Joint Committee on Taxation
June 12, 2002
JCX-61-02

DESCRIPTION OF CHAIRMAN'S MODIFICATIONS TO THE PROVISIONS OF THE "CARE ACT OF 2002" SCHEDULED FOR A MARKUP BY THE SENATE COMMITTEE ON FINANCE ON JUNE 13, 2002[1]

A. Modifications to the CARE Act of 2002

The following modifications would be made to the provisions of the CARE Act of 2002.[2]

1. Charitable deduction for contributions of food inventory

The Chairman's modification would delete the proposal to increase the amount of the deduction for eligible contributions of food inventory. Therefore, the Chairman's modification would retain the present-law rule relating to the amount of the enhanced deduction for eligible contributions of food inventory.

2. Charitable deduction for contributions of book inventory

The Chairman's modification would provide that the fair market value of a book is any bona fide published market price for the book (using the same printing and same edition), published within seven years preceding the contribution.

3. Charitable deduction for contributions of bonds

The Chairman's modification would eliminate the provision relating to charitable deduction for contributions of bonds.

4. Tax treatment of inversion transactions

The Chairman's modification would provide that, in cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Modifications to the Provisions of the "CARE Act of 2002" Scheduled for a Markup By the Senate Committee on Finance on June 13, 2002* (JCX-61-02), June 12, 2002.

[2] A description of the provisions of the "CARE Act of 2002" is contained in Joint Committee on Taxation, *Description of the "CARE Act of 2002"* (JCX-57-02), June 11, 2002.

provisions of the "Reversing the Expatriation of Profits Offshore Act" generally would not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary would be given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

The Chairman's modification would require inverting entities to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

5. Extension of IRS user fees

The Chairman's modification would adjust the period of extension of the IRS user fees so as to make the bill revenue neutral.

6. Extension of Custom user fees

The Chairman's modification would adjust the period of extension of the authority to impose and collect customs user fees for a sufficient period of time so as to make the bill revenue neutral.

B. New Provisions

The Chairman's modification would add the following provisions to the CARE Act of 2002:

1. Enhanced deduction for charitable contribution of literary, musical, artistic, and scholarly compositions

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction generally is limited to the taxpayer's basis in the property.[3] In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions of tangible personal property to a private foundation (other than certain private foundations),[4] the amount of the deduction is limited to the taxpayer's basis in the property.

Under present law, charitable contributions of literary, musical, and artistic compositions are considered ordinary income property and a taxpayer's deduction of such property is limited to the taxpayer's basis (typically, cost) in the property. To be eligible for the deduction, the contribution must be of an undivided portion of the donor's entire interest in the property.[5] For

[3] Sec. 170(e)(1).

[4] Sec. 170(e)(1)(B)(ii).

[5] Sec. 170(f)(3).

purposes of the charitable income tax deduction, the copyright and the work in which the copyright is embodied are not treated as separate property interests. Accordingly, if a donor owns a work of art and the copyright to the work of art, a gift of the artwork without the copyright or the copyright without the artwork will constitute a gift of a "partial interest" and will not qualify for the income tax charitable deduction.

Description of Proposal

The proposal would provide that a deduction for qualified artistic charitable contributions generally would be increased from the value under present law (generally, basis) to the fair market value of the property contributed, measured at the time of the contribution. However, the amount of the increase of the deduction provided by the proposal could not exceed the amount of the donor's adjusted gross income for the taxable year attributable to: (1) income from the sale or use of property created by the donor that is of the same type as the donated property; and (2) income from teaching, lecturing, performing, or similar activities with respect to such property. In addition, the increase to the present-law deduction provided by the proposal could not be carried over and deducted in other taxable years.

The proposal would define a qualified artistic charitable contribution to mean a charitable contribution of any literary, musical, artistic, or scholarly composition, or similar property, or the copyright thereon (or both). The tangible property and the copyright on such property would be treated as separate interests in the property for purposes of the "partial interest" rule; thus, a gift of artwork without the copyright or a copyright without the artwork would not constitute a gift of a partial interest and would be deductible. Contributions of letters, memoranda, or similar property that are written, prepared, or produced by or for an individual in his or her capacity as an officer or employee of any person (including a government agency or instrumentality) would not qualify for a fair market value deduction unless the contributed property was entirely personal.

In addition, a contribution would have to meet several requirements in order to qualify for the fair market value deduction. First, the contributed property would have to have been created by the personal efforts of the donor at least 18 months prior to the date of contribution. Second, the donor would have to obtain a qualified appraisal of the contributed property, a copy of which would be required to be attached to the donor's income tax return for the taxable year in which such contribution is made. Third, the contribution would have to be made to a public charity or to certain limited types of private foundations. Finally, the use of donated property by the recipient organization would have to be related to the organization's charitable purpose or function, and the donor must receive a written statement from the organization verifying such use.

Effective Date

The deduction for qualified artistic charitable contributions applies to contributions made after December 31, 2002.

