summary Report on the Provisions of Recent Senate Bills that would Codify the Economic Substance Doctrine,” Doc 2003-12678, at p. 17 (May 21, 2003), 2003 TNT 102-19.

<sup>124</sup> The Administration’s proposal imposes a penalty on an understatement of tax attributable to a transaction that lacks economic substance. H.R. 2419 (sec. 12522) which passed in the Senate (and was identical to the economic substance provisions of S. 2242, sec. 512) similarly provides for a penalty if the taxpayer has an understatement due to a transaction that lacks economic substance. The legislative history to the S. 2242 penalty provision is a bit broader and states: “For this purpose, a transaction is one that lacks economic substance if it 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 court uses a different term to describe the doctrine.” S. Rep. No. 110-206, p. 100. The legislative language in House bills has been broader. H.R. 4351 (sec. 212) which passed in the House (and H.R. 3200, sec. 453 which has been considered favorably by three House Committees) provides for a penalty for failing to meet the economic substance doctrine or “failing to meet the requirements of any similar rule of law.”

<sup>125</sup> See, *Nomination of Pamela F. Olson, to be Assistant Secretary of the Treasury: Hearing Before the Committee on Finance, 107th Congress 12-13 (2002)* (statement of Pamela F. Olson) (“I think it is going to make [the doctrine] more wooden and less flexible than it currently is. If that happens, I think it has the potential for being both too broad and too narrow.”); “Economic Substance Codification Could Create Tax Shelter Problems, Korb Warns” 31 *BNA DER* G-8 (Feb. 15, 2008); American Bar Association Section of Taxation, “Proposed Codification of the Economic Substance Doctrine (Apr. 12, 2007) 2007 TNT 72-22, supplementing “S. 476, Proposed Codification of Economic Substance Doctrine” 2003 TNT 81-74; AICPA, Letter to Hill Tax-Writing Committees, “Codification of Economic Substance,” (Mar. 26, 2007) (“We firmly believe that codifying the economic substance doctrine would have a long-term, negative effect on both taxpayers and the government.”).

<sup>126</sup> See, e.g., Jasper L. Cummings, Jr., “‘Economic Substance’: Not Close Enough Even for Government Work” 134 *BNA DER* J-1 (July 16, 2009); Dennis J. Ventry, Jr., “Save the Economic Substance Doctrine from Congress,” 118 *Tax Notes* 1405 (March 31, 2008); New York State Bar Association Tax Section Report No. 1032, “Summary Report on the Provisions of Recent Senate Bills that would Codify the Economic Substance Doctrine,” Doc 2003-12678, at p. 17 (May 21, 2003), 2003 TNT 102-19; see also Scott A. Schumacher, “MacNiven v. Westmoreland and Tax Advice: Using ‘Purposive Textualism’ to Deal With Tax Shelters and Promote Legitimate Tax Advice,” 92 *Marquette L. Rev.* 33 (Fall 2008). But see Samuel C. Thompson and Robert Allen Clary II, “Coming in From the ‘Cold’: the Case for ESD Codification,” 99 *Tax Notes* 1270 (May 26, 2003).

proponents would contend that adoption of the proposal would reflect a Congressional intent to apply certain minimal standards when a particular doctrine is addressed.<sup>127</sup>

### **Implications of penalty**

The uncertainties regarding the scope of the codification proposal should be considered in connection with the penalty that is proposed to be applied to understatements of tax attributable to transactions that lack economic substance. The penalty is an important aspect of the overall proposal. It is understood that the penalty regime is intended to give economic substance factors greater weight in taxpayers' decision-making prior to entering transactions and prior to reporting transactions for tax purposes. By increasing the cost to taxpayers when a transaction is determined to lack economic substance, the codification and penalty regime intends to change the taxpayer's cost-benefit analysis and deter some aggressive taxpayer behavior. The penalty is discussed at greater length in the next section.<sup>128</sup>

### **Other rules**

The most recent economic substance legislation to pass one of the legislative bodies, H.R. 2419<sup>129</sup> (which incorporates the provisions of S. 2242<sup>130</sup>) and H.R. 4351,<sup>131</sup> provide additional rules under the codification definition that are not described in the Administration proposal.<sup>132</sup>

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<sup>127</sup> Froelich and Westmoreland, "Common Law vs. Rule of Law," 2005 *TNT* 25-44 (January 31, 2005); Lawrence M. Stone, Letter to House Ways and Means Chair William M. Thomas, "Congress Should Codify Economic Substance," 97 *Tax Notes* 967 (November 18, 2002); Thompson and Clary II, "Coming in from the 'Cold': The Case for ESD Codification," 99 *Tax Notes* 1270 (May 26, 2003); Stone, "Economic Substance Codification: Naysayers Can Help Make it Work," 100 *Tax Notes* 730 (August 4, 2003).

<sup>128</sup> See "Penalty for understatements attributable to transactions lacking economic substance," *infra*.

<sup>129</sup> As mentioned above, a version of this bill including the economic substance provisions was passed by the Senate. H.R. 2419 (Food and Energy Security Act of 2007), secs. 12521-12523, 110th Congress, (Engrossed Amendment as Accepted by the Senate on December 14, 2007).

<sup>130</sup> S. 2242 (Heartland, Habitat, Harvest and Horticulture Act of 2007), secs. 511- 513, 110th Congress, (Placed on Senate Calendar on October 25, 2007).

<sup>131</sup> This bill was passed by the House. H.R. 4351 (The AMT Relief Act of 2007), secs. 211-212, 110th Congress, (Passed by the House on December 12, 2007).

<sup>132</sup> The following are the most recent economic substance bills introduced (but not passed by either legislative body): H.R. 3200 (America's Affordable Health Choices Act of 2009), secs. 452-453, 111th Congress, (Ordered to be Reported by House Education and Labor Committee and House Ways and Means Committee on July 17, 2009 and by House Energy and Commerce Committee on July 31, 2009); H.R. 2979 (Responsible Fatherhood and Healthy Families Act of 2009), sec. 204, 111th Congress, (Referred to House Committee on Ways and Means on June 19, 2009); S. 1309 (Responsible Fatherhood and Healthy Families Act of 2009), secs. 202-204, 111th Congress, (Referred to Senate Committee on Finance on June 19, 2009); and S. 506 (Stop Tax Haven Abuse Act), secs. 401-403, 111th Congress, (Referred to the Senate Committee on Finance on March 2, 2009); H.R. 1265 (Stop Tax Haven Abuse Act), secs. 401-403, 111th Congress, (Referred to the House Subcommittee on Courts and Competition Policy on March 16, 2009). These bills include additional rules under the codification definition that are not described in the Administration proposal.

The Administration proposal grants Treasury broad regulatory authority to publish regulations to carry out the purposes of the proposal. It is possible that such regulations might address some of the issues below in the same or similar manner to previously proposed legislation. In light of the possibility that the proposal may be similar to the provisions in these bills, additional rules concerning financial accounting benefits, treatment of foreign taxes, treatment of tax benefits other than Federal tax benefits, and application to individuals are noted below.

### Financial accounting benefits

Recent legislation provides that a financial accounting benefit cannot be claimed as a business purpose if the benefit arises from a Federal tax benefit.<sup>133</sup> In some instances taxpayers have asserted that a financial accounting benefit resulting from claimed tax benefits is itself a valid business purpose for entering into a transaction.<sup>134</sup> Legislative history to S. 2242 observes that 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.<sup>135</sup>

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<sup>133</sup> The various bills use slightly different language. For example, H.R. 2419 (and S. 2242) and H.R. 1265 (and S. 506) provide that “a purpose of achieving a financial accounting benefit shall not be taken into account in determining whether a transaction has a substantial purpose (other than a Federal tax purpose) if the origin of such financial accounting benefit is a reduction of Federal tax.” H.R. 4351 provides that no financial accounting benefit is a valid business purpose for entering into a transaction “if such transaction results in a Federal income tax benefit.” H.R. 3200 provides language similar to H.R. 2419 but adds the word “income” to Federal income tax. H.R. 2979 (and S. 1309) also uses similar language to H.R. 2419 except the bill leaves out the word “Federal.”

<sup>134</sup> See 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 28, 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. See, also, *Schering-Plough Corporation v. United States*, No. 05-2575 (D.N.J. August 28, 2009), 2009 TNT 167-3).

<sup>135</sup> S. Rep. No. 110-206, at p 94, n. 139, quoting *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).

## Treatment of foreign taxes

H.R. 4351<sup>136</sup> requires that foreign taxes be treated as an expense in applying a profit test for economic substance determinations. By contrast, H.R. 2419 (and S. 2242)<sup>137</sup> treats foreign taxes as expenses to the extent provided in regulations.<sup>138</sup>

Proponents of treating foreign taxes as an expense argue that foreign taxes should be treated in the same manner as any other expense in calculating pre-tax profits for purposes of the economic substance test.<sup>139</sup> Under this view, although U.S. income taxes are ignored in determining pre-tax profit, no principle compels the same income tax treatment for foreign taxes. Moreover, while taxpayers may be indifferent between paying domestic or foreign taxes, so long as they pay only one, the U.S. government cares a great deal as to which is paid as, in many cases, the U.S. government may not receive any revenue when the taxpayer pays foreign taxes (due to the existence of the foreign tax credits). A transaction that does not show a profit after taking into account foreign taxes arguably demonstrates a U.S. tax motivation, so that the desired U.S. tax benefit should be denied.<sup>140</sup>

The IRS raised these arguments and asserted that foreign taxes should be treated as an expense in the *Compaq*<sup>141</sup> and *IES*<sup>142</sup> cases. Both of these cases involved taxpayers that purchased foreign stock interests (American Depository Receipts) immediately before the record date for payment of a dividend (for a price including the value of the dividend) and sold the interests immediately after the record date, claiming both a loss (because the sale price was reduced by the amount of the dividend) and a foreign tax credit for foreign withholding tax imposed on the dividend received. Although the lower courts agreed with the IRS, the courts of appeals rejected the IRS approach and found the transactions to have economic substance on the basis that the taxpayers earned a profit, determined without reduction for the withholding tax.<sup>143</sup>

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<sup>136</sup> H.R. 3200 and H.R. 2979 (and S. 1309) also require foreign taxes to be treated as an expense in applying a profit test.

<sup>137</sup> H.R. 2419 and H.R. 1265 (and S. 506) also treat foreign taxes as expenses to the extent provided in regulations.

<sup>138</sup> The legislative history to S. 2242 states: “There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law. However, the Treasury Department may, in addition, choose to require treatment of foreign taxes as expenses as provided in regulations.” S. Rep. No. 110-206, at p. 95, n. 141.

<sup>139</sup> See, e.g., Daniel N. Shaviro & David A. Weisbach, “The Fifth Circuit Gets It Wrong in *Compaq v. Commissioner*,” 94 *Tax Notes* 511 (2002).

<sup>140</sup> See, e.g., Chief Counsel Advice 20062022 (January 30, 2006).

<sup>141</sup> *Compaq Computer Corp. v. Commissioner*, 277 F. 2d 778 (5th Cir 2001).

<sup>142</sup> *IES Indus. Inc. v. United States*, 253 F. 3d 350 (8th Cir. 2001).

Subsequent to the years at issue in the *Compaq* and *IES* cases, Congress enacted section 901(k), which requires a 15-day holding period for entitlement to a foreign tax credit for withholding tax on a dividend.

Others argue that foreign taxes should be ignored in calculating pre-tax profits.<sup>144</sup> Under this view, such treatment is appropriate because foreign taxes are creditable and therefore replace U.S. income taxes, which are themselves ignored in determining pre-tax profit. To treat foreign taxes as an expense is incompatible with the basic structure of the U.S. foreign tax credit system and will thus often result in double taxation by denying taxpayers foreign tax credits. Moreover, the Code already provides extensive rules, under section 904, intended to ensure that foreign tax credits are used only to mitigate double taxation of foreign-source income and not to offset U.S. tax on U.S.-source income; the Code does not require a second such test. It is also argued that section 901(k) addressed the issue of short holding periods around a dividend record date, and that treating foreign taxes as an expense for purposes of applying the economic substance doctrine is a poor means of identifying other transactions in which foreign tax credits should be denied (for example, cases involving inappropriate splitting of foreign taxes from the associated foreign income).<sup>145</sup> If taxpayers are inappropriately obtaining foreign tax credits, amending section 904 or the other Code sections leading to the inappropriate results would be a more direct and effective method of addressing such issues.<sup>146</sup>

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<sup>143</sup> In each case, the taxpayer earned a profit before the withholding tax was taken into account, because the pre-tax amount of the dividend exceeded the taxpayer's loss on the sale of the stock and the transaction expenses. However, each taxpayer incurred an overall loss on the transaction, taking the withholding taxes into account.

<sup>144</sup> See, e.g., Section of Taxation, American Bar Association, *Comments on the Proposed Codification of the Economic Substance Doctrine* (Apr. 24, 2003), available at 2003 *TNT* 81-74; James M. Peaslee, Creditable Foreign Taxes and the Economic Substance Profit Test, 114 *Tax Notes* 443 (2007).

<sup>145</sup> See, e.g., David P. Hariton, "The *Compaq* Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong," 94 *Tax Notes* 501 (2002), Michael Schler, letter to the editor, 114 *Tax Notes* 707 (Feb. 12, 2007). Schler, however, suggests that if the economic substance doctrine is not intended to be applied in cases where tax benefits are "clearly contemplated by the language and purpose of the relevant authority," (and he suggests the proposed codification statute so state in addition to the proposed legislative history) then, as with other economic substance issues, the fact that disregarding a foreign tax credit may be appropriate in many cases does not make it necessarily so in all economic substance cases.

The debate over the treatment of foreign taxes has also referenced questions as to whether the potential for market prices to incorporate the availability (or non-availability) of tax benefits to different market participants should be part of an "economic substance" analysis, and questions as to whether the price benefits obtained in the *Compaq* and *IES* cases should be viewed as tax arbitrage or some other form of arbitrage. See, e.g., Michael Knoll, "Implicit Taxes and Pretax Profit in *Compaq* and *IES* Industries" 114 *Tax Notes* 679 (Feb. 12, 2007); Michael Schler, "Implicit Taxes and Economic Substance" (letter to the editor), 114 *Tax Notes* 959 (Mar. 5, 2007); William A. Klein and Kirk J. Stark, "*Compaq v. Commissioner—Where Is the Tax Arbitrage?*," 106 *Tax Notes* 1335 (March 7, 2002); David P. Hariton, "The *Compaq* Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong," 94 *Tax Notes* 501 (2002).

<sup>146</sup> The Administration proposal includes a separate matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

### Treatment of tax benefits other than Federal tax benefits

The recent legislation generally contains provisions addressing when a purpose of achieving a non-Federal tax benefit will not be considered sufficient to satisfy the tests if there is a similar Federal tax benefit.<sup>147</sup> Such provisions are intended to prevent a taxpayer from claiming that obtaining a State (or other non-Federal) tax benefit is a sufficient “non-Federal-tax” purpose to satisfy the codified economic substance doctrine, even though the results under the two laws are similar or related (as one example, if a State tax law follows the Federal tax law).

### Limited application to individuals

The recent legislation would apply the economic substance codification to an individual only if the underlying transaction was entered into in connection with a trade or business or an activity engaged in for the production of income.<sup>148</sup> To the extent a transaction is entered into by an individual in some other context, the specific codification in the Administration proposal would presumably not apply but the transaction could still be disregarded under the economic substance doctrine or some other common law doctrine.

### Prior Action

A proposal for the codification of the economic substance doctrine was included in the President’s fiscal year 2001 budget proposals. That proposal differed from the Administration proposal in a number of respects. For example, unlike the Administration proposal which would impose a conjunctive “two-prong” test, the prior proposal required that the present value of the reasonably expected pre-tax profit, after taking into account foreign taxes as expenses and transaction costs, not be insignificant compared to the present value of the reasonably expected net tax benefits. Additionally, the prior proposal provided rules for financing transactions.<sup>149</sup>

In addition to the Fiscal Year 2001 President’s budget proposal, numerous bills have been proposed containing provisions relating to the economic substance doctrine. As noted, the two

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<sup>147</sup> For example, S. 2242 (sec. 511) (and H.R. 2419, sec. 12521), and H.R. 1265 (sec. 401) state that the taxpayer shall not be treated as having a substantial purpose (other than a Federal tax purpose) if “the only such purpose is the reduction of non-Federal taxes and the transaction would result in a reduction of Federal taxes substantially equal to, or greater than, the reduction in non-Federal taxes because of similarities between the laws imposing the taxes.” HR 3200 (sec. 452) and HR 4351 (sec. 211) state that “for purposes of paragraph (1) [application of the doctrine] 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.” H.R. 2979 (and S. 1309) does not address this issue.

<sup>148</sup> The language is almost identical in each of the bills. For example, H.R. 2419 (sec. 12521) provides “[i]n the case of an individual, this subsection shall apply only to transactions entered into in connection with a trade or business or an activity engaged for the production of income. Similarly, H.R. 4351 (sec. 211) provides “[i]n 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 for the production of income.”

<sup>149</sup> Department of the Treasury, *General Explanation of the Administration’s Fiscal Year 2001 Revenue Proposals* (February 2000), at pp. 124-126.

most recent bills to pass one body of Congress (in the 110th) are H.R. 4351, which passed in the House on December 12, 2007, and H.R. 2419 (and which contains identical economic substance provisions as S. 2242), which passed in the Senate (in the form of an Engrossed Amendment) on December 14, 2007.<sup>150</sup>

## **2. 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. The penalty for underpayments attributable to these failures is generally 20 percent of the underpayment, but in the case of a gross valuation misstatement the penalty is 40 percent (as described below).

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<sup>150</sup> To date, in the 111th Congress there have been five bills introduced that include economic substance provisions (H.R. 1265 (and S. 506), H.R. 3200, and H.R. 2979 (and S. 1309)). None of these bills have been voted on by either the House or the Senate. However, the economic substance provisions of H.R. 3200 were adopted by the House Ways and Means Committee in a markup on July 16, 2009. These provisions are substantially identical to the provisions of H.R. 4351, which pass the House in 2007.

In the 109th Congress, three bills with economic substance provisions were passed by the Senate (H.R. 3 (Safe, Accountable, flexible, and Efficient Transportation Equity Act of 2005) (Engrossed Amendment as Agreed to by Senate on May 17, 2005), H.R. 4297 (Tax Relief Act of 2005) (Engrossed Amendment as Agreed to by Senate on February 2, 2006), and S. 2020 (Tax Relief Act of 2005) (Engrossed as Agreed to or Passed by Senate on November 18, 2005)). In the 108th Congress, six bills containing economic substance provisions passed in the Senate (H.R. 2 (Jobs and Growth Tax Relief Reconciliation Act of 2003) (Engrossed Amendment as Agreed to by Senate on May 15, 2003), H.R. 3550 (Safe, Accountable, Flexible and Efficient Transportation Equity Act of 2004) (Engrossed Amendment as Agreed to by Senate on May 19, 2004), H.R. 4520 (Jumpstart Our Business Strength (JOBS) Act) (Engrossed Amendment as Agreed to by Senate on July 15, 2004), S. 476 (CARE Act of 2003) (Passed in Senate on April 9, 2003), S. 1072 (Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2004) (Engrossed as Agreed to or Passed by Senate on February 12, 2004), and S. 1637 (Jumpstart Our Business Strength (JOBS)) (Engrossed as Agreed to or Passed by Senate on May 11, 2004)). No prior bills containing these types of economic substance provisions passed either body of Congress.

These prior bills from the 109th Congress and the 108th Congress generally contain a number of differences from H.R. 2419 (and S. 2242), and H.R. 4351. The principal differences follow. The previous bills: (1) require that if the taxpayer relied upon profit potential, the reasonably expected profit from the transaction must exceed a “risk-free” rate of return, (2) contain special rules relating to financings and certain other transactions involving tax-indifferent parties, (3) provide, or allow the Secretary to provide, special rules for leases of tangible personal property; (4) require that a transaction be a “reasonable means” of accomplishing the taxpayer’s non tax purpose, and (5) contain somewhat different procedural rules for the penalty, allowing only the IRS Commissioner personally to waive the penalty and not including any special procedures for assertion of the penalty. H.R. 2419 and these prior Senate bills specify that the rules are to be applied “when a court determines” that the economic substance doctrine is relevant. H.R. 4351 specifies that the rules apply “in the case of any transaction to which the economic substance doctrine is relevant.”



Under section 6662(d), a substantial understatement of income tax exists 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). The penalty is equal to 20 percent of the portion of underpayment of tax attributable to the understatement.<sup>151</sup>

Under section 6662(e), a substantial valuation misstatement exists if the value of any property (or the adjusted basis of any property) claimed on any return is 150 percent<sup>152</sup> or more of the amount determined to be the correct amount (and certain additional thresholds are met).<sup>153</sup> If the overstatement is 200 percent<sup>154</sup> rather than 150 percent of such amounts (and additional thresholds are met) then there is a gross valuation misstatement under section 6662(h).<sup>155</sup> The penalty for a substantial valuation misstatement is 20 percent of the portion of an underpayment attributable to such valuation misstatement. In the case of a gross valuation misstatement under section 6662(h), the penalty is 40 percent.

Except in the case of tax shelters,<sup>156</sup> the amount of any understatement of income tax under section 6662(d) 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 are adequately disclosed<sup>157</sup> 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 is inapplicable (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.<sup>158</sup> The relevant regulations for a tax shelter provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based

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<sup>151</sup> Sec. 6662.

<sup>152</sup> Prior to amendment in 2006, the threshold was 200 percent rather than 150 percent.

<sup>153</sup> Different thresholds apply in the case of certain misstatements of items under section 482, dealing with related-party transactions.

<sup>154</sup> Prior to amendment in 2006, the threshold was 400 percent rather than 200 percent.

<sup>155</sup> A different set of gross valuation thresholds applies in the case of certain misstatements under section 482.

<sup>156</sup> 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).

