DESCRIPTION OF PROPOSED MODIFICATIONS TO THE CHAIRMAN'S MARK OF "THE COMMUNITY RENEWAL AND NEW MARKETS ACT OF 2000"

Scheduled for Markup

before the

Senate Committee on Finance

on September 27, 2000

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of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of proposed modifications to the Chairman's Mark of the "Community Renewal and New Markets Act of 2000,"[2] which is scheduled for markup before the Senate Committee on Finance on September 27, 2000.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Proposed Modifications to the Chairman's Mark of "The Community Renewal And New Markets Act of 2000"* (JCX-103-00), September 27, 2000.

[2] A description of the Chairman's Mark is contained in: Joint Committee on Taxation, *Description of Community Renewal and New Markets Act of 2000* (JCX-99-00), September 18, 2000.

I. MODIFICATIONS TO PROVISIONS IN THE CHAIRMAN'S MARK

A. Tax Incentives for Distressed Areas

The proposal in the Chairman's Mark relating to renewal zones would be modified to require that the General Accounting Office audit and report to Congress on an annual basis on the renewal zone program and its effect on poverty, unemployment, and economic growth within the designated renewal zones. In addition, in lieu of the poverty, income, and unemployment criteria, out migration may be taken into account in designating one rural renewal zone.

The proposal in the Chairman's Mark relating to the new markets tax credit would be modified to require that the General Accounting Office audit and report to Congress on an annual basis on the new markets program, including on all qualified community development entities that receive an allocation under the new markets tax credit. The modification also would clarify that a qualified low-income community investment may include an investment in a qualifying business in which the community development entity (or a related party) holds a significant interest. However, in allocating the credits among eligible community development entities, the Treasury Department will give priority to entities other than those where the entity (or a related party) will hold a significant interest in a qualifying business.

The proposal in the Chairman's Mark relating to the designation of the D.C. Enterprise Zone would be modified by extending the designation to December 31, 2006 (instead of December 31, 2009). The proposal would be effective for taxable years beginning after date of enactment.

B. Amtrak Tax Credit Bonds

Modification to Amtrak tax credit bonds.--The proposal in the Chairman's Mark relating to Amtrak tax credit bonds would be modified to define the third category of projects eligible for bond financing as other intercity passenger rail corridors, including station rehabilitation, track or signal improvements, or grade crossing elimination. This purpose would be limited to a maximum of 10 percent of the proceeds of any bond issue.

The proposal would be modified to provide that no more than $3 billion of the bonds may be designated for any one high-speed rail corridor.

The proposal would be modified to provide that a preference will be given for projects with State matching contributions greater than 20 percent.

Protection of Highway Trust Fund.--Issuance of tax-credit bonds by Amtrak (or the Alaska Railroad) would be conditioned on a certification by the Secretary of the Treasury (after consultation with the Secretary of Transportation) that the issuing railroad had not received any unauthorized funds from the Highway Trust Fund. Unauthorized funds would be defined as any funds received (directly or indirectly) beyond amounts permitted under law or administrative action in effect on the date of the proposal's enactment. Such funds would include only amounts received during the period beginning on the date of the proposal's enactment and ending on the last day of the year before the year in which the bonds were to be issued. The Treasury would be required to respond to a request for such a certification within 30 days.

In the event that Amtrak or the Alaska Railroad received any unauthorized Highway Trust Fund funds, no future tax-credit bonds could be issued until the Secretary of the Treasury certified that the issuing railroad had repaid to the Highway Trust Fund an amount equal to the funds received. Following certification of such a repayment, the railroad's tax-credit bond authority again would be available under the rules generally applicable to issuance of such bonds. These provisions would not affect tax credits on outstanding bonds.

Conforming amendments would be made to the Highway Trust Fund expenditure purposes to clarify that the limit on expenditures for the for the benefit of Amtrak or the Alaska Railroad applies without regard to subsequently enacted legislation and to provide for reimbursement of the Trust Fund in the even a repayment is required.

C. Broadband Tax Credit

The proposal in the Chairman's mark relating to a broadband internet access credit would be modified such that in the case of current generation broadband services, qualified expenditures would be those that are incurred by the taxpayer after December 31, 2000, and before January 1, 2004. In the case of next generation broadband services, qualified expenditures would be those that are incurred by the taxpayer after December 31, 2001, and before January 1, 2005.

D. Treatment of Indian Tribes as Non-Profit Organizations and State or Local Governments for Purposes of the Federal Unemployment Tax (FUTA)

The proposal generally would be effective with respect to service performed beginning on or after the date of enactment. Under a transition rule, service performed in the employ of an Indian tribe would not be treated as employment for FUTA purposes if: (1) it is service which is performed before the date of enactment and with respect to which FUTA tax has not been paid; and (2) such Indian tribe reimburses a State unemployment fund for unemployment benefits paid for service attributable to such tribe for such period.

II. ADDITIONAL PROVISIONS

The following provisions would be added to the Chairman's Mark.

A. Tax Relief For Farmers

1. Farm, Fish, and Ranch Risk Management accounts ("FFARRM Accounts")

Present Law

There is no provision in present law allowing the elective deferral of farm or fishing income.

Description of Proposal

The proposal would allow taxpayers engaged in an eligible business to establish FFARRM accounts. An eligible business would be any trade or business of farming in which the taxpayer actively participates, including the operation of a nursery or sod farm or the raising or harvesting of crop-bearing or ornamental trees. An eligible business also would be the trade or business of commercial fishing as that term is defined under section (3) of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. 1802) and would include the trade or business of catching, taking or harvesting fish that are intended to enter commerce through sale, barter or trade.

