**March 30, 2010**

# Health Care Act Codifies "Economic Substance" Doctrine, Expands Medicare Taxes on High Income Earners, and Imposes Reporting Requirements on Certain Payments to Corporations

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On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010 which supplements the Patient Protection and Affordable Care Act which was signed into law on March 23, 2010 (together, the "Act"). The Act codifies the common law "economic substance doctrine" for transactions entered into after March 30, 2010, expands the Medicare taxes on high income earners as from January 1, 2013, and imposes information reporting requirements on certain payments made to corporations after December 31, 2011.

## ECONOMIC SUBSTANCE DOCTRINE

*Background*

The "economic substance doctrine" allows the government to recast a transaction in a manner that reflects its substance, or disregard a transaction and its related federal income tax consequences, when the transaction has no economic substance other than its intended tax consequences. There is a conflict in the U.S. Circuit Courts of Appeal as to the proper standard that should apply in determining when a transaction is to be disregarded on the basis of the economic substance doctrine. In applying the doctrine, the Fourth and D.C. Circuits have adopted a two-prong "conjunctive" test. Pursuant to this test, in order to disregard a transaction for federal income tax purposes, the court must conclude that the taxpayer, in entering into the transaction, fails both of the following requirements: (i) subjective business purpose, and (ii) objective profit potential. The Sixth, Eleventh, and Federal Circuits have adopted the same test in a "disjunctive" fashion (i.e., if the taxpayer fails either of the aforementioned prongs, the transaction at issue may be disregarded). The Third, Ninth, and Tenth Circuits have adopted a "unitary" test. Pursuant to this test, the subjective business purpose and objective profit potential, in combination with each other, should form the analysis in determining whether a transaction has enough substance, apart from its tax consequences.

*Codification*

The Act provides that any transaction (including a series of transactions) entered into after March 30, 2010 and to which the economic substance doctrine is relevant is treated as having economic substance only if (i) the transaction changes in a meaningful way the taxpayer's economic position (the objective test), and (ii) the taxpayer has a substantial purpose for entering into such transaction (the subjective test). In applying the foregoing two tests, federal, state, or local income tax effects should be disregarded. The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision codifying the doctrine had not been enacted.

In determining whether the objective and subjective tests are met with respect to a transaction, a profit potential is only taken into account if the present value of the reasonably-expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits from the transaction. In calculating any pre-tax profit, fees and other transaction expenses must be taken into account as expenses. Further, the Act requires Treasury to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profits in appropriate cases. In addition, achieving a financial accounting benefit that originates from a reduction of federal income tax is not taken into account in determining whether the taxpayer meets the above-described subjective test.

The economic substance provision only applies to a transaction entered into by an individual if the transaction is entered into in connection with a trade or business or an activity engaged in for the production of income.

The technical explanation to the Act[1] clarifies that this provision is not intended to change the tax treatment of certain basic business transactions merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Examples noted in the technical explanation include: (i) the choice between capitalizing an entity with debt or equity, (ii) the choice between using a foreign corporation or a domestic corporation to make a foreign investment, (iii) the choice to enter into a transaction (or series of transactions) constituting a (re)organization, and (iv) the choice to use a related party in a transaction.

Further, the technical explanation states that no inference is intended as to the proper application of the common law economic substance doctrine and that the Act is additive to that doctrine.

*Penalties*

The Act introduces a new strict liability penalty of 20% for an understatement attributable to a disallowance of claimed tax benefits by reason of a transaction entered into after March 30, 2010 lacking economic substance or failing to meet the requirements of any similar rule of law (and therefore, it seems that the penalty would apply to both the statutory and common law version of the economic substance doctrine). The penalty is increased to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment of the transaction on its tax return or in a statement attached to the return. An amended tax return or a supplement to a tax return is not taken into account if it is filed after the taxpayer has been contacted for audit. Importantly, the "reasonable cause exception" is not available to avoid the penalty. Therefore, as the technical explanation points out, an opinion from outside counsel or an in-house analysis would not protect a taxpayer from imposition of the penalty.

## MEDICARE TAX

Under current law, both employers and employees are subject to a Medicare hospital insurance tax in an amount equal to 1.45 percent of the wages paid to the employee. The employee-level tax generally must be withheld and remitted to the federal government by the employer. As from January 1, 2013, the Act increases the Medicare hospital insurance tax and imposes a Medicare contribution tax on unearned income, in each case on certain high income earners.

*Medicare Hospital Insurance Tax*

The Act imposes an additional tax of .9 percent on the wages of an employee over a specified threshold amount. The

[1] Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patent Protection Act and Affordable Care Act," as amended, *Joint Committee on Taxation*, March 21, 2010 (JCX-18-10).

 

threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 for single filers. The additional tax is also imposed on income from self-employment.

*Medicare Contribution Tax*

The Act further introduces a 3.8 percent Medicare contribution tax on unearned income (i.e., income not from wages) of certain high income earners. Specifically, in the case of an individual, the tax is imposed at a rate of 3.8 percent on the lesser of (i) "net investment income," or (ii) the excess of "modified adjusted gross income" over the threshold amount specified in the preceding paragraph. "Net investment income" equals the taxpayer's gross investment income reduced by the deductions that are allocable to such income. Investment income generally includes passive income such as interest, dividends, annuities, royalties, rents, and capital gains. "Modified adjusted gross income" is adjusted gross income increased by the amount excluded from income as foreign earned income.

*Current and Future Federal Income Tax Rates on Investment Income*

The chart below shows the maximum federal income tax rate, assuming no changes to current law,[2] that applies to an individual earning in excess of the threshold amount with respect to three categories of investment income for the years 2010, 2011, and 2013 (taking into account the Medicare contribution tax starting in 2013).[3]

| | **2010** | **2011** | **2013** |
|---|---|---|---|
| *Dividends* | 15% | 39.6% | 43.4% |
| *Interest* | 35% | 39.6% | 43.4% |
| *Long-Term Capital Gain* | 15% | 20% | 23.8% |

## INFORMATION REPORTING ON CERTAIN PAYMENTS TO CORPORATIONS

Under current law, every person engaged in a trade or business and making payments in the course of that trade or business in an aggregate amount of $600 or more in a taxable year to one person, is required to prepare an information return (e.g., Form 1099) with respect to such payments. The information return is required to be sent to the Internal Revenue Service and the recipient of the payment. Payments made to corporations are generally exempt from information reporting.

[2] The Obama administration's FY 2011 revenue proposal would limit the federal income tax rate on qualifying dividends to 20%.
[3] The year 2012 is not included in the chart since, under current law, the federal income tax rates for that year are not scheduled to change from the 2011 levels.

The Act requires payors to file information returns with respect to payments made to a corporation after December 31, 2011 in an amount of $600 or more during a calendar year. Examples include payments made in consideration for property or services. However, certain payments that are currently exempt from information reporting if made to a corporation (e.g., payments of interest, dividends and gross proceeds from securities or broker transactions) will remain exempt from information reporting.

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