<sup>157</sup> Regulations provide guidance on the method and level of detail needed in order to be considered to have “adequately disclosed” for purposes of relief from the general accuracy related penalty. Treas. Reg. sec. 1.6662-4(f).

<sup>158</sup> Sec. 6664(c).

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.<sup>159</sup> 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.<sup>160</sup>

## **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 transaction, if a significant purpose of such transaction is the avoidance or evasion of Federal income tax (hereinafter referred to as a "reportable avoidance transaction").<sup>161</sup> The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed. This provision was enacted in 2004, along with provisions intended to improve the disclosure of positions taken by imposing penalties on failures to report "listed" or other reportable transactions, as well as requirements that promoters retain lists of investors.<sup>162</sup>

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 as required by the Secretary 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.<sup>163</sup> A listed transaction is defined as a reportable transaction which is

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<sup>159</sup> Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

<sup>160</sup> 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.

<sup>161</sup> Sec. 6662A(b)(2).

<sup>162</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1575 sec. 811 (2004).

<sup>163</sup> Sec. 6707A(c)(1).

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.<sup>164</sup>

### 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.<sup>165</sup> The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception provided under section 6664(d) (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,<sup>166</sup> 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.<sup>167</sup>

### 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.<sup>168</sup> 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.<sup>169</sup> 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.<sup>170</sup>

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 Securities and Exchange

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<sup>164</sup> Sec. 6707A(c)(2).

<sup>165</sup> Sec. 6662A(a).

<sup>166</sup> For reportable and listed transactions, “adequate disclosure” is not limited to the section 6662 standards discussed above. The form, content and timing of disclosure for these transactions is prescribed in detailed regulations at Treas. Reg. sec. 1.6011-4(d), *et seq.*

<sup>167</sup> 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”.

<sup>168</sup> Sec. 6662A(c).

<sup>169</sup> Sec. 6664(d).

<sup>170</sup> Sec. 6707A(d).

Commission (“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).<sup>171</sup>

#### 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);<sup>172</sup> 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.<sup>173</sup>

#### 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;<sup>174</sup> (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

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<sup>171</sup> Sec. 6707A(e).

<sup>172</sup> 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).

<sup>173</sup> Sec. 6662A(e)(3).

<sup>174</sup> See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

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.<sup>175</sup>

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<sup>176</sup> 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<sup>177</sup> 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.<sup>178</sup> 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

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<sup>175</sup> Sec. 6664(d).

<sup>176</sup> 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).

<sup>177</sup> 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.

<sup>178</sup> 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.

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, findings 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.<sup>179</sup>

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).

### Cases interpreting penalty provisions

In a number of cases, courts have upheld the applicability of penalties, including the 40-percent gross overvaluation penalty, for understatements attributable to transactions that were

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<sup>179</sup> Sec. 6676.

found to lack economic substance.<sup>180</sup> All of the cases decided to date have involved taxable years prior to the effective date of the 2004 enactment of section 6662A and the related disclosure provisions.

Many of these cases have involved factors such as a taxpayer that was believed to be sophisticated in tax matters;<sup>181</sup> an opinion that was from an attorney connected to the promotion or that disregarded facts believed to be known to the taxpayer;<sup>182</sup> a tax opinion that was questioned by other advisers;<sup>183</sup> and situations in which the IRS had previously specifically announced its disagreement with the tax outcome of the type of transaction.<sup>184</sup>

In other cases, however, no penalties have been applied. In some of these cases, the issue of penalties was not addressed.<sup>185</sup> In others, the court rejected the government's assertion of penalties, finding that the taxpayers had satisfied the reasonable cause and good faith defense by relying on an opinion of counsel.<sup>186</sup>

The courts of appeal for the Fifth and Ninth Circuits have concluded that the valuation overstatement penalties are not applicable to basis or corresponding deduction overstatements that result either from failures of economic substance or from other failures to meet the

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<sup>180</sup> *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd* 150 Fed. Appx. 40 (2nd Cir. 2005) (40 percent penalty for gross valuation understatement imposed; taxpayer did not have reasonable cause even if it had received an opinion of counsel, because taxpayer failed to show that opinion was based upon all pertinent facts and circumstances and did not unreasonably rely on statements that the taxpayer knew were unlikely to be true); *Maguire Partners-Master Investments, LLC v. United States*, 2009-1 USTC ¶50,215 (C.D. Cal. 2009) (40 percent gross valuation understatement penalty imposed in artificial "son of boss" basis step-up transaction involving partnership, even though taxpayer had opinion of counsel; the attorney was also the promoter and there was no showing that the partnership "diligently attempted to properly assess" the tax consequences; IRS had issued notice of its intent to challenge the transaction); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9, April 9, 2009 (40-percent gross valuation understatement penalty) .

<sup>181</sup> *Barranti v. United States*, 76 T.C.M. (CCH) 957 (1998).

<sup>182</sup> *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd* 150 Fed. Appx. 40 (2nd Cir. 2005)

<sup>183</sup> *Condor Int'l, Inc. v. Commissioner*, 78 F.3d 1355 (9th Cir. 1996), *aff'g* 98 T.C. 203 (1992).<sup>183</sup>

<sup>184</sup> *Maguire Partners-Master Investments, LLC v. United States*, 2009-1 USTC ¶50,215 (C.D. Cal. 2009). Although the cases predate the effective date of the strengthened reasonable cause exception under 6664(d), applicable to listed and certain other reportable transactions, a number of the decisions in effect involve transactions as to which the IRS had issued public notice of its intent to challenge, and the types of opinions involved contain elements that the 2004 legislation would disallow as well.

<sup>185</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 189 (1997), *cert. denied*, 526 U.S. 1017 (1999).

<sup>186</sup> See, e.g., *Southgate Master Fund, LLC v. United States*, No. 3:06-cv-2335-K, (N.D. Tex., August 18, 2009); *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).

requirements of the law that do not involve actual valuation disputes.<sup>187</sup> However, the courts of appeal for the Second, Third, Fourth, Sixth and Eighth Circuits, the Tax Court (when not constrained to follow a different rule of a circuit court to which a case is appealable),<sup>188</sup> and the Court of Federal Claims<sup>189</sup> have allowed the application of valuation overstatement penalties in such circumstances.<sup>190</sup>

In cases involving partnerships,<sup>191</sup> the Code provides rules for first determining the proper treatment of “partnership items”<sup>192</sup> in a single partnership proceeding,<sup>193</sup> followed by separate proceedings against each partner to determine “affected items.”<sup>194</sup> For tax years ending prior to August 5, 1997, penalties were generally considered to be “affected items,” properly determined at the partner level, and subject to the deficiency procedures.<sup>195</sup> For tax years ending

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<sup>187</sup> *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988); *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990); *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990); *Wiener v. United States*, 389 F.3d 152 (5th Cir. 2004); *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009).

<sup>188</sup> *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff’d* 445 F.2d 985 (10th Cir. 1981), held that the Tax Court is bound to follow the rule of the circuit to which a case is appealable, if the authority of the circuit is squarely on point.

<sup>189</sup> *Clearmeadow Investments LLC v. U.S.*, 2009-1 USTC ¶50,449 (Ct. Fed. Cl. 2009).

<sup>190</sup> *Illes v. Commissioner*, 982 F.2d 163 (6th Cir. 1992); *Massengill v. Commissioner*, 876 F.2d 616 (8th Cir. 1989); *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991); *Merino v. Commissioner*, 196 F.3d 147 (3d Cir. 1999); *Zfass v. Commissioner*, 118 F.3d 184 (4th Cir. 1997); *Petaluma FX Partners v. Commissioner*, 131 T.C. No. 9 (2008); see also *Clearmeadow Investments LLC v. United States*, 2009-1 USTC ¶50,449 (Ct. Fed. Cl. 2009); *Maguire Partners-Master Investments, LLC v. United States*, 2009-1 USTC ¶50,215 (C.D. Cal. 2009); *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9, (April 9, 2009). The Court of Federal Claims recently held that a taxpayer’s concession of an issue on the merits precluded the application of an overvaluation penalty. *Alpha I, LP v. United States*, 84 Fed. Cl. 622 (Ct. Fed. Cl. 2008), *rehearing denied*, 103 AFTR 2d 2009-1321 (Ct. Fed. Cl. 2009). However, the Court later allowed consideration of 20-percent negligence and substantial understatement penalties and defenses to such penalties in connection with the conceded issue. *Alpha I, L.P. v. United States*, No. 06-407 T, Opinion and Order on Action for Readjustment of Partnership Items, Effect of Concession on Defenses to Penalties (Ct. Fed. Cl., August 26, 2009). The Court denied the government’s motion to address certain additional issues in connection with such penalty proceedings. *Alpha I, L.P. v. United States*, No. 06-407 T, Order on Action for Readjustment of Partnership Items, Effect of Concession on Remaining Issues for Trial (Ct. Fed. Cl., August 26, 2009).

<sup>191</sup> Partnerships include all partnerships except any partnership having 10 or fewer partners each of whom is an individual, a C corporation, or an estate of a deceased partner (which did not elect to be included in the partnerships definition despite these characteristics). Sec. 6231(a)(B)(i).

<sup>192</sup> Any item required to be taken into account for the partnership’s taxable year that is more appropriately determined at the partnership level than at the partner level. Sec. 6231(a)(3).

<sup>193</sup> Sections 6221 through 6231, enacted under Section 402 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248 (96 Stat. 324), provide for unified audit and litigation procedures for determining the tax treatment of certain partnership items at the partnership level, rather than the partner level.

<sup>194</sup> Any item to the extent such item is affected by a partnership item. Sec. 6231(a)(5).

<sup>195</sup> Sec. 6320(a)(2).



on or after that date, penalties attributable to partnership items are subject to the partnership procedures.<sup>196</sup> In the partnership proceeding, only partnership level defenses may be presented. Courts have allowed reasonable cause defenses to be presented and, as noted above, have denied them and found penalties to be applicable in the partnership level proceeding in a number of cases.<sup>197</sup> Individual partners who wish to assert a separate reasonable cause and good faith defense to a penalty at the individual level must first pay the penalty and seek a refund.<sup>198</sup>

### **Description of Proposal**<sup>199</sup>

The proposal imposes a 30-percent penalty on an understatement of tax attributable to a transaction that lacks economic substance, reduced to 20 percent if there were adequate disclosure of the relevant facts in the taxpayer's return. The proposed penalty is imposed with regard to an understatement due to a transaction's lack of economic substance in lieu of other accuracy-related penalties that might be levied with respect to the tax understatement, although any understatement arising from a lack of economic substance would be taken into account in determining whether there is a substantial understatement of income tax under current law.

The IRS could assert and abate the new economic substance penalty. The IRS could assert the penalty even if there has not been a court determination that the economic substance doctrine was relevant. Any abatement of the economic substance penalty must be proportionate to the abatement of the underlying tax liability.

Effective date.—The proposal applies to transactions entered into after the date of enactment.

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<sup>196</sup> Sec. 6221 was amended in 1997, effective for tax years ending after August 5, 1997, to require that the applicability of any penalty or addition to tax be determined at the partnership level, in the same manner as any partnership item.

<sup>197</sup> See, e.g., *Petaluma FX Partners v. Commissioner*, 131 T.C. No. 9 (2008); *Clearmeadow Investments LLC v. United States*, 2009-1 USTC ¶50,449 (Ct. Fed. Cl. 2009); *Maguire Partners-Master Investments, LLC v. United States*, 2009-1 USTC ¶50,215 (C.D. Cal. 2009).

<sup>198</sup> Section 6230(a)(2) specifically exempts partner-level penalties and additions to tax from the deficiency procedures that would otherwise permit a taxpayer to seek pre-payment judicial review in Tax Court; *Tigers Eye Trading, LLC, et. al. v. Commissioner*, T.C. Memo. 2009-121.

<sup>199</sup> The description below appears in the Administration proposal at p. 26. Based on conversations with Treasury Department staff, this penalty proposal may be substantially similar to the provisions of H.R. 2419 which mirrors the economic substance provisions of S. 2242. For purposes of the estimated budgetary effects, the staff of the Joint Committee on Taxation has assumed this penalty proposal is the same as H.R. 2419 (and S. 2242). Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009* (JCX-28-09), June 11, 2009, at p. 5.

## Analysis

### Possible “strict liability” penalty

The proposed new penalty would apply to transactions that lack economic substance and could be abated only in proportion to the underlying tax liability. Based on prior similar proposals such as H.R. 2419 and S. 2242, it appears likely that the proposal would limit or prohibit the present law ability of taxpayers to assert defenses to the penalty on any ground, including reliance on a tax opinion.<sup>200</sup>

The purpose behind a strict liability penalty as proposed in prior similar bills is understood to be to change the calculus of taxpayers and their advisors in considering whether to enter a transaction or series of transactions, and in deciding what position to take on the tax return with respect to such transactions.

Proponents of similar proposals have argued that a strictly imposed penalty for cases that fail the economic substance doctrine, plus codification of the requirements of the doctrine, would deter certain aggressive tax shelter transactions by requiring practitioners and taxpayers to focus on the body of law that has disallowed tax benefits in cases lacking economic substance, and on the potential penalty downside if a case is lost.<sup>201</sup> It is argued that this approach might level the playing field between more aggressive and more conservative practitioners and their clients.<sup>202</sup> Proponents also contend that despite current IRS litigation successes, lack of IRS litigation resources may ultimately lead to settlements that are not sufficiently detrimental to the taxpayers to deter future activity.<sup>203</sup> Proponents contend that a new penalty that can be abated only in

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<sup>200</sup> As noted previously, for purposes of the estimated budgetary effects reported in JCX-28-09 at p. 5, the staff of the Joint Committee on Taxation has assumed the penalty proposal and the companion “economic substance” codification and interest disallowance proposals are the same as H.R. 2419 which mirrors S. 2242. The description of the proposal stated in the Administration proposal does not specifically state to what extent the penalty would be a “strict liability” penalty, not subject to defenses based on the personal intent or culpability of the taxpayer. The proposal merely states that the IRS can assert and abate the penalty without specifying standards. However, it is possible to conclude from the description that something akin to a strict liability penalty is intended, because the IRS is permitted to abate the penalty only in proportion to the abatement of underlying tax liability.

<sup>201</sup> Proponents point toward current law in which a taxpayer or a paid advisor may attempt to persuade a court that his position was reasonable, or at least reasonably held, based on an opinion from an adviser who concluded that there is “reasonable basis” for a position, “substantial authority” for a position, that the position is “more likely than not” to prevail, or even that the position “should” prevail. If the taxpayer loses the underlying tax issue in the case, penalty protection from the opinion could result in the taxpayer paying only the tax originally due plus interest at the deficiency rate (the Federal short term rate plus 3 percentage points under section 6621(a)(2)) which may be less than the cost of commercial borrowing. In that circumstance, the taxpayer is not worse off than if he had not taken the position (in the absence of a penalty making the loss more costly).

<sup>202</sup> See Statement of Samuel Thomson, Jr., before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (May 9, 2006).

<sup>203</sup> For example, the IRS settlement guidelines for so called “Sale In-Lease-Out (“SILO”))” transactions allow taxpayers to retain 20 percent of the claimed interest deductions and avoid penalties. IRS Releases Sample Letters for LILO, SILO Settlements, 2008 *TNT* 153-15. By contrast, in an earlier settlement initiative addressing so-called “Son of Boss” artificial basis enhancement transactions, the IRS offered more stringent terms, including penalties. Announcement 2004-46, 2004-21 I.R.B. 964. Some criticized this approach as failing to attract sufficient

proportion to the underlying tax liability related to the transaction would provide greater deterrence.<sup>204</sup>

Opponents contend that the uncertain scope of the proposed codification, when combined with the new penalty, may lead to increased taxpayer incentives to litigate and might even lead courts to be reluctant to find a lack of economic substance in certain situations, to avoid imposing the penalty.<sup>205</sup> Opponents argue that instead of leveling the playing field, cautious sophisticated taxpayers and their advisors will be able to avoid failure of the codified economic substance doctrine and the imposition of penalties, perhaps at the cost of avoiding some transactions that might have been successful without modification, or perhaps by adding sufficient economics and business purpose to pass muster under the rule. At the same time, less sophisticated or more aggressive parties may not be deterred. Some may contend that it is anomalous to impose a strict liability penalty on transactions that fail the newly codified economic substance test, but not on other transactions that fail the requirements of statute, regulations, or other interpretive or common law doctrines.

A rationale for imposing a strict liability rule in economic substance cases might be that it is often very difficult for the IRS to find and prove the economic reality of the transaction, while the taxpayer and advisors have more immediate access to the facts. For example, various economic substance cases in which the IRS has prevailed have turned upon extensive expert witness analyses regarding the operation of certain markets (such as foreign currency options markets) and the expected actions of parties such as a participant bank,<sup>206</sup> on discovered evidence analyzing profit potential or of understandings among the parties about future actions to

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voluntary taxpayer participation. Lee Sheppard, “Scorched Earth in Son-of-BOSS Cases,” 120 *Tax Notes* 9 (July 7, 2008), 2008 *TNT* 131-4.

<sup>204</sup> Proponents would cite the economic model which assumes that taxpayers calculate the risk attendant on the tax position under consideration and act in their perceived best interest. Accordingly, a strict liability penalty will force advisors to focus on the body of case law applying economic substance principles to disallow tax benefits and to advise their clients that, in the event the client’s position does not prevail, a penalty would apply. See Alex Raskolnikov, “Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty,” 106 *Colum. L. Rev.* 569, 576 (April 2006), adapting “Becker’s Model”, the economic model for a taxpayer would require a calculation of expected penalty,  $EP = NP \times PP$ , where  $EP$  = expected penalty,  $NP$  = nominal penalty, and  $PP$  = probable punishment.

<sup>205</sup> See David S. Miller, “An Alternative to Codification of the Economic Substance Doctrine,” 123 *Tax Notes* 747 (May 11, 2009) (footnote 10) citing: American Bar Association Section of Taxation, Comments on the Proposed Codification of the Economic Substance Doctrine (April 24, 2003), Doc 2003-10608, 2003 *TNT* 81-74 (“We oppose codification of the economic substance doctrine”); New York State Bar Association Tax Section Report No. 1032, “Summary Report on the Provisions of Recent Senate Bills that would Codify the Economic Substance Doctrine,” Doc 2003-12678, (May 21, 2003), 2003 *TNT* 102-19 (“We do not believe, however, that codifying the ‘economic substance doctrine’ will be an effective vehicle to combat the tax shelter problem”); “Economic Substance Codification Could Create Tax Shelter Problem, Korb Warns,” *BNA Daily Tax Report*, G-8 (Feb. 15, 2008) (“I am opposed to an inflexible administrative rule”); nomination of Olson, Hearing Before the Senate Finance Committee (Aug. 1, 2002), Doc. 2002-18361, 2002 *TNT* 154-27 (“I do not think codification of economic substance doctrine will help”).

<sup>206</sup> See, e.g., *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. No. 9, (April 9, 2009).

be taken,<sup>207</sup> or on evidence of the effect of non-tax aspects of law (such as whether a transfer of asbestos liabilities to a subsidiary effectively limits the transferor's liability or not), or of the taxpayer's belief regarding such aspects.<sup>208</sup> It is arguable that such structured transactions are appropriately subject to a strict liability penalty that cannot be avoided by the presence of a tax opinion.

Arguably, similar structured elements might exist in the cases that apply other common law doctrines as well. To the extent such doctrines overlap or intersect with the economic substance doctrine, the penalty would appear to apply under the proposal. However, there could be cases in which the economic substance doctrine is deemed satisfied, but the transaction fails to be respected solely for some other reason.

### **Procedural issues**

Some contend that strict liability penalties are inherently problematic and that those situations in which they appear in the Code have led to significant controversy and possibly to administrative and judicial reluctance to assert the underlying rule that would impose them.<sup>209</sup> To the extent that the result is a disparity between the penalty as described in the statute and as imposed in practice, there is a potentially negative effect on compliance due to perceived unfairness or ineffectiveness of the penalty.

The argument is that the courts and the IRS may be reluctant to assert the underlying rule that would impose the penalties due to the significant uncertainty regarding whether a particular position might fail the economic substance test, especially in light of the proposed statutory requirement that there be a significant non-Federal-tax purpose in order to satisfy the test if it is asserted. For example, it is argued that many well recognized tax planning choices (as one example, electing to be taxed as a corporation or as a partnership) may be pursued solely for Federal tax purposes, and the potential application of the penalty may improperly deter practitioners and taxpayers from well-recognized legitimate tax-saving steps. In addition, it is argued that in light of the penalty, IRS resources may be deflected to requests for clarification regarding its application, to the detriment of other anti-abuse projects.<sup>210</sup> Others contend that the economic substance doctrine has historically only been applied in circumstances that are unusual

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<sup>207</sup> See, e.g., Alvin C. Warren, Jr. "Understanding *Long Term Capital*" 106 *Tax Notes* 691 (Feb. 7, 2005).

<sup>208</sup> See, e.g., *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).

<sup>209</sup> See, e.g., AICPA, "Comments on Codifying Economic Substance to Hill Tax-Writing Committees" (Mar. 26, 2007); American Bar Association Section of Taxation, "S. 476, Proposed Codification of Economic Substance Doctrine" 2003 *TNT* 81-74 (April 24, 2003).

<sup>210</sup> *Ibid.*

or that clearly present a question of abuse, and that there is sufficient guidance as to when a transaction may run afoul of it.<sup>211</sup>

Some express a related concern that a “strict liability” penalty places too much power in the hands of IRS agents, who might assert (or threaten to assert) the penalty routinely or in inappropriate cases, as a bargaining chip for the taxpayer to yield on this issue or on another issue. However, the IRS manual indicates that such practices are against IRS policy.<sup>212</sup> If such practices nevertheless occurred, it could be argued that the IRS would face increased likelihood of taxpayer litigation and, if the taxpayer prevailed, a series of undesirable precedents. Thus, the IRS would have a strong incentive to impose coordinated controls and judgment as to when to assert the penalty. H.R. 2419 (and S. 2242)<sup>213</sup> imposes a number of procedural requirements on the IRS with respect to the assertion or abatement of the penalty, which are not explicitly specified in the Administration proposal.<sup>214</sup> Those rules include a requirement that the penalty could not be asserted without the personal approval of the IRS Chief Counsel or his delegate at the level of Chief Counsel branch chief. Once a penalty was asserted, the bill also provided that the penalty could not be abated except at the same levels. The requirements also afforded the taxpayer an opportunity to make a written submission opposing imposition of the penalty prior to its assertion. The purpose of these restrictions is understood to have been to provide taxpayers with certain procedural protections, and also to prevent inappropriate compromises of the penalty that might weaken its perceived impact.