Contributions to a FFARRM account would be deductible and would be limited to 20 percent of the taxable income that is attributable to the eligible business. The deduction would be taken into account in determining adjusted gross income and would reduce income attributable to the eligible business for all income tax purposes other than the determination of the 20 percent of eligible income limitation on contributions to a FFARRM account. Contributions to a FFARRM account would not reduce earnings from self-employment. Accordingly, distributions would not be included in self-employment income.

A FFARRM account would be taxed as a grantor trust and any earnings would be required to be distributed currently. Thus, any income earned in the FFARRM account would be taxed currently to the farmer or fisherman who established the account. Amounts could remain on deposit in a FFARRM account for up to five years. Any amount that has not been distributed by the close of the fourth year following the year of deposit would be deemed to be distributed and includible in the gross income of the account owner.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

2. Exclusion of rental income from SECA tax

Present Law

Generally, SECA taxes are imposed on an individual's net earnings from self employment. Net earnings from self-employment generally means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions. One exclusion from net earnings from self employment involves certain real estate rentals. Under this rule, net earnings from self employment do not include income from the rental of real estate and from personal property leased with the real estate unless the rental income is received under an arrangement between an owner or tenant of land and another individual that provides: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant with respect to any such agricultural or horticultural commodities. Other rules apply to rental payments received by an individual in the course of the individual's trade or business as a real estate dealer.

Description of Proposal

The proposal would provide that net earnings from self employment would not include income from the rental of real estate under a lease agreement (rather than an arrangement) between an owner or tenant of land and another individual which provides that: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant in the production or management of the production of such agricultural or horticultural commodities.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

3. Exclusion of conservation reserve program payments from SECA tax

Present Law

Generally, SECA tax is imposed on an individual's self-employment income within the Social Security wage base. Net earnings from self-employment generally means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions. A recent court decision found that payments made under the conservation reserve program are includible in an individual's self-employment income for purposes of SECA tax.

Description of Proposal

The proposal would provide that net earnings from self-employment would not include conservation reserve program payments for SECA.

Effective Date

The proposal would be effective for payments made after December 31, 2000.

4. Exemption of agricultural bonds from private activity bond volume cap

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds issued to finance loans to first-time farmers for the acquisition of land and certain equipment ("aggie bonds").

The volume of tax-exempt private activity bonds that States and local governments may issue in each calendar year (including aggie bonds) is limited by State-wide volume limits. The current annual volume limits are $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

Description of Proposal

The proposal would exempt "aggie bonds" from the State volume limits.

Effective Date

The proposal would apply to bonds issued after December 31, 2000.

5. Modifications to section 512(b)(13)

Present Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, “control” means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includible in the latter organization's UBI and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

The Taxpayer Relief Act of 1997 (the “1997 Act”) made several modifications, as described above, to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Description of Proposal

The proposal would provide that interest, rent, annuity, or royalty payments made by a controlled subsidiary to a tax-exempt parent is not Unrelated Business Income except to the extent that such payments exceed arm’s length values, as determined under sec. 482 principles.

Effective Date

The proposal would generally be effective for payments received or accrued after December 31, 2000.

6. Charitable deduction for contributions of food inventory

Present Law

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property. To be eligible for the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS.[3]

The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

Description of Proposal

The proposal would amend Code section 170 to expand the augmented deduction such that any taxpayer engaged in the trade or business of farming would be eligible to claim an enhanced deduction for donations of food inventory under section 170(e)(3).

The value of the enhanced deduction could be no greater than twice the taxpayer's basis in the donated property. The proposal would provide that in the case of a cash method taxpayer, the taxpayer's basis in the donated food would equal half of the fair market value of the donated food.

The proposal would modify and clarify the determination of fair market value. Under the proposal, the fair market value of donated food which cannot or will not be sold solely due to internal standards of the taxpayer, lack of market, or similar circumstances would be determined without regard to such factors and, if applicable, by taking into account the price at which the same or similar food items are sold by the taxpayer at the time of the contribution or in the recent past.

The proposal would not apply for taxable years beginning after December 31, 2003.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

7. Coordinate farmers and fisherman income averaging and the alternative minimum tax

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

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[3] See, e.g., *Lucky Stores Inc. v. Commissioner*, 105 TC 420 (1995), holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.

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 would extend to individuals engaged in the trade or business of fishing the election that is available to individual farmers to use income averaging.

The proposal also would coordinate farmers and fishermen income averaging with the alternative minimum tax. Under the proposed coordination, a farmer would owe alternative minimum tax only to the extent he or she would have owed alternative minimum tax had averaging not been elected. This result would be 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 proposal would be effective for taxable years beginning after December 31, 2000.

8. Cooperative marketing to include value added processing through animals

Present Law

Under present law, taxable cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Tax-exempt cooperatives (sec. 521) are cooperatives of farmers, fruit growers, and like organizations organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers and turning back the proceeds of sales, less necessary marketing expenses on the basis of either the quantity or the value of products furnished by them.

The Internal Revenue Service takes the position that a cooperative is not marketing the products of members or other producers where the cooperative adds value through the use of animals (e.g., farmers sell corn to cooperative which is feed to chickens which produce eggs).

Description of Proposal

The proposal would provide that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

9. Extend declaratory judgment procedures to farmers' cooperative organizations

Present Law

Cooperatives may deduct from their taxable income amounts distributed to patrons in the form of patronage dividends, and certain other amounts paid or allocated to patrons, to the extent the net earnings of the cooperative from business done with or for patrons, provided that there is a pre-existing obligation to distribute such amounts (sec. 1382). Cooperatives that qualify as farmers' cooperatives under section 521 also may deduct such amounts from income to the extent of all net income, and also may deduct to a limited extend dividends paid on common stock.

