

**DESCRIPTION OF THE CHAIRMAN'S AMENDMENT IN  
THE NATURE OF A SUBSTITUTE TO H.R. 2896,  
THE "AMERICAN JOBS CREATION ACT OF 2003"**

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By the  
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Prepared by  
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JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The House Committee on Ways and Means has scheduled a mark up of H.R. 2896, the “American Jobs Creation Act of 2003,”<sup>1</sup> for October 28, 2003. This document,<sup>2</sup> prepared by the staff of the Joint Committee on Taxation, describes the Chairman’s amendment in the nature of a substitute to H.R. 2896.

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<sup>1</sup> For a description of H.R. 2896 as introduced, see Joint Committee on Taxation, *Technical Explanation of H.R. 2896, the “American Jobs Creation Act of 2003”* (JCX-72-03), August 13, 2003.

<sup>2</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 2896, the “American Jobs Creation Act of 2003”* (JCX-94-03), October 24, 2003.

## I. CORPORATE REFORM AND GROWTH INCENTIVES

### A. Reduced Corporate Income Tax Rate for Domestic Production Activities Income and for Small Corporations (secs. 1001 and 1002 of the bill<sup>3</sup> and sec. 11 of the Code)

#### Present Law

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

**Table 1.—Marginal Federal Corporate Income Tax Rates for 2003**

<u>If taxable income is:</u>	<u>Then the income tax rate is:</u>
\$0 - \$50,000 .....	15 percent of taxable income
\$50,001 - \$75,000 .....	25 percent of taxable income
\$75,001 - \$10,000,000 .....	34 percent of taxable income
Over \$10,000,000.....	35 percent of taxable income

The first two graduated rates described above are phased out by a five-percent surcharge for corporations with taxable income between \$100,000 and \$335,000. Also, the application of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between \$15 million and \$18,333,333; a corporation with taxable income of \$18,333,333 or more effectively is subject to a flat rate of 35 percent.

Under present law, there is no provision that reduces the corporate income tax for taxable income attributable to domestic production activities.

#### Description of Proposal

##### Reduced corporate income tax rate for domestic production activities income

###### In general

The proposal provides that the corporate tax rate applicable to qualified production activities income may not exceed 34 percent (32 percent for taxable years beginning after 2006) of the qualified production activities income.

###### Qualified production activities income

“Qualified production activities income” is the income attributable to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to

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<sup>3</sup> All section references are to the *Chairman’s Amendment in the Nature of a Substitute to H.R. 2896*.



such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.<sup>4</sup>

#### Domestic production gross receipts

“Domestic production gross receipts” generally are gross receipts of a corporation that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States;<sup>5</sup> (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; or (3) construction services or engineering and architectural services for construction projects. However, domestic production gross receipts do not include any gross receipts of the taxpayer derived from a transaction with any related person.

“Qualifying production property” generally is any tangible personal property, computer software, or property described in section 168(f)(4) of the Code. “Qualified film” is any property described in section 168(f)(3) of the Code (other than certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

#### Reduced corporate income tax rate for small corporations

The proposal modifies the marginal tax rates applicable to corporations. For taxable years beginning in 2004, 2005, and 2006, the proposal provides a 33-percent marginal corporate tax rate for taxable incomes in excess of \$75,000 and less than or equal to \$1 million. For taxable years beginning after 2006 and before 2012, the proposal provides a 32-percent marginal corporate tax rate for taxable incomes in excess of \$75,000 and less than or equal to \$1 million (\$5 million for taxable years beginning in 2009, 2010 and 2011). Corporate taxable income in excess of \$1 million (\$5 million for taxable years beginning in 2009, 2010 and 2011) is taxed at a 34-percent marginal tax rate, and the benefit of the marginal corporate tax rates less than 34

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<sup>4</sup> The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., secs. 263A and 861).

<sup>5</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 (but not 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). Domestic production gross receipts also includes gross receipts of a taxpayer derived from any sale, exchange or other disposition of food products with respect to which the taxpayer performs processing activities.

percent is phased out by a five-percent surcharge. The phase-out creates a 39-percent marginal tax rate for incomes over \$1 million (\$5 million for taxable years beginning in 2009, 2010 and 2011) but less than \$1,420,000 (\$1,605,000 for taxable years beginning in 2007 and 2008 and \$7,205,000 for taxable years beginning in 2009, 2010 and 2011). Above the phase-out range, a 34-percent marginal corporate tax rate applies to taxable incomes up to \$10 million.

For taxable years beginning in 2012 and thereafter, the proposal extends the new 32-percent rate bracket to corporations with taxable incomes in excess of \$75,000 and less than or equal to \$20 million. The 35-percent marginal corporate tax rate applies to taxable incomes over \$20 million. In addition, beginning at corporate taxable incomes over \$20 million, the benefit of the 32-percent, 25-percent, and 15-percent marginal tax rates relative to the 35-percent marginal tax rate is phased out by a three-percent surcharge. The phase-out creates a 38-percent marginal tax rate for incomes over \$20 million, but less than \$40,341,667. Above the phase-out range, a 35-percent marginal corporate tax rate applies.

#### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2003.

**B. Extension of Increased Section 179 Expensing  
(sec. 1011 of the bill and sec. 179 of the Code)**

**Present Law**

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003<sup>6</sup> increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to \$100,000 of the cost of qualifying property placed in service for the taxable year.<sup>7</sup> 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. For taxable years beginning after 2002 and before 2006, the \$100,000 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 \$400,000. The dollar limitations are indexed annually for inflation for taxable years beginning in a calendar year after 2003 and before 2006. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning in 2003 through 2005 as qualifying property. The provision permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2006.

Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 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. 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. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter), an election to expense these items generally is made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with consent of the Commissioner.<sup>8</sup>

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<sup>6</sup> Pub. Law No. 108-27, sec. 202 (2003).

<sup>7</sup> Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)) or an empowerment zone (sec. 1397A).

<sup>8</sup> Section 179(c)(2). A taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Treas. Reg. sec. 1.179-5.

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.

### **Description of Proposal**

The proposal extends the increased amount that a taxpayer may deduct, and other changes that were made by JGTRRA of 2003, for an additional two years. Thus, the proposal provides that the maximum dollar amount that may be deducted under section 179 is \$100,000 for property placed in service in taxable years beginning before 2008 (\$25,000 for taxable years beginning in 2008 and thereafter). In addition, the \$400,000 amount applies for property placed in service in taxable years beginning before 2008 (\$200,000 for taxable years beginning in 2008 and thereafter). The proposal extends, through 2007 (from 2005), the indexing for inflation of both the maximum dollar that may be deducted and the \$400,000 amount. The provision also includes off-the-shelf computer software placed in service in taxable years beginning before 2008 as qualifying property. The proposal permits taxpayers to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning before 2008.

### **Effective Date**

The proposal is effective on the date of enactment.

**C. Recovery Period for Depreciation of Certain Leasehold  
Improvements and Restaurant Property  
(sec. 1021 of the bill and sec. 168 of the Code)**

**Present Law**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

**Depreciation of leasehold improvements**

Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).<sup>9</sup> This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.<sup>10</sup> If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c), (d)(2), and (i)(6)).<sup>11</sup>

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<sup>9</sup> The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System (“ACRS”) to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

<sup>10</sup> Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

<sup>11</sup> If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a “structural component” of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner.*, 52 TCM (CCH) 1440 (1987);

### **Qualified leasehold improvement property**

The Job Creation and Worker Assistance Act of 2002<sup>12</sup> as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003<sup>13</sup> generally provides an additional first-year depreciation deduction equal to either 30 percent or 50 percent of the adjusted basis of qualified property placed in service before January 1, 2005. Qualified property includes qualified leasehold improvement property. For this purpose, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

### **Treatment of dispositions of leasehold improvements**

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease. This rule conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.

### **Description of Proposal**

The proposal provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006.<sup>14</sup> The proposal requires that qualified leasehold improvement property be recovered using the straight-line method.

Qualified leasehold improvement property is defined as under present law for purposes of the additional first-year depreciation deduction (sec. 168(k)), with the following modification. If a lessor makes an improvement that qualifies as qualified leasehold improvement property such improvement shall not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

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*King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

<sup>12</sup> Pub. Law No. 107-147, sec 101 (2002).

<sup>13</sup> Pub. Law No. 198-27, sec. 201 (2003).

<sup>14</sup> Qualified leasehold improvement property continues to be eligible for the additional first-year depreciation deduction under sec. 168(k).

The proposal also provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006.<sup>15</sup> For purposes of the proposal, qualified restaurant property means any improvement to a building if such building has been in service more than three years and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. The proposal requires that qualified restaurant property be recovered using the straight-line method.

#### **Effective Date**

The proposal is effective for property placed in service after the date of enactment.

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<sup>15</sup> Qualified restaurant property would become eligible for the additional first-year depreciation deduction under sec. 168(k) by virtue of the assigned 20-year recovery period.

## **D. Alternative Minimum Tax Relief**

### **1. Net operating losses and foreign tax credit under the alternative minimum tax and expansion of exemption from alternative minimum tax for small corporations (secs. 1031-1032 of the bill and secs. 55-59 of the Code)**

#### **Present Law**

##### In general

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner that limits the tax benefits resulting from the regular tax treatment of such items.

##### Net operating loss

Taxpayers generally may use the net operating loss deduction to offset 90 percent of AMTI (determined without regard to the net operating loss deduction). A special rule allows a net operating loss carryback from, or carryover to, a taxable year ending during 2001 or 2002 to offset 100 percent of AMTI.

##### Foreign tax credit

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI. Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to total AMTI.

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit. For example, assume that a corporation has \$10 million of AMTI, has no AMT net operating loss deduction, and has no regular tax liability. In the absence of the AMT foreign tax credit, the corporation's tax liability would be \$2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below \$200,000. Any unused AMT foreign tax credit may be carried back two years and carried forward five years for use against AMT in those years under the principles of the foreign tax credit carryback and carryover rules set forth in section 904(c).



### Small corporation exemption

Corporations with average gross receipts of less than \$7.5 million for the prior three taxable years are exempt from the corporate alternative minimum tax. The \$7.5 million threshold is reduced to \$5 million for the corporation's first 3-taxable year period.

### **Description of Proposal**

The proposal phases-out the 90-percent limitation on the use of the net operating loss deduction in computing AMTI. The limitation is increased to 92 percent for taxable years beginning in 2005, 2006 and 2007; 94 percent for taxable years beginning in 2008 and 2009; 96 percent for taxable years beginning in 2010; 98 percent for taxable years beginning in 2011; and 100 percent for taxable years beginning in and after 2012.

The proposal repeals the 90-percent limitation on the utilization of the AMT foreign tax credit.

The proposal increases the amount of average gross receipts that an exempt corporation may receive from \$7.5 million to \$20 million.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2004.

## **2. Coordinate farmers income averaging and the alternative minimum tax (sec. 1033 of the bill and sec. 55 of the Code)**

### **Present Law**

An individual taxpayer engaged in a farming business as defined by section 263A(e)(4) may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming. The averaging election is not coordinated with the alternative minimum tax. Thus, some farmers may become subject to the alternative minimum tax solely as a result of the averaging election.

### **Description of Proposal**

The proposal coordinates farmers' income averaging with the alternative minimum tax. Under the proposal, a farmer would owe alternative minimum tax only to the extent he or she would owe alternative minimum tax had averaging not been elected. This result is achieved by excluding the impact of the election to average farm income from the calculation of both regular tax and tentative minimum tax, solely for the purpose of determining alternative minimum tax.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2002.

## **E. Proposals Relating to S Corporation Reform and Simplification (secs. 1041-1051 of the bill and secs. 1361-1379 and 4975 of the Code)**

### **Overview**

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

### **1. Shareholders of an S corporation**

#### **Present Law**

##### **In general**

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which has (1) no more than 75 shareholders, all of whom are individuals (and certain trusts, estates, charities, and qualified retirement plans)<sup>16</sup> who are citizens or residents of the United States, and (2) only one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means a corporation that is a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation electing the benefits of the Puerto Rico and possessions tax credit, a Domestic International Sales Corporation ("DISC") or former DISC.

##### **Individual retirement accounts**

An individual retirement account ("IRA") is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of

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<sup>16</sup> If a charity or a qualified retirement plan holds stock in an S corporation, the interest held is treated as an interest in an unrelated trade or business, and the charity's or plan's share of the S corporation's items of income, loss, or deduction, and gain or loss on the disposition of the S corporation stock, are taken into account in computing unrelated business taxable income.

nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Under present law, an IRA cannot be a shareholder of an S corporation.

Certain transactions are prohibited between an IRA and the individual for whose benefit the IRA is established, including a sale of property by the IRA to the individual. If a prohibited transaction occurs between an IRA and the IRA beneficiary, the account ceases to be an IRA, and an amount equal to the fair market value of the assets held in the IRA is deemed distributed to the beneficiary.

### **Description of Proposal**

#### **In general**

The proposal provides that all family members can elect to be treated as one shareholder for purposes of determining the number of shareholders in the corporation. A family is defined as the lineal descendants of a common ancestor (and their spouses). The common ancestor cannot be more than three generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of this proposal, if later). Except as provided by Treasury regulations, the election for a family may be made by any family member and remains in effect until terminated.

The proposal increases the maximum number of eligible shareholders from 75 to 100.

#### **Individual retirement accounts**

The proposal allows an IRA (including a Roth IRA) to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on the date of enactment of the proposal.<sup>17</sup>

The proposal also provides an exemption from prohibited transaction treatment for the sale by an IRA to the IRA beneficiary of bank stock held by the IRA on the date of enactment of the proposal. Under the bill, a sale is not a prohibited transaction if: (1) the sale is pursuant to an S corporation election by the bank; (2) the sale is for fair market value (as established by an independent appraiser) and is on terms at least as favorable to the IRA as the terms would be on a sale to an unrelated party; (3) the IRA incurs no commissions, costs, or other expenses in

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<sup>17</sup> Under the proposal, the present-law rules treating S corporation stock held by a qualified retirement plan or a charity as an interest in an unrelated trade or business apply also to an IRA holding stock of a bank that is an S corporation.

connection with the sale; and (4) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

### **Effective Date**

The proposals generally apply to taxable years beginning after December 31, 2003. The proposal relating to IRAs takes effect on the date of enactment.

## **2. Treatment of S corporation shareholders**

### **(a) Electing small business trusts**

#### **Present Law**

An electing small business trust (“ESBT”) holding stock in an S corporation is taxed at the maximum individual tax rate on its ratable share of items of income, deduction, gain, or loss passing through from the S corporation. An ESBT generally is an electing trust all of whose beneficiaries are eligible S corporation shareholders. For purposes of determining the maximum number of shareholders, each person who is entitled to receive a distribution from the trust (“potential current beneficiary”) is treated as a shareholder during the period the person may receive a distribution from the trust.

An ESBT has 60 days to dispose of the S corporation stock after an ineligible shareholder becomes a potential current beneficiary to avoid disqualification.

#### **Description of Proposal**

Under the proposal, powers of appointment to the extent not exercised are disregarded in determining the potential current beneficiaries of an electing small business trust.

The proposal increases the period during which an ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from 60 days to one year.

#### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

### **(b) Qualified subchapter S trusts**

#### **Present Law**

Under present law, the share of income of an S corporation whose stock is held by a qualified subchapter S trust (“QSST”), with respect to which the beneficiary makes an election, is taxed to the beneficiary. However, the trust, and not the beneficiary, is treated as the owner of the S corporation stock for purposes of determining the tax consequences of the disposition of the S corporation stock by the trust. A QSST generally is a trust with one individual income beneficiary for the life of the beneficiary.

### **Description of Proposal**

Under the proposal, the beneficiary of a qualified subchapter S trust is generally allowed to deduct suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the S corporation stock.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

#### **(c) Transfers of losses incident to divorce, etc.**

### **Present Law**

Under present law, any loss or deduction that is not allowed to a shareholder of an S corporation, because the loss exceeds the shareholder's basis in stock and debt of the corporation, is treated as incurred by the corporation with respect to that shareholder in the subsequent taxable year.

### **Description of Proposal**

Under the proposal, if a shareholder's stock in an S corporation is transferred to a spouse, or to a former spouse incident to a divorce, any suspended loss or deduction with respect to that stock is treated as incurred by the corporation with respect to the transferee in the subsequent taxable year.

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

### **3. Proposals relating to banks**

#### **(a) Exclusion of investment securities income from passive income test for bank S corporations**

### **Present Law**

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. In addition, an S corporation election is terminated whenever the corporation has accumulated earnings and profits at the close of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable

deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.

#### **Description of Proposal**

The proposal provides that, in the case of a bank or bank holding company, interest income and dividends on assets required to be held by the bank or bank holding company are not treated as passive investment income for purposes of applying the excess net passive income rules.

#### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

#### **(b) Treatment of qualifying director shares**

##### **Present Law**

An S corporation may have only one outstanding class of stock.

An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded.

#### **Description of Proposal**

Under the proposal, qualifying director shares are not treated as a second class of stock. Qualifying director shares means shares in a bank or bank holding company that are held by an individual solely by reason of status as a director of the bank or company and which are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of the holder's status as a director at the same price the individual acquired the shares. Qualifying director shares are not taken into account in allocating the S corporation's items of income, loss, etc. Distributions with respect to the shares are deductible by the S corporation and includible in the income of the holder.

#### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

#### **4. Qualified subchapter S subsidiaries**

##### **(a) Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations**

###### **Present Law**

Under present law, inadvertent invalid subchapter S elections and terminations may be waived.

###### **Description of Proposal**

The proposal allows inadvertent invalid qualified subchapter S subsidiary elections and terminations to be waived by the IRS.

###### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

##### **(b) Information returns for qualified subchapter S subsidiaries**

###### **Present Law**

Under present law, a corporation all of whose stock is held by an S corporation is treated as a qualified subchapter S subsidiary if the S corporation so elects. The assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation.

