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Client Alert

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Significant Tax Provisions In Newly Enacted Health Care Reform Legislation

On March 30, 2010, President Obama signed into law the second of two major pieces of legislation reforming the American health care system.[1] The two laws, referred to together in this *Alert* as the Act, include a number of changes to the Internal Revenue Code of 1986, as amended (the Code). Many of the revisions relate to the health care reforms, including provisions that impose new excise taxes on high-cost (Cadillac) health plans and several health-related industries (such as sellers of certain medical devices, manufacturers and importers of brand-name prescription drugs and certain providers of health insurance). The changes also require charitable hospitals to conduct community health needs assessments and adopt financial assistance policies,[2] require enhanced W-2 reporting of the cost of employer-sponsored health coverage and limit annual contributions to health flexible spending accounts (FSAs).

In addition, the Act includes several other significant tax law changes. This *Alert* addresses the following notable provisions:

- An increase in the Medicare tax on high-income workers for taxable years beginning after December 31, 2012.
- Imposition of an additional Medicare tax on net investment income for taxable years beginning after December 31, 2012.
- Modification of certain information reporting rules, effective for payments made after December 31, 2011.
- Codification of the economic substance doctrine and a new strict liability penalty for transactions lacking economic substance, effective for transactions entered into after March 30, 2010.

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Increased Medicare Tax on High-Income Workers

Employment taxes imposed with respect to employees under the Federal Insurance Contributions Act (FICA) and with respect to self-employed individuals under the Self-Employment Contributions Act (SECA) consist of two component taxes: the Old Age, Survivors and Disability Insurance (OASDI, commonly known as Social Security) tax,[3] which is imposed on wages and self-employment earnings up to an annual limit ($106,800 for 2010), and the Hospital Insurance tax (commonly known as the Medicare tax), which applies without any compensation limit. Under pre-Act law, the rate of Medicare tax on wages is 2.9 percent. The burden of this tax is split between the employee and the employer, with each responsible for 1.45 percent. Similarly, self-employed persons bear a 2.9 percent Medicare tax on their self-employment income, with

1.45 percent (analogous to the employer portion) allowed as a deduction from gross income.

For taxable years beginning after December 31, 2012, the Act increases the Medicare tax by 0.9 percent, to a total of 3.8 percent, on wages and self-employment income over $250,000 for taxpayers filing a joint return, $125,000 for married taxpayers filing separately and $200,000 for other taxpayers. Notably, this tax increase is borne completely by the employee, such that the employer remains liable for 1.45 percent and the employee's liability increases to 2.35 percent of covered wages. Employers will generally be responsible for collecting and remitting the 0.9 percent employee increase through payroll withholding, although the employer is only required to withhold on wages over $200,000 for the year, even if the employee is liable for some tax on wages below that amount (*e.g.*, in the case of joint return filers whose combined wages exceed $250,000). Self-employed persons are liable for the entire 3.8 percent tax, with the allowable deduction remaining at 1.45 percent (*i.e.*, no deduction is allowed for the 0.9 percent increase). As is generally the case with SECA taxes, the increased tax on self-employed persons will be required to be included in the individual's estimated tax payments.

Additional Medicare Tax Imposed on Net Investment Income

For taxable years beginning after December 31, 2012, in addition to increasing the Medicare tax rates on wage and self-employment income over the threshold amounts specified above, the Act imposes a 3.8 percent tax on certain "net investment income" of individuals, trusts and estates. Individuals will be subject to the 3.8 percent tax to the extent their "modified adjusted gross income" exceeds the threshold amounts specified above. Modified adjusted gross income is adjusted gross income, increased by the amount excluded as foreign earned income under Section 911 of the Code (net of deductions and exclusions disallowed with respect to such foreign earned income). Trusts and estates will be subject to the 3.8 percent tax for income that is taxed at the highest marginal rate (currently income over $7,500).

For purposes of this tax, net investment income includes income from interest, dividends, annuities, royalties, rents and gains from the disposition of property that is not connected with the taxpayer's trade or business (except if the trade or business is a passive activity with respect to the taxpayer or consists of trading financial instruments or commodities) reduced by any allowable deductions properly allocable to such investment income. As defined in the Act, net investment income does not include tax-exempt interest or distributions from tax-qualified plans, annuity plans, individual retirement accounts or government pensions. Further, gain from the disposition of interests in partnerships and S corporations will be limited to the amount of net investment income that would exist if the partnership or S corporation were to sell all of its assets for fair market value immediately prior to the disposition of the partnership or S corporation interest. Net investment income does not include amounts which are treated as wages or self-employment income for purposes of the Medicare tax.

New Information Reporting Requirements

Section 6041 of the Code requires taxpayers to complete an information return on Internal Revenue Service (IRS) Form 1099 for each payee receiving aggregate compensation or fixed and determinable payments of $600 or more from the taxpayer's trade or business during the course of the taxable year. The current regulations under Section 6041 of the Code exempt from these reporting requirements any payments to corporations, tax-exempt organizations, international organizations and retirement plans.

Under the Act, for payments made after December 31, 2011, payments to a corporation will no longer be exempt from the requirement that a payor complete an information return for payments aggregating over $600 in a taxable year. In addition, the Act expands the categories of income subject to information reporting, requiring payors to include on the information return not only compensation and fixed and determinable payments to the payee but also gross proceeds paid to the payee in consideration for property or services. It is important to note, however, that these amendments do not override other Code provisions excepting payments from the information reporting requirements, including the exception for certain broker transactions.