Under present law, there is limited access to judicial review of disputes regarding the initial or continuing qualification of a farmer's cooperative described in section 521. The only remedies available to such an organization are to file a petition in the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay tax and sue for a refund in a U.S. district court or the U.S. Court of Federal Claims.

In limited circumstances, declaratory judgment procedures are available, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures which are available include disputes involving the status of a tax-exempt organization under section 501(c)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166. In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

Declaratory judgment procedures are not available under present law to a cooperative with respect to an IRS determination regarding its status as a farmers' cooperative under section 521.

Description of Proposal

The amendment would extend the declaratory judgment procedures to cooperatives. Jurisdiction over such cases would be in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, and would include determination of initial or continuing qualification of a farmers' cooperative described in sec. 521.

Effective Date

The amendment would be effective with respect to pleadings filed after the date of enactment, but only with respect to determinations (or requests for determinations) made after January 1, 2000.

10. Small ethanol producer credit

Present Law

"Small ethanol producers" are allowed a 10-cents-per-gallon production income tax credit on up to 15 million gallons of production annually. This credit is in addition to the 54-cents-per-gallon benefit available for ethanol generally.

Description of Proposal

The proposal would: (1) allow cooperatives to flow the credit through to patrons; (2) provide that the small producer credit is not a "passive credit"; (3) allow the credit to be claimed against the alternative minimum tax; and (4) repeal the present rule that the amount of the credit is included in income.

Effective Date

The proposal would be effective for taxable years beginning after date of enactment.

11. Payment of dividends on stock of cooperatives without reducing patronage dividends

Present Law

Cooperatives, including tax-exempt farmers' cooperatives, are treated like a conduit for Federal income tax purposes since a cooperative may deduct patronage dividends paid from its taxable income. In general, patronage dividends are amounts paid to patrons (1) on the basis of the quantity or value of business done with or for its patrons, (2) under a valid enforceable written obligation to the patron to pay such amount, which obligation existed before the cooperative received such amounts, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests. The effect of this rule is to reduce the amount of earnings that the cooperative can treat as patronage earnings which reduces the amount that cooperative can deduct as patronage dividends.

Description of Proposal

The proposal would allow cooperatives to pay dividends on capital stock without those dividends reducing excludable patronage-sourced income to the extent that the cooperative's organizational documents provide that the dividends do not reduce amounts owed to patrons.

Effective Date

The proposal would apply to distributions in taxable years beginning after the date of enactment.

B. Energy Proposals

1. Allow geological and geophysical costs to be deducted currently

Present Law

In general

Under present law, current deductions are not allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate (sec. 263(a)). Treasury Department regulations define capital amounts to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use.[4]

The proper income tax treatment of geological and geophysical costs ("G&G costs") associated with oil and gas production has been the subject of a number of court decisions and administrative rulings. G&G costs are incurred by the taxpayer for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition and retention of oil or gas properties by taxpayers exploring for the minerals. Courts have ruled that such costs are capital in nature and are not deductible as ordinary and necessary business expenses.[5] Accordingly, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.[6] The term "property" includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proven at the time the costs are incurred.

Revenue Ruling 77-188

In Revenue Ruling 77-188[7] (hereinafter referred to as the "1977 ruling"), the Internal Revenue Service ("IRS") provided guidance regarding the proper tax treatment of G&G costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

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[4] Treas. Reg. sec. 1.263(a)-(1)(b).

[5] See, e.g., *Schermerhorn Oil Corporation,* 46 B.T.A. 151 (1942).

[6] By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

[7] 1977-1 C.B. 76.

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as the size and topography of the project area to be explored, the existing information available with respect to the project area and nearby areas, and the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques that are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.

- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.

- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

The 1977 ruling further provides that if, on the basis of data obtained from a detailed survey that does not relate exclusively to any particular property within a particular area of interest, an oil or gas property is acquired or retained within or adjacent to that area of interest, the entire G&G exploration expenditures, including those incurred prior to the identification of the particular area of interest but allocated thereto, are to be allocated to the property as a capital cost under section 263(a).

If, however, from the data obtained by the exploratory operations no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the G&G costs related to the exploration is deductible as a loss under section 165 for the taxable year in which that particular project area is abandoned as a potential source of mineral production.

Description of Proposal

The proposal would allow geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be deducted currently.

Effective Date

The proposal would be effective for G&G costs incurred or paid in taxable years beginning after December 31, 2001.

2. Allow certain oil and gas "delay rental payments" to be deducted currently

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 263A). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for "delay rental payments" as a condition of their extension. The Treasury Department has taken the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.

Description of Proposal

The proposal would allow delay rental payments to be deducted currently.

Effective Date

The proposal would apply to delay rental payments incurred in taxable years beginning after December 31, 2001.

The legislative history accompanying the provision would state that no inference is intended from the proposal as to the proper treatment of pre-effective date delay rental payments.

3. Allow net operating losses from oil and gas properties to be carried back for up to five years

Present Law

A net operating loss ("NOL") generally is the amount by which business deductions of a taxpayer exceed business gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[8] A carryback of an NOL results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year. Special NOL carryback rules apply to (1) casualty and theft losses of individual taxpayers, (2) Presidentially declared disasters for taxpayers engaged in a farming business or a small business, (3) real estate investment trusts, (4) specified liability losses, (5) excess interest losses, and (6) farm losses.