These requirements of the specified levels of IRS approval were strongly opposed by the then Chief Counsel of the IRS, on grounds that such requirements could significantly delay the processing of cases and might deter agents from seeking to assert economic substance issues.<sup>215</sup> In light of the incentives described above for IRS to establish coordinated procedures and to

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<sup>211</sup> See Samuel C. Thompson Jr. and Robert Allen Clary II, “Coming in From the ‘Cold’: The Case for EDS Codification”, 99 *Tax Notes* 1270 (May 26, 2003). Even apart from any legislative proposal, the ABA has previously requested additional guidance following certain judicial decisions. See ABA Tax Section, “Recommendations for IRS 2007-08 Guidance Priority List” (June 18, 2007), requesting “guidance on the effect of *Coltec Industries, Inc. v. United States*, 454 F. 3d 1340 (Fed. Cir. 2006) on routine business transactions that involve additional restructuring in order to obtain more favorable tax consequences.” Compare 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”).

<sup>212</sup> The Internal Revenue Manual states that penalties are not a ‘bargaining point’ in resolving the taxpayer’s other tax adjustments. For listed transactions, the Manual has a special rule that requires full development of accuracy-related or fraud penalties in all cases where an underpayment of tax is attributable to a listed transaction (identified as such pursuant the regulations under section 6011). IRM ¶1.2.20.1.1 (Approved 06-29-2004) Policy Statement 20-1 (Formerly P-1-18).

<sup>213</sup> H.R. 1265 (and S. 506) contains these same requirements.

<sup>214</sup> H.R. 4351 and H.R. 3200 do not contain these procedural requirements. H.R. 2979 (and S. 1309) does not provide for penalties.

<sup>215</sup> See, e.g., Jeremiah Coder, “Korb Again Condemns Idea of Codifying Economic Substance” 2007 *TNT* 209-6 (Oct. 29, 2007). Chief Counsel Korb also opposed codification for other reasons.

avoid being drawn into litigation of weak cases, some may contend that such specific statutory restrictions are unnecessary.<sup>216</sup>

### **Potential effects on application of the “economic substance” doctrine**

It has been argued that a court faced with the requirement of a significant strict liability penalty might be reluctant to make such a finding, hence courts might apply the economic substance doctrine less frequently.<sup>217</sup> It is not clear what effect that would have on taxpayer behavior because even if courts proved unwilling to impose the penalty in some situations, such litigation results might not appear until years after enactment of the proposal.

On the other hand, proponents argue that taxpayers, their advisors, and courts might well discern the Congressional intent to impose a strict liability penalty on certain types of structured transactions, and respect the penalty accordingly.<sup>218</sup>

### **Amount and structure of penalty compared to other penalties**

The Administration proposal would make the 30-percent (or 20-percent in cases of adequate disclosure) penalty applicable to understatements of tax attributable to transactions in all cases involving failure of economic substance. This amount is the penalty amount that is applied under present law for violations of section 6662A with respect to certain reportable (including “listed”) transactions. This penalty amount would be less than the 40-percent gross valuation misstatement penalty that has been applied in a number of relatively recent present law economic substance cases (though greater than the 20-percent penalty that might be imposed for accuracy related understatements other than gross valuation misstatements).

The Administration proposal does not specify whether the penalty is to be imposed on the base used under section 6662A for reportable transactions (that is a tax base determined by multiplying the unreported amount by the maximum tax rate, without regard to other items on the return)<sup>219</sup> or whether it is to be imposed on the base used under section 6662 for other penalties<sup>220</sup> (generally, the actual tax due for the year).<sup>221</sup> However, the proposal is understood

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<sup>216</sup> Opponents might contend that any special procedures, even if not statutorily required, could still result in delay or in IRS reluctance to raise economic substance issues. Proponents might contend that it would be important for the IRS to develop and implement effective procedures if the proposal were enacted.

<sup>217</sup> Donald L. Korb, “The Economic Substance Doctrine in the Current Tax Shelter Environment” (January 25, 2005) reprinted at 2005 *TNT* 16-2.

<sup>218</sup> See statement of Samuel Thompson, Jr. before the subcommittee on Select Revenue Measures of the House Committee on Ways and Means (May 9, 2006): “The argument ... that the courts and IRS will be reluctant to impose the penalty seems to acknowledge that the ESD [economic substance doctrine] provision is likely to apply only in rare cases. Indeed, taxpayers and their advisers will have a tendency to avoid those transactions that might give rise to the penalty; again, the ESD provision would act as an appropriate speed bump.”

<sup>219</sup> This is the base used under H.R. 2419 (and S. 2242) and H.R. 1265 (and S. 506).

<sup>220</sup> This is the base used under H.R. 4351 and H.R. 3200.

to be adopting the section 6662A approach. Some may contend that the section 6662A approach is desirable to deter taxpayers from entering transactions. Others may contend that it is unfair to impose a penalty with respect to tax that is not in fact due.

Consideration might be given to whether the percentage amount and the computation base for penalties applicable to different types of transactions should be more consistent. Otherwise, as it stands now, penalties could vary significantly depending on whether a transaction is explicitly found to fail to satisfy (i) the requirements of the economic substance doctrine, (ii) the requirements of some other common law doctrine that is determined to be different than the economic substance doctrine, or (iii) the basic technical requirements of the statute. As one example, it is possible that a listed transaction subject to section 6662 would be subject to the new penalty regime if the transaction is found to fail the economic substance doctrine, but subject to the present law section 6662A penalty (and not the new penalty regime) if the transaction were deemed to satisfy the economic substance doctrine, but to fail some other common law doctrine, or if the economic substance doctrine were not explicitly addressed.

Opponents contend that the proposed provision is unnecessary because changes to the Code in 2004<sup>222</sup> impose new reporting requirements and penalties to assist the IRS in finding taxpayers that have engaged in certain “reportable” (including “listed”) transactions, and impose more strict “reasonable cause” requirements as to the type of opinion on which a taxpayer might rely in order to avoid penalties. It is argued that experience may show that these changes in the law are sufficient.<sup>223</sup>

Proponents would contend that the proposal adds to the IRS’s existing deterrence abilities, because the proposal applies not only to listed and other reportable transactions, but also to new or otherwise unknown transactions that the IRS has not yet identified. In addition, it might be argued that even with respect to “reportable” transactions, further deterrence is desirable because of the complexity of the proof required to challenge many highly structured transactions, and the possibility that lack of litigation resources may lead the IRS to settle for less than the full tax plus present law penalty even where favorable precedent exists.<sup>224</sup>

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<sup>221</sup> Certain adjustments are not permitted under section 6662.

<sup>222</sup> These changes are described under “present law” above. They include the establishment of a regime allowing IRS to identify “listed” and other “reportable” transactions; the imposition of a 30-percent penalty on listed and certain reportable transactions under section 6662A, and the “strengthened reasonable cause exception” applicable to penalties for such transactions under section 6664(d).

<sup>223</sup> See, e.g., American Bar Association Section of Taxation, “Pending Tax Legislation” 2005 *TNT* 114-22 (June 13, 2005).

<sup>224</sup> Also, there is little experience to date as to how the “strengthened reasonable cause” requirements will be applied to particular facts; for example, in what circumstances an opinion by an independent tax counsel (not related to the transaction) may be deemed to have satisfied the necessary requirements.

## Prior Action

The President's fiscal year 2001 budget proposal did not impose a strict liability penalty on the taxpayer, but rather imposed a strengthened substantial understatement penalty on certain corporate taxpayers for items attributable to a corporate tax shelter (a definition that incorporated the economic substance codification standards), imposed penalties on persons who furthered corporate tax shelters, and taxed the income of certain tax-indifferent parties.<sup>225</sup>

As noted, in 2007 the Senate passed H.R. 2419,<sup>226</sup> a bill that contains similar penalty provisions to the Administration's proposal, and the House passed, H.R. 4351,<sup>227</sup> a bill that contains similar penalty provisions to the Administration's proposal.<sup>228</sup> On July 16, 2009, the House Ways and Means Committee adopted provisions of H.R. 3200 that are substantially identical to the 2007 bill passed in the House.

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<sup>225</sup> Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals* (February 2000), at pp. 124-126.

<sup>226</sup> H.R. 2419 (sec. 12522); S. 2242 (sec. 512) mirrors the provisions of H.R. 2419; S. Rep 110-206 to S. 2242 pp. 88-101. S. 506, (introduced by Senator Levin on March 2, 2009) and H.R. 1265 (introduced by Mr. Doggett on March 3, 2009) contain provisions similar to the 2007 bill passed in the Senate. No further action has occurred on S. 506 or H.R. 1265 to date.

<sup>227</sup> H.R. 4351 (sec. 212); see Joint Committee on Taxation, *Technical Explanation of the "AMT Relief Act of 2007" as Introduced in the House of Representatives on December 11, 2007* (JCX-113-07), December 12, 2007.

<sup>228</sup> The differences between the 2007 bill passed in the Senate and the 2007 bill passed in the House include the following: (i) The bill passed in the Senate imposes a 30 percent penalty, while the bill passed in the House imposes a 40 percent penalty (both bills reduce the penalty to 20 percent if there is adequate disclosure); (ii) the bill passed in the Senate computes the penalty with respect to the amount of tax that would have been due if the increase in income that would have resulted due to the failure of economic substance were multiplied by the highest tax rate applicable to the type of taxpayer (e.g. corporate or individual). This is the method used in present law section 6662A. The bill passed in the House computes the penalty by reference to the actual reduction in tax after accounting for any increase in taxable income due to the failure of economic substance. This is the method used under present law section 6662 (iii) the bill passed in the Senate contains explicit procedural rules regarding IRS' ability to impose the penalty or compromise the penalty once imposed, (iv) the bill passed in the House applies the penalty to transactions that fail the requirements of the economic substance doctrine or of "any similar rule of law." The bill passed in the Senate refers only to failures of the economic substance doctrine.



### 3. Deny interest deduction for interest attributable to lack of economic substance

#### Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.<sup>229</sup> Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

#### Description of Proposal<sup>230</sup>

The proposal denies any deduction for interest attributable to an understatement of federal income tax arising from the application of the economic substance doctrine.

Effective date.—The proposal applies to transactions entered into after the date of enactment. The denial of interest deduction component would be effective for taxable years ending after the date of enactment with respect to transactions entered into after such date.

#### Analysis

The proposal would be in addition to the strict liability penalty that is also proposed for understatements attributable to the application of the economic substance doctrine. Arguably, denial of an interest deduction in situations where a deduction would otherwise be allowed is similar to a strict liability penalty, though computed in a different amount.

Imposing non-deductibility of interest as well as a penalty would have the effect of further increasing the amount the taxpayer must pay, based on the length of the time period during which the position has resulted in unpaid tax.

However, in some situations interest might not be due even though a penalty could still be imposed, if the taxpayer did not in fact have a deficiency for the year in question but nevertheless incurred an economic substance understatement on which a penalty could be applied. This could occur if the penalty base followed the model of section 6662A (discussed above), which computes the understatement for penalty purposes as the amount with respect to which the noneconomic substance position was taken, multiplied by the highest rate of tax. This could also occur to the extent the taxpayer paid tax pending the outcome of the case, in order to prevent the running of interest, or to the extent the taxpayer paid the tax and subsequently sought a refund that was denied.

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<sup>229</sup> Sec. 163(a).

<sup>230</sup> The description below appears in the Administration proposal at p. 26. Based on conversations with Treasury Department staff, this interest proposal may be substantially similar to the provisions of H.R. 2419 which mirrors the economic substance provisions of S. 2242. For purposes of the estimated budgetary effects, the staff of the Joint Committee on Taxation has assumed the interest disallowance proposal is the same as H.R. 2419 (and S. 2242). Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009* (JCX-28-09), June 11, 2009, at p. 5.

### **Prior Action**

Prior budget proposals did not include a similar provision limiting the deduction for interest expenses. However, in 2007 the Senate passed H.R. 2419, a bill that contains similar interest expense disallowance provisions to the Administration's proposal.<sup>231</sup> The most recent House-passed bill addressing economic substance, H.R. 4351, did not contain an interest expense disallowance provision, nor did the provisions of H.R. 3200 adopted by the House Ways and Means Committee in markup on July 16, 2009.

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<sup>231</sup> H.R. 2419 (sec. 12523); S. 2242 (sec. 513); S. Rep No. 110-206, at pp. 88-101. H.R. 1265 (and S. 506), introduced in the 111th Congress, contains denial of interest deduction provisions similar to H.R. 2419.

## **B. Repeal Last-In, First-Out Inventory Method of Accounting**

### **Present Law**

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.<sup>232</sup>

#### **In general**

Under the last-in, first-out (“LIFO”) method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs. Compared to FIFO, LIFO produces net income which more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory is generally not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which sales exceed purchases.<sup>233</sup>

#### **Dollar-value LIFO**

Under a variation of the LIFO method, known as dollar-value LIFO, inventory is measured not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the “pooling” of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer’s method for defining an item, LIFO can be applied to a taxpayer’s entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

#### **Simplified rules for certain small businesses**

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.<sup>234</sup> In doing so, the Congress acknowledged that the LIFO method is generally considered to be an advantageous method of accounting, and that the complexity and greater cost

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<sup>232</sup> Sec. 471(a) and Treas. Regs. sec. 1.471-1.

<sup>233</sup> When sales exceed purchases, the business must treat a portion of its beginning inventory as having been sold. This results, to some extent, in recognition of previously deferred gain and is generally referred to as a LIFO liquidation.

<sup>234</sup> Sec. 474(a).

of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.<sup>235</sup>

To qualify for the simplified method, a taxpayer must have average annual gross receipts of \$5 million or less for the three preceding taxable years.<sup>236</sup> Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

#### Special rules for qualified liquidations of LIFO inventories

In general, assuming rising prices, taxpayers using LIFO have an incentive to maintain or build inventory levels rather than allowing them to fall. So long as inventory levels are steady or growing the taxpayer never is deemed to have sold any of its older, lower-cost inventory, and inflationary gain is deferred indefinitely. However, in a period in which the inventory level falls, the taxpayer necessarily will (absent a special rule) be deemed to have sold some units purchased in a prior period, and the inflationary gain in those periods will be recognized in taxable income.<sup>237</sup>

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 of the Code mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

#### **Description of Proposal**

The proposal repeals the LIFO inventory accounting method. Taxpayers that currently use LIFO would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. The resulting increase in income is taken into account ratably over eight taxable years beginning with the first taxable year the taxpayer is required to use FIFO.

Effective date.—The proposal is effective for taxable years beginning after December 31, 2011.

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<sup>235</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)*, (JCS-10-87), May 4, 1987, p. 482.

<sup>236</sup> Sec. 474(c).

<sup>237</sup> By contrast, inflationary gain is generally recognized in earlier periods under the FIFO method, so taxpayers using FIFO do not have a similar incentive to maintain or build inventory levels.

## Analysis

Proponents of the LIFO method argue that in periods of rising costs, the method provides the most accurate reflection of current-period income because it matches current costs against current sales revenues. They point out that the taxpayer will have to replace the inventory to continue in business and that by including the most recent additions to the inventory in cost of goods sold, the required cost of replacing the inventory is more closely projected.<sup>238</sup>

Alternatively, proponents of the FIFO method argue that LIFO permits deferral of inflationary gains in a taxpayer's inventory even when those gains arguably have been realized by the business. They note that outside of the inventory context, inflationary gains are generally taxed when the gain is realized (i.e., upon sale of the appreciated asset). They further assert that the use of earlier acquired items to value ending inventory understates net worth in times of rising prices resulting in an understatement of the income that measures the change in net worth for a given period.<sup>239</sup>

Proponents of FIFO also argue that a business whose inventory turns over with regularity during a taxable year should not value inventory as if it includes items purchased many years ago, as may frequently be the case under LIFO. However, LIFO advocates counter that, although there may be inventory turnover, it is highly unlikely that there is a time when there are no units in inventory. They view this perpetual inventory layer as a required condition of doing business and best valued at the time the layer was established, which is accomplished under LIFO. Thus, supporters of LIFO argue that during inflationary periods, using LIFO improves cash flow, thereby facilitating a business's use of retained capital to finance its physical inventory levels. In this respect, they note that LIFO functions much like accelerated depreciation for capital investment in productive machinery and equipment.<sup>240</sup>

Commentators contend that LIFO and, more specifically dollar-value LIFO (the most commonly used method of valuing inventory under LIFO), does not simply isolate changes in

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<sup>238</sup> See, e.g., LIFO Coalition letter to Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 *TNT* 125-18), wherein author Leslie J. Schneider explains that, "If a business is faced with the situation that, because of inflation, each time that it sells any item from its inventory, it must expend a larger amount of capital than the FIFO cost of the item to simply replace the item of inventory that has been sold, the business would continually be required to increase its capital investment in inventory to simply maintain the status quo. Presumably, this increased capital investment would ordinarily be financed from the proceeds of the sale of the inventory, but if that profit were taxed on a FIFO basis, the after-tax proceeds from the sale of the inventory would in many cases not be sufficient to finance the acquisition of the necessary replacement inventory."

<sup>239</sup> Commentators favoring FIFO have also noted that since ending inventory under LIFO can be controlled through the purchase of additional units at year-end, LIFO is susceptible to manipulation after most of the results for the year are known to the taxpayer. See George A. Plesko testimony at the June 13, 2006 Senate Finance Committee hearing on LIFO. However, proponents of LIFO point out that court decisions and Internal Revenue Service rulings effectively preclude taxpayers from acquiring unneeded inventory at year end to avoid liquidation of low-cost LIFO layers. See 2006 *TNT* 125-18.

<sup>240</sup> LIFO Coalition letter to Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 *TNT* 125-18). See also Alan D. Viard, "Why LIFO Repeal is Not the Way to Go," 2006 *TNT* 215-30.

inventory cost resulting from inflation, but includes increases and decreases due to other factors outside of normal inflation such as supply/demand imbalances and technological changes.<sup>241</sup> These commentators also note that a taxpayer's definition of an "item" for purposes of establishing its dollar-value LIFO pools can result in changes to inventory costs that are not attributable solely to inflation.<sup>242</sup> For example, a broad item definition generally results in fewer pools lessening the likelihood of that a previously established LIFO layer will be liquidated and thereby increasing the likelihood that such lower costs will remain in the taxpayer's ending inventory rather than flowing through cost of goods sold.

Supporters of LIFO have also pointed out the potential adverse economic effects of the recapture of the LIFO reserve, especially for those businesses that have used LIFO for decades. The tax imposed on the recapture of the reserve, even where the recapture is spread over a period of years (e.g., eight as is currently proposed), could be substantial, and could severely restrict the ability of such taxpayers to invest in capital, including maintaining their current physical inventory levels.

Recent discussion has surrounded the potential required use of international financial reporting standards ("IFRS") under which LIFO is not a permitted method of accounting.<sup>243</sup> The Securities and Exchange Commission has proposed the full adoption of IFRS by large U.S. companies by 2014.<sup>244</sup> The seemingly inevitable shift from Generally Accepted Accounting Principles ("GAAP") to IFRS raises the issue of whether companies will be able to continue using LIFO for tax purposes in light of the conformity requirement.<sup>245</sup>

### **Prior Action**

No prior action.<sup>246</sup>

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<sup>241</sup> See Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, "Is it Time to Liquidate LIFO?," 2006 *TNT* 200-39.

<sup>242</sup> *Ibid.*

<sup>243</sup> International Accounting Standards Board, International Accounting Standard (IAS) No. 2, *Inventories*, (rev. 2003).

<sup>244</sup> RIN 3235-AJ93, 73 Fed. Reg. 70816 (November 21, 2008).

<sup>245</sup> Some commentators have noted that the conformity requirement is a requirement "in form only" because changes to the regulations allowing alternative inventory valuations be disclosed in the financial statements provided the face of the income statement reflects LIFO. See Michael J. R. Hofman and Karen S. McKenzie, "Must LIFO Go to Make Way for IFRS?," *The Tax Adviser*, March 2009.

<sup>246</sup> A proposal to repeal LIFO was included in H.R. 3970 (introduced October 25, 2007).

## C. Deny Deduction for Punitive Damages

### Present Law

A deduction is allowed for all ordinary and necessary expenses paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.<sup>247</sup> A deduction is not allowed, however, for any payment made to an official of any government or governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.<sup>248</sup> In addition, no deduction is allowed for any fine or similar payment made to a government for violation of any law.<sup>249</sup> Finally, no deduction is allowed for two-thirds of the damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.<sup>250</sup>

In general, gross income does not include amounts received on account of personal injuries or sickness.<sup>251</sup> This exclusion generally does not apply to punitive damages.<sup>252</sup>

### Description of Proposal

The proposal repeals the deduction for punitive damages paid or incurred as a judgment or in settlement of a claim. If a liability for punitive damages is covered by insurance, any such damages paid by the insurer would be included in gross income of the insured person, and the insurer would be required to report such amounts to both the insured person and the Internal Revenue Service.

Effective date.—The proposal is effective for amounts paid or incurred after the date of enactment.

### Analysis

Proponents of the proposal argue that allowance of a tax deduction for punitive damages undermines the role of punitive damages in discouraging and penalizing the activities or actions for which the punitive damages were imposed.<sup>253</sup> Thus, proponents argue that punitive damages

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<sup>247</sup> Sec. 162(a).