###### **Description of Proposal**

The proposal provides authority to the Secretary of the Treasury to provide guidance regarding information returns of qualified subchapter S subsidiaries.

###### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2003.

#### **5. S corporation distributions to an employee stock ownership plan**

###### **Present Law**

An employee stock ownership plan (an “ESOP”) is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities. For purposes of ESOP investments, a “qualifying employer security” is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may

design a class of preferred stock that meets these requirements and that is held only by the ESOP. Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.<sup>18</sup> Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, and (3) the transfer to, or use by or for the benefit of, the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase qualifying employer securities.<sup>19</sup> In such a case, the employer securities purchased with the loan proceeds are generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer stock held by the ESOP are used to repay the loan. The employer stock is held in a suspense account and released for allocation to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and the collateral given to a disqualified person consists of only qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).<sup>20</sup> In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).<sup>21</sup> In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.<sup>22</sup>

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<sup>18</sup> Sec. 4975.

<sup>19</sup> Sec. 4975(d)(3). An ESOP that borrows money to purchase employer stock is referred to as a "leveraged" ESOP.

<sup>20</sup> Treas. reg. sec. 54.4975-7(b)(5).

<sup>21</sup> Sec. 404(k)(5)(B).

<sup>22</sup> Sec. 404(k)(2)(B).



### **Description of Proposal**

Under the proposal, an ESOP maintained by an S corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a distribution made with respect to S corporation stock that constitutes qualifying employer securities held by the ESOP is used to repay a loan that was used to acquire the securities (whether or not allocated to participants). This relief does not apply in the case of a distribution with respect to S corporation stock that is allocated to a participant unless the plan provides that stock with a fair market value of not less than the amount of such distribution is allocated to the participant for the year which the distribution would have been allocated to the participant.

### **Effective Date**

The proposal is effective for distributions made with respect to S corporation stock after December 31, 2003.

## F. Employee Benefits

### 1. Treatment of nonqualified deferred compensation plans (sec. 1061 of the bill and new sec. 409A and sec. 6051 of the Code)

#### Present Law

##### In general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,<sup>23</sup> the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.<sup>24</sup> Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf

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<sup>23</sup> See, e.g., *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

<sup>24</sup> Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.<sup>25</sup> Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

### **Rabbi trusts**

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.<sup>26</sup> As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.<sup>27</sup> Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language

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<sup>25</sup> Treas. Reg. secs. 1.451-1 and 1.451-2.

<sup>26</sup> This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

<sup>27</sup> Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which effectively allow deferred amounts to be available to individuals, while still meeting the safe harbor requirements set forth by the IRS.

### **Description of Proposal**

Under the proposal, all amounts deferred under a nonqualified deferred compensation plan<sup>28</sup> for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture<sup>29</sup> and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the proposal are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Actual or notional earnings on amounts deferred are also subject to the provisions of the proposal.

Under the proposal, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), disability, death, a specified time (or pursuant to a fixed schedule), change in control in a corporation (to the extent provided by the Secretary), or occurrence of an unforeseeable emergency. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution, except as provided in regulations by the Secretary.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees<sup>30</sup> of publicly-traded corporations.

Disability is defined as under the Social Security Act. Under such definition, an individual is considered to be disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period

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<sup>28</sup> A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

<sup>29</sup> As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

<sup>30</sup> Key employees are defined in section 416(i) and generally include officers having annual compensation greater than \$130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than \$150,000.

of not less than twelve months. In determining if a participant is disabled, a determination letter from the Social Security Administration is not required. It is intended that a nonqualified deferred compensation plan provide that the determination whether a participant is disabled must be based on the Social Security Administration statutory standard.

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the proposal. The proposal requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in 152(a)) of the participant; loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The proposal provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant. For example, it is anticipated that an exception could be provided in order to comply with Federal conflict of interest requirements or court-approved settlements.

The proposal requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made during the preceding taxable year, or at such other time as provided in Treasury regulations. In the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

Under the proposal, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that the Secretary shall issue guidance regarding to what extent elections to change a stream of payments are permissible.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Under the proposal, in the case of assets held in a trust or set aside (directly or indirectly) in another arrangement, as determined by the Secretary, for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 at the time set aside or transferred outside of the United States (whether or not such assets are available to satisfy the claims of general creditors). Any increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year such assets were first set aside for purposes of nonqualified deferred compensation. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the proposal, a transfer of property in connection with the performance of services under section 83 also occurs if a nonqualified deferred compensation plan provides that, upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. Any increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year such assets were first set aside for purposes of nonqualified deferred compensation.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a

qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.<sup>31</sup> A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the proposal.

Interest imposed under the proposal is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provisions of the proposal. The proposal is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the proposal. Any amount included in gross income under the proposal shall not be required to be included in gross income under any provision of law later than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the proposal, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.<sup>32</sup>

The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the purposes of proposal, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are principally used to postpone the timing of income inclusion. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

### **Effective Date**

The proposal is effective for amounts deferred in taxable years beginning after December 31, 2003.

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<sup>31</sup> A qualified employer plan also includes a section 501(c)(18) trust.

<sup>32</sup> It is intended that the exception be similar to that under Treas. Regs. sec. 31.3121(v)(2)-1(e)(4).

The proposal does not apply to amounts deferred in a taxable year beginning after December 31, 2003, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before October 24, 2003. Amounts deferred in taxable years beginning after December 31, 2004, even if pursuant to an election made before October 24, 2003, are subject to the proposal. Earnings on amounts deferred before the effective date are subject to the proposal to the extent that such amounts deferred are subject to the proposal.

No later than 90 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which an individual participating in a nonqualified deferred compensation plan adopted on or before December 31, 2003, may, without violating the requirements of the proposal, terminate participation or cancel an outstanding deferral election with regard to amounts earned after December 31, 2003, if such amounts are includible in income as earned.

## **2. Exclusion of incentive stock options and employee stock purchase plan stock options from wages (sec. 1062 of the bill and secs. 421(b), 423(c), 3121(a), 3231, and 3306(b) of the Code)**

### **Present Law**

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the “spread”) is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as “statutory stock options”), the spread is not included in income at the time of exercise.<sup>33</sup>

If the statutory holding period requirements are satisfied with respect to stock acquired through the exercise of a statutory stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock. Compensation income is recognized, however, if there is a disqualifying disposition (i.e., if the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option.

Federal Insurance Contribution Act (“FICA”) and Federal Unemployment Tax Act (“FUTA”) taxes (collectively referred to as “employment taxes”) are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.<sup>34</sup> On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.<sup>35</sup>

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<sup>33</sup> Sec. 421. For purposes of the individual alternative minimum tax, the transfer of stock pursuant to an incentive stock option is generally treated as the transfer of stock pursuant to a nonstatutory option. Sec. 56(b)(3).

<sup>34</sup> Secs. 3101, 3111, and 3301.

<sup>35</sup> Notice 2002-47, 2002-28 I.R.B. 97.



### **Description of Proposal**

The proposal provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the proposal, FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.<sup>36</sup> The proposal also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

Additionally, the proposal provides that Federal income tax withholding is not required on a disqualifying disposition, nor when compensation is recognized in connection with an employee stock purchase plan discount. Present-law reporting requirements continue to apply.

### **Effective Date**

The proposal is effective for stock acquired pursuant to options exercised after the date of enactment.

### **3. Extension of provision permitting qualified transfers of excess pension assets to retiree health accounts (sec. 1063 of the bill and sec. 420 of the Code)**

#### **Present Law**

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion of plan assets to the employer may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.<sup>37</sup> A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year.

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<sup>36</sup> The proposal also provides a similar exclusion under the Railroad Retirement Tax Act.

<sup>37</sup> Sec. 420.

Excess assets generally means the excess, if any, of the value of the plan's assets<sup>38</sup> over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003),<sup>39</sup> or (2) 125 percent of the plan's current liability. In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order for a transfer to be qualified, the employer generally must maintain retiree health benefit costs at the same level for the taxable year of the transfer and the following four years.

In addition, the Employee Retirement Income Security Act of 1974 ("ERISA") provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.<sup>40</sup>

No qualified transfers may be made after December 31, 2005.

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<sup>38</sup> The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

<sup>39</sup> These amounts relate to the full funding limit for defined benefit plans. The current liability full funding limit is repealed for years beginning after 2003. Under the general sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the limit is reinstated for years after 2010.

<sup>40</sup> ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

### **Description of Proposal**

The proposal allows qualified transfers of excess defined benefit plan assets through December 31, 2013.

### **Effective Date**

The proposal is effective on the date of enactment.

## **G. Treatment of Active Income**

### **1. Treatment of European Union as one country for purposes of the foreign base company sales and services rules (sec. 1071 of the bill and sec. 954 of the Code)**

#### **Present Law**

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include currently in income for U.S. tax purposes certain passive and other income of the controlled foreign corporation (referred to as “subpart F income”), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income encompasses certain categories of non-passive income, including foreign base company sales and services income (sec. 954(a)). Foreign base company sales income generally consists of sales income of a controlled foreign corporation located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person (sec. 954(d)). Foreign base company services income consists of income from services performed outside the controlled foreign corporation's country of incorporation for or on behalf of a related party (sec. 954(e)).

A special branch rule applies only for purposes of determining a controlled foreign corporation's foreign base company sales income. Under this rule, a branch of a controlled foreign corporation is treated as a separate corporation where the activities of the controlled foreign corporation through the branch outside the controlled foreign corporation's country of incorporation have substantially the same effect as if such branch were a subsidiary (sec. 954(d)(2)).

For purposes of the subpart F rules, a related person is defined as any individual, corporation, trust, or estate that controls or is controlled by the controlled foreign corporation, or any individual, corporation, trust, or estate that is controlled by the same person or persons that control the controlled foreign corporation (sec. 954(d)(3)). Control with respect to a corporation means ownership of more than 50 percent of the corporation's stock (by vote or value). Control with respect to a partnership, trust, or estate means ownership of more than 50 percent of the value of the beneficial interests of the partnership, trust, or estate. Indirect and constructive ownership rules apply.

#### **Description of Proposal**

The proposal treats all of the member states of the European Union as one country for purposes of the foreign base company sales and foreign base company services rules.

The current member states of the European Union are Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal, Sweden, Finland and the United Kingdom. As of January 1, 2004, the European Union will admit Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Bulgaria, Romania and Turkey have applied for admittance.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2008, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## **2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules (sec. 1072 of the bill and sec. 954(c) of the Code)**

### **Present Law**

In general, the rules of subpart F (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include certain income of the controlled foreign corporation (referred to as “subpart F income”) on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation is organized, or rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

### **Description of Proposal**

Under the bill, dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation are not treated as foreign personal holding company income to the extent attributable to non-subpart-F earnings of the payor. For these purposes, a related controlled foreign corporation is a controlled foreign corporation that controls or is controlled by the other controlled foreign corporation, or a controlled foreign corporation that is controlled by the same person or persons that control the other controlled foreign corporation. Ownership of more than 50 percent of the controlled foreign corporation's stock (by vote or value) constitutes control for these purposes.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

### **3. Look-through treatment for sales of partnership interests (sec. 1073 of the bill and sec. 954(c) of the Code)**

#### **Present Law**

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign personal holding company income. Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends. Thus, if a controlled foreign corporation sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10-percent U.S. shareholders of the controlled foreign corporation as subpart F income.

#### **Description of Proposal**

The bill treats the sale by a controlled foreign corporation of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule applies only to partners owning directly, indirectly, or constructively at least 25 percent of a capital or profits interest in the partnership. Thus, the sale of a partnership interest by a controlled foreign corporation that meets this ownership threshold constitutes subpart F income under the bill only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

#### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

#### **4. Repeal of foreign personal holding company rules and foreign investment company rules (sec. 1074 of the bill and secs. 542, 551-558, 954, 1246, and 1247 of the Code)**

##### **Present Law**

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. The foreign tax credit may reduce the U.S. tax imposed on such income.

Several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation. Detailed rules for coordination among the anti-deferral rules are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple rules.

The Code sets forth the following anti-deferral rules: the controlled foreign corporation rules of subpart F (secs. 951-964); the passive foreign investment company rules (secs. 1291-1298); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax rules (secs. 531-537); and the foreign investment company rules (secs. 1246-1247).

##### **Description of Proposal**

The bill: (1) eliminates the rules applicable to foreign personal holding companies and foreign investment companies; (2) excludes foreign corporations from the application of the personal holding company rules; and (3) includes as subpart F foreign personal holding company income personal services contract income that is subject to the present-law foreign personal holding company rules.

##### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2006, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

#### **5. Subpart F treatment of pipeline transportation income (sec. 1075 of the bill and sec. 954(g) of the Code)**

##### **Present Law**

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as

“subpart F income”). Subpart F income includes foreign base company income, which in turn includes foreign base company oil related income (sec. 954(a)).

Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign base company oil related income does not include income derived from a source within a foreign country in connection with: (1) oil or gas which was extracted from a well located in such foreign country or, (2), oil, gas, or a primary product of oil or gas which is sold by the controlled foreign corporation or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a controlled foreign corporation that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

### **Description of Proposal**

The bill provides an additional exception to the definition of foreign base company oil related income. Under the bill, foreign base company oil related income does not include income derived from a source within a foreign country in connection with the pipeline transportation of oil or gas within such foreign country. Thus, the exception applies whether or not the controlled foreign corporation that owns the pipeline also owns any interest in the oil or gas transported. In addition, the exception applies to income earned from the transportation of oil or gas by pipeline in a country in which the oil or gas was neither extracted nor consumed within such foreign country.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## **6. Determination of foreign personal holding company income with respect to transactions in commodities (sec. 1076 of the bill and sec. 954 of the Code)**

### **Present Law**

#### **Subpart F foreign personal holding company income**

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (“U.S. 10-percent shareholders”) are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, “foreign personal holding company income.”

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1)



property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and real estate mortgage investment conduits (“REMICs”); net gains from commodities transactions; net gains from foreign currency transactions; income that is equivalent to interest; income from notional principal contracts; and payments in lieu of dividends.

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.<sup>41</sup> In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation’s business is as an active producer, processor, merchant, or handler of commodities.<sup>42</sup>

### **Hedging transactions**

Under present law, the term “capital asset” does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe) (sec. 1221(a)(7)). The term “hedging transaction” means any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be

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<sup>41</sup> For hedging transactions entered into on or after January 31, 2003, Treasury regulations provide that gains or losses from a commodities hedging transaction generally are excluded from the definition of foreign personal holding company income if the transaction is with respect to the controlled foreign corporation’s business as a producer, processor, merchant or handler of commodities, regardless of whether the transaction is a hedge with respect to a sale of commodities in the active conduct of a commodities business by the controlled foreign corporation. The regulations also provide that, for purposes of satisfying the requirements for exclusion from the definition of foreign personal holding company income, a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business (Treas. Reg. sec. 1.954-2(f)(2)(v)). However, the regulations provide that a controlled foreign corporation is not a producer, processor, merchant or handler of commodities (and therefore would not satisfy the requirements for exclusion) if its business is primarily financial (Treas. Reg. sec. 1.954-2(f)(2)(v)).

<sup>42</sup> Treasury regulations provide that substantially all of a controlled foreign corporation’s business is as an active producer, processor, merchant or handler of commodities if the sum of its gross receipts from all of its active sales of commodities in such capacity and its gross receipts from all of its commodities hedging transactions that qualify for exclusion from the definition of foreign personal holding company income equals or exceeds 85 percent of its total receipts for the taxable year (computed as though the controlled foreign corporation was a domestic corporation) (Treas. Reg. sec. 1.954-2(f)(2)(iii)(C)).

held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations (sec. 1221(b)(2)(A)).

### **Description of Proposal**

The bill modifies the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the bill, gains or losses from a transaction with respect to a commodity are not treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this proposal, the general definition of a hedging transaction under section 1221(b)(2) is modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction are excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2) (sec. 1221(a)(7) and (b)(2)(B)).

The bill also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the bill, such gains or losses are not treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.<sup>43</sup>

### **Effective Date**

This proposal is effective with respect to transactions entered into after December 31, 2004.

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<sup>43</sup> For purposes of determining whether substantially all of the controlled foreign corporation's commodities are comprised of such property, it is intended that the 85-percent requirement provided in the current Treasury regulations (as modified to reflect the changes made by the bill) would continue to apply.

## **7. Repeal controlled foreign corporation rules for foreign base company shipping income (sec. 1077 of the bill and sec. 954 of the Code)**

### **Present Law**

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation to include currently in income for U.S. tax purposes certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income includes foreign base company shipping income (sec. 954(f)). Foreign base company shipping income generally includes income derived from the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or other disposition of any such aircraft or vessel, and certain space or ocean activities (e.g., leasing of satellites for use in space). Foreign commerce generally involves the transportation of property or passengers between a port (or airport) in the U.S. and a port (or airport) in a foreign country, two ports (or airports) within the same foreign country, or two ports (or airports) in different foreign countries. In addition, foreign base company shipping income includes dividends and interest that a controlled foreign corporation receives from certain foreign corporations and any gains from the disposition of stock in certain foreign corporations, to the extent the dividends, interest, or gains are attributable to foreign base company shipping income. Foreign base company shipping income also includes incidental income derived in the course of active foreign base company shipping operations (e.g., income from temporary investments in or sales of related shipping assets), foreign exchange gain or loss attributable to foreign base company shipping operations, and a controlled foreign corporation's distributive share of gross income of any partnership and gross income received from certain trusts to the extent that the income would have been foreign base company shipping income had it been realized directly by the corporation.