Description of Proposal

The proposal would provide a special five-year carryback for certain eligible oil and gas losses of independent producers. The carryforward period would remain 20 years. An "eligible oil and gas loss" would be defined as the lesser of (1) the amount which would be the taxpayer's NOL for the taxable year if only income and deductions attributable to operating mineral interests in oil and gas wells were taken into account, or (2) the amount of such net operating loss for such taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that would be attributable to an eligible oil and gas loss would be treated as a separate NOL and taken into account after the remaining portion of the NOL for the taxable year.

Effective Date

The proposal would apply to NOLs arising in taxable years beginning after December 31, 2001.

4. Temporary suspension of percentage of depletion deduction limitation based on 65 percent of taxable income

Present Law

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset–in the case of depletion for oil or gas interests, the mineral reserve itself–is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling). Depletion is available to any person having an economic interest in a producing property.

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[8] A taxpayer could elect to forgo the carryback of an NOL.

Two methods of depletion currently are allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

Under the percentage depletion method, generally, 15 percent of the taxpayer's gross income from an oil-or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[9]

Description of Proposal

The proposal would suspend the 65-percent-of-taxable-income limit for taxable years beginning after December 31, 2000, and before January 1, 2004.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

5. Tax credit for oil and gas production from marginal wells

Present Law

There is no income tax credit for oil or gas production from marginal wells generally. Present law does, however, provide a tax credit for production requiring the use of certain tertiary recovery methods (the "enhanced oil recovery credit") (sec. 43).

Description of Proposal

The proposal would provide an income tax credit equal to $3 per barrel of qualified crude oil produced from a marginal well and 50 cents per 1,000 cubic feet of qualified natural gas production. Qualified production would be defined as production from wells having production of 1,095 barrels per year (3 barrels per day) or less.

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[9] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

The credit would apply fully only when oil prices were below $14. The credit would phase-out ratably when the price of oil was between $14 and $17 per barrel for oil (and equivalent amounts for natural gas).

The credit could be claimed against both the regular income tax and the alternative minimum tax.

Effective Date

The proposal would apply to production in taxable years beginning after December 31, 2000.

6. Establish a seven-year recovery period for natural gas gathering lines

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are set forth in Revenue Procedure 87-56.[10] Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by non-producers of natural gas. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. The uncertainty regarding the appropriate recovery period has resulted in litigation between taxpayers and the IRS. Recently, the 10th Circuit Court of Appeals held that natural gas gathering lines owned by non-producers fall within the scope of Asset class 13.2 (*i.e.*, seven-year recovery period).[11]

Description of Proposal

The proposal would establish a statutory seven-year recovery period for all natural gas gathering lines. A natural gas gathering line would be defined to include pipe, equipment, and appurtenances that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

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[10] 1987-2 C.B. 674. Rev Proc 87-56 subsequently was clarified and modified by Rev. Proc. 88-22, 1988-1, CB 785.

[11] *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 TC 416 (1997). *See also True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

Effective Date

The proposal would be effective for property placed in service on or after the date of enactment. No inference would be intended as to the proper treatment of such property placed in service before the date of enactment.

7. Subpart F treatment of pipeline transportation income

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") 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 five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and 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 CFC 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 CFC 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 proposal would provide an exception to the definition of foreign base company oil related income. Under the proposal, foreign base company oil related income would 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 proposed exception would apply whether or not the CFC that owns the pipeline also owns any interest in the oil or gas transported. In addition, the proposed exception would apply 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 would be effective for taxable years of CFCs beginning after December 31, 2001, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

C. Conservation Proposals

1. Capital gains exclusion on sales of conservation property

Present Law

Gain from the sale or exchange of land held more than one year generally is treated as long-term capital gain.

Generally the net capital gain of an individual (i.e., long-term capital gain less short-term capital loss) is subject to a maximum rate of 20 percent.

Description of Proposal

The proposal would provide a 50-percent exclusion from a taxpayer's gross income for gain realized on the qualifying sale of land, or an interest in land or water, provided the land, or interest in land or water, has been held by the taxpayer or the taxpayer's family for at least three years prior to the date of sale. A qualifying sale would be a sale (including condemnation) to any agency of the Federal Government, a State government, or a local government, or a sale to 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In addition, to be a qualifying sale, the person acquiring the land, or interest in land or water, must provide the taxpayer with a letter detailing that the intent of the purchase is to further a qualified conservation purpose. A qualified conservation purpose is (1) the preservation of land areas for outdoor recreation by, or the education of, the general public, (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State or local governmental conservation policy that will yield a significant public benefit.

Effective Date

The proposal would be effective for sales after December 31, 2003.

2. Expand the estate tax rule for conservation easements

Present Law

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor.

Description of Proposal

The proposal would expand the availability of qualified conservation easements by eliminating the distance requirements. Under the proposal, the land would qualify without regard to the distance from which the land is situated from a metropolitan area, national park, wilderness area, or Urban National Forest.

Effective Date

The proposal would be effective for estates of decedents dying after December 31, 2001.

3. Cost-sharing payments under the Partners for Wildlife Program

Present Law

Under present law, gross income does not include the excludable portion of payments made to taxpayers by federal and state governments for a share of the cost of improvements to property under certain conservation programs. These programs include payments received under (1) the rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act, (2) the rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977, (3) the water bank program authorized by the Water Bank Act, (4) the emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978, (5) the agriculture conservation program authorized by the Soil Conservation and Domestic Allotment Act, (6) the great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act, (7) the resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act, (8) the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978, (9) any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in items (1) through (8), and (10) any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Description of Proposal

The amendment would expand the types of qualified cost-sharing payments to include payments under the Partners for Wildlife Program.

Effective Date

The amendment would apply to payments received after the date of enactment.

4. Deduction for energy-efficient commercial business property

Present Law

No special deduction is currently provided for expenses incurred for energy efficient building property.

