Tax Provisions in America's Affordable Health Choices Act


SUMMARY

On July 14, 2009, Rep. John Dingell, together with the Chairmen of the three Committees of the House of Representatives with jurisdiction over health policy in the United States (the Committees on Ways and Means, Education and Labor, and Energy and Commerce), introduced the America's Affordable Health Choices Act of 2009 (the "Act") in the House of Representatives. The Act is intended to broaden health care coverage, while also slowing growth in health care spending, through the introduction of a public health insurance plan, various incentives for employers to provide health benefits to their employees, and penalties on individuals who fail to acquire sufficient health coverage. The Act contains significant tax provisions intended to offset the costs of the public health insurance plan. In particular, the Act would, if enacted, (i) codify the economic substance doctrine, (ii) amend and expand various penalty provisions, (iii) delay the effective date of the worldwide interest allocation rules, (iv) limit treaty withholding tax rules for interest and other deductible payments made by U.S. persons and (v) impose surtaxes on the income of certain individuals. The Act would also impose excise taxes and provide credits intended to induce employers to provide health insurance to employees and individuals to acquire health insurance.

The House Committee on Ways and Means is currently marking-up the Act. In parallel, the Senate Finance Committee is considering an alternative set of revenue raisers, none of which are included in the part of the Act discussed below.
DISCUSSION
A. REVENUE RAISERS

1. Codification of the Economic Substance Doctrine

The common law economic substance doctrine has long been applied by courts and the IRS to disallow certain aspects or consequences of tax-motivated transactions that may technically satisfy the requirements of the Internal Revenue Code of 1986, as amended (the "Code"). As a common law doctrine, however, "economic substance" is not uniformly interpreted throughout the federal judicial system. Some circuit courts apply the so-called "conjunctive test," which requires that a transaction both (1) objectively have economic consequences to the taxpayer independent of tax benefits and (2) be motivated by a subjective business purpose.\(^1\) Other circuit courts apply a so-called "disjunctive test," under which a transaction lacks economic substance only if it both (1) objectively lacks economic effect and (2) lacks a subjective business motivation.\(^2\) Still other courts consider objective economic substance and subjective business purpose to be only two factors in a general investigation into whether a transaction has economic effects other than tax benefits.\(^3\)

The Act would, if enacted, codify the economic substance doctrine using the "conjunctive test," closely following the details of the codification proposal summarized in the Obama Administration's summary of revenue proposals earlier this year,\(^4\) and the text of a provision of a 2007 bill that passed in the House but not the Senate.\(^5\) Specifically, a transaction would have economic substance under the provision only if it (1) "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic

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\(^1\) See, e.g., *Pasternak v. Comm'r*, 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 . . . . If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made.").

\(^2\) See, e.g., *Rice's Toyota World Inc. v. Comm'r*, 752 F.2d 89 (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 into the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists.").

\(^3\) *Casebeer v. Comm'r*, 909 F.2d 1360, 1363 (9th Cir. 1990) (observing that "Frank Lyon was not intended to outline a rigid two-step analysis," but rather "the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses").

\(^4\) See General Explanations of the Administration's Revenue Proposals (colloquially known as the "Green Book"), released May 11, 2009. For our previous publication on the Green Book corporate and partnership taxation proposals, see *President Releases Fiscal Year 2010 Corporate and Partnership Taxation Proposals* (May 19, 2009).

\(^5\) See H.R. 4351, The AMT Relief Act of 2007 (approved by the House by a vote of 226 to 193).
position” and (2) “the taxpayer has a substantial purpose (other than Federal income tax effects) for entering into such transaction.” State and local income tax effects related to a Federal income tax effect would be “treated in the same manner” as a Federal income tax effect. Under the provision, the potential for a profit would also not cause a transaction to have economic substance unless the present value of the reasonably expected pretax profit is “substantial in relation to the present value of the net tax benefits that would be allowed if the transaction were respected.” Notably, fees, other transaction expenses and foreign taxes would be taken into account in determining whether a sufficient pretax profit potential exists. Furthermore, a financial accounting benefit could not be used as a substantial nontax purpose if the accounting benefit originates from a reduction in the taxpayer's Federal income tax. The provision would also, if enacted, permit the IRS to issue regulations to further define the scope of the economic substance doctrine.