Subpart F income also includes foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICS; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income does not include rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the controlled foreign corporation from a related corporation organized and

operating in the same foreign country in which the controlled foreign corporation was organized, and rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

### **Description of Proposal**

The bill repeals the subpart F rules related to foreign base company shipping income. The bill also amends the foreign base company rules related to foreign personal holding income to provide a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. Such rents are treated as active income if the active leasing expenses comprise at least 10 percent of the profit on the lease.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## **8. Modification of exceptions under subpart F for active financing income (sec. 1078 of the bill and sec. 954 of the Code)**

### **Present Law**

Under the subpart F rules, U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity

contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called “active financing income”).<sup>44</sup>

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

### **Description of Proposal**

The proposal modifies the present-law temporary exceptions from subpart F foreign personal holding company income and foreign base company services income for income derived in the active conduct of a banking, financing, or similar business. For purposes of

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<sup>44</sup> Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (P.L. No. 107-147) extended the temporary exceptions for five years, applicable only for taxable years beginning after 2001 and before 2007, with a modification relating to insurance reserves.

determining whether a CFC or QBU has conducted directly in its home country substantially all of the activities in connection with transactions with customers, the proposal provides that an activity is treated as conducted directly by the CFC or QBU in its home country if the activity is performed by employees of a related person and: (1) the related person is itself an eligible CFC the home country of which is the same as that of the CFC or QBU; (2) the activity is performed in the home country of the related person; and (3) the related person is compensated on an arm's length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in its home country for purposes of the tax laws of such country.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## **9. Partial exclusion for qualified film income (sec. 1079 of the bill and new sec. 139A of the Code)**

### **Present Law**

#### **In general**

Present law provides that gross income for U.S. tax purposes does not include extraterritorial income. Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income. Extraterritorial income is eligible for the exclusion to the extent that it is "qualifying foreign trade income."

#### **Qualifying foreign trade income**

"Qualifying foreign trade income" is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of (1) 1.2 percent of the "foreign trading gross receipts" derived by the taxpayer from the transaction, (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction, or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction. The amount of qualifying foreign trade income determined using 1.2 percent of the foreign trading gross receipts is limited to 200 percent of the qualifying foreign trade income that would result using 15 percent of the foreign trade income. Although these calculations are determined by reference to a reduction of taxable income (a net income concept), qualifying foreign trade income is an exclusion from gross income.

#### **Foreign trading gross receipts**

"Foreign trading gross receipts" are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain "economic processes" take place outside of the United States. The threshold for determining if gross

receipts will be treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving “qualifying foreign trade property.”

Qualifying foreign trade property is property manufactured, produced, grown, or extracted within or outside of the United States that is held primarily for sale, lease, or rental, in the ordinary course of a trade or business, for direct use, consumption, or disposition outside of the United States. In addition, not more than 50 percent of the fair market value of such property can be attributable to the sum of (1) the fair market value of articles manufactured outside of the United States, plus (2) the direct costs of labor performed outside of the United States. Certain property is excluded from the definition of qualifying foreign trade property, including patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property. Consequently, gross receipts from the license of films for reproduction abroad generally constitutes foreign trading gross receipts.<sup>45</sup>

### **Foreign trade income**

“Foreign trade income” is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. Certain dividends-paid deductions of cooperatives are disregarded in determining foreign trade income for this purpose.

### **Foreign sale and leasing income**

“Foreign sale and leasing income” is the amount of the taxpayer’s foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes.

## **Description of Proposal**

The proposal provides an exclusion from gross income for an amount equal to the applicable percentage of qualified film income. “Qualified film income” is defined as a taxpayer’s gross income from the license of a qualified film for the exploitation or direct use

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<sup>45</sup> Prior to their repeal, the foreign sales corporation (“FSC”) provisions of the Code applied to certain licenses of films for reproduction abroad. On February 24, 2000, the Appellate Body of the World Trade Organization (“WTO”) upheld the findings of the WTO Dispute Settlement Panel that had found that the FSC provisions of the Code constitute a prohibited export subsidy under the WTO Agreement on Subsidies and Countervailing Measures and under the Agreement on Agriculture. The WTO Appellate Body later adopted the findings of the WTO Dispute Settlement Panel. Congress enacted the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 to comply with the recommendations and rulings of the Panel and the Appellate Body. Although the legislation repealed the FSC provisions of the Code, it also provided certain transitional rules, including for certain binding contractual agreements (e.g., license agreements for the reproduction of films abroad).

outside the United States less all associated film costs.<sup>46</sup> Qualified film income does not include any gross income from the exploitation of characters, soundtracks, designs, scripts, scores, or other ancillary intangibles. For example, gross income from the foreign theatrical, home video, and television markets would be eligible, whereas gross income from the foreign license of characters, scripts, and other ancillary intangibles of such film would not be eligible for the proposal. In addition, qualified film income does not include any amount from the license of a qualified film to a related person<sup>47</sup> unless such film is held for license by such related person to an unrelated person for the exploitation or direct use by such unrelated person outside the United States.

For purposes of the proposal, the applicable percentage for taxable years ending in 2007 is one percent, in 2008 is two percent, in 2009 is three percent, in 2010 is five percent, in 2011 is eight percent, in 2012 is nine percent, after 2012 is ten percent.

A “qualified film” is defined as property described in section 168(f)(3) that the original use of which commences after December 31, 2006. However, a qualified film does not include sexually explicit productions as defined by section 2257 of title 18 of the U.S. Code.

The proposal provides that no foreign tax credit or deduction is allowed with respect to the excludible portion of any qualified film income. In addition, the proposal provides a taxpayer the ability to elect not to apply the proposal to a qualified film. Such election shall be made by the due date (including extensions of time) for the taxable year in which the qualified film is placed in service.

#### **Effective Date**

The proposal is effective for taxable years ending after December 31, 2006.

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<sup>46</sup> Associated film costs is defined as any expense properly apportioned and allocated to qualified film income, determined as provided under regulations prescribed by the Secretary.

<sup>47</sup> A person is related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 are made without regard to section 1563(b).



## **H. Reduction of Double Taxation of Earnings**

### **1. Interest expense allocation rules (sec. 1081 of the bill and sec. 864 of the Code)**

#### **Present Law**

##### **In general**

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below). The Code provides that for interest allocation purposes all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called “one-taxpayer rule”), and that allocation must be made on the basis of assets rather than gross income.

##### **Affiliated group**

###### **In general**

The term “affiliated group” in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns.

###### **Definition of affiliated group -- consolidated return rules**

For consolidation purposes, the term “affiliated group” means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

Generally, the term “includible corporation” means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies,

corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

#### Definition of affiliated group -- special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.<sup>48</sup> For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

#### Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as “financial corporations” (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies, subsidiaries of banks and bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

### **Description of Proposal**

#### **In general**

The bill modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is by allocating and apportioning the interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide

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<sup>48</sup> One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

affiliated group's worldwide interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group, over (2) the interest expense incurred by a foreign member of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.<sup>49</sup>

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)<sup>50</sup> as well as all controlled foreign corporations that in the aggregate either directly or indirectly<sup>51</sup> would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

In addition, if an affiliated group elects to apply the new elective rules based on worldwide fungibility, the present-law rules regarding the treatment of tax-exempt assets and the basis of stock in nonaffiliated ten-percent owned corporations apply on a worldwide affiliated group basis.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

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<sup>49</sup> Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

<sup>50</sup> The bill expands the definition of an affiliated group for interest expense allocation purposes to include certain insurance companies that are generally excluded from an affiliated group under section 1504(b)(2) (without regard to whether such companies are covered by an election under section 1504(c)(2)).

<sup>51</sup> Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

## **Financial institution group election**

The bill allows taxpayers to apply the present-law bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The bill also provides a one-time “financial institution group” election that expands the present-law bank group. Under the bill, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group,<sup>52</sup> and (2) all “financial corporations.” For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.<sup>53</sup> For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, the bill provides anti-abuse rules under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. The bill provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of the provision, prevent assets or interest expense from being taken into account more than once, and addressing changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2008.

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<sup>52</sup> No inference is intended as to the treatment under present law with respect to financial holding companies (within the meaning of section 2(p) of the Bank Holding Company Act of 1956), as well as subsidiaries of financial holding companies that are predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business. With respect to financial holding companies that make a financial institution group election under the bill, no inference is intended as to the application of present law to such taxpayers for taxable years prior to the taxable year for which such an election is made.

<sup>53</sup> See Treas. Reg. sec. 1.904-4(e)(2).

## **2. Recharacterization of overall domestic loss (sec. 1082 of the bill and sec. 904 of the Code)**

### **Present Law**

The United States provides a credit for foreign income taxes paid or accrued. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves the purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income. This overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S.-source and foreign-source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign-source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign-source income and, thus, the upper limit on the foreign tax credit for the year.

If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess ("overall foreign loss," or "OFL") may offset U.S.-source income. Such an offset reduces the effective rate of U.S. tax on U.S.-source income.

In order to eliminate a double benefit (that is, the reduction of U.S. tax previously noted and, later, full allowance of a foreign tax credit with respect to foreign-source income), present law includes an OFL recapture rule. Under this rule, a portion of foreign-source taxable income earned after an OFL year is recharacterized as U.S.-source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit). Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign-source taxable income earned in any particular taxable year is recharacterized as U.S.-source taxable income. The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

A U.S.-source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign-source income if viewed in isolation. The existence of foreign-source taxable income in the year of the U.S.-source loss reduces or eliminates any net operating loss carryover that the U.S.-source loss would otherwise have generated absent the foreign income. In addition, as the pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. As a result, some foreign tax credits in the year of the U.S.-source loss must be credited, if at all, in a carryover year. Tax on U.S.-source taxable income in a subsequent year may be offset by a net operating loss carryforward, but not by a foreign tax credit carryforward. There is currently no mechanism for recharacterizing such subsequent U.S.-source income as foreign-source income.

For example, suppose a taxpayer generates a \$100 U.S.-source loss and earns \$100 of foreign-source income in Year 1, and pays \$30 of foreign tax on the \$100 of foreign-source income. Because the taxpayer has no net taxable income in Year 1, no foreign tax credit can be claimed in Year 1 with respect to the \$30 of foreign taxes. If the taxpayer then earns \$100 of U.S.-source income and \$100 of foreign-source income in Year 2, present law does not recharacterize any portion of the \$100 of U.S.-source income as foreign-source income to reflect

the fact that the previous year's \$100 U.S.-source loss reduced the taxpayer's ability to claim foreign tax credits.

### **Description of Proposal**

The bill applies a re-sourcing rule to U.S.-source income in cases in which a taxpayer's foreign tax credit limitation has been reduced as a result of a prior overall domestic loss. Under the bill, a portion of the taxpayer's U.S.-source income for each succeeding taxable year is recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the uncharacterized overall domestic loss, and (2) 50 percent of the taxpayer's U.S.-source income for such succeeding taxable year.

The bill defines an overall domestic loss for this purpose as any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback. For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. Under the bill, an overall domestic loss does not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year.

Any U.S.-source income recharacterized under the bill is allocated among and increases the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic loss.

It is anticipated that situations may arise in which a taxpayer generates an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The bill grants the Secretary of the Treasury authority to prescribe such regulations as may be necessary to coordinate the operation of the OFL recapture rules with the operation of the overall domestic loss recapture rules added by the bill.

### **Effective Date**

The proposal applies to losses incurred in taxable years beginning after December 31, 2005.

## **3. Reduction to two foreign tax credit baskets (sec. 1083 of the bill and sec. 904 of the Code)**

### **Present Law**

The United States taxes its citizens and residents on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to

ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (“10/50 companies”),<sup>54</sup> (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called “general basket” income).

### **Description of Proposal**

The bill reduces the number of foreign tax credit limitation categories to two: passive category income and general category income. Income from the eliminated financial services income category is treated as general category income in the case of (1) a member of a financial services group (i.e., any affiliated group<sup>55</sup> that is predominately engaged in the active conduct of a banking, insurance, financing, or similar business) or (2) any other person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.<sup>56</sup> Income from the eliminated shipping, high withholding tax interest, and 10/50 limitation categories falls into one of the remaining two categories, as appropriate. For example, shipping income generally falls into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the general limitation categories, depending on

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<sup>54</sup> Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002 are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits). Under section 1115 of the bill, these dividends are subject to a look-through approach, irrespective of when the underlying earnings and profits arose.

<sup>55</sup> The bill expands the definition of an affiliated group as defined under section 1504(a) for these purposes to include certain insurance companies (without regard to whether such companies are covered by an election under section 1504(c)(2)) and foreign corporations that are generally excluded from an affiliated group under section 1504(b)(2) and section 1504(b)(3) respectively. In determining whether an affiliated group is predominately engaged in the active conduct of a banking, insurance, financing, or similar business, only the income of members of the group that are U.S. corporations or controlled foreign corporations in which such U.S. corporations own (directly or indirectly) at least 80 percent of total voting power and value of the stock are counted.

<sup>56</sup> The bill requires the Treasury Secretary to specify the treatment of financial services income received or accrued by pass-through entities that are not members of a financial services group.

the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all are assigned to the passive income limitation category. Creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles are treated as imposed on general limitation income.

#### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2004.

#### **4. Look-through rules to apply to dividends from noncontrolled section 902 corporations (sec. 1084 of the bill and sec. 904 of the Code)**

##### **Present Law**

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called “10/50 company”). Dividends paid by a 10/50 company that is not a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003 are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies).<sup>57</sup> Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company out of earnings and profits accumulated in taxable years after December 31, 2002 are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a “look-through” approach).

For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

##### **Description of Proposal**

The bill applies the look-through approach to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were

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<sup>57</sup> Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003 are subject to a separate foreign tax credit limitation for each 10/50 company.



accumulated.<sup>58</sup> If the Treasury Secretary determines that the taxpayer has not substantiated which limitation category applies under the look-through approach with respect to all or a portion of the dividend, such portion is treated as passive category income for foreign tax credit purposes.

The bill also provides transition rules regarding the use of pre-effective date foreign tax credits associated with a 10/50 company separate limitation category in post-effective date years. Look-through principles similar to those applicable to post-effective date dividends from a 10/50 company apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years. The bill allows the Treasury Secretary to issue regulations addressing the carryback of foreign tax credits associated with a dividend from a 10/50 company to pre-effective date years.

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2002.

## **5. Attribution of stock ownership through partnerships to apply in determining section 902 and 960 credits (sec. 1085 of the bill and secs. 902 and 901)**

### **Present Law**

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns ten percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such a domestic corporation is eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of the dividend to the foreign corporation's post-1986 undistributed earnings and profits.

Foreign income taxes paid or accrued by lower-tier foreign corporations also are eligible for the deemed-paid credit if the foreign corporation falls within a qualified group (sec. 902(b)). A "qualified group" includes certain foreign corporations within the first six tiers of a chain of foreign corporations if, among other things, the product of the percentage ownership of voting stock at each level of the chain (beginning from the domestic corporation) equals at least five percent. In addition, in order to claim indirect credits for foreign taxes paid by certain fourth-, fifth-, and sixth-tier corporations, such corporations must be controlled foreign corporations (within the meaning of sec. 957) and the shareholder claiming the indirect credit must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the controlled foreign corporations. The application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a controlled foreign corporation. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

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<sup>58</sup> Section 1113 of the bill eliminates the separate basket for dividends from 10/50 companies.

Section 960 similarly permits a domestic corporation with subpart F inclusions from a controlled foreign corporation to claim deemed-paid foreign tax credits with respect to foreign taxes paid or accrued by the controlled foreign corporation on its subpart F income.

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.<sup>59</sup> In Rev. Rul. 71-141,<sup>60</sup> the IRS held that a foreign corporation's stock held indirectly by two domestic corporations through their interests in a domestic general partnership is attributed to such domestic corporations for purposes of determining the domestic corporations' eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. Accordingly, a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership.

However, in 1997, the Treasury Department issued final regulations under section 902, and the preamble to the regulations states that “[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity.”<sup>61</sup> In recognition of the holding in Rev. Rul. 71-141, the preamble to the final regulations under section 902 states that a “domestic shareholder” for purposes of section 902 is a domestic corporation that “owns” the requisite voting stock in a foreign corporation rather than one that “owns directly” the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. Consequently, when adopting the 1997 final regulations, the IRS left uncertainty over whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit (other than through a domestic general partnership).

### **Description of Proposal**

The bill clarifies that a domestic corporation is entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or domestic

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<sup>59</sup> Under section 901(b)(5), an individual member of a partnership or a beneficiary of an estate or trust generally may claim a direct foreign tax credit with respect to the amount of his or her proportionate share of the foreign taxes paid or accrued by the partnership, estate, or trust. This rule does not specifically apply to corporations that are either members of a partnership or beneficiaries of an estate or trust. However, section 702(a)(6) provides that each partner (including individuals or corporations) of a partnership must take into account separately its distributive share of the partnership's foreign taxes paid or accrued. In addition, under section 703(b)(3), the election under section 901 (whether to credit the foreign taxes) is made by each partner separately.

<sup>60</sup> 1971-1 C.B. 211.

<sup>61</sup> T.D. 8708, 1997-1 C.B. 137.

partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. No inference is intended as to the treatment of such deemed-paid foreign tax credits under present law. The bill also clarifies that both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

### **Effective Date**

The proposal applies to taxes of foreign corporations for taxable years of such corporations beginning after the date of enactment.

## **6. Clarification of treatment of certain transfers of intangible property (sec. 1086 of the bill and sec. 367(d) of the Code)**

### **Present Law**

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the tax avoidance that may arise from shifting the income attributable to intangible property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign corporation to which the intangible was transferred are reduced by such amounts.

The Taxpayer Relief Act of 1997 repealed a rule of prior law that treated all such deemed payments as giving rise to U.S.-source income. Because the foreign tax credit is generally limited to the U.S. tax imposed on foreign-source income, the prior-law rule reduced the taxpayer's ability to claim foreign tax credits. As a result of the repeal of the rule, the source of payments deemed received under section 367(d) is determined under general sourcing rules. These rules treat income from sales of intangible property for contingent payments the same as royalties, with the result that the deemed payments may give rise to foreign-source income.<sup>62</sup>

The Taxpayer Relief Act of 1997 did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.<sup>63</sup> If the deemed payments are treated like proceeds of a sale, then they could fall into the passive category; if the deemed payments are treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).<sup>64</sup>

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<sup>62</sup> Secs. 865(d), 862(a).