Description of Proposal

The proposal would allow a deduction from income for expenses incurred for energy efficient commercial building property. Energy-efficient commercial building property would be defined as property which reduces annual energy and power costs with respect to lighting, cooling, heating, ventilation, and hot water supply by 50 percent or more in comparison to a reference building. A reference building is defined as one which meets the requirements of Standard 90.1-1999 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America. The maximum deduction would be $2.25 per square foot. For all property eligible for the deduction, the depreciable basis of the property would be reduced by the amount of the deduction. For public property, such as schools, the Secretary shall issue regulations to allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity owner.

Effective Date

The deduction would be effective for taxable years beginning after December 31, 2000, and before January 1, 2004.

5. Expand tax credit for electricity produced by wind, closed-loop biomass, and poultry waste

Present Law

Section 45

An income tax credit is allowed for the production of electricity from either qualified wind energy facilities, qualified "closed-loop" biomass facilities, or qualified poultry waste facilities (sec. 45). The current value of the credit is 1.7 cents/kilowatt hour of electricity produced and the value of the credit is indexed for inflation. The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a qualified poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

Section 29

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29) (referred to as the "section 29 credit"). Qualified fuels must be produced within the United States. Qualified fuels include:

(1) oil produced from shale and tar sands;
(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and
(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of nonconventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

Description of Proposal

The present-law tax credit for electricity produced by wind, closed-loop biomass, and poultry waste facilities would be expanded to include electricity produced from certain other biomass (in addition to closed-loop biomass and poultry waste) and electricity produced from landfill gas. Taxpayers producing electricity from other biomass or landfill gas could claim credit for production of electricity for three years commencing on the date the facility is placed in service (or in the case of other facilities producing electricity from other biomass three years commencing on the later of January 1, 2001, or the date the facility is placed in service).

"Other biomass" would be defined as solid nonhazardous, cellulose waste material which is segregated from other waste materials and which is derived from forest resources, but not including old growth timber. The term would include urban sources such as waste pallets, crates, manufacturing and construction wood waste, and tree trimmings, or agricultural sources (including orchard tree crops, grain, vineyard, legumes, sugar, and other crop by-products or residues). However, the term would not include unsegregated municipal solid waste, paper that is commonly recycled, or certain chemically treated wood wastes. Qualifying other biomass and landfill gas facilities would include facilities owned by the taxpayer.

A special rule would modify present-law qualified closed-loop biomass facilities to include facilities in which electricity is produced from closed-loop biomass fuels co-fired with coal.

In the case of other biomass facilities, the credit would apply to electricity produced after December 31, 2000, from facilities that are placed in service before January 1, 2002 (including facilities placed in service before the date of enactment of this provision). In the case of landfill gas facilities, the credit would apply to electricity produced from facilities placed in service after December 31, 1999, and before January 1, 2002. In the case of closed-loop biomass facilities in which closed-loop biomass fuel is co-fired with coal, the credit would apply to electricity produced after December 31, 2000 from facilities that are placed in service before January 1, 2002 (including facilities placed in service before the date of enactment of this provision).

Effective Date

The proposal would be effective on the date of enactment.

6. Credit for hybrid vehicles

Present Law

Present law does not provide a credit for the purchase of hybrid vehicles. However, taxpayers may claim a credit of 10 percent of the cost of an electric vehicle up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a vehicle powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The credit does not apply to property placed in service after December 31, 2004 and is reduced ratably between 2002 and 2004.

Taxpayers may claim an immediate deduction (expensing) for up to $2,000 of the cost of a qualified clean-fuel vehicle which is a car and up to $50,000 in the case of certain trucks or vans (sec. 179A). For the purpose of the deduction, gasoline and diesel fuel are not clean-burning fuels. The deduction expires after December 31, 2004, and is phased out ratably between 2002 and 2004.

Description of Proposal

The proposal would provide a temporary tax credit for qualified hybrid vehicles, with a rechargeable energy system used in business and for personal use. For vehicles with a rechargeable energy system that provides five percent to less than 10 percent of the maximum available power, the credit amount is $500; for a system that provides 10 percent to less than 20 percent of maximum available power the credit is $1,000; for a system that provides 20 percent to less than 30 percent of maximum available power, the credit is $1,500; and for a system that provides 30 percent or greater of maximum available power, the credit is $2,000. The credit amount would be increased for qualified hybrid vehicles that also actively employ a regenerative braking system that supplies energy to the rechargeable energy storage system. For a hybrid vehicle with a regenerative braking system that provides 20 percent to less than 40 percent of the energy available from braking in a typical 60 miles per hour to zero miles per hour breaking event, the additional credit amount is $250, for 40 percent to less than 60 percent, the additional credit would be $500, and for 60 percent or greater, the additional credit would be $1,000.

Effective Date

The credit would be available for a hybrid vehicle placed in service after December 31, 2003, and before January 1, 2005.

D. Additional Provisions Relating to Tax Incentives for Distressed Areas

1. Expand the zero-percent capital gains rate treatment for the District of Columbia

Present Law

For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent as determined on the basis of the 1990 Census (sec. 1400B(d)).

Description of Proposal

The proposal would eliminate the 10-percent poverty rate limitation for purposes of the zero-percent capital gains rate. Thus, the zero-percent capital gains rate would apply to capital gains from the sale of qualifying business stock, partnership interests, and business property held for more than five years attributable to qualifying businesses located in the District of Columbia.

Effective Date

The proposal would be effective for DC Zone business stock and partnership interests originally issued after, and DC Zone business property originally acquired by the taxpayer after December 31, 2000.