<sup>248</sup> Sec. 162(c).

<sup>249</sup> Sec. 162(f).

<sup>250</sup> Sec. 162(g).

<sup>251</sup> Sec. 104(a).

<sup>252</sup> Pub. L. No. 104-188; *K.M. O’Gilvie v. United States*, 519 U.S. 79 (1996).

<sup>253</sup> Kimberly A. Pace, “The Tax Deductibility of Punitive Damages: Who Should Ultimately Bear the Burden of Corporate Misconduct?” 47 *Ala. L. Rev.* 826, 863-861(1968).

should not be deducted as a matter of public policy.<sup>254</sup> Further, advocates of this view note that the determination of the amount of punitive damages generally can be made by reference to pleadings filed with a court and such determination is already made by plaintiffs in determining the portion of any payment that is taxable.

Opponents of the proposal argue that a deduction should be allowed for all ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business in order to properly measure the income of the taxpayer. They argue that disallowance of punitive damages would result in the taxpayer paying taxes on amounts in excess of his income, essentially imposing an additional direct federal fine.<sup>255</sup> Opponents also note that determining the amount of any punitive damages will be difficult in many cases, especially where the payment arises from the settlement of a claim.<sup>256</sup> A similar issue arises in cases where compensatory damages are too difficult or too costly to adequately calculate with the result that the punitive damages may have a compensatory element.<sup>257</sup>

Others question whether punitive damages serve as a deterrent and, therefore, whether the disallowance of a deduction would approximate the optimal penalties to deter certain behaviors in the most efficient manner.<sup>258</sup> Moreover, some question whether reliance on the federal tax system to influence societal objectives is more efficient than non-tax legislative or regulatory actions or market forces.<sup>259</sup>

### **Prior Action**

Substantially identical proposals were included in the President's fiscal years 2000 and 2001 budget proposals.

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<sup>254</sup> *Ibid.* See also Catherine M. Del Castillo, "Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine," *Texas Law Review* vol. 68, p. 838, 1990.

<sup>255</sup> Eric M. Zolt, "Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions," *University of California Los Angeles Law Review* vol. 37, p. 351, 1989.

<sup>256</sup> W. Kip Viscusi, "The Challenge of Punitive Damages Mathematics," *Journal of Legal Studies* vol. 30, pp. 342-43, 2001.

<sup>257</sup> Robert W. Wood, "Why Punitive Damages Should Remain Deductible," *Tax Notes* vol. 124, p. 149, July 13, 2009.

<sup>258</sup> Zolt, *supra* at 360-374.

<sup>259</sup> The New York State Bar Association Tax Section, "The Deductibility of Punitive Damages," 2001 *TNT* 213-21 (November 26, 2001).



## D. Repeal the Lower of Cost or Market Inventory Accounting Method

### Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in, first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in, last-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under the cost method or the "lower of cost or market" ("LCM") method.<sup>260</sup> Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Additionally, "subnormal goods", defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to net selling price, under either the cost or LCM method.

Retailers and wholesalers may use the "retail method" to determine ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at year-end is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at year-end by a fraction, the numerator of which is the cost of goods available for sale during the year, and the denominator of which is the total retail selling prices of the goods available for sale during the year, adjusted for mark-ups and mark-downs.<sup>261</sup> Under certain conditions, a taxpayer using the FIFO method may determine the approximate cost or market of inventory by not taking into account retail price mark-downs for the goods available for sale during the year, even though such mark-downs are reflected in the retail selling prices of the goods on hand at year end.<sup>262</sup> As a result, such taxpayer may write down the value of inventory below its market value.

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<sup>260</sup> Treas. Reg. sec. 1.471-2(c).

<sup>261</sup> Treas. Reg. sec. 1.471-8(a).

<sup>262</sup> Treas. Reg. sec. 1.471-8(d).

## **Description of Proposal**

The proposal repeals the LCM method and the write down for subnormal goods. Appropriate wash-sale rules would be provided to prevent taxpayers from circumventing the prohibition. In addition, under the proposal, a taxpayer is allowed to use the retail method for tax purposes only if it uses such method for financial accounting purposes. The proposal is treated as a change in method of accounting with any resulting section 481(a) adjustment taken into income ratably over four taxable years beginning with the year of change.

Effective date.—The proposal is effective for taxable years beginning after 12 months from the date of enactment.

## **Analysis**

Under present law, income or loss generally is not recognized until it is realized. In the case of a taxpayer that sells goods, income or loss generally is realized and recognized when the goods are sold or exchanged. The LCM method and the write down for subnormal goods under present law represent exceptions to the realization principle by allowing the recognition of losses without a sale or exchange.

Nonetheless, the LCM method and the write down for subnormal goods have long been accepted as in accordance with generally accepted accounting principles (“GAAP”) used in the preparation of financial statements and have been allowed by Treasury regulations for tax purposes since 1918. However, the mechanics of the tax rules differ from the financial accounting rules resulting. Moreover, the conservatism principle of GAAP generally requires the use of the LCM method and the write down of subnormal goods so the inventory reflected on a company’s balance sheet is not overstated relative to realizable values. There is no similar principle under Federal income tax law.

Similarly, the retail method has been allowed by Treasury regulations for tax purposes since 1920 and is a permitted method under GAAP. Also similar to the LCM method and the write down for subnormal goods, the retail method allows retailers and wholesalers to recognize a deduction for the decline in value of inventory due to normal and anticipated declines in retail price without a sale or exchange.

## **Prior Action**

A similar proposal for the repeal of the LCM method and subnormal goods write down was included in the President’s fiscal years 1997, 1998, 1999, 2000, and 2001 budget proposals.

## E. Modify Alternative Fuel Mixture Credit

### Present Law

The Code provides two excise tax credits with respect to alternative fuel that are calculated on a per-gallon basis, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term “alternative fuel” means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process (“coal-to-liquids”), compressed or liquified gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after September 30, 2009, through December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 50 percent of such facility’s total carbon dioxide emissions. The sequestration percentage increases to 75 percent for fuel produced after December 30, 2009.

The alternative fuel credit is allowed against the excise tax imposed under section 4041, and the alternative fuel mixture credit is allowed against the excise tax imposed under section 4081. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents<sup>263</sup> of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation, or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An “alternative fuel mixture” is a mixture of alternative fuel and taxable fuel that contains at least 1/10 of one percent taxable fuel.<sup>264</sup> The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits generally expire after December 31, 2009.

A person may file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after December 31, 2009. With respect to liquefied hydrogen, the credit and payment provisions expire after September 30, 2014. The alternative fuel credit and alternative fuel mixture credit must first be applied to excise tax liability for special and alternative fuels, and any excess credit may be taken as a payment.

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<sup>263</sup> “Gasoline gallon equivalent” means, with respect to any nonliquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

<sup>264</sup> See Internal Revenue Service, Notice 2006-92, *Alternative Fuel, Alternative Fuel Mixtures; Blood Collector Organizations*, 2006-43 I.R.B. 774 (October 23, 2006).

## Description of Proposal

For purposes of the alternative fuel mixture credit and payment provisions, the proposal limits the credit for mixtures containing alternative fuel derived from the processing of paper or pulp to mixtures that are sold for use or used as a fuel in a motor vehicle or motorboat. Accordingly, black liquor mixtures used as a fuel in paper processing would no longer be eligible for the credit.

Effective date.—The proposal is effective for fuel sold or used after the date of enactment.

## Analysis

The Safe, Accountable, Flexible, Transportation Equity Act: A Legacy for Users (“SAFETEA-LU”) was enacted in 2005 to reauthorize the Highway Trust Fund programs, among other purposes.<sup>265</sup> SAFETEA-LU created the alternative fuel credit and the alternative fuel mixture credit. The credits are structured in a form similar to the credits for ethanol and other alcohol fuels,<sup>266</sup> a credit for the use of “neat” fuel in a motor vehicle, and a credit for gallons of alternative fuel mixed with a transportation fuel (gasoline, diesel fuel and kerosene).<sup>267</sup> While the statute requires that the alternative fuel be mixed with a transportation fuel, it does not require that the fuel only be used for road use. The conference report for SAFETEA-LU included the following footnote, indicating that fuel mixtures could be used in stationary fuel sources:<sup>268</sup>

For example, the taxpayer produced fish oil in its trade or business. The taxpayer uses this fish oil to make a blend of 50 percent fish oil and 50 percent diesel fuel to run in a generator that is part of the taxpayer’s trade or business. This use of the fish oil-diesel blend made by the taxpayer qualifies as use of an alternative fuel mixture for purposes of the requirement that the fuel be used in the blender’s trade or business.

The use of “fish oil” in the footnote above indicates that Congress intended fish oil blends to qualify for the credit. SAFETEA-LU provided a credit for “liquid hydrocarbons derived from biomass.” After the legislation was passed, an issue arose as to whether a “hydrocarbon” could include elements other than hydrogen and carbon. Fish oil also contains oxygen. Concerned that fish oil would not qualify for the credit because it was not made up exclusively hydrogen and carbon, Congress enacted a technical correction to ensure that fish oil qualified. The 2007 legislation changed “liquid hydrocarbon” to “liquid fuel” to conform the

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<sup>265</sup> Pub. L. No. 109-59 (2005).

<sup>266</sup> See secs. 40(b), 6426(b), and 6427(e)(1) .

<sup>267</sup> See secs. 6426(d), 6426(e), and 6427(e)(1) and 6427(e)(2).

<sup>268</sup> H.R. Conf. Rep. No. 109-203 (2005) at 1121, footnote 36.

statute to the legislative intent of the 2005 provision as set forth in the footnote above. The explanation of the provision provides as follows:<sup>269</sup>

Definition of alternative fuel (Act sec. 11113).—Code section 6426(d)(2) defines alternative fuel to include “liquid hydrocarbons from biomass” for purposes of the alternative fuel excise tax credit and payment provisions under sections 6426 and 6427. The statute does not define liquid hydrocarbons, which has led to questions as to whether it is permissible for such a fuel to contain other elements, such as oxygen, or whether the fuel must consist exclusively of hydrogen and carbon. It was intended that biomass fuels such as fish oil, which is not exclusively made of hydrogen and carbon, qualify for the credit. The provision changes the reference in section 6426 from “liquid hydrocarbons” to “liquid fuel” for purposes of the alternative fuel excise tax credit and payment provisions.

A person can obtain a cash payment from the Treasury equal to the amount of the alternative fuel credit and alternative fuel mixture credit, if there is insufficient excise tax liability to offset the credit. The alternative fuel mixture credit is 50 cents per gallon. In 2005, the entire alternative fuel provision was estimated to generate revenue losses of \$265 million over five years and \$44 million over ten years.<sup>270</sup> For the first six months of 2009, and just for liquid fuel derived from biomass, more than \$2.5 billion in cash payments has been claimed. The bulk of that \$2.5 billion is attributable to paper manufacturers using “black liquor” and a small quantity of diesel fuel in their boilers (a stationary fuel use). Because the paper manufacturers have no excise tax liability, they receive the full amount of the claim as a cash payment from the Treasury.

The kraft process for making paper produces a byproduct called black liquor. It is composed of lignin and chemicals used to break down the wood. The amount of the biomass in black liquor varies. The black liquor is then used as a fuel source for the paper mills and what is not consumed is recycled back into the papermaking process. The use of black liquor as a fuel by paper manufacturers is a decades-long practice.

Because of the longstanding use of black liquor as a fuel by the paper industry, some contend that payments to the paper manufacturers are a windfall, and, but for the ability to obtain the alternative fuel mixture credit in the form of a cash payment, the paper industry would not be adding diesel fuel to black liquor and would not be claiming the credit. Others argue that small

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<sup>269</sup> Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2007, as Passed by the House of Representatives* (JCX-119-07) December 18, 2007, pp. 6-7. On the floor of the Senate, Senator Baucus made the following statement regarding JCX-119-07: “Mr. President, in connection with H.R. 4839, the Tax Technical Corrections Act of 2007, the nonpartisan Joint Committee on Taxation is making available a public document that contains a technical explanation of the bill. This technical explanation expresses the Senate Finance Committee’s understanding of the tax and other provisions of the bill and serves as a useful reference in understanding the legislative intent behind this important legislation.” 110 *Congressional Record* S16056 (December 19, 2007).

<sup>270</sup> Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for Title XI of H.R. 3, “Highway Reauthorization and Excise Tax Simplification”* (JCX-61-05), July 29, 2005, p. 1.

amounts of fossil fuel are needed for fuel stabilization and that the use of diesel fuel in the process (instead of other petroleum-based fuels) has made paper manufacturing emissions cleaner.

Opponents of the eligibility of black liquor for the alternative fuel mixture credit assert that the payments do not reduce the nation's dependence on fossil fuels, because the paper manufacturers are being rewarded for simply continuing a practice they have engaged in for more than 70 years.<sup>271</sup> Some argue that the incentive should not be available to firms that would have undertaken the activity regardless of the subsidy, making the incentive highly inefficient in terms of reducing fossil fuel consumption.<sup>272</sup>

Others note that the Code provides other incentives for the use of black liquor. The burning of black liquor to generate electricity sold to a third party is eligible for a non-refundable income tax credit for renewable electricity under section 45 of the Code. However, unlike section 45, the alternative fuel credit and payment provisions do not require sale to a third party.

Further, questions have been raised as to whether the payments represent an unfair trade subsidy in violation of the North American Free Trade Agreement. The Canadian view is the alternative fuel payments are a U.S. government subsidy to their U.S. competitors of which they cannot partake.<sup>273</sup>

According to the American Forest and Paper Association, the paper industry employs one million workers and generates six percent of U.S. manufacturing GDP.<sup>274</sup> Those supportive of the continued eligibility of black liquor for the alternative fuel payments assert that the payments have been vital to the financial well-being of the paper manufacturers, allowing them to avoid employee layoffs. Opponents note that unlike an express appropriation, these payments to stem job losses were not contemplated by Congress. Further, the amounts being claimed are far greater than those contemplated at the time the provision was enacted, costing billions of dollars to the U.S. Treasury when resources are constrained.

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<sup>271</sup> Recent alternative fuel mixture claims for the burning of black liquor (a byproduct of the manufacturing of pulp and paper) and diesel fuel in recovery boilers have highlighted the fact that the fuel mixture credits are not limited to transportation uses, and that there is no upper limit on the dollar amount that may be claimed. See International Paper, *News Release: International Paper Provides Update on Alternative Fuel Credits* (March 24, 2009); Steve Mufson, *Washington Post*, "Papermakers Dig Deep in Highway Bill to Hit Gold" (March 28, 2009 at p. D.1); Rebecca Penty, *New Brunswick Business Journal*, *Canada at a Disadvantage: Forestry Industry Contends Credits are Subsidies that Allow U.S. Firms to Better Compete* (April 3, 2009 at p. B.1); and Jad Mouawad and Clifford Krauss, *The New York Times*, "Lawmakers May Limit Paper Mills' Windfall" (April 18, 2009).

<sup>272</sup> Gilbert Metcalf, *Statement of Gilbert Metcalf, Technology Neutrality in Energy Tax: Issues and Options before the Committee on Finance, U.S. Senate* (April 23, 2009) at 10.

<sup>273</sup> *Wall Street Journal*, "Black Liquor War" (June 29, 2009) at A12 (noting that Canada has enacted its own subsidy in response).

<sup>274</sup> Scott Milburn, American Forest and Paper Association, *News Release: AF&PA Statement on Alternative Fuel Mixture Tax Credit "Staff Draft"* (June 11, 2009).

## Prior Action

No prior action.<sup>275</sup>

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<sup>275</sup> On June 11, 2009, the staff of the Senate Finance Committee put forth a discussion draft to exclude black liquor from the alternative fuel credit and payment provisions. See, Committee on Finance, United States Senate, *News Release: Baucus, Grassley Release Staff Draft of Legislation to Close Alternative Fuels Tax Credit Loophole* (June 11, 2009).

### III. OIL AND GAS PRODUCTION PROPOSALS

#### A. Levy Tax on Certain Offshore Oil and Gas Production

##### Present Law

Under present law, there is no Federal severance tax on oil and gas produced on the Outer Continental Shelf (“OCS”). The Department of the Interior estimated reserves of OCS inventory at 8.5 billion barrels of oil and 29.3 trillion cubic feet of natural gas. Approximately another 86 billion barrels of oil and 420 trillion cubic feet of natural gas are classified as undiscovered resources.<sup>276</sup>

The United States leases Federal lands containing oil and gas deposits in offshore or submerged lands under the Outer Continental Shelf Lands Act of 1953, as amended.<sup>277</sup> Revenues are returned to the Federal government in the form of bonus bids (discussed below), rents, and royalties. The offshore leasing program is administered by the Minerals Management Service (“MMS”) within the Department of the Interior.

Leases are awarded to the highest bidder in a competitive, sealed bidding process. Successful bidders make an up-front cash payment, called a “bonus bid” to secure a lease. In addition to the bonus bid, generally a royalty rate of 12.5 percent or 16.7 percent is imposed on the value of production, depending on location factors, or the royalty received in kind. The royalty rate could be higher than 16.7 percent depending on the lease sale. According to the Congressional Research Service, MMS officials have indicated that a royalty rate of 18.75 percent is likely to remain in place for future lease sales.

The Outer Continental Shelf Deep Water Royalty Relief Act (the “DWRRA”) authorized MMS to provide royalty relief on oil and gas produced in the deep waters of the Gulf of Mexico from certain leases issued from 1996 through 2000. Royalty relief waives or reduces the amount of royalties that companies would otherwise be obligated to pay on the initial volumes of production from leases (“suspension volumes”).

In implementing the DWRRA for leases sold in 1996, 1997 and 2000, MMS specified that royalty relief would be applicable only if oil and gas prices were below certain prices thresholds. MMS did not include these price thresholds for leases issued in 1998 and 1999.

Kerr-McGee Corporation (“Kerr McGee,” now owned by Anadarko Petroleum Corporation) filed suit challenging the government’s authority to include price thresholds in DWRRA leases issued from 1996-2000. The district court for the Western District of Louisiana ruled in favor of Kerr-McGee. It held that the DWRRA suspended the payment of royalties on amounts severed up to certain specified production volume thresholds and the Department of the Interior could not collect royalties when the volume thresholds had not yet been met. Thus,

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<sup>276</sup> Department of Interior, Report to the Secretary: Survey of Available Data of OCS Resources and Identification of Data Gaps (2009) p. 5.

<sup>277</sup> 43 U.S.C. 1331, et seq.



because the statute specified that certain amounts are to be royalty free, the Department of Interior had no authority to collect royalties, regardless of whether the price threshold had been exceeded. On January 12, 2009, the Court of Appeals for the Fifth Circuit affirmed the district court's ruling.<sup>278</sup>

With respect to the 1998 and 1999 leases (with no price thresholds), the GAO has estimated that the Federal government could lose royalties between \$4.3 billion and \$14.7 billion.<sup>279</sup> In light of the Kerr-McGee ruling, with respect to the 1996, 1997, and 2000 leases, the GAO asserts that the Federal government may have to refund over \$1.13 billion in royalties already collected and forgo additional royalty revenues on future production from these leases. The GAO estimates additional forgone royalties between \$21 billion and \$53 billion.<sup>280</sup>

### **Description of Proposal**

The Administration does not have a proposal at this time. The Administration is developing a proposal to impose an excise tax on certain oil and gas produced offshore in the future and indicates that the Administration will work with Congress to develop the details of this proposal.

### **Analysis**

At this time, the Administration does not have a proposal to analyze.

### **Prior Action**

No prior action.

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<sup>278</sup> *Kerr-McGee Oil and Gas Corp. v. United States Department of Interior*, 554 F.3d 1082 (5th Cir. 2009).

<sup>279</sup> Government Accountability Office, GAO 08-792R, *Oil and Gas: Litigation over Royalty Relief Could Cost the Federal Government Billions of Dollars* (June 5, 2008) p. 3.

<sup>280</sup> *Ibid.* p. 4.

## **B. Repeal Oil and Gas Production Incentives**

### **Present Law**

#### **In general**

The Code provides a number of tax incentives that increase the after-tax return on investment in domestic oil and gas production projects. These incentives include the enhanced oil recovery credit, the marginal wells credit, the expensing of intangible drilling costs, the deduction for using tertiary injectants, the passive loss exemption for working interests in oil and gas properties, percentage depletion, the domestic manufacturing deduction for oil and gas production, and accelerated amortization for geological and geophysical expenses.

Some of these incentives are available to all domestic producers and all domestic production, while others target smaller producers or production that utilizes specific types of extractive technologies. Some of the incentives are not available (or are only partially available) to oil and gas producers whose production activities are integrated with refining and retail sales activities.<sup>281</sup>

#### **Credit for enhanced oil recovery costs (sec. 43)**

Taxpayers may claim a credit equal to 15 percent of qualified enhanced oil recovery (“EOR”) costs.<sup>282</sup> Qualified EOR costs consist of the following designated expenses associated with an EOR project: (1) amounts paid for depreciable tangible property; (2) intangible drilling and development expenses; (3) tertiary injectant expenses; and (4) construction costs for certain Alaskan natural gas treatment facilities. An EOR project is generally a project that involves increasing the amount of recoverable domestic crude oil through the use of one or more tertiary recovery methods (as defined in section 193(b)(3)), such as injecting steam or carbon dioxide into a well to effect oil displacement.

The EOR credit is ratably reduced over a \$6 phase-out range when the reference price for domestic crude oil exceeds \$28 per barrel (adjusted for inflation after 1991). The reference price is determined based on the annual average price of domestic crude oil for the calendar year preceding the calendar year in which the taxable year begins.<sup>283</sup> The EOR credit is currently phased-out.

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<sup>281</sup> Integrated oil companies subject to these limitations are oil and gas producers that sell more than \$5 million of retail product per year or refine more than 75,000 barrels of oil per year. Major integrated oil companies are a subset of integrated oil companies that (1) have average daily worldwide production exceeding 500,000 barrels per year, (2) had gross receipts in excess of \$1 billion in 2005, and (3) own at least a 15 percent interest in a refinery that produces more than 75,000 barrels of oil per year.