2. Modify rules governing tax-exempt bonds for section 501(c)(3) organizations as applied to organizations engaged in timber conservation activities

Present Law

Interest on State or local government bonds is tax-exempt when the proceeds of the bonds are used to finance activities carried out by or paid for by those governmental units. Interest on bonds issued by State or local governments acting as conduit borrowers for private businesses is taxable unless a specific exception is included in the Code. One such exception allows tax-exempt bonds to be issued to finance activities of non-profit organizations described in Code section 501(c)(3) ("qualified 501(c)(3) bonds").

Qualified 501(c)(3) bonds may be issued only to finance the activities that qualify the organization for tax-exemption, as opposed to unrelated business activities of these organizations. If the bonds are issued to finance property which is intended to be sold to a private business while the bonds are outstanding, bond interest may not qualify for tax-exemption. Similarly, if the property is in fact sold, bond interest may become retroactively taxable unless remedial actions specified in Treasury Department regulations are taken. An example of such a situation would be bonds that are issued as qualified 501(c)(3) bonds issued to finance the purchase of land and standing timber when the timber was to be sold.

As is true of governmental activities receiving tax-exempt financing, section 501(c)(3) organizations are restricted in the arrangements they may have with private businesses relating to control and use of bond-financed property.

Description of Proposal

The proposal would modify the rules governing issuance of qualified 501(c)(3) bonds to permit the issuance of long-term bonds for the acquisition of land and timber associated with such land subject to a conservation restriction. Under the proposal, the bonds would not fail to be qualified 501(c)(3) bonds if the timber was sold, leased, or otherwise used by an unaffiliated person to the extent that such sale, leasing, or other use did not constitute an unrelated trade or business, and so long as the other requirements of the proposal were met. In addition, these bonds may not constitute qualified 501(c)(3) bonds unless the seller of the land and timber property that is to be acquired with the bond proceeds irrevocably elects not to exclude from income any portion of the gain on the sale of such property made for qualifying conservation purposes.

Under the proposal, section 501(c)(3) organizations could enter into certain otherwise prohibited timber management arrangements with private businesses without losing tax-exemption on bonds used to finance the property and timber. Similarly, the bonds could be issued on a tax-exempt basis notwithstanding plans by the section 501(c)(3) organization to harvest and sell standing timber on land being acquired.

The aggregate amount of bonds that could be issued pursuant to this proposal would be subject to a national limitation of $2 billion. This volume limitation, for the period October 1, 2002, to December 31, 2005, would be allocated by the Department of Treasury to qualified

section 501(c)(3) organizations based on criteria established by the Treasury (after consultation with appropriate Federal, State, and local officials).

Effective Date

The proposal would be effective for bonds issued after September 30, 2002, and before January 1, 2006.

3. Modification with respect to Rite Aid case

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[6]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[7]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[8]

In the recent case of *Rite Aid Corp. v. United States*,[9] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid. The particular provision,

---

[6] Section 1501.

[7] Section 1502.

[8] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. The Supreme Court has stated that ". . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984).

[9] 255 F.3d 1357 (Fed. Cir. 2001).

known as the "duplicated loss" provision,[10] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[11]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years not to apply that provision.[12]

There is a concern that some taxpayers might attempt to take a position that under the language and reasoning of the Federal Circuit Court decision in the *Rite Aid* case, other consolidated return regulations not involved in that case (*i.e*., to the extent they provide a different result than if corporations had filed separate returns) might now be considered subject to challenge. This might create uncertainty or lead to protracted litigation.

Description of Proposal

The proposal would provide that the regulatory authority provided in section 1502 shall be construed without regard to the interpretation of that authority in the decision of the Federal Circuit Court in *Rite Aid Corp. v. United States.* [13] That is, the proposal would overrule the

---

[10] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[11] For example, the court stated: "The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[12] The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also*, Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002).

[13] 255 F.3d 1357 (2001).

court's reasoning that there was not a problem resulting from the filing of consolidated returns because a corporate taxpayer could deduct a loss on the sale of stock of a nonconsolidated subsidiary. The proposal would thus deny the case any precedential effect with respect to other consolidated return regulations.

The proposal would nevertheless allow the result of the case to stand, with respect to the specific regulatory provision that was invalidated in the case (Treas. Reg. Sec. 1.1502-20(c)(1)(iii)).

The proposal would confirm that consolidated return regulations may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

The proposal would thus confirm that Treasury is authorized to issue consolidated return regulations utilizing either a single entity or separate entity approach or a combination of the two approaches, as Treasury deems necessary, in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Effective Date

The proposal would be effective for all taxable years, whether beginning before, with, or after the date of enactment of the proposal.

No inference is intended that the results following from this proposal are not the same as the results under present law.

4. Provide tax exemption for organizations created by a State to provide property and casualty insurance coverage for property for which such coverage is otherwise unavailable

Present Law

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance income reduced by life insurance deductions (sec. 801). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). Present law provides that the term "corporation" includes an insurance company (sec. 7701(a)(3)).