2. Conform the gross income test for D.C. zone business

Present Law

A zero-percent capital gains rate applies to gain from the sale of certain qualified DC zone assets. In general, a "DC Zone asset" means stock or partnership interests held in, or tangible property held by, a DC Zone business. A DC zone business generally refers to certain enterprise zone businesses within the DC Zone, except that 80 percent of the total gross income of the entity must be derived from the active conduct of the business (sec. 1400B(c)(2)).

Description of Proposal

The proposal would reduce the level of gross income needed to qualify as a D.C. zone business to 50 percent.

Effective Date

The proposal would be effective for DC Zone business stock and partnership interests originally issued after, and DC Zone business property originally acquired by the taxpayer after December 31, 2000.

3. First-time D.C. homebuyer tax credit

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2001.

Description of Proposal

The proposal would extend the first-time homebuyer credit for two years, through December 31, 2003. The proposal also would extend the phase-out range for married individuals filing a joint return so that it is twice that of individuals. Thus, under the proposal, the D.C. homebuyer credit would be phased out for joint filers with adjusted gross income between $140,000 and $180,000.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

4. Mortgage financing for certain residences located in Presidentially declared disaster areas

Present Law

Qualified mortgage bonds are private activity tax-exempt bonds issued by States and local governments acting as conduits to provide mortgage loans to first-time home buyers who satisfy specified income limits and who purchase homes that cost less than statutory maximums. The income and purchase price limits are increased for homes purchased in economically distressed areas, and a portion of loans made in such areas is exempt from some requirements.

Present law waives the three buyer targeting requirements for a portion of the loans made with proceeds of a qualified mortgage bond issue if the loans are made to finance homes in statutorily prescribed economically distressed areas.

For bonds issued during 1997 and 1998, a special exception exempted loans made in Presidentially declared disaster areas within two years of the declaration from the first-time homebuyer limit. In addition, the more liberal income and purchase price rules applicable to economically distressed areas applied to such loans. There was no requirement that the specially treated loans be made to repair or replace housing damaged or destroyed by the disaster.

Description of Proposal

The proposal would reinstate, with modifications, the prior-law exception for certain qualified mortgage bond financed loans in Presidentially declared disaster areas. First, the proposal would: (1) allow loans for replacement housing without regard to the first-time homebuyer requirement; and (2) increase the borrower income and house purchase price requirements to those that apply in targeted areas of economic distress. Second, the proposal would increase the per-borrower "home improvement loan" maximum from $15,000 to $100,000 and extend the more liberal borrower income limits for targeted areas to these loans. In both cases, the exception would apply only to loans made during the two-year period after the area was declared a qualified disaster area. A qualified disaster area would be defined as an area determined by the President (1) to warrant assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act and (2) with respect to which the Federal share of disaster payments exceeds 75 percent.

Effective Date

The proposal would be effective for bonds issued after December 31, 2000.

5. Exclusion from gross income for certain forgiven mortgage obligations

Present Law

Generally, gross income means all income from whatever source derived, including income from the discharge of indebtedness. However, gross income does not include discharge of indebtedness income if: (1) the discharge occurs in a Title 11case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness. No exclusion provided for qualified residential indebtedness.

Description of Proposal

In the case of an individual taxpayer, the proposal would provide an exclusion from discharge of indebtedness income to the extent such income is attributable to the sale of real property securing qualified residential indebtedness. Qualified residential indebtedness would be defined as indebtedness incurred or assumed by the taxpayer for the acquisition, construction, reconstruction, or substantial improvement of the taxpayer's residence and which is secured by such residence. The taxpayer would elect to have this exclusion apply. The exclusion would not apply to qualified farm indebtedness or qualified real property business indebtedness.

Effective Date

The proposal would be effective for discharges of indebtedness after the date of enactment.

6. Extend and modify Puerto Rico economic-activity tax credit

Present Law

The Small Business Job Protection Act of 1996 generally repealed the Puerto Rico and possession tax credit. However, certain domestic corporations that had active business operations in Puerto Rico or another U.S. possession on October 13, 1995, may continue to claim credits under section 936 or section 30A for a 10-year transition period. Such credits apply to possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is granted whether or not the corporation pays income tax to the possession.

One of two alternative limitations is applicable to the amount of the credit attributable to possession business income. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes); beginning in 2002, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income adjusted for inflation. Under the alternative limit, the amount of the credit is limited to the applicable percentage (40 percent for 1998 and thereafter) of the credit that would otherwise be allowable with respect to possession business income; beginning in 1998, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Special rules apply in computing the credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The credit expires for taxable years beginning after December 31, 2005.

Description of Proposal

The proposal would modify the credit computed under the economic activity limit with respect to operations in Puerto Rico only. First, the proposal would expand the lines of business eligible under the credit to include existing credit claimants that establish new lines of business in Puerto Rico after December 31, 2000, and before January 1, 2005. These “new opportunity credit” claimants would be eligible to claim credits in taxable years beginning before January 1, 2006. In addition, income eligible for the credit computed under the economic activity limitation would not be subject to the present-law income limitation. Also, these “new opportunity credit” claimants would be required to calculate their credit in each taxable year, but claim that amount of credit over a five-year period (on a pro-rata basis) beginning the year in which the credit is earned.

In addition, for taxpayers eligible to claim the credit under present law ("existing credit claimants"), the present-law limitation on income eligible for the credit for any taxable year would be increased by the ratio of the average number of full-time employees of taxpayer during the taxable year to the average number of full-time employees of the taxpayer in 1995 and 1996.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2000.

7. 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

In general

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 or 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.

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.

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 requirements.

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 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.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

E. Miscellaneous Provisions

1. Creation of Individual Development Accounts

Present Law

There are no tax benefits to encourage financial institutions to match savings of low-income individuals.