<sup>63</sup> Sec. 904(d).

<sup>64</sup> Sec. 904(d)(3).

## Description of Proposal

The bill specifies that deemed payments under section 367(d) are treated as royalties for purposes of applying the separate limitation categories of the foreign tax credit.

## Effective Date

The proposal is effective for amounts treated as received on or after August 5, 1997 (the effective date of the relevant provision of the Taxpayer Relief Act of 1997).

## **7. United States property not to include certain assets acquired by dealers in ordinary course of trade or business (sec. 1087 of the bill and sec. 956 of the Code)**

### Present Law

In general, the subpart F rules (secs. 951-964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (“U.S. 10-percent shareholders”) to include in taxable income their pro rata shares of certain income of the controlled foreign corporation (referred to as “subpart F income”) when such income is earned, whether or not the earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax on their pro rata shares of the controlled foreign corporation’s earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year (sec. 951(a)(1)(B)).

A shareholder’s income inclusion with respect to a controlled foreign corporation’s investment in U.S. property for a taxable year is based on the controlled foreign corporation’s average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property’s adjusted basis as determined for purposes of reporting the controlled foreign corporation’s earnings and profits, reduced by any liability to which the property is subject. The amount determined for inclusion in each taxable year is the shareholder’s pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation’s average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation’s earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation’s current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation’s earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

### **Description of Proposal**

The bill adds a new exception from the definition of U.S. property for determining current income inclusion by a U.S. 10-percent shareholder with respect to an investment in U.S. property by a controlled foreign corporation. The exception generally applies to securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a dealer in securities. The exception applies only if the controlled foreign corporation dealer: (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business; and (2) disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

### **Effective Date**

The proposal is effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable year of the foreign corporation ends.

## **8. Election not to use average exchange rate for foreign tax paid other than in functional currency (sec. 1088 of the bill and sec. 986 of the Code)**

### **Present Law**

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate (sec. 986(a)(1)). This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S.

corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period (sec. 986(a)(2)).

### **Description of Proposal**

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the bill provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.<sup>65</sup> Any election under this provision applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The bill authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

### **Effective Date**

This proposal is effective with respect to taxable years beginning after December 31, 2004.

## **9. Repeal of withholding tax on dividends from certain foreign corporations (sec. 1089 of the bill and sec. 871 of the Code)**

### **Present Law**

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

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<sup>65</sup> Electing taxpayers translate foreign income tax payments pursuant to the same present-law rules that apply to taxpayers that are required to translate foreign income taxes using the exchange rates as of the time such taxes are paid.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30-percent withholding tax (sec. 861(a)(2)(B)). This rule is sometimes referred to as the “secondary withholding tax.” The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation’s “dividend equivalent amount,” which generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (secs. 884(a) and (b)).

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

### **Description of Proposal**

The bill eliminates the secondary withholding tax with respect to dividends paid by certain foreign corporations.

### **Effective Date**

The proposal is effective for payments made after December 31, 2004.

## **10. Provide equal treatment for interest paid by foreign partnerships and foreign corporations (sec. 1090 of the bill and sec. 861 of the Code)**

### **Present Law**

In general, interest income from bonds, notes or other interest-bearing obligations of noncorporate U.S. residents or domestic corporations is treated as U.S.-source income.<sup>66</sup> Other interest (e.g., interest on obligations of foreign corporations and foreign partnerships) generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States.<sup>67</sup> Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the general rule described above, in the case of a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).<sup>68</sup>

### **Description of Proposal**

The proposal treats interest paid by foreign partnerships in a manner similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The proposal applies only to foreign partnerships that are principally owned by foreign persons. For this purpose, a foreign partnership is principally owned by foreign persons if, in the aggregate, U.S. citizens, resident aliens and domestic corporations do not own, directly or indirectly, 20 percent (or more) of the capital or profits interests in the partnership.

### **Effective Date**

This provision is effective for taxable years beginning after December 31, 2003.

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<sup>66</sup> Sec. 861(a)(1).

<sup>67</sup> Treas. Reg. sec. 1.861-2(a)(2).

<sup>68</sup> Sec. 884(f)(1).



## **I. Other Provisions**

### **1. Special rules for livestock sold on account of weather-related conditions (sec. 1101 of the bill and secs. 1033 and 451 of the Code)**

#### **Present Law**

Generally, a taxpayer recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period"). Special rules extend the replacement period for certain real property and principal residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized.

Section 1033(e) provides that the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought, flood, or other weather-related conditions is treated as an involuntary conversion. Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the weather-related condition.

#### **Description of Proposal**

The proposal extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. The

extension is only available if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for Federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than three years. Also, for property eligible for the proposal's extended replacement period, the proposal provides that the taxpayer can make an election under section 451(e) until the period for reinvestment of such property under section 1033 expires.

### **Effective Date**

The proposal is effective for any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

## **2. Payment of dividends on stock of cooperatives without reducing patronage dividends (sec. 1102 of the bill and sec. 1388 of the Code)**

### **Present Law**

Under present law, cooperatives generally are treated similarly to pass-through entities in that a cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. In general, patronage dividends are comprised of amounts that are paid to patrons (1) on the basis of the quantity or value of business done with or for patrons, (2) under a valid enforceable written obligation to the patron that was in existence before the cooperative received such amounts, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the "dividend allocation rule").<sup>69</sup> The effect of this rule is to reduce the amount of earnings that a cooperative can treat as patronage income and, thus, the amount that the cooperative can deduct as patronage dividends.

### **Description of Proposal**

The proposal provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income.

### **Effective Date**

The proposal is effective for distributions made in taxable years beginning after the date of enactment.

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<sup>69</sup> Treas. Reg. sec. 1.1388-1(a)(1).

### **3. Add vaccines against hepatitis A to the list of taxable vaccines (sec. 1103 of the bill and sec. 4131 of the Code)**

#### **Present Law**

A manufacturer's excise tax is imposed at the rate of 75 cents per dose<sup>70</sup> on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, and streptococcus pneumoniae. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

#### **Description of Proposal**

The proposal adds any vaccine against hepatitis A to the list of taxable vaccines. The proposal also makes a conforming amendment to the trust fund expenditure purposes.

#### **Effective Date**

The proposal is effective for vaccines sold beginning on the first day of the first month beginning more than four weeks after the date of enactment.

### **4. Expand human clinical trials expenses qualifying for the orphan drug tax credit (sec. 1104 of the bill and sec. 45C of the Code)**

#### **Present Law**

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration ("FDA") in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

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<sup>70</sup> sec. 4131

## Description of Proposal

The proposal expands qualifying expenses to include those expenses related to human clinical testing paid or incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

## Effective Date

The proposal is effective for expenditures paid or incurred after the date of enactment.

## **5. Distributions from publicly traded partnerships treated as qualifying income of regulated investment company (sec. 1105 of the bill and secs. 851 and 469(k) of the Code)**

### Present Law

#### Treatment of RICs

A regulated investment company (“RIC”) generally is treated as a conduit for Federal income tax purposes. In computing its taxable income, a RIC deducts dividends paid to its shareholders to achieve conduit treatment (sec. 852(b)). In order to qualify for conduit treatment, a RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, the corporation must elect RIC status, and must satisfy certain other requirements (sec. 851(b)).

One of the RIC qualification requirements is that at least 90 percent of the RIC's gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies (sec. 851(b)(2)). Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the “look-through” rule for partnership income) (sec. 851(b)). Under present law, no distinction is made under this rule between a publicly traded partnership and any other partnership.

The RIC qualification rules include limitations on the ownership of assets and on the composition of the RIC's assets (sec. 851(b)(3)). Under the ownership limitation, at least 50 percent of the value of the RIC's total assets must be represented by cash, government securities and securities of other RICs, and other securities; however, in the case of such other securities, the RIC may invest no more than 5 percent of the value of the total assets of the RIC in the securities of any one issuer, and may hold no more than 10 percent of the outstanding voting securities of any one issuer. Under the limitation on the composition of the RIC's assets, no more than 25 percent of the value of the RIC's total assets may be invested in the securities of

any one issuer (other than Government securities), or in securities of two or more controlled issuers in the same or similar trades or businesses. These limitations generally are applied at the end of each quarter (sec. 851(d)).

### **Treatment of publicly traded partnerships**

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation (sec. 7704(a)), but an exception to corporate treatment is provided if 90 percent or more of its gross income is interest, dividends, real property rents, or certain other types of qualifying income (sec. 7704(c) and (d)).

A special rule for publicly traded partnerships applies under the passive loss rules. The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). 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. The special rule for publicly traded partnerships provides that the passive loss rules are applied separately with respect to items attributable to each publicly traded partnership (sec. 469(k)). Thus, income or loss from the publicly traded partnership is treated as separate from income or loss from other passive activities.

### **Description of Proposal**

The proposal modifies the 90 percent test with respect to income of a RIC to include income derived from an interest in a publicly traded partnership. The proposal also modifies the lookthrough rule for partnership income of a RIC so that it applies only to income from a partnership other than a publicly traded partnership.

The proposal provides that the limitation on ownership and the limitation on composition of assets that apply to other investments of a RIC also apply to RIC investments in publicly traded partnership interests.

The proposal provides that the special rule for publicly traded partnerships under the passive loss rules (requiring separate treatment) applies to a RIC holding an interest in a publicly traded partnership, with respect to items attributable to the interest in the publicly traded partnership.

### **Effective Date**

The provision is effective for taxable years beginning after the date of enactment.

## **6. REIT modification provisions (sec. 1106 of the bill and secs. 856 and 857 of the Code)**

### **Present Law**

#### **In general**

Real estate investment trusts (“REITs”) are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are generally restricted to investing in passive investments primarily in real estate and securities.

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. Whether the REIT meets the asset tests is generally measured each quarter.

#### **Organizational structure requirements**

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

#### **Income requirements**

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the “95 percent income test”). In addition, at least 75 percent of its income generally must be from certain real estate sources (the “75 percent income test”), including rents from real property (as defined) and gain from the sale or other disposition of real property.

#### **Qualified rental income**

Amounts received as impermissible “tenant services income” are not treated as rents from real property.<sup>71</sup> In general, such amounts are for services rendered to tenants that are not

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<sup>71</sup> A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

“customarily furnished” in connection with the rental of real property.<sup>72</sup> Special rules also permit amounts to be received from certain “foreclosure property” treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or an indebtedness which such property secured.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.<sup>73</sup> An exception applies to rents received from a taxable REIT subsidiary (“TRS”) (described further below) if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.<sup>74</sup>

#### Certain hedging instruments

Except as provided in regulations, a payment to a REIT under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets, and any gain from the sale or disposition of any such investment, is treated as income qualifying for the 95-percent income test.

#### Tax if qualified income tests not met

If a REIT fails to meet the 95-percent or 75-percent income tests but has set out the income it did receive in a schedule and any error in the schedule is due to reasonable cause and not willful neglect, then the REIT does not lose its REIT status but instead pays a tax measured by the greater of the amount by which 90 percent<sup>75</sup> of the REIT’s gross income exceeds the amount of items subject to the 95-percent test, or the amount by which 75 percent of the REIT’s gross income exceeds the amount of items subject to the 75-percent test.<sup>76</sup>

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<sup>72</sup> Rents for certain personal property leased in connection are treated as rents from real property if the fair market value of the personal property does not exceed 15 percent of the aggregate fair market values of the real and personal property

<sup>73</sup> Section 856(d)(2)(B).

<sup>74</sup> Section 856(d)(8).

<sup>75</sup> Prior to 1999, the rule had applied to the amount by which 95 percent of the income exceeded the items subject to the 95 percent test.

<sup>76</sup> The ratio of the REIT’s net to gross income is applied to the excess amount, to determine the amount of tax (disregarding certain items otherwise subject to a 100-percent tax). In effect, the formula seeks to require that all of the REIT net income attributable to the failure of the income tests will be paid as tax. Sec. 857(b)(5).

## Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (the “75-percent asset test”). The term real estate asset is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

### Limitation on investment in other entities

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own such securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities or 10 percent of the value of the outstanding securities of any one issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.

### “Straight debt” exception

Securities of an issuer that are within a safe-harbor definition of “straight debt” (as defined for purposes of subchapter S<sup>77</sup>) are not taken into account in applying the limitation that a REIT may not hold more than 10 percent of the value of outstanding securities of a single issuer, if : 1) the issuer is an individual, or 2) the only securities of such issuer held by the REIT or a taxable REIT subsidiary of the REIT are straight debt, or 3) the issuer is a partnership and the trust holds at least a 20 percent profits interest in the partnership.

Straight debt is defined as a written or unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower’s discretion, or similar factors; (ii) there is no convertibility (directly or indirectly) into stock; and (iii) the creditor is an individual (other than a nonresident alien), an estate, certain trusts, or a person which is actively and regularly engaged in the business of lending money.

### Certain subsidiary ownership permitted with income treated as income of the REIT

Under one exception to the rule limiting a REIT’s securities holdings to no more than 10 percent of the vote or value of a single issuer, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT.

### Special rules for Taxable REIT subsidiaries

Under another exception to the general rule limiting REIT securities ownership of other entities, a REIT can own stock of a taxable REIT subsidiary (“TRS”), generally, a corporation

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<sup>77</sup> Section 1361(c)(5), without regard to paragraph (B)(iii) thereof.



other than a real estate investment trust<sup>78</sup> with which the REIT makes a joint election to be subject to special rules. A TRS can engage in active business operations that would produce income that would not be qualified income for purposes of the 95-percent or 75-percent income tests for a REIT, and that income is not attributed to the REIT. For example a TRS could provide noncustomary services to REIT tenants, or it could engage directly in the active operation and management of real estate (without use of an independent contractor); and the income the TRS derived from these nonqualified activities would not be treated as disqualified REIT income. Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the pass through entity REIT or from absorbing more than its share of expenses. Under one rule, a 100 percent excise tax is imposed on rents, deductions, or interest paid by the TRS to the REIT to the extent such items would exceed an arm's length amount as determined under section 482.<sup>79</sup>

Rents subject to the 100 percent excise tax do not include rents for services of a TRS that are for services customarily furnished or rendered in connection with the rental of real property.

They also do not include rents from a TRS that are for real property or from incidental personal property provided with such real property.

### **Income distribution requirements**

A REIT is generally required to distribute 90 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICs") that requires distribution of 90 percent of income. Both RICS and REITs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. Deficiency dividends may be declared on or after the date of "determination". A determination is defined to include only (i) a final decision by the Tax Court or other court of competent jurisdiction, (ii) a closing agreement under section 7121, or (iii) under Treasury regulations, an agreement signed by the Secretary and the REIT.

### **Description of Proposal**

The proposal makes several modifications to the REIT rules.

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<sup>78</sup> Certain corporations are not eligible to be a TRS, such as a corporation which directly or indirectly operates or manages a lodging facility or a health care facility or directly or indirectly provides to any other person rights to a brand name under which any lodging facility or health care facility is operated. Sec. 856((1)(3).

<sup>79</sup> If the excise tax applies, the item is not also reallocated back to the TRS under section 482.

## **Straight debt modification**

The proposal modifies the definition of “straight debt” for purposes of the limitation that a REIT may not hold more than 10 percent of the value of the outstanding securities of a single issuer, to provide more flexibility than the present law rule. In addition, except as provided in regulations, neither such straight debt nor certain other types of securities are considered “securities” for purposes of this rule.

### **Straight debt securities**

“Straight-debt” is still defined by reference to section 1361(c)(5), however, without regard to subparagraph (B)(iii) thereof (limiting the nature of the creditor).

Special rules are provided permitting certain contingencies for purposes of the REIT provision. Any interest or principal shall not be treated as failing to satisfy section 1361(c)(5)(B)(i) solely by reason of the fact that the time of payment of such interest or principal is subject to a contingency, but only if one of several factors applies. The first type of contingency that is permitted is one that does not have the effect of changing the effective yield to maturity, as determined under section 1272, other than a change in the annual yield to maturity which either (i) does not exceed the greater of  $\frac{1}{4}$  of 1 percent or 5 percent of the annual yield to maturity, or (ii) results solely from a default or the exercise of a prepayment right by the issuer of the debt.

The second type of contingency that is permitted is one under which neither the aggregate issue price nor the aggregate face amount of the debt instruments held by the REIT exceeds \$1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder.

The proposal eliminates the present law rule requiring a REIT to own a 20 percent equity interest in a partnership in order for debt to qualify as “straight debt”. The proposal instead provides new “look-through” rules determining a REIT partner’s share of partnership securities, generally treating debt to the REIT as part of the REIT’s partnership interest for this purpose, except in the case of otherwise qualifying debt of the partnership.

Certain corporate or partnership issues that otherwise would be permitted to be held without limitation under the special straight debt rules described above will not be so permitted if the REIT holding such securities, and any of its taxable REIT subsidiaries, holds any securities of the issuer which are not permitted securities (prior to the application of this rule) and have an aggregate value greater than 1 percent of the issuer’s outstanding securities (determined without regard to the new “look-through” rules).

### **Other securities**

Except as provided in regulations, the following also are not considered “securities” for purposes of the rule that a REIT cannot own more than 10 percent of the value of the outstanding securities of a single issuer: (i) any loan to an individual or an estate, (ii) any section 467 rental agreement, (as defined in section 467(d)), other than with a person described in section 856(d)(2)(B), (iii) any obligation to pay rents from real property, (iv) any security issued by a

State or any political subdivision thereof, the District of Columbia, a foreign government, or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on the profits of any entity not described in this category, or payments on any obligation issued by such an entity, (v) any security issued by a real estate investment trust; (vi) any other arrangement that, as determined by the Secretary, is excepted from the definition of a security.