<sup>282</sup> Sec. 43.

<sup>283</sup> Secs. 43(b) and 45K(d)(2)(C).

Taxpayers claiming the EOR credit must reduce by the amount of the credit any otherwise allowable deductions associated with EOR costs. In addition, to the extent a property's basis would otherwise be increased by any EOR costs, such basis is reduced by the amount of the EOR credit.

### **Marginal well tax credit (sec. 45I)**

The Code provides a \$3-per-barrel credit (adjusted for inflation) for the production of crude oil and a \$0.50-per-1,000-cubic-foot credit (also adjusted for inflation) for the production of qualified natural gas. In both cases, the credit is available only for domestic production from a "qualified marginal well."

A qualified marginal well is defined as a domestic well: (1) production from which is treated as marginal production for purposes of the Code percentage depletion rules; or (2) that during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95 percent of total well effluent. The maximum amount of production on which a credit may be claimed is 1,095 barrels or barrel equivalents.

The credit is not available if the reference price of oil exceeds \$18 (\$2.00 for natural gas). The credit is reduced proportionately for reference prices between \$15 and \$18 (\$1.67 and \$2.00 for natural gas). Currently the credit is phased out completely.

In the case of production from a qualified marginal well which is eligible for the credit allowed under section 45K for the taxable year, no marginal well credit is allowable unless the taxpayer elects not to claim the credit under section 45K with respect to the well. The section 45K credit is currently expired with respect to qualified natural gas and oil production. The credit is treated as a general business credit. Unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year.

### **Expensing of intangible drilling costs (sec. 263(c))**

The Code provides special rules for the treatment of intangible drilling and development costs ("IDCs"). Under these special rules, an operator or working interest owner<sup>284</sup> that pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs.<sup>285</sup>

IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract.

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<sup>284</sup> An operator or working interest owner is defined as a person that holds an operating or working interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting operating or working rights.

<sup>285</sup> Sec. 263(c).

Such work includes labor, fuel, repairs, hauling, and supplies which are used (1) in the drilling, shooting, and cleaning of wells; (2) in the clearing of ground, draining, road making, surveying, and geological works as necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items that have a salvage value (such as pipes and casings) or items that are part of the acquisition price of an interest in the property.<sup>286</sup> They also do not include (1) the cost to operators payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and (2) amounts properly allocable to the cost of depreciable property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. In the case of a nonproductive well (“dry hole”), IDCs may be deducted at the election of the operator.<sup>287</sup> For an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.<sup>288</sup>

Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred.<sup>289</sup> This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax (“AMT”).

The election to deduct IDCs applies only to those IDCs associated with domestic properties.<sup>290</sup> For this purpose, the United States includes certain wells drilled offshore.<sup>291</sup>

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<sup>286</sup> Treas. Reg. sec. 1.612-4(a).

<sup>287</sup> Treas. Reg. sec. 1.612-4(b)(4).

<sup>288</sup> Sec. 291(b)(1)(A). The IRS has ruled that, if a company that has capitalized and begun to amortize IDCs over a 60-month period pursuant to section 291 ceases to be an integrated oil company, it may not immediately write off the unamortized portion of the capitalized IDCs, but instead must continue to amortize the IDCs so capitalized over the 60-month amortization period. Rev. Rul. 93-26, 1993-1 C.B. 50.

<sup>289</sup> Sec. 59(e)(1).

<sup>290</sup> In the case of IDCs paid or incurred with respect to an oil or gas well located outside of the United States, the costs, at the election of the taxpayer, are either (1) included in adjusted basis for purposes of computing the amount of any deduction allowable for cost depletion or (2) capitalized and amortized ratably over a 10-year period beginning with the taxable year such costs were paid or incurred (sec. 263(i)).

<sup>291</sup> The term “United States” for this purpose includes the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in

Pursuant to a special exception, the uniform capitalization rules do not apply to IDCs incurred with respect to oil or gas wells that are otherwise deductible under the Code.<sup>292</sup>

### **Deduction for qualified tertiary injectant expenses (sec. 193)**

Taxpayers engaged in petroleum extraction activities may generally deduct qualified tertiary injectant expenses used while applying a tertiary recovery method, including carbon dioxide augmented waterflooding and immiscible carbon dioxide displacement.<sup>293</sup> The deduction is available even if such costs are otherwise subject to capitalization. The deduction is permitted for the later of--(1) the tax year in which the injectant is injected or (2) the tax year in which the expenses are paid or incurred.<sup>294</sup> No deduction is permitted for expenditures for which a taxpayer has elected to deduct such costs under section 263(c) (intangible drilling costs) or if a deduction is allowed for such amounts under any other income tax provision.<sup>295</sup>

A “qualified tertiary injectant expense” is defined as any cost paid or incurred for any tertiary injectant (other than a recoverable hydrocarbon injectant) which is used as part of a tertiary recovery method.<sup>296</sup> The cost of a recoverable hydrocarbon injectant (which includes natural gas, crude oil and any other injectant with more than an insignificant amount of natural gas or crude oil) is not a qualified tertiary injectant expense unless the amount of the recoverable hydrocarbon injectant in the qualified tertiary injectant is insignificant.<sup>297</sup>

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accordance with international law, with respect to the exploration and exploitation of natural resources (i.e., the Continental Shelf area) (sec. 638).

<sup>292</sup> Sec. 263A(c)(3).

<sup>293</sup> Sec. 193. Prior to the enactment of section 193, the income tax treatment of tertiary injectant costs was unclear. In enacting section 193, Congress sought to clarify the tax treatment and encourage the use of qualified tertiary injectants. See, e.g., Joint Committee on Taxation, *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980* (JCS-1-81), January 29, 1981, pp. 114-115.

<sup>294</sup> Treas. Reg. sec. 1.193-1.

<sup>295</sup> Sec. 193(c).

<sup>296</sup> Sec. 193(b). A tertiary recovery method is any of the nine methods described in section 212.78(c)(1) - (9) of the June 1979 energy regulations, as defined in former section 4996(b)(8)(C), or any other method approved by the IRS.

<sup>297</sup> Sec. 193(b)(2). Treas. Reg. sec. 1.193-1(c)(3) provides that an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

### **Exception from passive loss rules for working interests in oil and gas property (sec. 469)**

The passive loss rules limit deductions and credits from passive trade or business activities.<sup>298</sup> A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.<sup>299</sup> Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

Losses from certain working interests in oil and gas property are not limited under the passive loss rule.<sup>300</sup> Thus, losses and credits from such interests can be used to offset other income of the taxpayer without limitation under the passive loss rule. Specifically, a passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity. If the taxpayer has a loss from a working interest in any oil or gas property that is treated as not from a passive activity, then net income from the property for any succeeding taxable year is treated as income of the taxpayer that is not from a passive activity.

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property. Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision. Thus, for purposes of the passive loss rules, an interest owned by a limited partnership is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder. The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form.

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<sup>298</sup> Sec. 469. These rules were enacted in 1986 to curtail tax shelters. They apply to individuals, estates and trusts, and closely held corporations.

<sup>299</sup> Regulations provide more detailed standards for material participation. See Treas. Reg. sec. 1.469-5 and -5T.

<sup>300</sup> Sec. 469(c)(3). See also Treas. Reg. sec. 1.469-1T(e)(4).

When an interest is not treated as a working interest because the taxpayer's form of ownership limits his liability, the general rules regarding material participation apply to determine whether the interest is treated as a passive activity. Thus, for example, a limited partner's interest generally is treated as in a passive activity. In the case of a shareholder in an S corporation, the general facts and circumstances test for material participation applies and the working interest exception does not apply, because the form of ownership limits the taxpayer's liability.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, e.g., property acquired in a sec. 1031 like kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.

### **Percentage depletion for oil and natural gas (secs. 613 and 613A)**

#### In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income.<sup>301</sup> Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction. These include the cost of acquiring the lease or other interest in the property.

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital. Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit, however, does not acquire an economic interest merely by possessing an economic or pecuniary advantage derived from production through a contractual relation.

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.<sup>302</sup> Under the cost depletion method, the

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<sup>301</sup> In the context of mineral extraction, depreciable assets are generally used to recover depletable assets. For example, natural gas gathering lines, used to collect and deliver natural gas, have a class life of 14 years and a depreciation recovery period of seven years.

<sup>302</sup> Secs. 611-613A.

taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

A taxpayer is required to determine the depletion deduction for each property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. The taxpayer must use whichever method produces the larger deduction for any taxable year.<sup>303</sup>

In the case of domestic oil and gas wells, independent producers and royalty owners generally are allowed a deduction under the percentage depletion method of 15 percent of the gross income from the property. The deduction may not exceed the net income from the oil and gas property in any year (the "net-income limitation").<sup>304</sup> Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).<sup>305</sup>

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.<sup>306</sup> For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated,<sup>307</sup> each group is then treated as one producer in applying the 1,000-barrel limitation.

Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions for any property may be greater than the amount expended by the taxpayer to acquire and develop the property.<sup>308</sup>

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<sup>303</sup> Sec. 613(a).

<sup>304</sup> Sec. 613(a). For marginal production, discussed *infra*, this limitation is suspended for taxable years beginning in 2009.

<sup>305</sup> Sec. 613A(d)(1).

<sup>306</sup> Sec. 613A(c).

<sup>307</sup> Sec. 613A(c)(8).

<sup>308</sup> In the case of iron ore and coal (including lignite), a corporate preference reduces the amount of percentage depletion calculated by 20 percent of the amount of percentage depletion in excess of the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Sec. 291(a)(2).



### Limitation on oil and gas percentage depletion to independent producers and royalty owners

As stated above, percentage depletion of oil and gas properties generally is not permitted to persons other than independent producers and royalty owners. For purposes of the percentage depletion allowance, an independent producer is any producer that is not a “retailer” or “refiner.” A retailer is any person that directly, or through a related person, sells oil or natural gas (or a derivative thereof): (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or a derivative thereof) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person.<sup>309</sup>

Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales. Further, if the combined gross receipts of the taxpayer and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed \$5 million for the taxable year, the taxpayer will not be treated as a retailer.

A refiner is any person that directly or through a related person engages in the refining of crude oil in excess of an average daily refinery run of 75,000 barrels during the taxable year.<sup>310</sup>

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.<sup>311</sup> For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated,<sup>312</sup> each group is then treated as one producer in applying the 1,000-barrel limitation.

### Percentage depletion on marginal production

In the case of oil and gas production from so-called marginal properties held by independent producers or royalty owners,<sup>313</sup> the statutory percentage depletion rate is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than \$20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The increased rate applies for the taxpayer's taxable year that immediately follows a calendar year for which the average crude oil price falls below the \$20 floor. Because the price of oil

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<sup>309</sup> Sec. 613A(d)(2).

<sup>310</sup> Sec. 613A(d)(4).

<sup>311</sup> Sec. 613A(c).

<sup>312</sup> Sec. 613A(c)(8).

<sup>313</sup> Sec. 613A(c)(6).

currently is above the \$20 floor, there is no increase in the statutory depletion rate for marginal production.

The Code defines the term “marginal production” for this purpose as domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less, corrected to 60 degrees Fahrenheit).<sup>314</sup> A stripper well property is any oil or gas property that produces a daily average of 15 or fewer equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.<sup>315</sup>

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, a taxpayer makes the stripper well property determination for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's interest. If the property satisfies the requirements of a stripper well property, then the benefits of this provision apply with respect to the taxpayer's allocable share of the production from the property. The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

### **Deduction for income attributable to domestic production of oil and gas (sec. 199)**

Section 199 of the Code provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the lesser of a taxpayer's taxable

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<sup>314</sup> Sec. 613A(c)(6)(D).

<sup>315</sup> Sec. 613A(c)(6)(E).

income or its qualified production activities income.<sup>316</sup> For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction was three percent and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent. With respect to a taxpayer that has oil related qualified production activities income for taxable years beginning after 2009, the deduction is limited to six percent of the least of its oil related production activities income, its qualified production activities income, or its taxable income.<sup>317</sup>

A taxpayer's deduction under section 199 for a taxable year may not exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.<sup>318</sup>

### Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other expenses, losses, or deductions which are properly allocable to such receipts.

### Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of

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<sup>316</sup> In the case of an individual, the deduction is equal to a portion of the lesser of the taxpayer's adjusted gross income or its qualified production activities income. For this purposes, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the section 199 deduction.

<sup>317</sup> "Oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas or any primary product thereof (as defined in section 927(a)(2)(C) prior to its repeal). Treas. Reg. sec. 1.927(a)-1T(g)(2)(i) defines the term "primary product from oil" to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil. Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii) defines the term "primary product from gas" as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii) provides that these primary products and processes are not intended to represent either the only primary products from oil or gas or the only processes from which primary products may be derived under existing and future technologies. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv) provides as examples of non-primary oil and gas products petrochemicals, medicinal products, insecticides, and alcohols.

<sup>318</sup> For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

qualifying production property (“QPP”) that was manufactured, produced, grown or extracted (“MPGE”) by the taxpayer in whole or in significant part within the United States;<sup>319</sup> (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;<sup>320</sup> or (5) engineering or architectural services performed in the United States with respect to the construction of real property in the United States.

#### Drilling oil or gas wells

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.<sup>321</sup> Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of Treas. Reg. sec. 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.<sup>322</sup>

#### Qualifying in-kind partnerships

In general, an owner of a pass-through entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for “qualifying in-kind partnerships,” which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.<sup>323</sup> In the case of a qualifying in-kind partnership, each partner is treated as having MPGE the property MPGE or produced by the partnership that is distributed to that partner.<sup>324</sup> If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the

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<sup>319</sup> Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

<sup>320</sup> For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

<sup>321</sup> Treas. Reg. sec. 1.199-3(m)(1)(i).

<sup>322</sup> Treas. Reg. sec. 1.199-3(m)(2)(iii).

<sup>323</sup> Treas. Reg. sec. 1.199-9(i)(2).

<sup>324</sup> Treas. Reg. sec. 1.199-9(i)(1).

time the partner disposes of the property, the partner is treated as conducting the MPGE activities previously conducted by the qualifying in-kind partnership with respect to that property.<sup>325</sup>

#### Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing AMTI (including adjusted current earnings). The deduction in computing AMTI is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the AMTI (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

#### **Amortization period for geological and geophysical costs (sec. 167(h))**

Geological and geophysical expenditures (“G&G costs”) are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.<sup>326</sup> G&G costs incurred by independent producers and smaller integrated oil companies in connection with oil and gas exploration in the United States may generally be amortized over two years.<sup>327</sup>

Major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007 (the date of enactment of the Energy Independence and Security Act of 2007 (“EISA”).<sup>328</sup> A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company<sup>329</sup> which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property, but instead must continue to be amortized over the remaining applicable amortization period.

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<sup>325</sup> *Ibid.*

<sup>326</sup> Geological and geophysical costs include expenditures for geologists, seismic surveys, gravity meter surveys, and magnetic surveys.

<sup>327</sup> This amortization rule applies to G&G costs incurred in taxable years beginning after August 8, 2005, the date of enactment of the Energy Policy Act of 2005, Pub. L. No. 109-58. Prior to the effective date, G&G costs associated with productive properties were generally deductible over the life of such properties, and G&G costs associated with abandoned properties were generally deductible in the year of abandonment.

<sup>328</sup> Pub. L. No. 110-140. Prior to the enactment of the Energy Independence and Security Act of 2007, major integrated oil companies were required to amortize G&G costs paid or incurred after May 17, 2006 over five years, as provided in Energy Tax Incentives Act of 2005.

<sup>329</sup> Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

## **Description of Proposal**

The proposal repeals (1) the enhanced oil recovery credit, (2) the marginal wells credit, (3) the expensing of IDCs, (4) the deduction for tertiary injectants,<sup>330</sup> (5) the exception for passive losses from working interests in oil and gas properties, (6) percentage depletion for oil and gas, and (7) the domestic manufacturing deduction for income derived from the domestic production of oil, gas, or primary products thereof. With respect to IDCs, in lieu of expensing, the proposal requires that such costs be capitalized and recovered through depletion or depreciation as applicable.

The proposal also increases the amortization period for G&G costs of independent producers from two to seven years. The seven-year amortization period would apply even if the property is abandoned such that any remaining unrecovered basis of the abandoned property would continue to be recovered over the remainder of the seven-year period.

Effective date.—The repeal of the enhanced oil recovery credit, the marginal wells credit, the exception for passive losses from working interests in oil and gas properties, percentage depletion for oil and gas, and the domestic manufacturing deduction for oil production is effective for taxable years beginning after December 31, 2010. The capitalization of IDCs, the repeal of the deduction for tertiary injectant costs, and the increased amortization period for G&G expenses are effective for amounts paid or incurred after December 31, 2010.

## **Analysis**

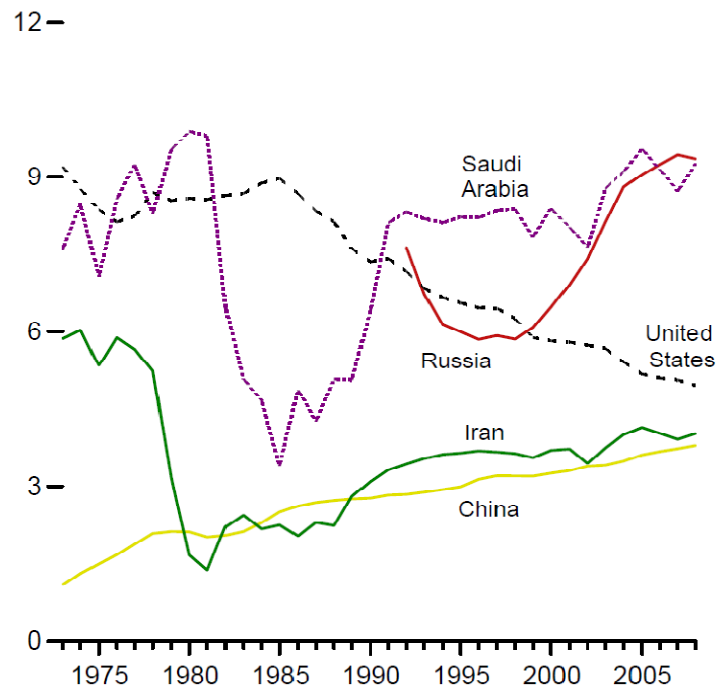
### **Overview of domestic oil and gas production**

Although domestic oil production has declined steadily since the mid-1980s, the United States remains one of the largest oil producers in the world.

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<sup>330</sup> If section 193 were repealed, the treatment of tertiary injectant expenses would revert to prior law and might include capitalization and recovery through depreciation, capitalization and recovery as consumed (e.g., as a supply), or deduction as loss in the year of abandonment or the year production benefits ceased. Amounts expensed as depreciation, depletion, or supplies may be subject to capitalization under section 263A. See, e.g., Treas. Reg. sec. 1.263A-1(e)(3).

**Figure 2.—Crude Oil Production in Selected Countries  
(millions of barrels per day)**



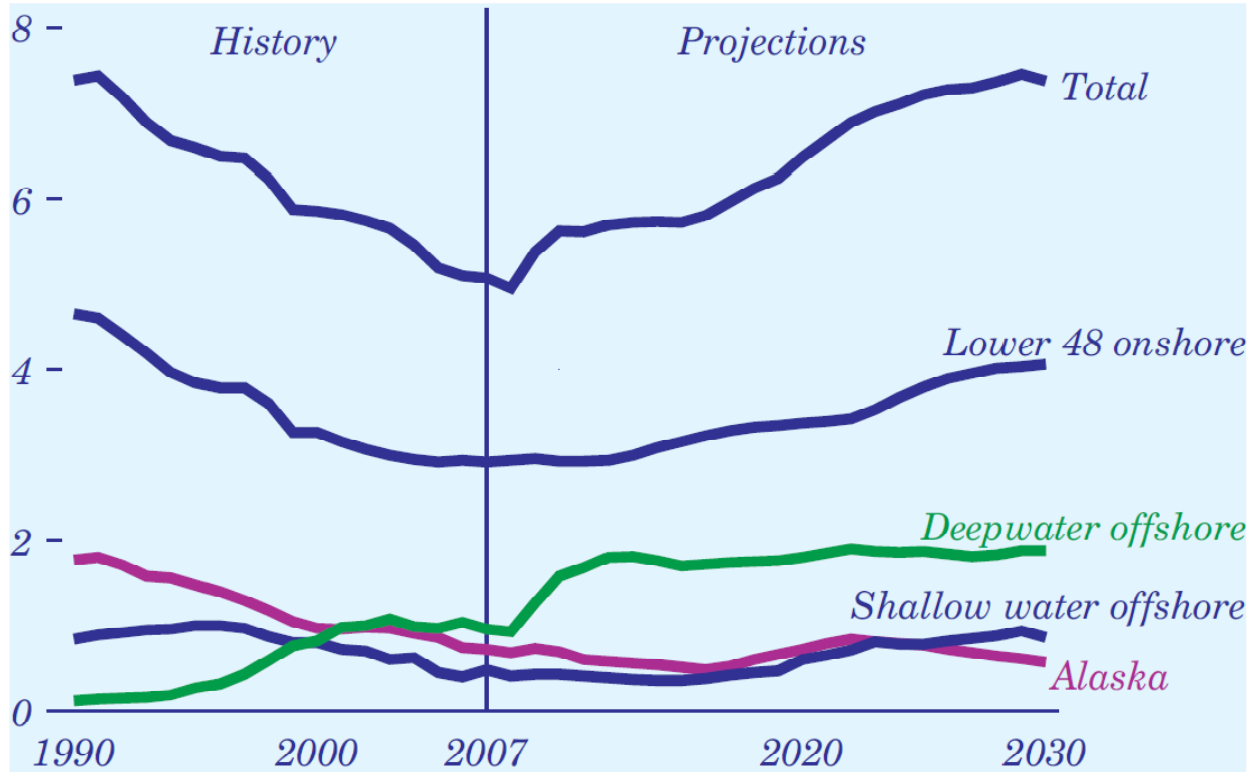
Source: Energy Information Administration, Monthly Energy Review, May 2009, Table 11.1a.