Description of Proposal

The proposal would create individual development accounts ("IDA"s) to which eligible individuals could contribute up to $2,000 annually. Contributions to IDAs by eligible individuals would not be deductible, and earnings on such contributions would be currently includible in income. An eligible individual would be an individual who is: (1) at least 18 years of age; (2) a citizen or legal resident of the United States; and (3) a member of a household with family gross income of 60 percent or less of national median gross income and a net worth not to exceed $10,000. In addition, the proposal would provide a maximum annual tax credit of $270 (90 percent of $300) for certain matching contributions made to an IDA by the financial institution maintaining the IDA. An additional $100 tax credit would be allowed for each account opened. The credits could be claimed by the financial institution or its legal affiliate. Matching contributions (and earnings thereon) would not be includible in the gross income of the eligible individual. If an individual withdraws his or her own IDA contributions (or earnings thereon) for a purpose other than a qualified purpose, the matching contribution attributable to such individual contribution would be forfeited.[12] Matching contributions could be withdrawn only for the following qualified purposes: (1) certain educational expenses, (2) first-time homebuyer expenses, (3) business start-up or expansion expenses, and (4) qualified rollovers. Any amounts in the IDA would not be taken into account for certain Federal means-tested programs.

Effective Date

The proposal would be effective for contributions to IDAs and matching contributions made with respect to such IDAs after December 31, 2001, and before January 1, 2006.

2. Enhanced deduction for corporate contributions of computers

Present Law

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)).

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[12] The financial institution would be required to adjust tax deposits to take into account forfeitures of matching contributions.

Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K-12. Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) tax-exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

The provision is scheduled to expire for contributions made in taxable years beginning after December 31, 2000.

Description of Proposal

The proposal would extend the current enhanced deduction for donations of computer technology and equipment through December 31, 2003. In addition, the enhanced deduction would be expanded to include donations to public libraries.

Effective date

The proposal would be effective for contributions made upon the date of enactment.

3. Limitation on use of non-accrual experience method of accounting

Present Law

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

A cash method taxpayer is not required to include an amount in income until it is received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million.

Description of Proposal

The proposal would provide that the non-accrual experience method of accounting will be available only for amounts received for the performance of qualified personal services. Amounts to be received for all other services will be subject to the general rule regarding inclusion of income. Qualified personal services are personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting.

As under present law, the availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Effective Date

The proposal would be effective for taxable years ending after date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the proposal would be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment is to be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.

4. Charitable contribution deduction for certain expenses in support of native Alaskan subsistence whaling

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution (Treas. Reg. sec. 1.170A-1(g)). Specifically, section 170(j) provides that no charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

Description of Proposal

The proposal would allow individuals to claim a deduction under section 170 not exceeding $7,500 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction would be available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The deduction would be available for reasonable and necessary expenses paid by the taxpayer during the taxable year for (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities, (2) the supplying of food for the crew and other provisions for carrying out such activities, and (3) storage and distribution of the catch from such activities.

For purposes of the provision, the term "sanctioned whaling activities" would mean subsistence bowhead whale hunting activities conducted pursuant to the management plan of the Alaska Eskimo Whaling Commission.

Effective Date

The proposal would be effective for taxable years ending after December 31, 2000.

5. Extension of the adoption tax credit

Present Law

Taxpayers are entitled to a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer (sec. 23). In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). A special needs child is a child who the State has determined: (1) cannot or should not be returned to the home of the birth parents, and (2) has a specific factor or condition because of which the child cannot be placed with adoptive parents without adoption assistance. The adoption of a child who is not a citizen or a resident of the United States is a foreign adoption.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption are qualified adoption expenses. Otherwise qualified adoption expenses paid or incurred in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are paid or incurred in the year the adoption becomes final.

An eligible child is an individual (1) who has not attained age 18 or (2) who is physically or mentally incapable of caring for himself or herself. After December 31, 2001, the credit will be available only for domestic special needs adoptions.

No credit is allowed for expenses incurred (1) in violation of State or Federal law, (2) in carrying out any surrogate parenting arrangement, (3) in connection with the adoption of a child of the taxpayer's spouse, (4) that are reimbursed under an employer adoption assistance program or otherwise, or (5) for a foreign adoption that is not finalized.

The credit is phased out ratably for taxpayers with modified AGI above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933.

Description of Proposal

The proposal would extend the adoption credit for the adoption of non-special needs children through December 31, 2003.

Effective Date

The proposal would be effective on the date of enactment.

6. Repeal of section 1706 of the Tax Reform Act of 1986

Present Law

Under present law, determination of whether a worker is an employee or independent contractor is generally made under a common-law test. Section 530 of the Revenue Act of 1978 provides safe harbors under which a service recipient may treat a worker as an independent contractor for employment tax purposes (regardless of their status under the common-law test) if certain requirements are satisfied. One of the requirements of safe-harbor relief under section 530 is that the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period after 1977. In determining whether workers hold substantially similar positions, one of the factors that is to be taken into account is the relationship of the parties, including the degree of supervision and control of the worker by the taxpayer.

Under section 1706 of the Tax Reform Act of 1986, section 530 safe-harbor relief does not apply to certain technical services personnel.

Description of Proposal

The proposal would repeal section 1706 of the Tax Reform Act of 1986. Thus, section 530 safe-harbor relief would be available with respect to workers covered by section 1706, if the requirements of the safe harbor are otherwise satisfied. The proposal would not repeal the consistency requirement with respect to workers covered by section 1706.

Effective Date

The proposal would be effective for periods beginning after the date of enactment.