### **Safe harbor testing date for certain rents**

The proposal provides specific safe-harbor rules regarding the dates for testing whether 90 percent of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents. These testing rules are provided solely for purposes of the special provision permitting rents received from a related party to be treated as qualified rental income for purposes of the income tests.<sup>80</sup>

### **Customary services exception**

The proposal prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100 percent excise tax if the rents are for customary services performed by the TRS<sup>81</sup> or are from a TRS and are for the provision of certain incidental personal property. Instead, such payments would be free of the excise tax if they satisfy the present law safe-harbor that applies if the REIT pays the TRS at least 150 percent of the cost to the TRS of providing any services.

### **Hedging rules**

The rules governing the tax treatment of arrangements engaged in by a REIT to reduce interest rate risks are prospectively conformed to the rules included in section 1221.

### **95-percent gross income requirement**

The proposal prospectively amends the tax liability owed by the REIT when it fails to meet the 95-percent of gross income test by applying a taxable fraction based on 95 percent, rather than 90 percent of the REIT's gross income.

### **Effective Date**

The proposal is generally effective for taxable years beginning after December 31, 2000.

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<sup>80</sup> The proposal does not modify any of the standards of section 482 as they apply to REITS and to taxable REIT subsidiaries.

<sup>81</sup> Although a REIT could itself provide such services and receive the income for them without receiving any disqualified income, in that case the REIT itself would be bearing the cost of providing the service. Under the present law exception for a TRS providing such service, there is no explicit requirement that the TRS be reimbursed for the full cost of the service.

However, some of the provisions are effective for taxable years beginning after the date of enactment. These are: the new “look through” rules determining a REIT partner’s share of partnership securities for purposes of the “straight debt” rules; the provision changing the 90-percent of gross income reference to 95 percent, for purposes of the tax liability if a REIT fails to meet the 95-percent of gross income test; the new hedging definition; and the rule modifying the treatment of rents with respect to customary services.

## **7. Simplification of excise tax imposed on bows and arrows (sec. 1107 of the bill and sec. 4161 of the Code)**

### **Present Law**

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more.<sup>82</sup> An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point,nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).<sup>83</sup> No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).<sup>84</sup>

### **Description of Proposal**

The proposal increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more. The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the proposal. The proposal provides that the 12-percent excise tax on arrows will not apply if the arrow contains an arrow shaft upon which the tax imposed on arrow components has been paid. Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

### **Effective Date**

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

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<sup>82</sup> Sec. 4161(b)(1)(A).

<sup>83</sup> Sec. 4161(b)(2).

<sup>84</sup> Sec. 4161(b)(1)(B).

## **8. Repeal excise tax on fishing tackle boxes (sec. 1108 of the bill and sec. 4162 of the Code)**

### **Present Law**

Under present law, a 10-percent manufacturer's excise tax is imposed on specified sport fishing equipment. Examples of taxable equipment include fishing rods and poles, fishing reels, artificial bait, fishing lures, line and hooks, and fishing tackle boxes. Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

### **Description of Proposal**

The proposal repeals the excise tax on fishing tackle boxes.

### **Effective Date**

The provision is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

## **9. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories (sec. 1109 of the bill, new sec. 5011 of the Code)**

### **Present Law**

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. Tax on domestically produced and/or bottled distilled spirits arises upon production (receipt) in a bonded distillery and is collected based on removals from the distillery during each semi-monthly period. Distilled spirits that are bottled before importation into the United States are taxed on removal from the first U.S. warehouse where they are landed (including a warehouse located in a foreign trade zone).

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

### **Description of Proposal**

The proposal creates a new income tax credit for eligible wholesale distributors of distilled spirits. An eligible wholesaler is any person who holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits.

The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment

rates during an assumed 60-day holding period on an assumed tax rate of \$22.83 per case of 12 750-milliliter bottles.

The credit only applies to domestically bottled distilled spirits<sup>85</sup> purchased directly from the bottler of such spirits. The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

The credit cannot be carried back to a taxable year beginning before January 1, 2004.

#### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2003.

### **10. Capital gains treatment to apply to outright sales of timber by landowner (sec. 1110 of the bill and sec. 631(b) of the Code)**

#### **Present Law**

Under present law, a taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations. First, if the taxpayer sells or exchanges timber that is a capital asset (sec. 1221) or property used in the trade or business (sec. 1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (sec. 631(b)). Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)).

#### **Description of Proposal**

Under the proposal, in the case of a sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gain under section 631(b) does not apply. Outright sales of timber by the landowner will qualify for capital gains treatment in the same manner as sales with a retained economic interest qualify under present law, except that the usual tax rules relating to the timing of the income from the sale of the timber will apply (rather than the special rule of section 631(b) treating the disposal as occurring on the date the timber is cut).

#### **Effective Date**

The provision is effective for sales of timber after the date of enactment.

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<sup>85</sup> Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

## **11. Repeal of excise tax on sonar devices suitable for finding fish (sec. 1111 of the bill, and secs. 4161 and 4162 of the Code)**

### **Present Law**

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.<sup>86</sup> A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.<sup>87</sup> Further, the tax imposed on the sale of electric outboard motors and sonar devices suitable for finding fish is limited to \$30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.<sup>88</sup>

Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

### **Description of Proposal**

The proposal repeals the excise tax on all sonar devices suitable for finding fish.

### **Effective Date**

The proposal is effective for articles sold by the manufacturer, producer, or importer after December 31, 2003.

## **12. Taxation of certain settlement funds (sec. 1112 of the bill, sec. 468B of the Code)**

### **Present Law**

The cleanup of hazardous waste sites is sometimes funded by environmental “settlement funds” or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency (“EPA”) and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 (“CERCLA”).

In general, section 468(B) provides that a payment to a designated settlement fund that extinguishes a tort liability of the taxpayer will result in a deduction to the taxpayer. A designated settlement fund means a fund which is established pursuant to a court order,

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<sup>86</sup> Sec. 4161(a)(1).

<sup>87</sup> Sec. 4161(a)(2).

<sup>88</sup> Sec. 4162(b).

extinguishes the taxpayer's tort liability, is managed and controlled by persons unrelated to the taxpayer, and in which the taxpayer does not have a beneficial interest in the trust.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

### **Description of Proposal**

The proposal provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore, not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving or satisfying claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, disbursed to the government or an agency or instrumentality thereof (e.g., the EPA).

### **Effective Date**

The proposal is effective for taxable years beginning after December 31, 2003.

## **13. Suspension of occupational taxes relating to distilled spirits, wine, and beer (sec. 1113 of the bill, sec. 5148 of the Code)**

### **Present Law**

Under present law, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory engine governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year. The present tax rates are as follows:

#### **Producers**<sup>89</sup>:

Distilled spirits and wines (sec. 5081)	\$1,000 per year, per premise
Brewers (sec. 5091)	\$1,000 per year, per premise

#### **Wholesale dealers (sec. 5111):**

Liquors, wines, or beer	\$500 per year
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<sup>89</sup> A reduced rate of tax in the amount of \$500.00 is imposed on small proprietors (secs. 5081(b) and 5091(b)).



Retail dealers (sec. 5121):

Liquors, wines, or beer	\$250 per year
<u>Nonbeverage use of distilled spirits (sec. 5131):</u>	\$500 per year
<u>Industrial use of distilled spirits (sec. 5276):</u>	\$250 per year

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.<sup>90</sup> A delegate of the Secretary of the Treasury is authorized to inspect the records of any dealer during business hours.<sup>91</sup> There are penalties for failing to comply with the recordkeeping requirements.<sup>92</sup>

The Code limits the persons from whom dealers may purchase their liquor stock intended for resale. Under the Code, a dealer may only purchase from:

- (1) a wholesale dealer in liquors who has paid the special occupational tax as such dealer to cover the place where such purchase is made; or
- (2) a wholesale dealer in liquors who is exempt, at the place where such purchase is made, from payment of such tax under any provision chapter 51 of the Code; or
- (3) a person who is not required to pay special occupational tax as a wholesale dealer in liquors.<sup>93</sup>

Violation of this restriction is punishable by \$1,000 fine, imprisonment of one year, or both.<sup>94</sup> A violation also makes the alcohol subject to seizure and forfeiture.<sup>95</sup>

### **Description of Proposal**

The special occupational taxes on producers and marketers of alcoholic beverages are suspended for a three-year period, July 1, 2004 through June 30, 2007. Present law recordkeeping and registration requirements will continue to apply, notwithstanding the

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<sup>90</sup> Secs. 5114 and 5124.

<sup>91</sup> Sec. 5146.

<sup>92</sup> Sec. 5603.

<sup>93</sup> Sec. 5117. For example, purchases from a proprietor of a distilled spirits plant at his principal business office would be covered under item (2) since such a proprietor is not subject to the special occupational tax on account of sales at his principal business office (sec. 5113(a)). Purchases from a State-operated liquor store would be covered under item (3) (sec. 5113(b)).

<sup>94</sup> Sec. 5687.

<sup>95</sup> Sec. 7302.

suspension of the special occupation taxes. In addition, during the suspension period, it shall be unlawful for any dealer to purchase distilled spirits for resale from any person other than a wholesale dealer in liquors who is subject to the recordkeeping requirements.

**Effective Date**

The proposal is effective on the date of enactment.

## **II. PROPOSALS TO REDUCE TAX AVOIDANCE THROUGH CORPORATE EARNINGS STRIPPING AND EXPATRIATION**

### **A. Reduction in Potential for Earnings Stripping by Further Limiting Deduction for Interest on Certain Indebtedness (sec. 2001 of the bill and sec. 163(j) of the Code)**

#### **Present Law**

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties (“disqualified interest”),<sup>96</sup> if the payor’s debt-equity ratio exceeds 1.5 to 1 and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income” (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company’s net interest expense for a given year) can be carried forward three years.

#### **Description of Proposal**

The bill strengthens the earnings stripping provisions of section 163(j) in several respects. The debt-equity threshold is eliminated, carryovers of excess limitation are eliminated, and carryovers of disallowed interest are limited to 10 years.

In addition, the “adjusted taxable income” percentage threshold is lowered from 50 percent to 25 percent with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee (hereinafter referred to as “guaranteed debt”).<sup>97</sup> Interest on guaranteed debt generally is not subject to the lowered threshold under the bill.<sup>98</sup> Disallowed interest is treated as interest on related-party debt to the extent thereof, and then as interest on guaranteed debt to the extent of any excess, for purposes of determining whether a deduction is allowable for such interest when carried forward to another taxable year.

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<sup>96</sup> This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

<sup>97</sup> This lowered threshold is phased in over two years. The threshold is 35 percent for a taxpayer’s first taxable year beginning after 2003. The remainder of this discussion describes the provisions of the bill as fully phased-in.

<sup>98</sup> However, a taxpayer can make a one-time election to apply a 30-percent threshold for purposes of determining the disallowance amount with respect to all of its disqualified interest, in which case no distinction is made between guaranteed debt and other debt. This election is not available to taxpayers involved in certain inversion transactions completed after 1996.

The bill applies the different percentage thresholds to interest on related-party debt and interest on guaranteed debt by disallowing all disqualified interest, subject to a cap equal to the sum of “excess interest expense” and “excess related party interest expense.” Excess interest expense is defined as the excess of net interest expense over 50 percent of adjusted taxable income. Excess related party interest expense is determined by subtracting 25 percent of adjusted taxable income from the lesser of: (1) interest on related-party debt, or (2) net interest expense. In no event can the disallowance under the provision reduce the taxpayer’s deduction for interest expense below the sum of: (1) the amount of interest income included in the gross income of the taxpayer, and (2) 25 percent of adjusted taxable income.

The following examples illustrate the basic operation of the bill:

Example 1.—Foreign Parent owns all the stock of U.S. Subsidiary (“U.S. Sub”). U.S. Sub has adjusted taxable income of \$100, incurs interest expense of \$70 on debt owed to Foreign Parent, incurs interest expense of \$5 on non-guaranteed debt owed to unrelated third parties, and has no interest income or other interest expense. Under the bill, U.S. Sub has \$70 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ( $\$75 - \$50 = \$25$ ) and excess related party interest expense ( $\$70 - \$25 = \$45$ ), or \$70. Under the special disallowance limit, however, the provision cannot cause U.S. Sub’s interest expense deduction to fall below \$25. Thus, only \$50 of interest is disallowed, and U.S. Sub can deduct its \$5 of unrelated-party interest and \$20 of its related-party interest.

Example 2.—Same as Example 1, except U.S. Sub incurs \$25 of interest expense on non-guaranteed debt owed to unrelated third parties and \$30 of interest expense on debt owed to Foreign Parent. Under the bill, U.S. Sub has \$30 of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ( $\$55 - \$50 = \$5$ ) and excess related party interest expense ( $\$30 - \$25 = \$5$ ), for \$10 of disallowance.

Example 3.—Same as Example 2, except U.S. Sub also incurs \$20 of interest expense on debt owed to unrelated third parties, subject to a guarantee by Foreign Parent. Under the bill, U.S. Sub has  $\$30 + \$20 = \$50$  of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ( $\$75 - \$50 = \$25$ ) and excess related party interest expense ( $\$30 - \$25 = \$5$ ), for \$30 of disallowance. This example illustrates how the bill effectively applies the present-law 50-percent threshold to interest on guaranteed debt, subjecting only interest on debt owed to related parties to the lowered threshold under the bill.

Example 4.—Same as Example 3, except U.S. Sub also earns \$10 of interest income. Under the bill, U.S. Sub has  $\$30 + \$20 = \$50$  of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ( $\$65 - \$50 = \$15$ ) and excess related party interest expense ( $\$30 - \$25 = \$5$ ), for \$20 of disallowance.

Example 5.—Same as Example 4, except U.S. Sub earns \$50 of interest income. Under the bill, U.S. Sub has  $\$30 + \$20 = \$50$  of disqualified interest, the disallowance of which is subject to a cap equal to the sum of excess interest expense ( $\$25 - \$50 = \$0$ ) and excess related party interest expense ( $\$25 - \$25 = \$0$ ), thus yielding no disallowance. Examples 4 and 5 illustrate the operation of the interest-income netting rules.

The bill continues the present-law rules in the case of taxable REIT subsidiaries.

### **Effective Date**

The proposal generally is effective for taxable years beginning after December 31, 2003. For purposes of applying the ten-year limit on carryovers of interest, amounts carried to any taxable year beginning after December 31, 2003 are treated as having been first disallowed for the most recent taxable year beginning before January 1, 2004. For taxpayers involved in certain inversion transactions completed after 1996, the proposal is effective for taxable years ending after March 4, 2003, with a similar rule for carryovers. In addition, such taxpayers are subject to the fully reduced 25-percent threshold immediately, with no phase-in.

**B. Tax Treatment of Expatriated Entities**  
(sec. 2002 of the bill and new sec. 7874 of the Code)

**Present Law**

**Determination of corporate residence**

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.

**U.S. taxation of domestic corporations**

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the double taxation that may arise from taxing the foreign-source income of a domestic corporation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (sections 951-964) and the passive foreign investment company rules (sections 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

**U.S. taxation of foreign corporations**

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is “effectively connected” with the conduct of a trade or business in the United States. Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a “permanent establishment” in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected

by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

### **U.S. tax treatment of inversion transactions**

Under present law, a U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions are commonly referred to as inversion transactions. Inversion transactions may take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions to date have been stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation's shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion reaches a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction may be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., sections 163(j) and 482).

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under sections 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not

recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

### **Description of Proposal**

The bill applies special tax rules to corporations that undertake certain defined inversion transactions. For this purpose, an inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (i.e., the “expanded affiliated group”) does not conduct substantial business activities in the entity’s country of incorporation compared to the total worldwide business activities of the expanded affiliated group.

In such a case, any applicable corporate-level “toll charges” for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

In determining whether a transaction meets the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called “hook” stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the proposal are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the proposal, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

Under the proposal, inversion transactions include certain partnership transactions. Specifically, the proposal applies to transactions in which a foreign-incorporated entity acquires



substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified “toll charge” provisions apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

#### **Effective Date**

The proposal applies to taxable years ending after March 4, 2003.

### **C. Excise Tax on Stock Compensation of Insiders in Expatriated Corporations (sec. 2003 of the bill and secs. 162(m), 275(a), and new sec. 4985 of the Code)**

#### **Present Law**

The income taxation of a nonstatutory<sup>99</sup> compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.<sup>100</sup> Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is generally included in the recipient's gross income as ordinary income in such taxable year.<sup>101</sup>

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

#### **Description of Proposal**

Under the proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes a 15-percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

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<sup>99</sup> Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

<sup>100</sup> If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

<sup>101</sup> Under section 83, such amount is includable in gross income in the first taxable year in which the rights to the stock are transferable or are not subject to substantial risk of forfeiture.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,<sup>102</sup> or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),<sup>103</sup> directors, and 10-percent-or-greater owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as previously defined in the bill) only if gain (if any) is recognized in whole or part by any shareholder by reason of a corporate inversion transaction previously defined in the bill.

Specified stock compensation subject to the excise tax includes any payment<sup>104</sup> (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than a non-lapse restriction, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the proposal applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

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<sup>102</sup> An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

<sup>103</sup> An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

<sup>104</sup> Under the proposal, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply if a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual would be paid a cash bonus of \$500,000 if the corporation's stock increased in value by 25 percent over two years or \$1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual would be paid a cash bonus equal to \$10,000 for every \$1 increase in the share price of the corporation's stock is subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options. It is intended that the Secretary issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then re-granted during the applicable twelve-month period.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, tax-sheltered annuity, simplified employee pension, or SIMPLE. In addition, under the proposal, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the proposal, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants or other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire

stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or “spread”) because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the proposal. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable). It is expected that the Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term and would be modified as necessary or appropriate to carry out the purposes of the provision. Pending the issuance of guidance, it is intended that taxpayers can rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Secretary issue guidance on determining when a payment is made in respect of the tax and that such guidance include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the \$1,000,000 limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the proposal. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual’s basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the proposal, the Secretary is authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the proposal.