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax-exempt status under section 501(c)(4) as a social welfare organization or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Certain specific provisions provide tax-exempt status to organizations meeting statutory requirements.

Health coverage for high-risk individuals

Section 501(c)(26) provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Description of Proposal

The proposal would provide tax-exempt status for any association created before January 1, 1999, by State law and organized and operated exclusively to provide property and casualty insurance coverage for wind storm, hail and fire damage to property located within the State for which the State has determined that coverage in the authorized insurance market is limited or unavailable at reasonable rates, provided certain requirements are met.

Under the proposal, no part of the net earnings of the association may inure to the benefit of any private shareholder or individual. Except as provided in the case of dissolution, no part of the assets of the association may be used for, or diverted to, any purpose other than: (1) to satisfy, in whole or in part, the liability of the association for, or with respect to, claims made on policies written by the association; (2) to invest in investments authorized by applicable law; (3) to pay reasonable and necessary administration expenses in connection with the establishment and operation of the association and the processing of claims against the association; or (4) to make remittances pursuant to State law to be used by the State to provide for the payment of claims on policies written by the association, purchase reinsurance covering losses under such policies, or to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. Under the proposal, it would be required that the State law governing the association permit the association to levy assessments on insurance companies authorized to sell property and casualty insurance in the State, or on property and casualty insurance policyholders with insurable interests in property located in the State to fund deficits of the association, including the creation of reserves. Under the proposal, it would be required that the plan of operation of the association be subject to approval by the chief executive officer or other official

of the State, by the State legislature, or both. In addition, it would be required that the assets of the association revert upon dissolution to the State, the State's designee, or an entity designated by the State law governing the association, or that State law not permit the dissolution of the association.

The proposal would provide a special rule in the case of any entity or fund created before January 1, 1999, pursuant to State law and organized and operated exclusively to receive, hold, and invest remittances from an association exempt from tax under the proposal, to make disbursements to pay claims on insurance contracts issued by the association, and to make disbursements to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The special rule would provide that the entity or fund may elect to be disregarded as a separate entity and be treated as part of the association exempt from tax under the proposal, from which it receives such remittances. The election would be required to be made no later than 30 days following the date on which the association is determined to be exempt from tax under the proposal, and would be effective as of the effective date of that determination.

An organization described in the proposal would be treated as having unrelated business taxable income ("UBIT") in the amount of its taxable income (computed as if the organization were not exempt from tax under the proposal), if at the end of the immediately preceding taxable year, the organization's net equity exceeded 15 percent of the total coverage in force under insurance contracts issued by the organization and outstanding at the end of that preceding year.

Under the proposal, no income or gain would be recognized solely as a result of the change in status to that of an association exempt from tax under the proposal.

Effective Date

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

5. Conform provisions relating to arbitrage treatment of certain university fund to State constitutional amendments

Present Law

In general, present-law tax-exempt arbitrage restrictions provide that interest on a State or local government bond is not eligible for tax-exemption if the proceeds are invested, directly or indirectly, in materially higher yielding investments or if the debt service on the bond is secured by or paid from (directly or indirectly) such investments. An exception, enacted in 1984, provides that the pledge of income from investments in a Fund established under a provision of a State constitution adopted in 1876 as security for a limited amount of tax-exempt bonds will not cause interest on those bonds to be taxable. The terms of this exception are limited to State constitutional or statutory restrictions in effect as of October 9, 1969.

The Fund consists of certain State lands that were set aside for the benefit of higher education, the income from mineral rights to these lands, and certain other earnings on Fund assets. The State constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. The constitution does not permit the expenditure or

mortgage of the Fund for any purpose. Income from the Fund is apportioned between two university systems operated by the State. Tax-exempt bonds issued by the two university systems are secured by and payable from the income of the Fund. These bonds are used to finance buildings and other permanent improvements for the universities.

The State constitutional rules governing the Fund have been modified with regard to the manner in which amounts in the Fund are paid for the benefit of the two university systems.

Description of Proposal

The 1984 exception would be conformed to the present State constitutional provisions governing the Fund's ability to make annual distributions in a manner similar to standard university endowment funds. Limitations on the aggregate amount of bonds that may benefit from the exception would not be modified.

Effective Date

The proposal would be effective on the date of enactment.

6. Matching grants to low-income taxpayer clinics for return preparation

Present Law

The Code[14] provides that the Secretary is authorized to provide up to $6 million per year in matching grants to certain low-income taxpayer clinics that represent low-income taxpayers in controversies with the IRS or that operate programs to inform individuals for whom English is a second language about their tax-related rights and responsibilities.

Description of Proposal

The proposal would authorize the Secretary to create a separate grant program to provide up to $10 million per year in matching grants to not for profit organizations that assist low-income taxpayers in the preparation of their Federal tax returns.

Effective Date

The proposal would be effective on the date of enactment.

[14] Sec. 7526.