Although the provision is broadly applicable to taxpayers, it is only applicable to an individual taxpayer if the individual enters into a transaction in connection with (1) a trade or business or (2) an activity engaged in for the production of income.

The new provision would be effective with respect to transactions entered into after the date of the enactment of the Act.


Under current law, the penalty for a “substantial understatement” of income tax is generally 20%, but the taxpayer has three possible defenses:

(1) the position was supported by "substantial authority";

(2) the position had at least a "reasonable basis" and was disclosed in the tax return (usually on a Form 8275 or 8275-R); and

(3) there was "reasonable cause" for the understatement and the taxpayer acted in good faith.

If the understatement is attributable to a "plan or arrangement" that had "a significant purpose of tax avoidance" (i.e., a "tax shelter" as defined in Section 6662(d)(2)(C)), the only defense available is the third defense (i.e., reasonable cause and good faith).

The Act would, if enacted, significantly change these rules.

In the case of an understatement arising from application of the new economic substance rule described above or "any similar rule of law":

- the penalty would be increased to 40% unless the transaction had been adequately disclosed with the return (presumably on a Form 8275), in which case the normal 20% penalty would apply; and
• there would be no "reasonable cause and good faith" defense. This would mean that the
taxpayer would be strictly liable for the 40% or 20% penalty.

In the case of an understatement arising from a Section 6662(d) "tax shelter" (as defined above):

• there would be no reasonable cause and good faith defense. This would mean that the
taxpayer would be strictly liable for the 20% penalty.

In the case of an understatement by any "specified person":

• the only possible defense to understatement penalties would be that the person reasonably
believed the claimed treatment was "more likely than not" proper. Therefore, all three
defenses would be replaced by this one defense (which is similar to the current reasonable
cause and good faith defense).

The Act defines a "specified person" as any (1) person required to file annual, quarterly and other reports
(for example, Forms 10-K or 10-Q) with the SEC and any (2) corporation with gross receipts in excess of
$100 million for the relevant taxable year (with an aggregation rule in the case of certain controlled
groups).

The amendments to these penalties and exceptions would be effective with respect to transactions
entered into after the date of the enactment of the Act.

3. Nine-year Delay in Effective Date of Worldwide Interest Allocation Rules

Corporations are required to allocate interest and other expenses between U.S. and non-U.S. sources for
foreign tax credit limitation purposes. The American Jobs Creation Act of 2004 provided that a domestic
corporation could elect to allocate interest as if all members of its worldwide affiliated group were a single
corporation. The worldwide affiliated group would consist of all corporations in an affiliated group and
also all controlled foreign corporations that would be members of the affiliated group if the rule excluding
foreign corporations did not apply. The "worldwide interest allocation rules" were originally to be effective
for taxable years beginning after December 31, 2008, but the Housing and Economic Recovery Act of
2008 delayed the effectiveness of these rules by two years to taxable years beginning after December 31,
2010. The Act would further delay the effectiveness of these rules to taxable years beginning after
December 31, 2019 and would also eliminate a transition rule applicable in the first year in which the
worldwide interest allocation rules are applicable.

4. Limitation on Treaty Benefits for Certain Payments

The Act would deny withholding tax reductions or exemptions under U.S. income tax treaties for interest,
royalties and other "deductible payments" made by a U.S. entity to a related foreign entity if both entities
were members of the same controlled group of entities, the controlled group had a foreign entity as its

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parent and no treaty reduction would have been available if the payment had been made by the U.S. member of the group to the foreign parent. Generally speaking, under the test introduced by the Act, one entity would control another if it owned more than 50% of either the voting power or value of an entity that is a corporation or, together with other members of the group, owned more than 50% of the value of an entity other than a corporation. For purposes of constructing the controlled group, various indirect and constructive ownership rules would apply.