Codification of the Economic Substance Doctrine

Conjunctive Test Requires Both Economic Substance and Business Purpose

The Act codifies the economic substance judicial doctrine, which denies a taxpayer the tax benefits of a transaction if the transaction does not change the taxpayer's economic position, apart from the claimed tax benefits, in a meaningful way. Courts have reached different conclusions on whether a transaction must have either economic substance or a non-tax business purpose, or both, to be respected, and prior to the Act there was no specific penalty that applied to transactions lacking economic substance. In enacting a codified definition of economic substance, Congress intends to standardize the doctrine's application, encourage the disclosure of transactions for which the economic substance doctrine may be relevant and impose a specific penalty on underpayments resulting from transactions that fail the new codified definition.

The Act adopts a conjunctive approach. In the case of any transaction (or series of transactions) to which the economic substance doctrine is relevant, the transaction will be treated as having economic substance only if: (1) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction (*i.e.*, a business purpose).

The Act also provides specific rules for applying the codified economic substance doctrine. For example, a transaction's profit potential will be taken into account only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. In determining pre-tax profit, fees and other transaction expenses will be taken into account as expenses, and the Act directs the IRS to issue regulations specifying when foreign taxes will be treated as expenses. In addition, an expected financial accounting benefit is not a sufficient business purpose for a transaction subject to the codified economic substance doctrine if the origin of the financial accounting benefit is a reduction of federal income tax. A transaction entered into by an individual will be covered by these new rules if the individual enters into the transaction in connection with his or her trade or business or an activity engaged in for the production of income.

Notably, the Act does not specify or otherwise set forth criteria for determining when the codified economic substance doctrine is to apply. The legislative history states that the provision does not change present law standards in determining when the economic substance doctrine applies to a transaction. In light of the significant, strict liability penalties that now apply to transactions that fail to satisfy the codified economic substance doctrine, taxpayers should expect the IRS to reconsider how it develops and raises challenges to claimed tax benefits based on the economic substance doctrine.

The legislative history states further that the provision is not intended to alter the tax treatment of certain basic business transactions that are respected under longstanding judicial and administrative practice, merely because the choice between meaningful economic alternatives is based largely or entirely on comparative tax advantages. Such basic transactions include, without limitation:

- The choice between using debt or equity to capitalize a business.
- A US person's choice between using a foreign or a domestic corporation to make a foreign investment.
- The choice to enter into a transaction or series of transactions constituting an incorporation or a corporate reorganization.
- The choice to use a related-party entity in a transaction, provided the arm's length standard and other applicable criteria are satisfied.

The legislative history states that leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances, and whether a transaction satisfies the requirements for specific treatment under any particular tax provisions is a question of facts and circumstances. The fact, however, that a transaction satisfies the requirements for specific treatment under any provision of the Code is not determinative of whether the transaction, or a series of transactions of which it is a part, has economic substance.

Provisions Relating to Penalties and Taxpayer Defenses

The Act imposes a new accuracy-related penalty of 20 percent on an underpayment resulting from a transaction that lacks economic substance (as codified by the Act) or, critically, that fails to meet the requirements of "any similar rule of law."[4] The penalty increases to 40 percent if the relevant facts affecting the tax treatment of the transaction are not adequately disclosed on the taxpayer's tax return or a statement attached to the return (or an amended return filed before notice of an audit or such other date specified by the IRS).

The new penalty is a strict liability penalty; no reasonable cause defense is available. As a result, reliance on the opinion of a tax professional will not be a defense to the penalty if the transaction lacks economic substance or fails to meet the requirements of any similar rule of law.

Similarly, for a reportable transaction giving rise to an understatement of taxable income, the Act applies a strict liability standard to the reportable transaction understatement penalty even if the transaction had been disclosed, if the transaction also lacks economic substance or fails to meet the requirements of any similar rule of law. In addition, if a claim for an income tax refund or credit is for an excessive amount (*i.e.*, the amount by which such claim exceeds the claim allowable), the claim is subject to a 20 percent, strict liability penalty to the extent the excessive amount is attributable to a transaction that lacks economic substance or fails to meet the requirements of any similar rule of law.

Conclusion

Different versions of the codification of the economic substance doctrine have been considered by Congress over the last decade, and administrative guidance on the new statute is anticipated. That guidance may be important in determining how the new statute will affect the tax planning for and IRS audits of transactions reflecting, at least in part, tax considerations.

Although the language of the Act and the legislative history appear to signal consistency with pre-Act law on the economic substance doctrine, the uncertainty inherent in whether a court would treat the doctrine as applying to a transaction carries over into the new statute. Further, as noted above, the Act applies the new penalties to transactions that fail to meet the requirements of "any similar rule of law." The scope of what falls within that term is uncertain, and its potential breadth could make the new statute an even greater change to the accuracy-related penalty rules.

These provisions of the Act apply to transactions entered into after March 30, 2010, and to underpayments, understatements and refunds and credits attributable to transactions entered into after March 30, 2010.

Endnotes

1 The health care reforms were adopted in two separate measures: the Patient Protection and Affordable Care Act, signed by President Obama on March 23, 2010, and the Health Care and Education Reconciliation Act of 2010, signed on March 30, 2010.

2 *See* Latham & Watkins *Client Alert* Number 1005, "Recent Legislative Changes Affecting Tax-Exempt Hospitals," March 30, 2010. Available at www.lw.com.

3 For a discussion of the exemption from the employer portion of the OASDI tax with respect to certain wages paid in 2010 to qualified new employees, *see* Latham & Watkins *Client Alert* Number 1001, "President Signs HIRE Act, Enacting Foreign Account Tax Compliance Provisions Along With Hiring Incentives," March 24, 2010. Available at www.lw.com.

4 The legislative history indicates that the term "a similar rule of law" is intended to be based on the factors and analysis used for the economic substance doctrine, even if a different term is used to describe the doctrine.

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