**Effective Date**

The proposal is effective as of March 4, 2003, except that periods before March 4, 2003, are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

## **D. Reinsurance of U.S. Risks in Foreign Jurisdictions (sec. 2004 of the bill and sec. 845(a) of the Code)**

### **Present Law**

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.<sup>105</sup> For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.<sup>106</sup> In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

### **Description of Proposal**

The bill clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The bill authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority<sup>107</sup> be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

No regulations have been issued under section 845(a). It is expected that the Treasury Secretary will issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

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<sup>105</sup> Sec. 845(a).

<sup>106</sup> See S. Rep. No. 97-494, 99th Cong., 2d Sess., 337 (1982) (describing provisions relating to the repeal of modified coinsurance provisions).

<sup>107</sup> The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.

### **Effective Date**

The proposal is effective for any risk reinsured after the date of enactment of the proposal.



**E. Modification of the Tax Treatment of Individual Expatriates  
(sec. 2005 of the bill and secs. 877, 2107, 2501 and 6039G of the Code)**

**Present Law**

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresidents who are not U.S. citizens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business.

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency<sup>108</sup> with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the citizenship relinquishment or residency termination (the “alternative tax regime”). The alternative tax regime modifies the rules generally applicable to the taxation of nonresident noncitizens. For the 10-year period, the individual is subject to tax only on U.S.-source income at the rates applicable to U.S. citizens, rather than the rates applicable to nonresident noncitizens. However, for this purpose, U.S.-source income has a broader scope than it does for normal U.S. Federal tax purposes and includes, for example, gain from the sale of U.S. corporate stock or debt obligations. The alternative tax regime applies only if it results in a higher U.S. tax liability than the liability that would result if the individual were taxed as a nonresident noncitizen.

In addition, the alternative tax regime includes special estate and gift tax rules. Under present law, estates of nonresident noncitizens are subject to U.S. estate tax on U.S.-situated property. For these purposes, stock in a foreign corporation generally is not treated as U.S.-situated property, even if the foreign corporation itself owns U.S.-situated property. However, a special estate tax rule (sec. 2107) applies to former citizens and former long-term residents who are subject to the alternative tax regime. Under this rule, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets, if the former citizen or former long-term resident dies within 10 years of citizenship relinquishment or residency termination. This rule prevents former citizens and former long-term residents who are subject to the alternative tax regime from avoiding U.S. estate tax through the expedient of transferring U.S.-situated assets to a foreign corporation (subject to income tax on any appreciation under section 367). In addition, under the alternative tax regime, the individual is subject to gift tax on

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<sup>108</sup> The alternative tax regime applies to long-term residents of the United States that have terminated their residency with a principal purpose of avoiding U.S. tax. A “long-term resident” is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tiebreaker rule (and the individual does not elect to waive the benefits of such treaty).

gifts of U.S.-situated intangibles, such as U.S. stock, made during the 10 years following citizenship relinquishment or residency termination.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime. Accordingly, the alternative tax regime generally applies to an exchange of property that gives rise to U.S.-source income for property that gives rise to foreign source income. In addition, amounts earned by former citizens and former long-term residents through controlled foreign corporations are subject to the alternative tax regime, and the 10-year liability period is suspended during any time a former citizen's or former long-term resident's risk of loss with respect to property subject to the alternative tax regime is substantially diminished, among other measures.

A U.S. citizen who relinquishes citizenship or a long-term resident who terminates residency is treated as having done so with a principal purpose of tax avoidance (and, thus, generally is subject to the alternative tax regime described above) if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds \$100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds \$500,000. These amounts are adjusted annually for inflation.<sup>109</sup> Certain categories of individuals may avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons.

Under present law, the Immigration and Nationality Act governs the determination of when a U.S. citizen is treated for U.S. Federal tax purposes as having relinquished citizenship. Similarly, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration laws (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty). In view of this reliance on immigration-law status, it is possible in many instances for a U.S. citizen or resident to convert his or her Federal tax status to that of a nonresident noncitizen without notifying the IRS.

Individuals subject to the alternative tax regime are required to provide certain tax information, including tax identification numbers, upon relinquishment of citizenship or termination of residency (on IRS Form 8854, Expatriation Initial Information Statement). In the case of an individual with a net worth of at least \$500,000, the individual also must provide detailed information about the individual's assets and liabilities. The penalty for failure to provide the required tax information is the greater of \$1,000 or five percent of the tax imposed under the alternative tax regime for the year.<sup>110</sup> In addition, the U.S. Department of State and other governmental agencies are required to provide this information to the IRS.

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<sup>109</sup> The income tax liability and net worth thresholds under section 877(a)(2) for 2003 are \$122,000 and \$608,000, respectively. *See* Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

<sup>110</sup> The penalty applies for each year of the 10-year period beginning on the date the individual ceases to be a U.S. citizen or resident.

Former citizens and former long-term residents who are subject to the alternative tax regime also are required to file annual income tax returns, but only in the event that they owe U.S. Federal income tax. If a tax return is required, the former citizen or former long-term resident is required to provide the IRS with a statement setting forth (generally by category) all items of U.S.-source and foreign-source gross income, but no detailed information with respect to all assets held by the individual.

## **Description of Proposal**

### **In general**

The bill provides: (1) objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime; (2) tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes; (3) the imposition of full U.S. taxation for individuals who are subject to the alternative tax regime and who return to the United States for extended periods; (4) imposition of U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (5) an annual return-filing requirement for individuals who are subject to the alternative tax regime, for each of the 10 years following citizenship relinquishment or residency termination.<sup>111</sup>

### **Objective rules for the alternative tax regime**

The bill replaces the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law with objective rules. Under the bill, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed \$122,000 (adjusted for inflation after 2003) and his or her net worth does not exceed \$2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

The monetary thresholds under the bill replace the present-law inquiry into the taxpayer's intent. In addition, the bill eliminates the present-law process of IRS ruling requests.

If a former citizen exceeds the monetary thresholds, that person is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions provide relief to individuals who have never had

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<sup>111</sup> These proposals reflect recommendations contained in Joint Committee on Taxation, *Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency*, (JCS-2-03), February 2003.

substantial connections with the United States, as measured by certain objective criteria, and eliminate IRS inquiries as to the subjective intent of such taxpayers.

In order to be excepted from the application of the alternative tax regime under the bill, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also is required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary of the Treasury may require evidencing such compliance (*e.g.*, tax returns, proof of tax payments). Until such time, the individual remains subject to the alternative tax regime. It is intended that the IRS will continue to verify that the information submitted was accurate, and it is intended that the IRS will randomly audit such persons to assess compliance.

#### **Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes**

Under the bill, an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

#### **Sanction for individuals subject to the individual tax regime who return to the United States for extended periods**

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes<sup>112</sup> generally do not apply for this purpose. However, for individuals with certain ties to

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<sup>112</sup> Sections 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

countries other than the United States<sup>113</sup> and individuals with minimal prior physical presence in the United States,<sup>114</sup> a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

### **Imposition of gift tax with respect to stock of certain closely held foreign corporations**

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax under this bill, if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (*e.g.*, whether issued originally to the donor, purchased, or received as a gift or bequest).

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<sup>113</sup> An individual has such a relationship to a foreign country if the individual becomes a citizen or resident of the country in which (1) the individual becomes fully liable for income tax or (2) the individual was born, such individual's spouse was born, or either of the individual's parents was born.

<sup>114</sup> An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if (1) the individual is a teacher or trainee, a student, a professional athlete in certain circumstances, or a foreign government-related individual or (2) the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Section 7701(b)(3)(D)(ii).

### **Annual return**

The bill requires former citizens and former long-term residents to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules of this bill.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of \$5,000. The \$5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

### **Effective Date**

The proposal applies to individuals who relinquish citizenship or terminate long-term residency after February 27, 2003.

**F. Reporting of Taxable Mergers and Acquisitions**  
**(sec. 2006 of the bill and new sec. 6043A of the Code)**

**Present Law**

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

**Description of Proposal**

Under the bill, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

- (1) A description of the transaction;
- (2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);
- (3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and
- (4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee<sup>115</sup>) whose name is required to be set forth in such return a written statement showing:

- (1) The name, address, and phone number of the information contact of the person required to make such return;
- (2) The information required to be shown on that return; and
- (3) Such other information as the Treasury Secretary may prescribe.

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<sup>115</sup> In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary of the Treasury.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements is extended to failures to comply with the requirements set forth under this bill.

**Effective Date**

The proposal is effective for acquisitions after the date of enactment.



**G. Studies**  
**(sec. 2007 of the bill)**

**Present Law**

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits in order to arrive at a reduced overall tax burden. Such a shifting of items could be accomplished by establishing artificial, non-arm's-length (i.e., non-market) prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to reallocate income, deductions, or credits between or among two or more organizations, trades, or businesses under common control if he determines that such a reallocation is necessary to prevent tax evasion or to clearly reflect income. Treasury regulations adopt the arm's length standard as the standard for determining whether such reallocations are appropriate. Thus, the regulations provide rules to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length. Transactions involving intangible property and certain services may present particular challenges to the administration of the arm's length standard, because the nature of these transactions may make it difficult or impossible to compare them with third-party market transactions.

Present law also provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),<sup>116</sup> if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

In addition to the statutory rules governing the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income (e.g., dividends, interest and royalties) paid to residents of the other treaty country. Treaties also contain provisions governing the creditability of taxes imposed by the treaty country in which income was earned in computing the amount of tax owed to the other country by its residents with respect to such income. Treaties further provide procedures under which

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<sup>116</sup> This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

inconsistent positions taken by the treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries.

### **Description of Proposal**

The bill requires the Secretary of the Treasury to conduct and submit to the Congress three studies. The first study will examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study will examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study will examine the impact of the provisions of this bill on earnings stripping and inversion transactions.

### **Effective Date**

The tax treaty study required under the proposal is due no later than June 30, 2004. The transfer pricing study required under the proposal is due no later than June 30, 2004. The earnings stripping and inversions study required under the proposal is due no later than December 31, 2005.

### III. PROPOSALS RELATING TO TAX SHELTERS

#### A. Taxpayer Related Proposals

##### 1. Penalty for failure to disclose reportable transactions (sec. 3001 of the bill and new sec. 6707A of the Code)

###### Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each “reportable transaction” in which the taxpayer participates.<sup>117</sup>

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)<sup>118</sup> a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a “listed transaction”).<sup>119</sup>

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer’s disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).<sup>120</sup>

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the

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<sup>117</sup> On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003, are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

<sup>118</sup> The regulations clarify that the term “substantially similar” includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1.6011-4(c)(4).

<sup>119</sup> Treas. Reg. sec. 1.6011-4(b)(2).

<sup>120</sup> Treas. Reg. sec. 1.6011-4(b)(3).

transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.<sup>121</sup>

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) \$10 million in any single year or \$20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) \$2 million in any single year or \$4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) \$50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.<sup>122</sup>

The fifth category of reportable transactions refers to any transaction done by certain taxpayers<sup>123</sup> in which the tax treatment of the transaction differs (or is expected to differ) by more than \$10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.<sup>124</sup>

The final category of reportable transactions is any transaction that results in a tax credit exceeding \$250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.<sup>125</sup>

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.<sup>126</sup>

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<sup>121</sup> Treas. Reg. sec. 1.6011-4(b)(4).

<sup>122</sup> Treas. Reg. sec. 1.6011-4(b)(5). IRS Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

<sup>123</sup> The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have \$250 million or more in gross assets.

<sup>124</sup> Treas. Reg. sec. 1.6011-4(b)(6). IRS Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

<sup>125</sup> Treas. Reg. sec. 1.6011-4(b)(7).

<sup>126</sup> Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

## **Description of Proposal**

### **In general**

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

### **Transactions to be disclosed**

The proposal does not define the terms “listed transaction”<sup>127</sup> or “reportable transaction,” nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a “listed transaction” and a “reportable transaction” under section 6011.

### **Penalty rate**

The penalty for failing to disclose a reportable transaction is \$10,000 in the case of a natural person and \$50,000 in any other case. The amount is increased to \$100,000 and \$200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally. Thus, a revenue agent, an Appeals officer, or any other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

### **Effective Date**

The proposal is effective for returns and statements the due date for which is after the date of enactment.

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<sup>127</sup> The provision states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of “substantially similar” will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of “listed transaction” and “reportable transactions”) as appropriate.

## **2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 3002 of the bill and new sec. 6662A of the Code)**

### **Present Law**

The accuracy-related penalty 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. 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 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.<sup>128</sup> The amount of any understatement generally 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 were adequately disclosed and there was a reasonable basis for its tax treatment.<sup>129</sup>

Special rules apply with respect to tax shelters.<sup>130</sup> For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (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>131</sup> The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based 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>132</sup>

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<sup>128</sup> Sec. 6662.

<sup>129</sup> Sec. 6662(d)(2)(B).

<sup>130</sup> Sec. 6662(d)(2)(C).

<sup>131</sup> Sec. 6664(c).

<sup>132</sup> Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

## **Description of Proposal**

### **In general**

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a “reportable avoidance transaction”).<sup>133</sup> The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

#### **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. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (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 are adequately disclosed, 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.

#### **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 applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

### **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 the proposal, 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>134</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.

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<sup>133</sup> The terms “reportable transaction” and “listed transaction” have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

<sup>134</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.

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.

### **Strengthened reasonable cause exception**

A penalty is not imposed under the proposal with respect to any portion of an understatement if it 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>135</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 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.

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>136</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>137</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

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<sup>135</sup> See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

<sup>136</sup> The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) 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).

<sup>137</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.



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.

Organization, management, promotion or sale of a 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>138</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 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

Any understatement upon which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such 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).

The penalty imposed under this provision shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

#### Effective Date

The proposal is effective for taxable years ending after the date of enactment.

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<sup>138</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).

### **3. Tax shelter exception to confidentiality privileges relating to taxpayer communications (sec. 3003 of the bill and sec. 7525 of the Code)**

#### **Present Law**

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

#### **Description of Proposal**

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

#### **Effective Date**

The proposal is effective with respect to communications made on or after the date of enactment.

### **4. Statute of limitations for unreported listed transactions (sec. 3004 of the bill and sec. 6501 of the Code)**

#### **Present Law**

In general, the Code requires that taxes be assessed within three years<sup>139</sup> after the date a return is filed.<sup>140</sup> If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.<sup>141</sup> If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.<sup>142</sup>

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<sup>139</sup> Sec. 6501(a).

<sup>140</sup> For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

<sup>141</sup> Sec. 6501(e).

<sup>142</sup> Sec. 6501(c).

## Description of Proposal

The proposal extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction<sup>143</sup> which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject extended statute of limitations.<sup>144</sup>

## Effective Date

The proposal is effective for taxable years with respect to which the period for assessing a deficiency did not expire before date of enactment.

## **5. Disclosure of reportable transactions by material advisors (sec. 3005 of the bill and secs. 6111 and 6707 of the Code)**

### Present Law

#### Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.<sup>145</sup> A “tax shelter” means any investment with respect to which the tax shelter ratio<sup>146</sup> for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one

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<sup>143</sup> The term “listed transaction” has the same meaning as described in a previous provision regarding the penalty for failure to disclose reportable transactions.

<sup>144</sup> If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer’s tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this proposal does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are recognized over multiple tax years, the proposal’s extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

<sup>145</sup> Sec. 6111(a).

<sup>146</sup> The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than \$250,000 and at least five investors).<sup>147</sup>

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of \$100,000 in the aggregate.<sup>148</sup>

In general, a transaction has a “significant purpose of avoiding or evading Federal income tax” if the transaction: (1) is the same as or substantially similar to a “listed transaction,”<sup>149</sup> or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.<sup>150</sup> Certain exceptions are provided with respect to the second category of transactions.<sup>151</sup>

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know that the offeree’s use or disclosure of information relating to the transaction is limited in any other manner.<sup>152</sup>

### **Failure to register tax shelter**

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500.<sup>153</sup> However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the

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<sup>147</sup> Sec. 6111(c).

<sup>148</sup> Sec. 6111(d).

<sup>149</sup> Treas. Reg. sec. 301.6111-2(b)(2).

<sup>150</sup> Treas. Reg. sec. 301.6111-2(b)(3).

<sup>151</sup> Treas. Reg. sec. 301.6111-2(b)(4).

<sup>152</sup> The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree’s disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

<sup>153</sup> Sec. 6707.

greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a \$100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a \$250 penalty on the investor for each failure to include the tax shelter identification number on a return.

### **Description of Proposal**

#### **Disclosure of reportable transactions by material advisors**

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including any listed transaction)<sup>154</sup> to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.<sup>155</sup>

A “material advisor” means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of \$250,000 (\$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section (including, for example, rules regarding the aggregation of fees in appropriate circumstances).

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<sup>154</sup> The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related provisions.

<sup>155</sup> See the previous discussion regarding the disclosure requirements under new section 6707A.

## **Penalty for failing to furnish information regarding reportable transactions**

The proposal repeals the present-law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).<sup>156</sup> The amount of the penalty is \$50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) \$200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.<sup>157</sup> All or part of the penalty may be rescinded only if rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

### **Effective Date**

The proposal requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

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<sup>156</sup> The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related provisions.

<sup>157</sup> The Secretary’s present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the provision.

## **6. Investor lists and modification of penalty for failure to maintain investor lists (secs. 3006 and 3007 of the bill and secs. 6112 and 6708 of the Code)**

### **Present Law**

#### **Investor lists**

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).<sup>158</sup> Recently issued regulations under section 6112 contain rules regarding the list maintenance requirements.<sup>159</sup> In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.<sup>160</sup>

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.<sup>161</sup> A material advisor is defined as any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) \$250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) \$50,000 for any other transaction that is a potentially abusive tax shelter.<sup>162</sup> For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to \$25,000 and \$10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).<sup>163</sup>

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.<sup>164</sup>

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<sup>158</sup> Sec. 6112.

<sup>159</sup> Treas. Reg. sec. 301-6112-1.