Despite declining output in recent decades, domestic oil production is predicted to increase over the next twenty years, with most of the near-term increase resulting from deepwater offshore drilling.<sup>331</sup> Domestic onshore crude oil production is also projected to increase, primarily as the result of increased application of carbon dioxide-enhanced oil recovery techniques and the startup of liquids production from oil shale.<sup>332</sup>

<sup>331</sup> Energy Information Administration, *Annual Energy Outlook 2009*, March 2009, p. 79.

<sup>332</sup> *Ibid.*

**Figure 3.—Projected Domestic Crude Oil Production by Source, 1990-2030  
(millions of barrels per day)**



Source: Energy Information Administration, Annual Energy Outlook 2009, March 2009, Figure 70, p. 79.

Because the remaining domestic oil reserves generally require more costly secondary or tertiary recovery techniques, domestic crude oil production is highly sensitive to world crude oil prices.<sup>333</sup>

Domestic production of natural gas is also expected to increase, with most of the increase attributable to onshore unconventional production (such as natural gas produced from tight sand and shale formations).<sup>334</sup> For 2008, the oil and gas extraction sector employed a seasonally adjusted average of 161,600 workers.<sup>335</sup>

<sup>333</sup> *Ibid.*

<sup>334</sup> *Ibid.* p. 77.

<sup>335</sup> Bureau of Labor Statistics, *Monthly Labor Review*, vol. 132, no. 5, May 2009, Table 12, p. 87.



## History of specific provisions

The tax rules governing oil and gas production have undergone numerous changes over the past half century. The following table lists the major changes to the provisions whose repeal has been proposed.

<b><u>Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities</u></b>			
<b>Year</b>	<b>Act</b>	<b>Code Section</b>	<b>Description of Modification</b>
1969	Tax Reform Act of 1969 (Pub. L. No. 91-172)	613(b)	Percentage depletion rates for oil and gas wells decreased from 27.5 percent to 15 percent.
1975	Tax Reduction Act of 1975 (Pub. L. No. 94-12)	613A	Percentage depletion eliminated for integrated oil and gas companies; taxable income limitation to independent producers and royalty owners claiming percentage depletion added to the Code.
1980	Crude Oil Windfall Profit Tax Act of 1980 (Pub. L. No. 96-223)	193	Deduction for qualified tertiary injectant expenses added to the Code.
1982	Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)	291(b)	Provision requiring amortization over 36 months of 15 percent of intangible drilling costs (IDCs) not currently deductible by integrated oil and gas companies added to the Code.
1984	Deficit Reduction Act of 1984 (Pub. L. No. 98-369)	291(b)	IDC capitalization percentage increased from 15 percent to 20 percent.
1986	Tax Reform Act of 1986 (Pub. L. No. 99-514)	291(b)	IDC capitalization percentage increased to 30 percent and extended the amortization period to 60 months
		469(c)(3)	Provision excluding working interests in oil and gas property from the definition of a passive activity for purposes of the limitation on passive activity losses added to the Code.
1990	Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508)	43	Enhanced oil recovery credit added to the Code.
		613	Maximum percentage depletion allowance for oil and gas properties increased from 50 percent to 100 percent of income from the property.
1997	Taxpayer Relief Act of 1997 (Pub. L. No. 105-34)	613A	Temporary suspension of taxable income limit for marginal production. <sup>336</sup>
2004	American Jobs Creation Act of 2004 (Pub. L. No. 108-357)	45I	Marginal wells credit added to the Code.
		199	Deduction for domestic production activities (including domestic oil and gas production) added to the Code.

<sup>336</sup> This temporary suspension has been extended multiple times, most recently in the Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) through December 31, 2009.

**Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities**

<b>Year</b>	<b>Act</b>	<b>Code Section</b>	<b>Description of Modification</b>
2005	Energy Policy Act of 2005 (Pub. L. No. 109-58)	167(h)	Two-year amortization of geological and geophysical (G&G) costs added to the Code. Prior to this, G&G costs incurred with respect to abandoned sites could be expensed, while G&G costs associated with producing wells had to be recovered over the life of the well.
2006	Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222)	167(h)	Two-year amortization period of G&G costs extended to five years for major integrated oil companies.
2007	Energy Independence and Security Act of 2007 (Pub. L. No. 110-140)	167(h)	Five-year amortization period of G&G costs extended to seven years for major integrated oil companies.
2008	Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343)	199	Capped the section 199 deduction percentage for oil related qualified production activities to six percent for taxable years beginning after 2009.

As the table makes apparent, Congressional action with respect to domestic oil and gas production incentives has varied over time. With some exceptions, during the 1970s and 1980s, the trend of Congressional action was to reduce or limit the tax benefits available to oil and gas producers. During the 1990s and the early part of this decade, the trend reversed direction and favored expanded incentives. More recently, Congress has begun reducing incentives once again. In the broadest sense, these trends tend to coincide with periods of high and low oil prices.

**Effect of repealing oil and gas production incentives**

A common rationale for favorable tax treatment of certain activities (tax credits or other forms of subsidy), or unfavorable treatment (taxes), is that there exist externalities in the consumption or production of certain goods. An externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole. When the social costs of consumption or production exceed the private costs of consumption or production, a negative externality exists. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over-consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under-consumption or under-production of the good producing the positive externality. The reason for the over-consumption or under-consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face. But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the

private actions lead to the socially optimal level of consumption or production, because in this case private costs and benefits will be equal to social costs and benefits.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, one intervention that could produce a more socially desirable level of pollution would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. In the case of a positive externality, an appropriate economic policy would be to impose a negative tax (i.e. a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production. The favorable tax treatment accorded the oil and gas industry represent other, less direct, means of subsidizing an activity through the tax code by reducing the tax burden on capital employed in the sector, thus encouraging more capital to be employed in that sector of the economy.

Many observers today would agree that there are negative externalities to the consumption of fossil fuels, including both pollution and increased dependence on foreign sources of oil. For this reason, many feel that fossil fuels should be taxed heavily rather than granted certain favorable treatment in the Code. Repealing incentives for oil and gas production would increase the after-tax costs associated with these activities, reduce the amount of capital employed in these activities in the long run, and potentially increase the prices of oil and gas. To the extent that oil and gas prices rise, there could be substitution from oil and gas and into other energy sources, including coal, nuclear, or renewable sources of energy. The impact on pollution of any such substitution is unclear and would depend on the type and quantity of pollution associated with the alternative energy resource. To the extent that addressing pollution concerns was a major objective, economic theory would suggest the need for a tax on the externality from the consumption of oil and gas that equaled the social harm from the consumption. Simply removing selected subsidies related to the production of oil and gas does not address the issue of establishing proper prices on the consumption of goods that cause pollution.

If the proposals caused substitution into alternative sources of energy, reliance on foreign sources of oil and gas could be reduced because nuclear and renewable energy sources are domestically produced, and the United States has an abundance of domestic coal resources. Alternatively, to the extent that the proposals primarily affect domestic production of oil and gas, it is possible that any substitution into these alternate energy sources reflects a substitution from domestic production of oil and gas into domestic production of these alternate sources, thus leaving the United States' reliance on foreign oil and gas unchanged. Furthermore, as the proposals are likely to have no effect on the world price of oil and gas, any increase in prices for domestically consumed oil and gas is likely to be attenuated, and the proposals could primarily result in substitution of foreign oil and gas sources for domestic sources whose production is more reliant on the subsidies provided in current law. Such an outcome would further imply that the proposals would not lead to any shift into the alternate energy sources of coal, nuclear, or renewables. Lastly, other observers have argued that current prices and expected future demand

for oil and gas provide sufficient market-based incentives for domestic exploration and production, and have argued that the present law subsidies are unnecessary to secure a viable domestic oil and gas production industry.

Additional motivations may also support specific proposed changes. For example, with respect to tertiary injectants opponents of repeal have also argued that the deduction for tertiary injectants encourages the use of carbon dioxide in enhanced oil recovery projects. Such projects represent a primary method of carbon sequestration, which reduces greenhouse gas emissions by capturing and storing carbon dioxide that would otherwise be released into the atmosphere.<sup>337</sup> Proponents of the proposal might argue that encouraging carbon dioxide sequestration is better handled through incentives directly targeting carbon sequestration.

Another example is the exception to the passive loss rules for working interests in oil and gas properties, which in addition to providing an incentive to produce oil and gas, creates the potential to shelter income that would otherwise be taxable. It could be argued that tax sheltering has become an increasing problem in the Federal tax system as some of the base-broadening and rate-lowering changes made by the Tax Reform Act of 1986 have been reversed or modified by subsequent legislation. From a tax policy perspective (rather than an energy policy perspective), some might argue that the perception of fairness in the tax system, as well as the need for improved horizontal equity among individual taxpayers, support repeal of the special tax benefits for oil and gas working interests.

Those in favor of retaining incentives for domestic production might argue that a healthy domestic oil and gas production base serves national security goals, by reducing our dependence on foreign sources of oil. However, it can be argued that such reliance is more effectively addressed through a direct tax on imported oil or an import fee, which could encourage less consumption and promote the use of lower emission, renewable energy alternatives. Others might argue that in the current economic environment, eliminating the incentives might adversely affect employment in domestic oil and gas production. Furthermore, the deduction for domestic production activities is a broadly available incentive for all domestic production industries, and thus does not bias investment in favor of the oil and gas sector. Repealing the deduction for the oil and gas sector alone would bias investment away from this sector.

Finally, it could be argued that some of the President's oil and gas proposals might reintroduce administrative complexity currently absent under present law, such as in the case of the repeal of the deduction for tertiary injectants.

### **Prior Action**

The proposal with respect to G&G expenses was included in the President's budget for fiscal year 2009. Similar G&G proposals were also included in the President's budget proposals for fiscal years 2007 and 2008. The President's budget for fiscal year 2007 included a proposal to extend the G&G amortization period to five years for all producers. At the time, all domestic

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<sup>337</sup> See also sec. 45Q, which provides a credit for certain qualified tertiary injectant projects that use carbon sequestration.

oil and gas producers (including major integrated oil companies) could amortize their G&G expenses over two years. Congress partially implemented the 2007 proposal by extending the G&G amortization period to five years for major integrated oil companies. The President's budget for fiscal year 2008 included a proposal to extend the G&G amortization period to five years for independent producers. At the time, independent producers could amortize their G&G expenses over two years while major integrated oil companies had to amortize their G&G expenses over five years. Congress did not implement the 2008 proposal but extended the amortization period to seven years for major integrated oil companies.

## IV. FINANCIAL INSTITUTIONS, INSURANCE COMPANIES, AND PRODUCTS

### A. Require Accrual of the Time Value Element on Forward Sale of Corporate Stock

#### Present Law

A corporation generally recognizes no gain or loss on the receipt of money or other property in exchange for its own stock (including treasury stock).<sup>338</sup> Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued. In addition, no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).

In general, a forward contract means a contract to deliver at a set future date (the “settlement date”) a substantially fixed amount of property (such as stock) for a substantially fixed price. Gains or losses from forward contracts generally are not taxed until the forward contract is closed. A corporation does not recognize gain or loss with respect to a forward contract for the sale of its own stock. A corporation does, however, recognize interest income upon the current sale of its stock for a deferred payment.

With respect to certain “conversion transactions” (transactions generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer’s return is attributable to the time value of the taxpayer’s net investment in the transaction), gain recognized that would otherwise be treated as capital gain may be recharacterized as ordinary income.<sup>339</sup>

#### Description of Proposal

The proposal requires a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received with respect to the forward contract as a payment of interest.

Effective date.—The proposal is effective for forward contracts entered into on or after December 31, 2010.

#### Analysis

Under a traditional forward contract, the purchase price generally is determined by reference to the value of the underlying property on the contract date and is adjusted (1) upward to reflect a time value of money component to the seller for the deferred payment (i.e. for holding the property) from the contract date until the settlement date and (2) downward to reflect the current yield on the property that will remain with the seller until the settlement date.

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<sup>338</sup> Sec. 1032.

<sup>339</sup> Sec. 1258.

Strategies have been developed whereby a corporation can obtain favorable tax results through entering into a forward sale of its own stock, which results could not be achieved if the corporation merely sold its stock for a deferred payment. One such strategy that might be used to exaggerate a corporation's interest deductions could involve a corporation borrowing funds (producing an interest deduction) to repurchase its own stock, which it immediately sells in a forward contract at a price equal to the principal and interest on the debt for settlement on the date that the debt matures. Taxpayers may be taking the position that the interest on the debt is deductible, while the gain and loss from the forward contract (including any interest component) is not taxable to the corporation. Although the leveraged purchase illustrates the problem, the borrowing is not necessary to achieve the tax benefits. A corporation could simply use excess cash (which otherwise would be earning a taxable return) to purchase its own outstanding stock and contemporaneously enter into a forward contract to sell the same amount of its stock at a price that reflects a return that is substantially based on the time value of money. In either case, the corporation arguably has achieved a tax-free return on investment.

Advocates of the proposal argue that there is little substantive difference between a corporation's current sale of its own stock for deferred payment (upon which the corporate issuer would accrue interest) and the corporation's forward sale of the same stock. The primary difference between the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, while in a forward sale, the stock is issued on the settlement date. In both cases, a portion of the deferred payment economically compensates the corporation for the time-value element of the deferred payment. Proponents of the proposal argue that these two transactions should be treated the same. Additionally, some would argue that the proposal is a logical extension of the conversion rules of section 1258 which treat as ordinary income the time value component of the return from certain conversion transactions.

Opponents of the proposal argue that there is, in many cases, a substantive difference between a corporation's forward sale of its stock and a current sale for a deferred payment. Under a forward sale, the stock is not outstanding until it is issued on the settlement date. The purchaser does not actually own stock that it can transfer free of its obligation to make payment under the forward contract. The purchaser has no current dividend rights, voting rights or rights in liquidation. The forward price may reflect expected dividends on the underlying stock, but that price is generally established in advance and actual dividends may vary from expected dividends. The purchaser of stock for a deferred payment, on the other hand, actually owns the stock and the attendant rights thereto. Therefore, the current sale of stock for deferred payment and the forward sale of stock for future delivery may not be equivalent transactions, but the proposal would treat them the same. Conversely, the proposal would treat differently a forward sale of stock and an issuance in the future of stock for the same price on the same date as the settlement date, which in many respects may be viewed as similar transactions.

In addition, any forward sale by its very nature has a time value component: that feature is not unique to a corporate issuer of its own stock. The time value component should compensate the holder for its carrying costs with respect to the property. One could argue that if it is appropriate to impute interest on a forward contract, it should be done for all forward contracts and not just forward contracts involving a corporation's own stock. In other words, as a policy matter it may be inappropriate to address forward sales of a corporation's own stock

without addressing the broader question of taxation of the time value component of forward contracts in general.

The conversion rules of section 1258 provide the closest analog under present law to the proposal. There are, however, several important distinctions between section 1258 and the proposal. Unlike the proposal, the conversion rules (1) do not affect the timing of recognition of the ordinary income and (2) apply only to forward contracts that are part of a conversion transaction. In addition, some also might argue that the policy rationale underlying the conversion rules is not present with respect to the issuance of corporate stock because there is no conversion of ordinary income to capital gain. For example, assume a taxpayer buys gold today for \$100 and immediately enters into a forward contract to sell that gold in the future for \$110 (\$10 of which represents the time value of money). Upon closing of the forward sale, the taxpayer (and its shareholders if it is a corporation) would recognize an economic gain of \$10. Absent the conversion rules, the \$10 gain on that transaction may be treated as capital gain notwithstanding that substantially all of the taxpayer's return is with respect to the time value of money. The taxpayer is in the economic position of a lender with an expectation of a return from the transaction that is in the nature of interest and with no significant risks other than those typical of a lender. That arguably is not the case (at least with respect to the economic position of the existing shareholders) with respect to a corporation that enters into a forward sale of its own stock (or certainly not all forward sales of a corporation's own stock). A corporation's ownership of its own stock arguably has no economic significance to the corporation or its shareholders. The purchase or issuance by a corporation of its own stock at fair market value does not affect the value of the shareholders' interests in the corporation. The economic gain or loss, if any, to the existing shareholders of the corporation on the forward sale of its stock would depend on the fair market value of the corporation's stock on the settlement date. If the fair market value of the corporation's stock on the settlement date equals the contract price under the forward sale, then there is no economic gain or loss to the corporation or its shareholders. On the other hand, if the forward price does not equal the fair market value, there could be situations in which the corporation suffers an economic loss (because, for example, the value of the stock is greater than the forward price). Even in situations in which there is an economic loss, however, the proposal would tax the corporation on the imputed time value element.<sup>340</sup>

Some have suggested that a more narrowly tailored solution could be developed to address the perceived abuse of a corporation in essence being able to make a tax-free, fixed-income investment in its own stock (i.e., the "cash and carry transaction"). Under such an approach, the corporation would recognize taxable gain only if it acquired its own stock and on a substantially contemporaneous basis entered into a forward contract to sell its own stock and

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<sup>340</sup> Advocates of the proposal would observe that so long as the forward price is higher than the market price on the contract date, there is at least a "profit" established in the forward contract (representing the time value component of the contract) that should be taxable regardless of whether that profit is higher or lower than it otherwise would be in the absence of the contract.



substantially all of its expected return from the transaction was attributable to the time value of money invested.<sup>341</sup>

Finally, some would argue that the provision narrowly focuses on one type of derivative contract with respect to a corporation's own stock and that a broader approach addressing the treatment under section 1032 of derivative contracts and other techniques for using a corporation's own stock would be more appropriate. Otherwise, the inconsistent treatment of economically equivalent transactions under section 1032 and the uncertainty as to its scope, in particular with respect to its applications to derivative contracts in a corporation's own stock, could result in whipsaw against the government. Those who espouse this view would argue that consideration should be given to a range of alternative approaches for addressing the issue of derivatives and section 1032, including (1) expanding the scope of section 1032 to cover all derivatives in a corporation's stock, or (2) contracting the scope of section 1032 to cover only transactions in which a corporation issues or purchases its own stock for fair market value.<sup>342</sup> In November 1999, Representative Neal introduced a bill that would expand the scope of section 1032 to cover all derivatives.<sup>343</sup>

### **Prior Action**

An identical proposal was included in the President's fiscal year 2000 and 2001 budget proposals.

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<sup>341</sup> See New York State Bar Association, *Report on Section 1032*, 1999 TNT 199-22 (June 22, 1999). H.R. 3283, 106th Cong., 1st Sess. (1999), introduced by Representative Neal in November 1999, adopts a similar approach with respect to such cash and carry transactions.

<sup>342</sup> New York State Bar Association, *Report on Section 1032*.

<sup>343</sup> H.R. 3283.

## **B. Require Ordinary Treatment for Options Dealers and Commodities Dealers**

### **Present Law**

#### **In general**

In general, gain or loss on the sale of stock in trade of a taxpayer or other property of a kind that properly would be included in inventory, or property that is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, is treated as ordinary income.<sup>344</sup> Consistent with this general rule, a taxpayer's status as a "dealer" in a particular type of property generally means that the taxpayer recognizes ordinary gain or loss when it engages in its day-to-day dealer activities, namely selling or exchanging the type of property for which it is a dealer.

A dealer in securities must compute its income pursuant to the mark-to-mark method of accounting.<sup>345</sup> Any security that is inventory in the hands of the dealer must be included in inventory at its fair market value; in the case of any security that is not inventory and that is held at the end of the taxable year, the dealer must recognize gain or loss as if the security had been sold for its fair market value. The resulting gain or loss generally is treated as ordinary gain or loss.<sup>346</sup>

#### **Section 1256 contracts**

Notwithstanding the general rule applicable to dealers, special rules apply to gains and losses of commodities dealers, commodities derivative dealers, dealers in securities, options dealers, and dealers in securities futures contracts or options with respect to "section 1256 contracts." Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market rule and generally is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss.<sup>347</sup> Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.<sup>348</sup> A taxpayer other than a corporation may elect to carry back its net section 1256 contracts loss for three taxable years.<sup>349</sup>

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<sup>344</sup> Sec. 1221(a)(1).

<sup>345</sup> Sec. 475(a).

<sup>346</sup> Sec. 475(d)(3).

<sup>347</sup> Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

<sup>348</sup> Sec. 1256(c)(1).

<sup>349</sup> Sec. 1212(c).

A “section 1256 contract” is any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.<sup>350</sup>

### **Dealers in section 1256 contracts**

A “commodities dealer” is any person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.<sup>351</sup> Commodities dealers recognize capital gains and losses with respect to their section 1256 contracts unless they elect to have the rules of section 475 apply.<sup>352</sup>

A “commodities derivatives dealer” is a person that regularly offers to enter into, assume, offset, assign, or terminate positions in “commodities derivative financial instruments” with customers in the ordinary course of a trade or business.<sup>353</sup> Commodities derivative financial instruments held by a commodities derivatives dealer generally are not capital assets, and the sale or exchange of such instruments by a commodities derivatives dealer results in ordinary gain or loss.<sup>354</sup> However, the definition of “commodities derivative financial instruments” excludes section 1256 contracts.<sup>355</sup> As a result, the gains and losses of commodities derivatives dealers with respect to section 1256 contracts typically are capital under the general rules of section 1256.

A “dealer in securities” is a taxpayer who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.<sup>356</sup> The general rules applicable to securities dealers do not apply to section 1256 contracts held by security dealers. As a result, the gains and losses of

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<sup>350</sup> Sec. 1256(b). The term “section 1256 contract” does not include any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract.

<sup>351</sup> Sec. 1402(i)(2)(B).

<sup>352</sup> Sec. 1256(f)(3).

<sup>353</sup> Sec. 1221(b)(1)(A).

<sup>354</sup> Sec. 1221(a)(6).