7. Treatment of purchase of structured settlements

Present Law

Present law provides tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (sec. 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (sec. 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity that funds the liability to pay damages, generally is subject to tax.

The exclusion for recipients of the periodic payments received under a structured settlement arrangement as damages for personal physical injuries or physical sickness can be contrasted with the treatment of investment earnings that are not paid as damages. If a recipient of damages chooses to receive a lump sum payment (excludable from income under sec. 104), and then to invest it himself, generally the earnings on the investment are includible in income. For example, if the recipient uses the lump sum to purchase an annuity contract providing for periodic payments, then a portion of each payment under the annuity contract is includible in income, and the balance is excludable under present-law rules based on the ratio of the individual's investment in the contract to the expected return on the contract (sec. 72(b)).

Present law provides that the payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient. Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain "factoring" companies in exchange for their payment streams. The tax effect on the parties of these transactions may not be completely clear under present law.

Description of Proposal

The proposal generally would impose an excise tax on any person acquiring a payment stream under a structured settlement arrangement. The amount of the excise tax would be 40 percent of the excess of (1) the undiscounted amount of the payment stream acquired, over (2) the total amount actually paid.

The 40 percent excise tax would not apply, however, if the transfer is approved in advance in a final court order (or order of the responsible administrative authority) that finds: (1) that the transaction does not contravene any Federal or State statute or the order of any court or responsible administrative authority; and (2) is in the best interest of the payee, taking into account the welfare and support of the payee's dependents. Rules would be provided for determining the applicable State statute.

The proposal would also provide that the acquisition transaction does not affect the application of certain present-law rules, if those rules were satisfied at the time the structured settlement was entered into. The rules are section 130 (relating to an exclusion from gross income for personal injury liability assignments), section 72 (relating to annuities), sections 104(a)(1) and (2) (relating to an exclusion for amounts received under workers' compensation acts and for damages on account of personal physical injuries or physical sickness), and section 461(h) (relating to the time of economic performance in determining the taxable year of a deduction).

Effective Date

The proposal would generally be effective for acquisition transactions entered into on or after 30 days following enactment. A transition rule would apply during the period from that date to July 1, 2002. If no applicable State law (relating to the best interest of the payee) applies to a transfer during that period, then the exception from the 40 percent excise tax is available without the otherwise required court (or administrative) order, provided certain disclosure requirements are met. The person acquiring the structured settlement payments would be required to disclose in advance to the payee: (1) the amounts and due dates of the payments to be transferred; (2) the aggregate amount to be transferred; (3) the consideration to be received by the payee; (4) dis discounted present value of the transferred payments; and (5) the expenses to be paid by the payee or deducted from the payee's proceeds.

The provision providing that the acquisition transaction does not affect the application of certain present-law rules would be effective for transactions entered into before, on, or after the 30^{th} day following enactment.

8. Modify personal holding company "lending or finance business" exception

Present Law

Personal holding companies (PHC's) are subject to a 39.6 percent tax on undistributed PHC income. This tax can be avoided by distributing the income to shareholders, who then pay shareholder level tax. PHC's are closely held companies with at least 60 percent "personal holding company income" (PHCI). This is generally passive income, including interest, dividends, and rents. Certain rent is excluded from the definition, if rent is at least 50 percent of the adjusted ordinary gross income of the company and other undistributed PHCI does not exceed 10 percent of the adjusted ordinary gross income.

In the case of a group of corporations filing a consolidated return, with certain exceptions, the application of the PHC tax to the group and any member thereof is generally determined on the basis of consolidated income and consolidated PHCI. If any member of the group is excluded from the definition of a PHC under certain provisions (including one for certain lending or finance businesses), then each other member of the group is tested separately for PHC status.

A special rule of present law excludes a lending or finance business from the definition of a PHC if certain requirements are met. At least 60 percent of its income must come from the active conduct of a lending or finance business, and no more than 20 percent of its adjusted gross income may be from certain other PHCI. A lending or finance business does not include a business of making loans longer than 144 months (12 years). Also, the deductions attributable to this active lending or finance business (but not including interest expense) must be at least 5 percent of income over $500,000 (plus 15 percent of income under that amount).

Description of Proposal

The proposal would modify the personal holding company exclusion for lending or finance companies to provide that, in determining whether a member of an affiliated group (as defined in section 1504(a)(1)) filing a consolidated return is a lending or finance company, only corporations engaged in a lending or finance business would be taken into account, and all such companies would be aggregated for purposes of this determination. The effect of this rule would be to treat a corporation as a lending or finance company if all companies engaged in a lending or finance business in the affiliated group, in the aggregate, satisfy the requirements of the exclusion.

The proposal would also repeal the business expense requirement and the limitation on the maturity of loans made by a lending or finance business.

The proposal would also broaden the definition of a lending or finance business to include providing financial or investment advisory services, as well as engaging in leasing, including entering into leases and/or purchasing, servicing, and/or disposing of leases and leased assets.

Rents that are not derived from the active and regular conduct of a lending or finance business would continue to be treated under the present law personal holding company income rules.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

9. Additional funding for empowerment zones and enterprise communities

The proposal would provide a one-time grant in fiscal year 2001 of $5,000,000 for each of the 15 urban empowerment zones designated pursuant to the Taxpayer Relief Act of 1997, and $2,000,000 for each of the 5 rural empowerment zones designated pursuant to the Taxpayer Relief Act of 1997.

The proposal also would provide a one-time grant $250,000 for each of the remaining Round I enterprise communities (i.e., those that have not become empowerment zones).

10. Funding for Social Service Block Grant

The proposal would amend Section 203(c) of Title XX of the Social Security Act and provide an additional one-time amount of $700,000,000 for fiscal year 2001.