Under the Act, the Internal Revenue Service would be authorized to prescribe regulations or other guidance necessary or appropriate to carry out the purposes of this provision, including regulations that would treat two or more persons as members of a foreign controlled group of entities if such persons would be the common parent of such group if treated as one corporation, and regulations that would treat any member of a foreign controlled group as the common parent if such treatment would be "appropriate" taking into account the "economic relationships" among the entities in the group.

The amendment would apply with respect to payments made after the date of the enactment of the Act.

5. Individual Income Surtaxes

The Act would impose a three-tier surtax on individual and other non-corporate taxpayers' Modified Adjusted Gross Income ("MAGI"). The surtax would apply to taxable years beginning after December 31, 2010. MAGI, for individuals, would be based on adjusted gross income (which excludes most personal deductions) reduced by any allowable deduction for investment interest and, effectively, increased by the net amount of foreign earned income otherwise excluded from income.

Married couples would be subject to a surtax of 1% on MAGI between $350,000 and $500,000; an additional 1.5% on MAGI between $500,000 and $1,000,000; and an additional 5.4% on MAGI in excess of $1,000,000. Married individuals filing separately would incur surtax at one-half of those MAGI levels ($175,000, $250,000, and $500,000 respectively), while other filers would incur surtax at 80% of those income levels ($280,000, $400,000, and $800,000 respectively). The income thresholds would be indexed to inflation for taxable years beginning after 2011.

Additionally, in the case of taxable years beginning after December 31, 2012, the surtax would be calibrated to savings in federal healthcare costs as determined by the White House Office of Management and Budget. If the "Federal Health Reform Savings" exceeds a predetermined target of $525 billion by less than $150 billion, the 1% and 1.5% surtaxes will be raised to 2% and 3% respectively.

6 A similar provision previously passed the House by a vote of 231 to 191 as part of the House version of the Food, Conservation, and Energy Act of 2008. See H.R. 2419. Furthermore, the same provision was part of the proposed Tax Reduction and Reform Act of 2007 (the "Mother Bill"), introduced by Rep. Charles Rangel, Chairman of the Committee on Ways and Means. See H.R. 3970.
If the excess is between $150 billion and $175 billion, the surtaxes will remain unchanged. If the excess exceeds $175 billion, the 1% and 1.5% surtaxes will be eliminated.

**B. HEALTH-RELATED TAX PROVISIONS**

1. **Taxes and Penalties on Employers**

The Act would impose taxes on employers that fail to provide qualifying insurance to their employees and also provide limited credits to offset the cost of providing insurance. Each of these provisions would apply to periods beginning after December 31, 2012.

The Act provides that, if an employer intends to provide health benefits to its employees, it must make an affirmative election and must also offer a health plan that meets certain minimum coverage requirements. An electing employer that fails to offer such a plan would generally be subject to a penalty of $100 per day/per employee.

Any employer that does not elect to provide health benefits to its employees would generally be subject to an additional payroll tax equal to 8% of wages (commonly referred to as the "play or pay" mandate). Certain small businesses would be eligible for a tax credit to offset the cost of providing health benefits if they elect to do so or, in the case of small businesses with annual payrolls of $400,000 or less, would be subject to smaller penalties if they do not so elect.

2. **Tax on Individuals Failing to Acquire "Acceptable Coverage"**

The Act would also impose a tax on certain individuals who fail to acquire "acceptable health care coverage" equal to 2.5% of the excess of MAGI over the amount of income at which an individual is generally required to file an income tax return, with an overall limit on such tax of the "applicable national average premium" for health insurance. Several narrow exceptions would apply in the case of dependents who can be claimed on another’s tax return, nonresident aliens, individuals residing outside the United States, and certain adherents of religious sects or divisions. The tax would apply to taxable years beginning after December 31, 2012.

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