<sup>355</sup> Section 1221(b)(1)(B) provides that the term “commodities derivative financial instrument” means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b) )), the value or settlement price of which is calculated by or determined by reference to a “specified index.” A specified index means any one or more or any combination of (1) a fixed rate, price, or amount, or (2) a variable rate, price, or amount, which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties’ circumstances.

<sup>356</sup> Sec. 475(c)(1).

dealers in securities with respect to section 1256 contracts typically are capital under the general rules of section 1256.

An “options dealer” is any person registered with a national securities exchange as a market maker or specialist in listed options, as well as any person whom the Secretary determines performs similar functions.<sup>357</sup> An option dealer’s transactions with respect to both non-equity options and dealer equity options, both of which are section 1256 contracts, give rise to capital gain or loss under section 1256.<sup>358</sup>

A person is treated as a “dealer in securities futures contracts or options on such contracts” if the Secretary determines that such person performs, with respect to such contracts or options, as the case may be, functions similar to functions performed by an options dealer.<sup>359</sup> Dealer securities futures contracts are section 1256 contracts, and the transactions of a dealer in securities futures contracts with respect to such contracts give rise to capital gain or loss.<sup>360</sup>

### **Description of Proposal**

The proposal requires commodities dealers, commodities derivatives dealers, dealers in securities, and options dealers to treat the income from their day-to-day dealer activities with respect to section 1256 contracts as ordinary in character, not capital. The proposal does not affect the application of the mark-to-market rules with respect to such gains and losses.

Effective date.—The proposal is effective for tax years beginning after the date of enactment.

### **Analysis**

The proposal provides that a commodities dealer’s, commodities derivative dealer’s, securities dealer’s, and an option dealer’s gains and losses with respect to section 1256 contracts are treated as ordinary income. The proposal thus denies such dealers the benefits of the 60/40 rule, but allows net losses to be taken into account without regard to any capital loss limitations.

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<sup>357</sup> Sec. 1256(g)(8).

<sup>358</sup> Sec. 1256(f)(3). This section, added as part of the Deficit Reduction Act of 1984 (H.R. 4170, P.L. 98-369), changed the rules for options market makers. Prior to the enactment of section 1256(f)(3), some options market makers took the position that options with respect to which they made a market were granted or acquired in the course of a trade or business. As a consequence, they maintained that transactions with respect to such options gave rise to ordinary income or loss. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 302.

<sup>359</sup> Sec. 1256(g)(9).

<sup>360</sup> Section 1256(g)(9)(A) provides that a “dealer securities futures contract” means, with respect to any dealer, any securities futures contract, and any option on such a contract, which (1) is entered into by such dealer (or, in the case of an option, is purchased or granted by such dealer) in the normal course of his activity of dealing in such contracts or options, as the case may be, and (2) is traded on a qualified board or exchange.

The proposal does not otherwise affect the present-law requirement that such dealers report their section 1256 gains and losses under the mark-to-market method.

The 60/40 rule provides favorable treatment for certain dealers with respect to income that otherwise would not qualify for preferential capital gains treatment. This special treatment is not currently relevant in the case of corporate dealers because corporate capital gain is taxed at the same tax rates as ordinary income. For individuals, however, the 60/40 rule results in a maximum tax rate of 26 percent on their business income. Proponents argue that eliminating the 60/40 rule for dealers is appropriate – their business income should be taxed in the same manner as dealers of other types of property.<sup>361</sup>

On the other hand, Congress implicitly has acknowledged that the day-to-day activity of commodities dealers and options dealers with respect to section 1256 contracts is in fact “trading.”<sup>362</sup> And section 1256(f)(3)(A), which provides that “trading” section 1256 contracts gives rise to capital gain or loss, is arguably nothing more than a codification of a basic tax principle. Thus, the Administration’s proposal also could be viewed (at least with respect to commodities dealers and options dealers) as creating a special character rule for certain categories of traders.

Furthermore, some will contend that the 60/40 rule, which was enacted in 1981 and expanded in 1984 and 2000, was intended to provide the benefit of a lower rate for these taxpayers who, by virtue of the enactment of the mark-to-market regime, were being required to pay tax with respect to gains prior to their realization. For purposes of determining a taxpayer’s holding period, applying a mark-to-market method to capital assets creates uncertainty and complexity if a mark when the asset is still short term is followed by a second mark after the long-term holding period has been reached.<sup>363</sup> The 60/40 rule could be viewed as ameliorating these aspects of the mark-to-market regime and, therefore, its retention may be appropriate. Others would respond by noting that these concerns have become less significant since the 1993

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<sup>361</sup> See, e.g., Erika W. Nijenhuis, “Taxation of Securities Futures Contracts,” 792 *PLI/Tax* 103, 121 (2007) (“The 60/40 treatment provided by section 1256 is, however, a complete distortion of the Code’s character rules, in two respects. First, it accords capital rather than ordinary treatment to taxpayers (dealers) who are acting in the normal course of their business activities. It does so, moreover, without imposing the normal limitations on the deductibility of capital losses, through a special rule that permits non-corporate taxpayers to carry back losses from section 1256 contracts to offset gains in prior years from such contracts. [Section 1212(c)] Second, it accords preferential long-term capital gain rates to taxpayers who have not made the long-term investment in capital assets that the rate differential is intended to encourage.”).

<sup>362</sup> See sec. 1402(i)(2)(B) (defining a “commodities dealer” as a person who is actively engaged in *trading* section 1256 contracts). Section 1256(f)(3), which by its terms is applicable to “trading” section 1256 contracts, was enacted for the purpose of codifying the character rules for commodities dealers and changing the character rules for options market makers, i.e., options dealers. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 312.

<sup>363</sup> Even in the absence of the mark-to-market rules in section 1256, it is not clear that many traders would have a long-term holding period with respect to their section 1256 contracts. Traders make money by trading in and out of positions, not by buying and holding positions. Moreover, many section 1256 contracts, commodities futures in particular, have settlement dates that are less than one year from the date on which the parties initially enter into the contract.

enactment of section 475, which mandates mark-to-market treatment (and ordinary gain or loss) for dealers in securities.<sup>364</sup>

**Prior Action**

A similar proposal was included in the President's fiscal year 2001 Budget Proposals.

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<sup>364</sup> In 1997, section 475 was expanded to include an elective regime for commodities dealers (and traders in commodities and securities).

## **C. Modify the Definition of Control for Purposes of the Section 249 Deduction Limitation**

### **Present Law**

In general, where a corporation repurchases its indebtedness for a price in excess of the adjusted issue price, the excess of the repurchase price over the adjusted issue price (the “repurchase premium”) is deductible as interest.<sup>365</sup> However, in the case of indebtedness that is convertible into the stock of (1) the issuing corporation, (2) a corporation in control of the issuing corporation, or (3) a corporation controlled by the issuing corporation, section 249 provides that any repurchase premium is not deductible to the extent it exceeds “a normal call premium on bonds or other evidences of indebtedness which are not convertible.”<sup>366</sup>

For purposes of section 249, the term “control” has the meaning assigned to such term by section 368(c). Section 368(c) defines “control” as “ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.” Thus, section 249 can apply to debt convertible into the stock of the issuer, the parent of the issuer, or a first-tier subsidiary of the issuer.

### **Description of Proposal**

The proposal modifies the definition of “control” in section 249(b)(2) to incorporate “indirect control relationships, of the nature described in section 1563(a)(1).”<sup>367</sup> Section 1563(a)(1) defines a parent-subsidiary controlled group as one or more chains of corporations connected through stock ownership with a common parent corporation if (1) stock possessing 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, except the common parent corporation, is owned (within the meaning of subsection (d)(1) ) by one or more of the other corporations; and (2) the common parent corporation owns (within the meaning of subsection (d)(1) ) stock possessing 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 at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

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<sup>365</sup> See Treas. Reg. sec. 1.163-7(c).

<sup>366</sup> Regulations under section 249 provide that “[f]or a convertible obligation repurchased on or after March 2, 1998, a call premium specified in dollars under the terms of the obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including original issue discount) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased).” Treas. Reg. sec. 1.249-1(d)(2). Where a repurchase premium exceeds a normal call premium, the repurchase premium is still deductible to the extent that it is attributable to the cost of borrowing (e.g., a change in prevailing yields or the issuer’s creditworthiness) and not attributable to the conversion feature. See Treas. Reg. sec. 1.249-1(e).

<sup>367</sup> Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals, May 2009, p. 111.

Effective date.—The proposal is effective on the date of enactment.

### **Analysis**

Section 249 was added to the Code in 1969, and has not been altered substantially in 40 years. The reason for the original provision was explained by the staff of the Joint Committee on Taxation in 1969: “A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, the Congress believed that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner.”<sup>368</sup> The extension of the basic rule of section 249 to the stock of a corporation in control of the issuer or a corporation controlled by the issuer can be viewed simply an anti-avoidance measure.

The Administration now proposes to bolster the anti-avoidance rule by expanding the definition of “control.” According to the Administration: “The definition of “control” in section 249 is unnecessarily restrictive, and has resulted in situations in which the limitation in section 249 is too easily avoided. Indirect control relationships (e.g., a parent corporation and a second-tier subsidiary) present the same economic identity of interests as direct control relationships, and should be treated in a similar manner.”<sup>369</sup>

Similar changes have been proposed by others in the past. For instance, a 1987 report of the Tax Section of the New York State Bar Association noted: “Section 249 applies only to debt instruments convertible into stock of the issuer or a corporation controlled by or controlling the issuer, using the section 368(c) definition of control. This definition is overly narrow in some respects (e.g., a class of nonvoting preferred stock held by a third party would avoid a finding of control, and ownership attribution is not taken into account), and a statutory amendment to adopt a broader definition seems warranted.”<sup>370</sup>

### **Prior Action**

No prior action.

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<sup>368</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, p. 131.

<sup>369</sup> Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals*, May 2009, p. 111.

<sup>370</sup> New York State Bar Association Tax Section, *Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations*, in *Tax Notes*, January 26, 1987, p. 363 at p. 421 fn. 135; *see also* Lee A. Sheppard, “A Real Mickey Mouse Deal (Or Can Disney Beat Section 249?),” 47 *Tax Notes* 1282 (June 11, 1990) (noting that “[o]thers have argued that the section 1504(a) standard should be used, so that section 249 would look through affiliated corporations.”)



## D. Modify Rules That Apply to Sales of Life Insurance Contracts

### Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.<sup>371</sup>

Under the so-called transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited. Under the limitation, the excludable amount may not exceed the sum of: (1) the actual value of the consideration; and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if: (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract;<sup>372</sup> or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.<sup>373</sup>

In the case of certain accelerated death benefits and viatical settlements,<sup>374</sup> special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance

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<sup>371</sup> Sec. 101(a)(1).

<sup>372</sup> Sec. 101(a)(2)(A).

<sup>373</sup> Sec. 101(a)(2)(B).

<sup>374</sup> Sec. 101(g).

contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

Recent IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts.

In Rev. Rul. 2009-13,<sup>375</sup> the IRS ruled that income recognized under section 72(e) on surrender of a life insurance contract with cash value to the life insurance company is ordinary income. In the case of sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain.

In Rev. Rul. 2009-14,<sup>376</sup> the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

### **Description of Proposal**

The proposal imposes reporting requirements on the buyer in the case of the purchase of an existing life insurance contract with a death benefit equal to or exceeding \$1 million, and on the issuing insurance company in the case of the payment of benefits under such a contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is: (1) the purchase price; (2) the buyer's and seller's taxpayer identification numbers; and (3) the name of the issuer of the contract and the policy number.

When a death benefit is paid under the contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports: (1) the gross amount of the payment; (2) the taxpayer identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract. The payee is required to report the computation of the taxable portion of the payment on a separate schedule filed with the taxpayer's return for the year of inclusion of the payment.

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<sup>375</sup> 2009-21 I.R.B. 1029.

<sup>376</sup> 2009-21 I.R.B. 1031.

In addition, the proposal modifies the present-law rules providing an exception to the limitation on the excludable amount of a death benefit. Under the proposal, the exceptions do not apply to buyers of policies.

Effective date.—The proposal is effective for sales or assignments of interests in life insurance contracts and payments of death benefits for taxable years beginning after December 31, 2010.

## Analysis

### Reporting

The proposal is directed to the issue of collection of tax on amounts that are includable in income with respect to a life insurance contract that has been transferred for value. Because information about the identity of parties to transfers of contracts, amounts paid for transferred contracts, and payments under transferred contracts is not now reported, enforcement of present-law income inclusion requirements is needlessly difficult. Taxpayers who are parties to transfers of life insurance contracts may have a reduced incentive accurately to measure gain on transfers and on payments under transferred contracts, or even to include any amount in income, because they believe enforcement of the requirement of inclusion is impaired by the lack of reporting. Thus, it is argued, the reporting provisions are needed to improve voluntary compliance with present law.

Purchasers of life insurance contracts (such as viatical settlement or life settlement companies, or others that securitize purchased life insurance contracts) should not be more easily able to escape tax on their business income than other business taxpayers because enforcement may be difficult due to lack of reporting. The perception that taxpayers might not include income because enforcement of the inclusion requirement may be difficult can be corrected, advocates argue, by making it very clear that enforcement of the inclusion requirement is easy using the reported information.

Opponents of the reporting requirement may argue that the reporting requirements are burdensome. They may argue that processing and putting to use all the information that would be required by the proposal is an inefficient use of IRS resources, which might be better employed addressing other, more pressing tax issues. They may further argue that the level of detail of the reporting under the proposal is excessive, and that if any reporting of transfers of life insurance contracts is proposed, it should be more limited than that proposed. On the other hand, some might point to present-law reporting requirements applicable to banks and mutual funds.

The mechanics of the reporting requirement could be criticized as not fully developed. The proposal does not address the mechanism for reporting in the case of periodic payments for the purchase of an insurance contract. On the other hand, these details could be developed either as Congress drafts the proposal, or as it is implemented by the IRS.

The reporting requirement on payment of a death benefit under a contract could also be criticized as somewhat complex. If, by contrast, the reporting requirement applied to any payment under a contract, regardless of the size of the death benefit, then this determination would be eliminated, and the payee would still report the taxable portion (if any) of the payment.

On the other hand, those opposed to the proposal's reporting requirements generally on the grounds that they are unduly burdensome might argue that expanding the circumstances in which reporting applies would exacerbate the problem.

Opponents might argue that it is inconsistent to modify the reporting requirements only for purchases of an existing life insurance contract with a death benefit equal to or exceeding \$1 million, while modifying the exclusion rules regardless of the amount of the death benefit under the contract. If reporting is inadequate under present law, it could be argued, it should be applied to all cases in which income should be reported, not just some; or alternatively, the modifications of the exclusion rules should parallel the reporting rules, if the underreporting is principally a problem at that level of death benefits under purchased contracts. On the other hand, most reporting requirements under present law require reporting only for amounts over a dollar threshold, and this proposal is consistent with that approach.

### **Modifying exceptions to transfer for value rule**

Opponents of the modification to the present-law exceptions may argue that the proposal is not sufficiently detailed or specific, and that a vague proposal to modify the exceptions could have a chilling effect on legitimate business transactions that are not intended to be covered by the proposal. On the other hand, it could be noted that the proposal would become specific during the legislative process, before any provision would be enacted.

The recent promulgation of guidance by the IRS in Rev. Ruls. 2009-13 and 2009-14 may prompt the argument that legislative change to the transfer for value rule is not needed, as these rulings address all the important open questions of determining the basis of a life insurance contract and determining the character of gain on transactions involving the contract. It is not necessary to repeal the exceptions to the transfer for value rules in the case of purchased contracts, once these issues are clarified for taxpayers. Nevertheless, basis and character are not the issues involved in the exceptions: instead, the issue is whether gain is recognized at all. The exceptions may have arisen long ago when transfers of life insurance contracts were relatively rare and often took place among family members or owners of closely held businesses. In the past 10 or 20 years, however, an enormous and growing secondary market for life insurance contracts has developed.<sup>377</sup> Transfers of life insurance contracts are significantly more common and typically involve transactions among parties that are not family members or involved in a closely held business together. Rather, buyers of life insurance contracts are typically participants in a market for financial intermediation. The exceptions to the transfer for value rule should not apply in this context, it is argued.

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<sup>377</sup> See, e.g., Jenny Anderson, "Wall Street Pursues Profit in Bundles of Life Insurance," *New York Times*, September 6, 2009, A.1; Marc Lifsher, "Treating Death as a Commodity: A Growing Industry Involves Buying, Selling and Profiting from Life Insurance," *Los Angeles Times*, February 20, 2008, A1; Genevieve Cua, "Investing in Second-Hand Life; This Fund Pools Policies Sold by the Insured," *Business Times Singapore*, July 2, 2008, section Fmony; Anita Juslin, "Insuring a Controversy: the Wealthy are Selling Their Life Insurance Policies for Profit," *Washington Post*, November 27, 2007, D-1.

**Prior Action**

A similar proposal was included in President Clinton's fiscal year 2001 budget proposals.

## **E. Modify Dividends Received Deduction for Life Insurance Company Separate Accounts**

### **Present Law**

#### **Dividends received deduction**

A corporate taxpayer may partially or fully deduct dividends received.<sup>378</sup> The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

#### **Life insurance company proration rules**

A life insurance company is subject to proration rules in calculating its taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income. Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.<sup>379</sup>

Similarly, under the proration rules, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,<sup>380</sup> but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.<sup>381</sup> Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.<sup>382</sup>

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<sup>378</sup> Sec. 243 et seq. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.

<sup>379</sup> Secs. 807(a)(2)(B) and (b)(1)(B).

<sup>380</sup> Secs. 805(a)(4), 812.

<sup>381</sup> Sec. 812(a).

<sup>382</sup> Sec. 812(c).

Gross investment income includes specified items (sec. 812(d)). The specified items include interest (including tax-exempt interest), dividends rents, royalties and other related specified items, short term capital gains, and trade or business income. Gross investment income does not include gain (other than short term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) certain policyholder dividends (sec. 812(b)(1)). Policy interest is defined to include required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what this rate is.<sup>383</sup>

Recently, the IRS issued Rev. Rul. 2007-54,<sup>384</sup> interpreting required interest under section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts. However, Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.<sup>385</sup> No regulations have been issued to date.

### **Life insurance company tax treatment of variable contracts**

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.<sup>386</sup> The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These

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<sup>383</sup> Legislative history of section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. No. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). This concept is referred to in Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84) December 31, 1984, 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (i.e., by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Rev. Rul. 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

<sup>384</sup> 2007-38 I.R.B. 604.

<sup>385</sup> 2007-42 I.R.B.799.

<sup>386</sup> Section 817(d) provides a more detailed definition of a variable contract.

separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves (sec. 807). Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule (sec. 817), in determining reserves for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed of. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

### **Description of Proposal**

The proposal generally has the effect of reducing the amount treated as the company's share of dividends received under the proration rules in the case of a separate account. Under the proposal, amounts retained by a life insurance company are treated as derived proportionately from items included in net investment income and items not so included (such as capital gain). The result of the proposal is that the company's share of the dividends received deduction approximates the ratio of (1) the surplus (including seed money) in the separate account to (2) the total assets of the account. The amount of surplus and of total assets is determined as an annual mean for this purpose.

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

### **Analysis**

#### **In general**

The proposal is directed towards improving the accuracy of measurement of income of life insurance companies by modifying the proration rules that limit deductions associated with untaxed income. The proposal also serves to simplify these proration rules, which are rather complex. The proposal aims to improve the clarity of the law and resolve interpretive issues that have arisen in recent years, thus reducing controversies between the IRS and taxpayers.

In analyzing the proposal, it is useful to compare the life insurer proration rules to other present-law rules limiting deductions associated with untaxed income of taxpayers other than life insurers. A further question is why the life insurance company proration rules involve such complex calculations, and whether complexity is inevitable. In addition, analysis of the proposal may be aided by examining other possible options for modifying the life insurance company proration rules.



## **Expenses and interest relating to tax-exempt income of taxpayers generally**

For taxpayers other than insurance companies, present-law section 265 disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax (tax-exempt obligations).<sup>387</sup> The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations. Similarly, present law disallows a deduction for expenses allocable to tax-exempt interest income.

This limitation reflects the fundamental notion that the base of an income tax is the taxpayer's accretions to wealth. Conceptually, expenses of earning amounts included in income reduce the taxpayer's accretions to wealth, and should be deductible. Expenses of earning amounts that are not included in income, by the same token, do not reduce the taxpayer's taxable accretions to wealth, and should not be deductible.

This policy concept is not expressed uniformly throughout the tax law, it may be observed. Examples of the failure of the tax law to match deductible expenses with taxable income can be cited, such as the allowance of home mortgage interest as a deduction though the imputed rental value of residence in the home is not includable in income for individuals. However, these instances may reflect nontax social policies that are implemented through the tax law, practical difficulties of valuation or administrability, or historical norms that are broadly accepted even though inconsistent with fundamental tax policy. The proration rule applicable to property and casualty insurers could also be cited as perhaps a partial failure to match deductible expenses with taxable income. That rule disallows a deduction for expenses of earning untaxed income at a flat 15 percent rate. If untaxed income represents more than 15 percent of after-tax income, the rule may not operate effectively to prevent tax arbitrage.<sup>388</sup> On the other hand, the two insurance company proration rules, because of their different operation as currently structured, are not necessarily connected. It may be argued that the proposal to modify the life insurance proration rule does not necessarily implicate the other rule, is consistent with the corresponding broadly applicable rule of section 265, and is in line with fundamental income tax policy concepts.

## **Historical background**

### **In general**

Proration rules limiting deductions associated with untaxed income of life insurance companies were adopted as part of the earliest Federal income tax rules applicable to life insurers

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<sup>387</sup> Sec. 265. A pro rata interest expense allocation rule applies in the case of financial institutions, and exceptions to the general rule apply in the case of certain types of tax-exempt obligations (sec. 265(b)).