<sup>160</sup> A special rule applies the list maintenance requirements to transactions entered into after February 28, 2000 if the transaction becomes a listed transaction (as defined in Treas. Reg. 1.6011-4) after February 28, 2003.

<sup>161</sup> Treas. Reg. sec. 301.6112-1(c)(1).

<sup>162</sup> Treas. Reg. sec. 301.6112-1(c)(2) and (3).

<sup>163</sup> Treas. Reg. sec. 301.6112-1(b).

<sup>164</sup> Sec. 6112(c)(2).

## **Penalties for failing to maintain investor lists**

Under section 6708, the penalty for failing to maintain the list required under section 6112 is \$50 for each name omitted from the list (with a maximum penalty of \$100,000 per year).

## **Description of Proposal**

### **Investor lists**

Each material advisor<sup>165</sup> with respect to a reportable transaction (including a listed transaction)<sup>166</sup> is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.

The proposal also clarifies that, for purposes of section 6112, the identity of any person is not privileged for any purpose, such as either under the common law attorney-client privilege or under the section 7525 federally authorized tax practitioner rules.

### **Penalty for failing to maintain investor lists**

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a \$10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.<sup>167</sup>

## **Effective Date**

The proposal requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

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<sup>165</sup> The term “material advisor” has the same meaning as when used in connection with the requirement to file an information return under section 6111.

<sup>166</sup> The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related provisions.

<sup>167</sup> In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.



The proposal imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

The proposal clarifying that the identity of any person is not privileged for purposes of section 6112 is effective as if included in the amendments made by section 142 of the Deficit Reduction Act of 1984.

## **7. Penalties on promoters of tax shelters (sec. 3008 of the bill and sec. 6700 of the Code)**

### **Present Law**

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.<sup>168</sup> A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is \$1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

### **Description of Proposal**

The proposal modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

### **Effective Date**

The proposal is effective for activities after the date of enactment.

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<sup>168</sup> Sec. 6700.

## **8. Modifications to the definition of the substantial understatement (sec. 3009 of the bill and sec. 6662 of the Code)**

### **Present Law**

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A “substantial understatement” exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations).<sup>169</sup>

### **Description of Proposal**

The proposal modifies the definition of “substantial” for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.

### **Effective Date**

The proposal is effective for taxable years beginning after date of enactment.

## **9. Actions to enjoin conduct with respect to tax shelters and reportable transactions (sec. 3010 of the bill and sec. 7408 of the Code)**

### **Present Law**

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.<sup>170</sup>

### **Description of Proposal**

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions<sup>171</sup> and the keeping of lists of investors by material advisors.<sup>172</sup> Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

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<sup>169</sup> Sec. 6662(a) and (d)(1)(A).

<sup>170</sup> Sec. 7408.

<sup>171</sup> Sec. 6707, as amended by other provisions of this bill.

<sup>172</sup> Sec. 6708, as amended by other provisions of this bill.

### Effective Date

The proposal is effective on the day after the date of enactment.

### **10. Penalty for failure to report interests in foreign financial accounts (sec. 3011 of the bill and sec. 5321 of Title 31, United States Code)**

#### Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.<sup>173</sup> In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of \$100,000; the minimum amount of the penalty is \$25,000.<sup>174</sup> In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than \$250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to \$500,000 and the maximum length of imprisonment is increased to 10 years.<sup>175</sup>

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.<sup>176</sup> This report, which was statutorily required,<sup>177</sup> studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

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<sup>173</sup> 31 U.S.C. 5314.

<sup>174</sup> 31 U.S.C. 5321(a)(5).

<sup>175</sup> 31 U.S.C. 5322.

<sup>176</sup> *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

<sup>177</sup> Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

### **Description of Proposal**

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to \$5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

### **Effective Date**

The proposal is effective with respect to failures to report occurring on or after the date of enactment.

## **11. Regulation of individuals practicing before the Department of the Treasury (sec. 3012 of the bill and sec. 330 of Title 31, United States Code)**

### **Present Law**

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.<sup>178</sup> The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

### **Description of Proposal**

The proposal makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal expressly permits censure as a sanction. Second, the proposal permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure of such individual.

The proposal also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

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<sup>178</sup> 31 U.S.C. 330.

### **Effective Date**

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

## B. Other Proposals

### 1. Treatment of stripped interests in bond and preferred stock funds (sec. 3021 of the bill and secs. 305 and 1286 of the Code)

#### Present Law

##### Assignment of income in general

In general, an “income stripping” transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the “assignment of income” doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had “assigned” to the donee the right to receive the income.<sup>179</sup>

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).<sup>180</sup> However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).<sup>181</sup>

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<sup>179</sup> *Helvering v. Horst*, 311 U.S. 112 (1940).

<sup>180</sup> Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

<sup>181</sup> However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

## **Stripped bonds**

Special rules are provided with respect to the purchaser and “stripper” of stripped bonds.<sup>182</sup> A “stripped bond” is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.<sup>183</sup> In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount (“OID”) on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.<sup>184</sup> The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.<sup>185</sup> Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer’s gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer’s basis allocable to such retained

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<sup>182</sup> Sec. 1286.

<sup>183</sup> Sec. 1286(e).

<sup>184</sup> Sec. 1286(a).

<sup>185</sup> Sec. 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.<sup>186</sup>

### **Stripped preferred stock**

“Stripped preferred stock” is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.<sup>187</sup> A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.<sup>188</sup> This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer’s adjusted basis in the stripped preferred stock.<sup>189</sup>

### **Description of Proposal**

The bill authorizes the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. This provision applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends. However, it is intended that Treasury regulations issued under this provision would not apply to certain transactions involving direct or indirect interests in an entity or account substantially all the assets of which consist of tax-

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<sup>186</sup> Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond’s coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

<sup>187</sup> Sec. 305(e)(5).

<sup>188</sup> Sec. 305(e)(1).

<sup>189</sup> Sec. 305(e)(3).



exempt obligations (as defined in section 1275(a)(3)), such as a tax-exempt bond partnership described in Rev. Proc. 2002-68,<sup>190</sup> *modifying and superceding* Rev. Proc. 2002-16.<sup>191</sup>

No inference is intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds, preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

### **Effective Date**

This proposal is effective for purchases and dispositions occurring after the date of enactment.

## **2. Minimum holding period for foreign tax credit on withholding taxes on income other than dividends (sec. 3022 of the bill and sec. 901 of the Code)**

### **Present Law**

In general, U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company (“RIC”) if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable

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<sup>190</sup> 2002-43 I.R.B. 753.

<sup>191</sup> 2002-9 I.R.B. 572.

holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

### **Description of Proposal**

The proposal expands the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The proposal does not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The proposal also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the proposal. In addition, the proposal authorizes the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.

### **Effective Date**

The proposal is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

### **3. Disallowance of certain partnership loss transfers (sec. 3023 of the bill and secs. 704, 734, and 743 of the Code)**

#### **Present Law**

##### **Contributions of property**

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner at the time of contribution.<sup>192</sup> The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.<sup>193</sup> The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.<sup>194</sup> Any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution.<sup>195</sup> This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating

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<sup>192</sup> Sec. 721.

<sup>193</sup> Sec. 723.

<sup>194</sup> Sec. 722.

<sup>195</sup> Sec. 704(c)(1)(A).

items to the noncontributing partners based on the value of their contributions and by allocating to the contributing partner the remainder of each item.<sup>196</sup>

If the contributing partner transfers its partnership interest, the built-in gain or loss will be allocated to the transferee partner as it would have been allocated to the contributing partner.<sup>197</sup> If the contributing partner's interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be "transferred" to other partners where the contributing partner no longer remains a partner.

### **Transfers of partnership interests**

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.<sup>198</sup> If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.<sup>199</sup> These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

### **Distributions of partnership property**

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership.<sup>200</sup> In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).<sup>201</sup> In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's

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<sup>196</sup> If there is an insufficient amount of an item to allocate to the noncontributing partners, Treasury regulations allow for reasonable allocations to remedy this insufficiency. Treas. Reg. sec. 1.704-3(c) and (d).

<sup>197</sup> Treas. Reg. 1.704-3(a)(7).

<sup>198</sup> Sec. 743(a).

<sup>199</sup> Sec. 743(b).

<sup>200</sup> Sec. 731(a) and (b).

<sup>201</sup> Sec. 732(b).

adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).<sup>202</sup>

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.<sup>203</sup> If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner).<sup>204</sup> To the extent the adjusted basis of the distributed properties increases (or loss is recognized) the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

### **Description of Proposal**

#### **Contributions of property**

Under the proposal, a built-in loss may be taken into account only by the contributing partner and not by other partners. Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution. Thus, if the contributing partner's partnership interest is transferred or liquidated, the partnership's adjusted basis in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.<sup>205</sup>

#### **Transfers of partnership interests**

The proposal provides that the basis adjustment rules under section 743 are mandatory in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss (rather than being elective as under present law). For this purpose, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than \$250,000 the fair market value of the partnership property.

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<sup>202</sup> Sec. 732(a).

<sup>203</sup> Sec. 734(a).

<sup>204</sup> Sec. 734(b).

<sup>205</sup> It is intended that a corporation succeeding to attributes of the contributing corporate partner under section 381 shall be treated in the same manner as the contributing partner.

Thus, for example, assume that partner A sells his 25-percent partnership interest to B for its fair market value of \$1 million. Also assume that, immediately after the transfer, the fair market value of partnership assets is \$4 million and the partnership's adjusted basis in the partnership assets is \$4.3 million. Under the bill, section 743(b) applies, so that a \$300,000 decrease is required to the adjusted basis of the partnership assets with respect to B. As a result, B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

### **Distribution of partnership property**

The proposal provides that a basis adjustment under section 734(b) is required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than \$250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

Thus, for example, assume that A and B each contributed \$2.5 million to a newly formed partnership and C contributed \$5 million, and that the partnership purchased LMN stock for \$3 million and XYZ stock for \$7 million. Assume that the value of each stock declined to \$1 million. Assume LMN stock is distributed to C in liquidation of its partnership interest. Under present law, the basis of LMN stock in C's hands is \$5 million. Under present law, C would recognize a loss of \$4 million if the LMN stock were sold for \$1 million.

Under the proposal, however, there is a substantial basis adjustment because the \$2 million increase in the adjusted basis of LMN stock (described in section 734(b)(2)(B)) is greater than \$250,000. Thus, the partnership is required to decrease the basis of XYZ stock (under section 734(b)(2)) by \$2 million (the amount by which the basis of LMN stock was increased), leaving a basis of \$5 million. If the XYZ stock were then sold by the partnership for \$1 million, A and B would each recognize a loss of \$2 million.

### **Effective Date**

The proposal applies to contributions, transfers, and distributions (as the case may be) after the date of enactment.

## **4. No reduction of basis under section 734 in stock held by partnership in corporate partner (sec. 3024 of the bill and sec. 755 of the Code)**

### **Present Law**

#### **In general**

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to a partnership.<sup>206</sup> Similarly, a partner and the partnership generally do not recognize

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<sup>206</sup> Sec. 721(a).

gain or loss on the distribution of partnership property.<sup>207</sup> This includes current distributions and distributions in liquidation of a partner's interest.

### **Basis of property distributed in liquidation**

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).<sup>208</sup> Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

### **Election to adjust basis of partnership property**

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.<sup>209</sup> The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.<sup>210</sup> In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and

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<sup>207</sup> Sec. 731(a) and (b).

<sup>208</sup> Sec. 732(b).

<sup>209</sup> Sec. 754.

<sup>210</sup> Sec. 755(a).

depreciable and real property used in the trade or business held for more than one year, and (2) any other property.<sup>211</sup>

### **Description of Proposal**

The proposal provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the proposal, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

### **Effective Date.**

The proposal applies to distributions after date of enactment.

## **5. Repeal of special rules for FASITs, etc. (sec. 3025 of the bill and secs. 860H through 860L of the Code)**

### **Present Law**

#### **Financial asset securitization investment trusts**

In 1996, Congress created a new type of statutory entity called a "financial asset securitization trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.<sup>212</sup> A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

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<sup>211</sup> Sec. 755(b).

<sup>212</sup> Sections 860H through 860L.

### Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;<sup>213</sup> (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called “permitted assets;” (3) have non-ownership interests be certain specified types of debt instruments called “regular interests;” (4) have a single ownership interest which is held by an “eligible holder;” and (5) not qualify as a regulated investment company (“RIC”). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

### Permitted assets

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following “permitted assets”: (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

### “Regular interests” of a FASIT

“Regular interests” of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a “regular interest”, an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to real estate mortgage investment conduit interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate (“AFR”) for the calendar month in which the instrument is issued.

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<sup>213</sup> Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.



### Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

### Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT's owner (or a person related to the FASIT's owner), the property is treated as being first acquired by the FASIT's owner for the FASIT's cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules. In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.

### Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount ("OID") accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

### Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

### Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of

the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

### **Real estate mortgage investment conduits**

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.<sup>214</sup> In order to qualify as a REMIC, substantially all of the assets of the entity must consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A "qualified mortgage" generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A "permitted investment" generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A "regular interest" is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a "residual interest" is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

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<sup>214</sup> See sections 860A through 860G.

Original issue discount accruals with respect to debt instruments and pools of debt instruments subject to acceleration of principal payment

The holder of a debt instrument with original issue discount (“OID”) generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument.<sup>215</sup> In general, issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holder.

Special rules for determining the amount of OID allocated to a period apply to certain instruments and pools of instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a REMIC or qualified mortgage held by a REMIC, (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, or (3) any pool of debt instruments the yield on which may be affected by reason of prepayments, the daily portions of the OID on such debt instruments and pools of debt instruments generally are determined by taking into account an assumption regarding the prepayment of principal for such instruments. The prepayment assumption to be used for this purpose is that which the parties use in pricing the particular transaction.

**Description of Proposal**

The proposal repeals the special rules for FASITs. The proposal provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules would not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the proposal also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the proposal modifies the present-law definition of a REMIC “regular interest” to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and

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<sup>215</sup> The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument’s yield to maturity, and then subtracting the interest payable during the accrual period.

interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

In addition, the proposal makes three modifications to the present-law definition of a “qualified mortgage.” First, the proposal modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the proposal modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a “reverse mortgage loan” is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a “balance increase”), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the proposal modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the proposal modifies the present-law definition of a “permitted investment” to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a “qualified mortgage.”

The proposal also modifies the OID rules with respect to certain instruments and pools of instruments that may be subject to principal prepayment by directing the Secretary to prescribe regulations permitting the use of a current prepayment assumption determined as of the close of the accrual period (or such other time as the Secretary may prescribe during the taxable year in which the accrual period ends).

### **Effective Date**

Except as provided by the transition period for existing FASITs, this proposal is effective for taxable years beginning after December 31, 2003.

## **6. Limitation on transfer of built-in losses on REMIC residuals (sec. 3026 of the bill and sec. 362 of the Code)**

### **Present Law**

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.<sup>216</sup> The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.<sup>217</sup>

The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.<sup>218</sup>

### **Description of Proposal**

The proposal provides that if a residual interest (as defined in section 860G(a)(2)) in a real estate mortgage investment conduit ("REMIC") is contributed to a corporation and the transferee corporation's adjusted basis in the REMIC residual interest would (but for the proposal) exceed the fair market value of the REMIC residual interest immediately after the contribution, the transferee corporation's adjusted basis in the REMIC residual interest is limited to the fair market value of the REMIC residual interest immediately after the contribution, regardless of whether the fair market value of the REMIC residual interest is less than, equal to, or greater than zero (i.e., the proposal may result in the transferee corporation having a negative adjusted basis in the REMIC residual interest).

### **Effective Date**

The proposal applies to transactions after the date of enactment.

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<sup>216</sup> Sec. 351.

<sup>217</sup> Sec. 358.

<sup>218</sup> Secs. 334(b) and 362(a) and (b).

## **7. Clarification of banking business for purposes of determining investment of earnings in U.S. property (sec. 3027 of the bill and sec. 956 of the Code)**

### **Present Law**

In general, the subpart F rules (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as “subpart F income”), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property (sec. 951(a)(1)(B)).

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of: (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis; or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for: (1) obligations of the United States, money, or deposits with persons carrying on the banking business; (2) certain export property; (3) certain trade or business obligations; (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States; (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks; (6) stock or debt of certain unrelated U.S. corporations; (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf; (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with

a U.S. trade or business; (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities; (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer; and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

With regard to the exception for deposits with persons carrying on the banking business, the U.S. Court of Appeals for the Sixth Circuit in *The Limited, Inc. v. Commissioner*<sup>219</sup> concluded that a U.S. subsidiary of a U.S. shareholder was "carrying on the banking business" even though its operations were limited to the administration of the private label credit card program of the U.S. shareholder. Therefore, the court held that a controlled foreign corporation of the U.S. shareholder could make deposits with the subsidiary (e.g., through the purchase of certificates of deposit) under this exception, and avoid taxation of the deposits under section 956 as an investment in U.S. property.

### **Description of Proposal**

The proposal provides that the exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with corporations with respect to which a bank holding company (as defined by section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation.

No inference is intended as to the meaning of the phrase "carrying on the banking business" under present law or whether this phrase was correctly interpreted by the Sixth Circuit in *The Limited*.

### **Effective Date**

This proposal is effective on the date of enactment.

## **8. Modify rules related to certain small property and casualty insurance companies (sec. 3028 of the bill and secs. 501(c)(15) and 831(b) of the Code)**

### **Present Law**

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832).

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<sup>219</sup> 286 F.3d 324 (6th Cir. 2002), *rev'g* 113 T.C. 169 (1999).

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed \$350,000 (sec. 501(c)(15)).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed \$350,000, but do not exceed \$1.2 million (sec. 831(b)).

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account. For this purpose, a more-than-50-percent threshold applies under the vote and value requirements with respect to stock ownership for determining a controlled group, and rules treating a life insurance company as part of a separate controlled group or as an excluded member of a group do not apply (secs. 501(c)(15), 831(b)(2)(B) and 1563).

### **Description of Proposal**

The proposal modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, and to elect to be taxed only on taxable investment income.

Under the proposal, a property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed \$600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts. For purposes of determining gross receipts, the gross receipts of all members of a controlled group of corporations of which the company is a part are taken into account. The proposal expands the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

A company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax under the proposal. For this purpose, the term "insurance company" means any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)). A company whose investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose.<sup>220</sup> It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

The proposal also provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed a specified amount (without regard to whether such premiums exceed \$350,000) (sec. 831(b)). The proposal increases from \$1.2 million to \$1.89 million the upper limit on net (or direct) written premiums for purposes of such election. The \$1.89 million amount is indexed for inflation for taxable years beginning in calendar years after 2004. As under present law, for purposes of determining the amount of a company's net

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<sup>220</sup> See, e.g., *Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972).



written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account.

It is intended that regulations or other Treasury guidance provide for anti-abuse rules so as to prevent improper use of the provision, including, for example, by attempts to characterize as premiums any income that is other than premium income.

### **Effective Date**

The provision is effective for taxable years beginning after December 31, 2003.

## **9. Definition of insurance company for property and casualty insurance company tax rules (sec. 3029 of the bill and sec. 831(c) of the Code)**

### **Present Law**

Present law provides specific rules for taxation of the life insurance company taxable income of a life insurance company (sec. 801), and for taxation of the taxable income of a company other than a life insurance company (sec. 831) (generally referred to as a property and casualty insurance company). For Federal income tax purposes, a life insurance company means an insurance company that is engaged in the business of issuing life insurance and annuity contracts, or noncancellable health and accident insurance contracts, and that meets a 50-percent test with respect to its reserves (sec. 816(a)). This statutory provision applicable to life insurance companies explicitly defines the term "insurance company" to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)).

The life insurance company statutory definition of an insurance company does not explicitly apply to property and casualty insurance companies, although a long-standing Treasury regulation<sup>221</sup> that is applied to property and casualty companies provides a somewhat similar definition of an "insurance company" based on the company's "primary and predominant business activity."<sup>222</sup>

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<sup>221</sup> The Treasury regulation provides that "the term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code." Treas. Reg. section 1.801-3(a)(1).

<sup>222</sup> Court cases involving a determination of whether a company is an insurance company for Federal tax purposes have examined all of the business and other activities of the company. In considering whether a company is an insurance company for such purposes, courts have considered, among other factors, the amount and source of income received by the company

When enacting the statutory definition of an insurance company in 1984, Congress stated, “[b]y requiring [that] more than half rather than the 'primary and predominant business activity' be insurance activity, the proposal adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies . . . . Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities.”<sup>223</sup>

### **Description of Proposal**

The proposal provides that, for purposes of determining whether a company is a property and casualty insurance company, the term "insurance company" is defined to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, the proposal conforms the definition of an insurance company for purposes of the rules taxing property and casualty insurance companies to the rules taxing life insurance companies, so that the definition is uniform. The provision adopts a stricter and more precise standard than the "primary and predominant business activity" test contained in Treasury Regulations. A company whose investment activities outweigh its insurance activities is not considered to be an insurance company under the provision.<sup>224</sup> It is not intended that a company whose sole activity is the run-

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from its different activities. *See Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182 (1932); *United States v. Home Title Insurance Co.*, 285 U.S. 191 (1932). *See also Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), in which the court concluded that the company was not an insurance company: "The ... financial data clearly indicates that petitioner's primary and predominant source of income was from its investments and not from issuing insurance contracts or reinsuring risks underwritten by insurance companies. During each of the years in issue, petitioner's investment income far exceeded its premiums and the amounts of earned premiums were de minimis during those years. It is equally as clear that petitioner's primary and predominant efforts were not expended in issuing insurance contracts or in reinsurance. Of the relatively few policies directly written by petitioner, nearly all were issued to [family members]. Also, Investment Life, in which [family members] each owned a substantial stock interest, was the source of nearly all of the policies reinsured by petitioner. These facts, coupled with the fact that petitioner did not maintain an active sales staff soliciting or selling insurance policies . . . , indicate a lack of concentrated effort on petitioner's behalf toward its chartered purpose of engaging in the insurance business. . . . For the above reasons, we hold that during the years in issue, petitioner was not 'an insurance company . . . engaged in the business of issuing life insurance' and hence, that petitioner was not a life insurance company within the meaning of section 801." 56 T.C. 497, 507-508.

<sup>223</sup> H.R. Rep. 98-432, part 2, at 1402-1403 (1984); S. Prt. No. 98-169, vol. I, at 525-526 (1984); *see also* H.R. Rep. No. 98-861 at 1043-1044 (1985) (Conference Report).

<sup>224</sup> *See Inter-American Life Insurance Co. v. Comm'r*, *supra*.

off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income.

#### **Effective Date**

The provision applies to taxable years beginning after December 31, 2003.

### **10. Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions (sec. 3030 of the bill and sec. 163 of the Code)**

#### **Present Law**

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.<sup>225</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**

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from an undisclosed reportable avoidance transaction or an undisclosed listed transaction.<sup>226</sup>

#### **Effective Date**

The provision is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

### **11. Clarification of rules for payment of estimated tax for certain deemed asset sales (sec. 3031 of the bill and sec. 338 of the Code)**

#### **Present Law**

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15<sup>th</sup> day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

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<sup>225</sup> Sec. 163(a).

<sup>226</sup> The definitions of these transactions are the same as those previously described in connection with the provision elsewhere in this bill to modify the accuracy-related penalty for listed and certain reportable transactions.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account.

### **Description of Proposal**

The proposal clarifies section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the proposal, if a transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on the stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

Thus, if at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax is computed from the date of the sale, based on an asset sale. If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on a stock sale, estimated tax is recomputed based on the asset sale election.

No inference is intended as to present law.

### **Effective Date**

The proposal is effective for transactions that occur after the date of enactment of the provision.

## **12. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence (sec. 3032 of the bill and sec. 121 of the Code)**

### **Present Law**

Under present law, a taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.<sup>227</sup> To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two

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<sup>227</sup> Sec. 121.

years that the ownership and use requirements are met. There are no special rules relating to the sale or exchange of a principal residence that was acquired in a like-kind exchange within the prior five years.

### **Description of Proposal**

The proposal provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

### **Effective Date**

The proposal is effective for sales or exchanges of principal residences after the date of enactment.

## **13. Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons (sec. 3033 of the bill and secs. 163 and 267 of the Code)**

### **Present Law**

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. person that holds stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from such operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. However, certain anti-deferral regimes may cause the U.S. person to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by the foreign corporations in which the U.S. person holds stock. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F (sections 951-964), the passive foreign investment company rules (sections 1291-1298), and the foreign personal holding company rules (sections 551-558).

As a general rule, there is allowed as a deduction all interest paid or accrued within the taxable year with respect to indebtedness, including the aggregate daily portions of original issue discount (“OID”) of the issuer for the days during such taxable year.<sup>228</sup> However, if a debt instrument is held by a related foreign person, any portion of such OID is not allowable as a deduction to the payor of such instrument until paid (“related-foreign-person rule”). This related-foreign-person rule does not apply to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation).<sup>229</sup> Treasury regulations further modify the related-foreign-person rule by providing

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<sup>228</sup> Section 163(e)(1).

<sup>229</sup> Section 163(e)(3).

that in the case of a debt owed to a foreign personal holding company (“FPHC”), controlled foreign corporation (“CFC”) or passive foreign investment company (“PFIC”), a deduction is allowed for OID as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC, respectively.<sup>230</sup>

In the case of unpaid stated interest and expenses of related persons, where, by reason of a payee's method of accounting, an amount is not includible in the payee's gross income until it is paid but the unpaid amounts are deductible currently by the payor, the amount generally is allowable as a deduction when such amount is includible in the gross income of the payee.<sup>231</sup> With respect to stated interest and other expenses owed to related foreign corporations, Treasury regulations provide a general rule that requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to such related foreign persons (with an exception for income of a related foreign person that is effectively connected with the conduct of a U.S. trade or business and that is not exempt from taxation or subject to a reduced rate of taxation under a treaty obligation).<sup>232</sup> As in the case of OID, the Treasury regulations additionally provide that in the case of stated interest owed to a FPHC, CFC, or PFIC, a deduction is allowed as of the day on which the amount is includible in the income of the FPHC, CFC or PFIC.<sup>233</sup>

### **Description of Proposal**

The proposal provides that deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related FPHCs, CFCs, or PFICs are allowable only to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently included in the income of all of the direct or indirect U.S. owners of the related foreign person under the relevant inclusion rules. Deductions that have accrued but are not allowable under this proposal are allowed when the amounts are paid. The proposal grants the Secretary regulatory authority to provide exceptions to these rules, including an exception for amounts accrued where payment of the amount accrued occurs within a short period after accrual, and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged.

### **Effective Date**

The proposal is effective for payments accrued on or after date of enactment.

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<sup>230</sup> Treas. Reg. sec. 1.163-12(b)(3). In the case of a PFIC, the regulations further require that the person owing the amount at issue has in effect a qualified electing fund election pursuant to section 1295 with respect to the PFIC.

<sup>231</sup> Section 267(a)(2).

<sup>232</sup> Treas. Reg. sec. 1.267(a)-3(b)(1), (c).

<sup>233</sup> Treas. Reg. sec. 1.267(a)-3(c)(4).

## **14. Exclusion from gross income for interest on overpayments of income tax by individuals (sec. 3034 of the bill and new sec. 139A of the Code)**

### **Present Law**

#### **Overpayment interest**

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy. Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.

#### **Underpayment interest**

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that “(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from conduct of a trade or business.” The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth, Sixth, Eighth, and Ninth Circuits.

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.

### **Description of Proposal**

The proposal excludes overpayment interest that is paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the provision is

not considered disqualified income that could limit the earned income credit. Interest excluded under the provision also is not considered in determining what portion of a taxpayer's social security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

The exclusion from income of overpayment interest does not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principal purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the overpayment could not be excluded from income.

It is expected that the Secretary will indicate whether the interest is eligible to be excluded from income on the Form 1099 it provides that taxpayer for taxable year in which the underpayment interest is paid.

#### **Effective Date**

The proposal is effective for interest received in calendar years beginning after the date of enactment.

### **15. Deposits made to suspend the running of interest on potential underpayments (sec. 3035 of the bill and new sec. 6603 of the Code)**

#### **Present Law**

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount



will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative. Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax. If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer will not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.

### **Description of Proposal**

#### **In general**

The proposal allows a taxpayer to deposit cash with the IRS that the may subsequently be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest will not be charged on the portion of the underpayment that is paid by the deposited amount for the period the amount is on deposit. Generally, deposited amounts that have not been used to pay a tax may be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts will earn interest at the applicable Federal rate to the extent they are attributable to a disputable tax.

The Secretary may issue rules relating to the making, use, and return of the deposits.

#### **Use of a deposit to offset underpayments of tax**

Any amount on deposit may be used to pay an underpayment of tax that is ultimately assessed. If an underpayment is paid in this manner, the taxpayer will not be charged underpayment interest on the portion of the underpayment that is so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits \$20,000 on May 15, 2005, with respect to a disputable item on its 2004 income tax return. On April 15, 2007, an

examination of the taxpayer's year 2004 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2004 taxes were underpaid by \$25,000. The \$20,000 on deposit is used to pay \$20,000 of the underpayment, and the taxpayer also pays the remaining \$5,000. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only with respect to the \$5,000 of the underpayment that is not paid by the deposit. The taxpayer will owe underpayment interest on the remaining \$20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the \$20,000 was deposited.

### **Withdrawal of amounts**

A taxpayer may request the withdrawal of any amount of deposit at any time. The Secretary must comply with the withdrawal request unless the amount has already been used to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest will be paid on deposited amounts that are withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal. Interest is not payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of \$20,000 for taxable year 2004 and deposits \$20,000 on May 15, 2006. On April 15, 2007, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2004 taxes were underpaid by \$15,000. \$15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer will owe underpayment interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the \$20,000 was deposited. Simultaneously with the use of the \$15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2005, to May 15, 2006). This amount must be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

### **Limitation on amounts for which interest may be allowed**

Interest on a deposit that is returned to a taxpayer shall be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item is any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose. Thus, once a 30-day letter has been issued, the disputable amount cannot be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

## **Deposits are not payments of tax**

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Thus, the interest received on withdrawn deposits will not be eligible for the proposed exclusion from income of an individual. Similarly, withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

### **Effective Date**

The proposal applies to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment are treated as deposited (for purposes of applying this provision) on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.

## **16. Authorize IRS to enter into installment agreements that provide for partial payment (sec. 3036 of the bill and sec. 6159 of the Code)**

### **Present Law**

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

### **Description of Proposal**

The proposal clarifies that the IRS is authorized to enter into installment agreements with taxpayers which do not provide for full payment of the taxpayer's liability over the life of the agreement. The proposal also requires the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

### **Effective Date**

The proposal is effective for installment agreements entered into on or after the date of enactment.

## **17. Extension of IRS user fees (sec. 3037 of the bill and sec. 7528 of the Code)**

### **Present Law**

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination.<sup>234</sup> Public Law 108-89<sup>235</sup> extended the statutory authorization for these user fees through December 31, 2004, and moved the statutory authorization for these fees into the Code.<sup>236</sup>

### **Description of Proposal**

The proposal extends the statutory authorization for these user fees through September 30, 2013.

### **Effective Date**

The proposal is effective for requests made after the date of enactment.

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<sup>234</sup> These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100-203, December 22, 1987). Public Law 104-117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)) extended the statutory authorization for these user fees through September 30, 2003.

<sup>235</sup> 117 Stat. 1131; H.R. 3146, signed by the President on October 1, 2003.

<sup>236</sup> That Public Law also moved into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16, June 7, 2001).

## IV. TRADE ENHANCEMENT AND COMPLIANCE PROVISIONS

### A. Repeal of Exclusion for Extraterritorial Income (sec. 4001 of the bill and secs. 114 and 941-943 of the Code)

#### Present Law

The United States has long provided export-related benefits under a series of tax regimes, including the domestic international sales corporation (“DISC”) regime, the foreign sales corporation (“FSC”) regime, and the extraterritorial income (“ETI”) regime. Each of these regimes has been found to violate U.S. obligations under international trade agreements. In 2000, the European Union (“EU”) succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted a new regime under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements.

Under the ETI regime, an exclusion from gross income applies with respect to “extraterritorial income,” which is a taxpayer’s gross income attributable to “foreign trading gross receipts.” This income is eligible for the exclusion to the extent that it is “qualifying foreign trade income.” Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the “foreign trade income” derived by the taxpayer from the transaction;<sup>237</sup> or (3) 30 percent of the “foreign sale and leasing income” derived by the taxpayer from the transaction.<sup>238</sup>

Foreign trading gross receipts are gross receipts derived from certain activities in connection with “qualifying foreign trade property” with respect to which certain economic processes take place outside of the United States. Specifically, the gross receipts must be: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat

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<sup>237</sup> “Foreign trade income” is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

<sup>238</sup> “Foreign sale and leasing income” is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes. Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside the United States that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property can be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

### **Description of Proposal**

The bill repeals the ETI exclusion. Pursuant to transition rules, taxpayers retain a portion of their otherwise-applicable ETI benefits for transactions during a three-year transition period (80 percent for 2004 and 2005, and 60 percent for 2006). However, the proposal provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract<sup>239</sup> between the taxpayer and an unrelated person and such contract is in effect on January 14, 2002, and at all times thereafter.

In addition, foreign corporations that elected to be treated for all Federal tax purposes as domestic corporations in order to facilitate the claiming of ETI benefits are allowed to revoke such elections within one year of the date of enactment of the bill without recognition of gain or loss, subject to anti-abuse rules.

### **Effective Date**

The provision is effective for transactions after December 31, 2003.

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<sup>239</sup> This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract.

**B. Extension of Customs User Fees  
(sec. 4002 of the bill)**

**Present Law**

Section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) (P.L. 99-272), authorized the Secretary of the Treasury to collect certain service fees. Section 412 (P.L. 107-296) of the Homeland Security Act of 2002 authorized the Secretary of the Treasury to delegate such authority to the Secretary of Homeland Security. Provided for under 19 U.S.C. 58c, these fees include: processing fees for air and sea passengers, commercial trucks, rail cars, private aircraft and vessels, commercial vessels, dutiable mail packages, barges and bulk carriers, merchandise, and Customs broker permits. COBRA was amended on several occasions but most recently by P.L. 108-89, which extended authorization for the collection of these fees through March 31, 2004.

**Description of Proposal**

The bill extends the certain merchandise processing fees authorized under the Consolidated Omnibus Budget Reconciliation Act of 1985 through September 30, 2013. Certain other fees, the so-called “COBRA fees” related to overtime and premium services, also are extended through September 30, 2013. For fiscal years after September 30, 2005, the Secretary of the Treasury is to charge fees in amount that are reasonably related to the costs of providing customs services in connection with the activity or item for which the fee is charged.

The bill also includes a Sense of the Congress that the fees set forth in paragraphs (1) through (8) of subsection (a) of section 13031 of the Consolidated Omnibus Budget Reconciliation Act of 1985 have been reasonably related to the costs of providing customs services in connection with the activities or items for which the fees have been charged under such paragraphs. The Sense of Congress also states that the fees collected under such paragraphs have not exceeded, in the aggregate, the amounts paid for the costs described in subsection (f)(3)(A) incurred in providing customs services in connection with the activities or items for which the fees were charged under such paragraphs.

The bill further provides that the Secretary of the Treasury conduct a study of all the fees collected by the Department of Homeland Security, and shall submit to the Congress, not later than September 30, 2005, a report containing the recommendations of the Secretary on what fees should be eliminated, what the rate of fees retains should be, and any other recommendations with respect to the fees that the Secretary considers appropriate.

**Effective Date**

The proposal is effective upon the date of enactment.