<sup>388</sup> For a discussion of a proposal to modify the property and casualty insurer proration rule, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000, pp. 425-428.

in 1921.<sup>389</sup> Those rules required that the reserve deduction for investment income be reduced by tax-exempt interest. In 1928, however, the Supreme Court held that this deduction limitation rule was unconstitutional because it indirectly imposed Federal tax on State obligations.<sup>390</sup>

In subsequent legislation, the proration rule was restructured,<sup>391</sup> and ultimately in 1959 a further revised proration rule was adopted providing that taxable investment yield of a life insurance company was reduced by the company's share of tax-exempt interest and deductible dividends received.<sup>392</sup> The 1959 provision included the notions of required interest and an amount retained by the company in determining the company's share of investment income for separate accounts. More generally, the 1959 Act provided for a three-phase system of taxation of life insurers, under which, generally, gain from operations was taxed only if it exceeded the company's taxable investment income. The rules for taxing life insurance companies were substantially revised in 1984 to eliminate the three-phase system and generally to tax both operating income and investment income.<sup>393</sup> The 1984 revisions retained proration rules for life insurers, and generally retained the 1959 notion that the proration rules are based on a determination of the company's share of income and deductions.

In 1988, the Supreme Court held that imposing Federal tax on interest earned on State bonds does not violate the intergovernmental tax immunity doctrine, and so is not unconstitutional.<sup>394</sup> The life insurance company proration rules have not been substantially modified since the 1988 Supreme Court decision.

The current proration formula may provide a benefit independent of the amount of any reserve deduction or tax-exempt interest and deductible dividend income because of the way the calculation treats investment expenses. The company's share increases when the actual net investment income is less than the statutorily defined net investment income. That is, a company

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<sup>389</sup> Sec. 245(a)(2) of the Revenue Act of 1921, Pub. L. No. 67-98, 67th Cong. 2d Sess., ch. 136, 42 Stat. 227.

<sup>390</sup> *National Life Insurance Company v. U.S.*, 277 United States 508 (1928), in which the Court relied on "settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves," and held that "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

<sup>391</sup> Sec. 163 of the Revenue Act of 1942, Pub. L. No. 77-753, 77<sup>th</sup> Cong. 2d Sess., enacting section 202(b) of the Internal Revenue Code (1942), 56 Stat. 798, 899. See also Letter of Walter C. Welsh, Executive Vice President, and William Elwell, Senior Counsel, American Council of Life Insurers, to the Honorable Eric Solomon, Assistant Secretary for Tax Policy, U.S. Treasury Department, and the Honorable Donald L. Korb, Chief Counsel, Internal Revenue Service, June 26, 2008, at 5-6, and Harold Wurzel, "Tax-Exempt Interest of Life Insurance Companies: A Study in 'Discriminatory' Taxation," 70 *Yale Law Journal* 15 (1960).

<sup>392</sup> Sec. 801, as enacted in the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 86th Cong., 1st Sess.

<sup>393</sup> See Title II, Life Insurance Provisions, Deficit Reduction Act of 1984, Pub. L. No. 98-369, July 18, 1984.

<sup>394</sup> *South Carolina v. Baker*, 485 U.S. 505, *reh. den.*, 486 U.S. 1062 (1988).

receives a benefit from the proration rules for a separate account if the amount retained by the company is greater than five percent of defined gross investment income. This may be particularly true of separate accounts that attribute more of their appreciation to items excluded from the definition of gross investment income, such as capital gains.

### Sources of complexity

It could be argued that the complexity of the rules and the calculations under the life insurance company proration provisions is largely attributable to the origin of the rules over 90 years ago and Congress' multiple attempts during the period to express tax policy in a manner that did not violate Constitutional doctrine. The complexity of the current proration rules may be exacerbated by the application of a few details of the 1959 Act three-phase system under modern rules shorn of that context.

The company's share served multiple purposes under the 1959 Act. It served to prorate the deduction for tax-exempt interest and dividends received as under present law. It also determined the amount of taxable investment yield included in taxable investment income. While an increase in the company's share under present law necessarily lowers taxable income, an increase in the company's share under prior law had a differing effect on taxable income depending on whether a company's gain from operations exceeded taxable investment income and the importance of tax-exempt interest and deductible dividends in investment yield.

Similarly, under the 1959 Act, gross investment income served multiple purposes. Not only did it determine the company's share for proration, but also it provided the basis for calculation of investment yield and taxable investment income. Gross investment income includes only positive ordinary income items, perhaps to avoid having to interpret and allocate negative amounts. It may be argued that the selection of items included in the current definition of gross investment income stem primarily from this function under prior law, rather than the present law proration function, and that the definition of gross investment income should now be tailored to mesh with the proration rule where it is used today.

Furthermore, retention of the 1959 Act concepts arguably is no longer necessitated by concern for potential unconstitutionality. The Federal income tax policy not to allow a deduction for expenses of earning amounts that are not included in income could be expressed more simply in the life insurance tax rules. An explicit statutory statement of the operation of the proration of the dividends received deduction would be simplifying. Administrability of the law would be enhanced, and disputes would be reduced, if reliance on arcane, layered pre-1984 regulations were no longer an interpretive option.

If the problem is incorrect or aggressive taxpayer positions under the proration rule (as under any present-law rule), the IRS can address this through enforcement action. If this is the situation, perhaps legislative change is not needed. To the extent that the problem arises from aggressive interpretation of the current rules, it could be countered that a case by case approach, potentially leading to the expense of litigating each taxpayer's case, may be an inefficient use of government and taxpayer resources, without effectively clarifying the law in all circuits or giving a near-term answer to all taxpayers.

Perhaps more importantly, enforcement of the law is not the sole or even the principal issue: rather, clarification of, or change to, the law arguably is needed to eliminate uncertainty about how to determine interest when present law refers to “another appropriate rate” (in the flush language of section 812(b)(2)). In short, a change is needed to the legislative language to state a clear rule. Alternatively, Treasury Department guidance is needed to clarify application of the current rules.<sup>395</sup> However, further administrative guidance may be viewed as insufficient or inadequate without a legislative pronouncement of the rules.

### **Operation of the proposal**

The proposal could be criticized as insufficiently detailed; however, a response is that the result of the proposal is clearly stated to be that the company’s share of the dividends received deduction approximates the ratio of (1) the surplus (including seed money) in the separate account to (2) the total assets of the account.

On substantive grounds, an arguably simpler and more rational proposal might be to eliminate more of the pieces of the present-law rules that were imported from pre-1984 law. Under this type of approach, one option would be affirmatively to excise the investment income-base rules of section 812, and to substitute a proration rule for life insurance company separate accounts stating that the ratio of (1) mean surplus in the account to (2) mean assets in the account<sup>396</sup> determines the company’s share of the dividends received deduction with respect to the separate account. Under this approach, the earnings rate of the separate account would not be a part of the calculation. Rather, the ratio would be based on assets, not earnings, of the separate account. Using this simple formula makes amounts retained, as well as investment expenses, or any other reduction to investment income, irrelevant. The company’s share would reflect the company’s economic interest in the separate account assets, but would not include any portion of the policyholder’s economic interest. Under this approach, the company would receive the tax benefits to which it is entitled under the economic arrangement of the separate account.

While it could be argued that the proposal could motivate taxpayers to shuffle assets between the separate account and the general account to maximize the Federal tax benefit, current State regulatory rules prevent shifting of assets (or income from assets) as between separate accounts, or between a separate account and the general account of a life insurer.

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<sup>395</sup> Arguably, in fact, the rules were relatively clear, if complex, prior to the 2003 IRS issuance of TAMs that addressed some issues but left others open, and the subsequent issuance and suspension of Rev. Rul. 2007-54 which set forth a different approach, possibly fueling disputes between the IRS and taxpayers based on differing interpretations of the law. See Susan J. Hotine, “Proration for Segregated Asset Accounts – How is the Company’s Share Computed?,” 3 *Taxing Times* 1 (September 2007); Richard N. Bush and Greg L. Stephenson, “Separate Account DRD Under Attack: Five Decades of Practice Regarding Company Share Computation Ignored,” *The Insurance Tax Review* 39 (January 2008); and Susan J. Hotine, “Proration for Segregated Asset Accounts – Part Two,” 4 *Taxing Times* 21 (February 2008).

<sup>396</sup> Another way of stating this ratio could be: (1) assets in the account that exceed mean reserves for the account, divided by (2) assets in the account. If applied to the life insurance company general account, the ratio could be: (1) assets in the general account that exceed mean reserves for the general account, divided by (2) assets in the general account.

However, a life insurer could respond by charging higher fees for separate account products or by changing its product offerings.

Another option could be to provide proration only for separate accounts, not for general accounts. The obligation of the life insurer to policyholders of general account products is more attenuated than its obligation to credit separate account dividends received directly to variable contracts. Thus, perhaps like other corporate taxpayers that are not required to prorate their deduction for dividends received, the general account of life insurers arguably should not be subject to proration. Because life insurers tend to have a relatively low proportion of dividend-paying assets in the general account, imposing a complex proration rule on general account assets may not be worthwhile. On the other hand, money is fungible, and proration of untaxed income is appropriate in any case in which the insurer has a reserve deduction with respect to amounts ultimately payable to a policyholder. Further, under present law, no dividends received deduction is allowed to corporate taxpayers for any dividend to the extent the taxpayer is under an obligation to make related payments with respect to similar property.<sup>397</sup> Thus, the concept exists outside the insurance context.

A possible criticism of the proposal, or of any proposal that reduces deductions pursuant to a change in the proration rule with respect to separate account products, is that the price of the products could increase. The insurer could pass some or all of the increased tax cost through to customers. In fact, if the proration rule does not accurately measure the insurer's income by allowing either too great, or too little, a deduction, the company can share with product purchasers, or pass along to purchasers, the unintended benefit or detriment of income mismeasurement. If it is not intended to provide either a Federal tax subsidy, or an excessive tax burden, that would affect the price of separate account products of insurance companies, then improving the accuracy and administrability of the life insurance proration rule is a desirable improvement in the tax law.

Taxpayers may argue, on horizontal equity grounds, that the proration rules for life insurance companies should not give rise to any reduction in the dividends received deduction, by analogy to nonlife corporations that are not subject to any rule reducing their dividends received deduction. On the other hand, dividend income of life insurance companies is arguably most analogous to operating income of nonfinancial-intermediation businesses. The normal rationale for the dividends received deduction – that it eliminates multiple incidence of tax on the same income items while they remain in corporate solution – does not apply if the business the firm engages in includes the earning of dividends on the customers' behalf. Under this view, no portion of the dividends received deduction should be allowed for what is effectively business income or operating income.

### **Prior Action**

No prior action.

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<sup>397</sup> Sec. 246(c)(1)(B) provides that no dividends received deduction is allowed in respect of any dividend to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

## F. Expand Pro Rata Interest Expense Disallowance for Company-Owned Life Insurance (COLI)

### Present Law

#### **Inside buildup and death benefits under life insurance contracts generally tax-free**

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract<sup>398</sup> (“inside buildup”).<sup>399</sup> Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.<sup>400</sup>

#### **Premium and interest deduction limitations with respect to life insurance contracts**

##### Premiums

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.<sup>401</sup>

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<sup>398</sup> By contrast to the treatment of life insurance contracts, if an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

<sup>399</sup> This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer’s basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59 1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory “7-pay” test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

<sup>400</sup> Sec. 101(a).

<sup>401</sup> Sec. 264(a)(1).

### Interest paid or accrued with respect to the contract<sup>402</sup>

In addition, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual,<sup>403</sup> with a key person insurance exception.<sup>404</sup>

### Pro rata interest deduction limitation

A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.<sup>405</sup> Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values of life insurance, annuity, and endowment contracts, plus the average adjusted bases of other assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is an employee or is an officer, director, or 20-percent owner of the entity of the trade or business. The exception also applies to a joint-life contract covering a 20 percent owner and his or her spouse.

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<sup>402</sup> Earlier-enacted interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts, known as the "single premium" and "4-out-of-7" limitations. The single premium limitation provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (sec. 264(a)(2)). Under the general rule to which the 4-out-of-7 limitation is a safe harbor, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise) (Sec. 264(a)(3)). Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven year period is paid by means of such debt.

<sup>403</sup> Sec. 264(a)(4).

<sup>404</sup> This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise deductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed \$50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.

<sup>405</sup> Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

In 2006, additional rules for excludability of death benefits under a life insurance contract were added in the case of employer-owned life insurance contracts<sup>406</sup> (generally, those contracts insuring employees that are excepted from the pro rata interest deduction limitation). These rules permit an employer to exclude the death benefit under a contract insuring the life of an employee if the insured was an employee at any time during the 12-month period before his or her death, or if the insured is among the highest paid 35 percent of all employees. Notice and consent requirements must be satisfied.

### **Description of Proposal**

The proposal eliminates the exception under the pro rata interest deduction disallowance rule for employees, officers and directors. The exception for 20-percent owners is retained, however.

Effective date.—The proposal is effective for contracts entered into after the date of enactment.

### **Analysis**

The proposal is directed to the issue of borrowing against life insurance contracts to achieve tax arbitrage. Businesses that own life insurance on employees and borrow from a third-party lender or from the public can achieve tax arbitrage by deducting interest that funds the tax-free inside buildup on the life insurance (or the tax-deferred inside buildup of annuity and endowment contracts). This opportunity for tax arbitrage results from the exception under the pro rata interest deduction limitation for insurance covering employees and others, it is argued. This tax arbitrage opportunity is being utilized particularly by financial intermediation businesses which often have a relatively large amount of debt in the ordinary course of business. Thus, it is argued, the exception should be repealed.

Some would point to the 2006 legislation as having addressed any undesirable aspects of company-owned life insurance (“COLI”), obviating any need for further tax legislation. By adding a notice and consent requirement, the 2006 legislation removed the risk that insured employees would never know that they were insured by their employers. Similarly, the 2006 requirement that the insured must have been an employee within 12 months before death for the employer to be able to exclude from income the death benefit received means that there would no longer be a huge pool of former employees in whose continued productivity, and life, the employer has an interest. Lastly, because the pool of employees that can be insured is limited to the highest paid 35 percent if the employer is to exclude the death benefits under the policies, the employer has no incentive to insure individuals who are not central to the operation of the business but may be lower paid, fungible workers whose life the employer has little incentive to protect. Due to these limitations on excludable death benefits under employer COLI, it is argued, there is no longer a need to resuscitate the 1999 proposal, which was made shortly after the perception that the 1996 and 1997 legislation had failed to stem the growth of COLI but before the improvements made by the 2006 legislation. Similarly, some might argue that the

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<sup>406</sup> Sec. 101(j).



1999 proposal was previously rejected (or, certainly, not adopted) by Congress, and that it is not appropriate to continue to raise it.<sup>407</sup>

The 2006 legislation, however, does not address the issue of tax arbitrage. The tax policy issue of COLI is the tax arbitrage opportunity it creates to deduct expenses such as interest with respect to tax-free inside buildup of life insurance contracts. The allowance of deductible expenses with respect to untaxed income is inconsistent with the concept of an income tax. While there may be social policy benefits to limiting employer opportunities to collect death benefits on insured individuals whom the employer has no economic incentive to protect, that is not the tax policy issue created by COLI; tax arbitrage is. The 2006 legislation did not stem tax arbitrage, despite socially meritorious changes on other grounds effected in 2006.

Further, the 2006 legislation does not affect the overall amount of COLI that any particular taxpayer acquires. Limiting the group of individuals that may be insured generally to 35 percent of the employer's workforce arguably creates an incentive to insure each covered individual for a larger amount than without such a limitation, and has no impact on the overall face amount of life insurance that an employer can maintain on its books. Rather, as a practical matter, the face amount of life insurance of the employer is limited by the underwriting practices of the insurer.

A recent study shows that COLI held by banks grew to \$126.1 billion in 2008, an increase of five percent from \$120.1 billion in 2007.<sup>408</sup> Thus, it is argued, the 2006 legislation has not slowed the growth of COLI, and in fact, the tax arbitrage impact of COLI is increasing.

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<sup>407</sup> A letter to Treasury Secretary Timothy Geithner from 24 Members of Congress states that the fiscal 2010 budget "contains several worrisome tax increases on life insurance products" and expresses concern about budget proposals that would "impose new taxes on dividends and increase taxes on business and family-owned life insurance." See letter dated June 17, 2009, to Secretary Timothy Geithner, United States Department of the Treasury, from Representatives Ron Kind, Richard E. Neal, Patrick J. Tiberi, Sander M. Levin, Jim McDermott, John B. Larson, Charles W. Boustany Jr., Bill Pascrell Jr., Shelley Berkley, David G. Reichert, Robert A. Brady, Artur Davis, Allyson Y. Schwartz, Paul Ryan, Geoff Davis, Dean Heller, Ginny Brown-Waite, Kendrick B. Meek, Peter J. Roskam, Bob Etheridge, Mike Thompson, Neil Abercrombie, Earl Pomeroy, and Kevin Brady. A separate letter to Treasury Secretary Geithner from Representative Earl Pomeroy commenting on insurance-related budget proposals states that "Congress should not further restrict companies that want to plan for the risks of transitions through difficult times from using time-tested risk management solutions, such as COLI." See letter dated June 17, 2009, to The Honorable Timothy F. Geithner, Secretary of the Treasury, from Representative Earl Pomeroy. A separate letter to Treasury Secretary Geithner from Representative Richard E. Neal states that the budget proposal relating to COLI "revisits an area of the law that has been the subject of repeated debate and Congressional action" and that "we should approach with caution any proposals that would remove options for individuals to save and plan for their retirement or for businesses to legitimately and safely manage their risk." See letter dated June 19, 2009, to The Honorable Timothy F. Geithner, U.S. Department of the Treasury, from Representative Richard E. Neal.

<sup>408</sup> Darla Mercado, "Survey: Bank-owned life insurance assets hit \$126B in '08," *Investment News.com*, June 23, 2009; Ellen E. Schultz, "Banks Use Life Insurance to Fund Bonuses – Controversial Policies on Employees Pay for Executive Benefits, Help Companies With Taxes," *Wall Street Journal*, May 20, 2009, C1. The study referred to in the Mercado article does not account for COLI that may be held by financial institutions other than banks or by other types of businesses.

The proposal could be criticized on the grounds that it fails to take into account the concern that retaining an exception from the pro rata interest disallowance rule for employees, officers, and directors is important for small businesses. Small businesses might argue that they need access to cash, in particular the cash value of life insurance on key employees, and that it would be inappropriate to reduce the tax subsidy stemming from the exception in their case, regardless of the application of the proposal to others. A more targeted proposal, whether limited to financial intermediaries or to large employers, or alternatively a narrower employee exception structured like the 20-key-person exception under the 1996 legislation, might address the tax arbitrage concern without negatively impacting the cash needs of small business. On the other hand, it could be countered that in most cases the cash needs of small businesses have already been addressed by the proposal's continuation of the exception for 20-percent owners. In addition, it can be argued that insuring the lives of key employees can be accomplished by purchasing term life insurance, which is not affected by the proposal, and that cash needs arising from loss of a key employee can be addressed without the purchase of cash value life insurance. Further, because of the extension of the average person's expected life span in recent decades, it is argued that the purchase of term life insurance on a key employee through his or her likely retirement age is no longer difficult or expensive.

Opponents of the proposal argue that the funds borrowed under the life insurance contracts are used for tax-advantaged pre-funding of expenses such as retiree health benefits and supplemental pension benefits. On the other hand, Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits. It was not intended that tax arbitrage with respect to investments in COLI be used to circumvent statutory limits that Congress enacted for these tax-favored health and pension benefits. Further, the assertion that particular sources of funds are used by corporations for particular expenses can be countered by pointing out that money is fungible.

A related argument is that COLI is accepted as tier 1 capital for banks, an important incentive for banks to hold COLI, and that limiting its tax advantages negatively impacts these financial institutions. This may be a particularly inappropriate side effect of the proposal at the current time of economic downturn, illiquidity, unavailability of credit, and instability among some banks. Arguably the proposal is inconsistent with efforts of the Federal government to stabilize and temporarily provide capital to the financial sector. On the other hand, it could be questioned whether a heavy investment in life insurance is a stabilizing influence on bank capital. Further, these types of nontax policy arguments could be criticized as unrelated to the tax policy issue addressed by the proposal.

Some might criticize the proposal as somewhat ineffective because it would not impose any dollar limitation on the amount of insurance an employer would be permitted to purchase with respect to a 20-percent owner, nor on the amount of interest expense allocable to unborrowed policy cash values with respect to such insurance that would remain deductible under the proposal. It could be argued that the proposal would not effectively deter undesirable tax arbitrage in many cases, without any such limitations.<sup>409</sup> On the other hand, it could be

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<sup>409</sup> Some might go so far as to assert that, short of a rule that borrowing against life insurance value is a taxable receipt of the value borrowed, the tax arbitrage opportunity of tax-free inside buildup cannot be effectively

argued that State law concepts of insurable interest could operate as limits (but some might say these concepts would not impose any significant limit). It could also be argued that businesses with 20-percent owners might tend to be small businesses, and that encouraging the economic success of small businesses is more important than limiting their tax arbitrage opportunities. Some might respond that a test based on the ownership percentage of shareholders is not actually targeted to small businesses, and that a more appropriate test would be focused on the assets or income of the business. Another response might be that 20-percent owners do not necessarily have any connection to the business, so the death of such a person might have no significant impact that would create a business need to insure the person's life. Further, it could be argued that any tax incentives provided to a sector of the economy, such as small business, should not be structured as arbitrage opportunities denied to other taxpayers, but rather as positive incentives towards socially or economically desirable goals.

### **Prior Action**

A similar proposal was included in President Clinton's fiscal year 1999, 2000, and 2001 budget proposals.

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addressed. Such a rule would be similar to section 956(c)(1)(C), for example, which provides that if a U.S. multinational borrows from its foreign subsidiary, the U.S. entity is subject to tax as if it had repatriated the (otherwise untaxed) foreign earnings.