

**DESCRIPTION OF THE CHAIRMAN'S MODIFICATION
TO THE PROVISIONS OF THE
"HIGHWAY REAUTHORIZATION AND EXCISE
TAX SIMPLIFICATION ACT OF 2005"**

Scheduled for Markup
By the
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Prepared by the Staff
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 the Chairman's modification to the provisions of the "Highway Reauthorization and Excise Tax Simplification Act of 2005," which is to be marked up by the Senate Committee on Finance on April 19, 2005.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of the "Highway Reauthorization and Excise Tax Simplification Act of 2005."* (JCX-27-05), April 19, 2005.

I. ADDITIONAL PROVISIONS

A. Quarterly Excise Tax Filing for Small Alcohol Excise Taxpayers

Present Law

Excise taxes on distilled spirits, wines, and beers are collected on the basis of returns filed in accordance with rules prescribed by the Secretary of the Treasury.² Domestic producers of distilled spirits, beer, and wine are generally required to pay alcohol excise taxes within 14 days after the last day of the semi-monthly period during which the article is withdrawn under a deferred payment bond.³ Treasury regulations also permit certain very small wine producers to file and pay on an annual basis.⁴ In the case of distilled spirits, wines, and beer which are imported into the United States (other than in bulk containers), the importer is generally required to pay alcohol excise taxes within 14 days after the last day of the semi-monthly period during which the article is entered into the customs territory of the United States.⁵ In the case of imported articles entered for warehousing, the taxes are generally due within 14 days after the last day of the semi-monthly period during which the article is removed from the first such warehouse.⁶

Special rules apply to accelerate payments made with respect to taxes allocable to the second half of the month of September.⁷

Description of Proposal

Under the proposal, domestic producers and importers of distilled spirits, wines, and beers with annual excise tax liability of \$50,000 or less attributable to alcohol may file returns and pay taxes within 14 days after the end of the calendar quarter instead of on a semi-monthly basis. In order to qualify, the taxpayer's tax liability for such taxes during the immediately preceding year must have been \$50,000 or less, and, as of the beginning of the current calendar year, the taxpayer must reasonably expect to pay less than \$50,000 in such taxes for that year.

² Sec. 5061(a).

³ Sec. 5061(d)(1).

⁴ Annual filing and payment is permitted to a wine producer who has not given a deferred payment bond, and who either paid wine excise taxes in an amount less than \$1,000 during the previous calendar year or is a proprietor of a new bonded wine premise and expects to pay less than \$1,000 in wine excise taxes before the end of the calendar year. 27 CFR sec. 24.273(a).

⁵ Sec. 5061(d)(2)(A).

⁶ Sec. 5061(d)(2)(B).

⁷ Sec. 5061(d)(4).

The proposal does not apply to a taxpayer for any portion of the calendar year following the first date on which the aggregate amount of tax due for that year exceeds the \$50,000 threshold.

The special rules accelerating payments for taxes allocable to the second half of September do not apply to quarterly filers under the proposal.

Very small wine producers may still file and pay on an annual basis as under present law.

Effective Date

The proposal is effective for quarterly periods beginning January 1, 2006.

B. Delta Regional Transportation Plan

Present Law

The Delta Regional Authority is a Federal-State partnership, serving a 240-county/parish area in an eight-State region.⁸ No State is required to participate with the authority. The duties of the authority are to: (1) produce a regional development plan; (2) set priorities for approval of grants in the region; (3) assess the region's needs and assets; (4) inform participating States about interstate cooperation; (5) work with States and local agencies to develop model legislation; (6) enhance the capacity of and support Local Development Districts, as well as the creation of Local Development Districts where none currently exist; (7) encourage private investment in economic development projects in the region; and (8) assist State governments with the States' economic development program.

Description of Proposal

The proposal directs the Delta Regional Authority to conduct a comprehensive study of transportation assets and needs in the eight states comprising the Delta region (Alabama, Arkansas, Illinois, Kentucky, Louisiana, Mississippi, Missouri, and Tennessee). Upon completion of the study, the Delta Regional Authority is to create a regional strategic plan to achieve efficient transportation systems in the Delta region.

The study and plan are to include but are not limited to the following transportation modes and systems: transit, rail, highway, interstate, bridges, air, airports, waterways and ports. The Delta Regional Authority is to work with local planning and development districts, local and regional governments, metropolitan planning organizations, State transportation entities, and Federal transportation agencies to develop a regional strategic transportation plan.

The proposal authorizes the Delta Regional Authority to receive \$500,000 in fiscal year 2005, and \$500,000 in fiscal year 2006 to conduct a comprehensive study and plan. These funds are to remain available until spent.

Effective Date

The proposal is effective on the date of enactment

⁸ The covered States and counties are: Alabama - 20 counties; Arkansas - 42 counties; Illinois, 16 counties; Kentucky - 21 counties; Louisiana - 46 parishes; Mississippi - 45 counties; Missouri - 29 counties; and Tennessee - 21 counties. Delta Regional Authority, *Legislative Matters and Overview*, (February 1, 2004) < www.dra.gov/legislation.php >.

C. Establish Build America Corporation

Present law

There is no provision in Federal law establishing a nonprofit corporation dedicated to providing financing or other financial support for transportation infrastructure projects.

Description of Proposal

The proposal establishes a nonprofit corporation, to be known as the “Build America Corporation.” The Build America Corporation is not an agency or establishment of the United States Government. The Build America Corporation generally shall be subject to the laws of the State of Delaware applicable to corporations not for profit.

The purpose of the corporation is to provide financial support for qualified projects. Under the proposal a “qualified project” generally is defined as any transportation infrastructure project of any governmental unit or other person that is proposed by a State, including a highway project, a transit system project, a railroad project, an airport project, a port project, and an inland waterways project. The proposal imposes additional requirements if a qualified project is financed by debt issued by the Build America Corporation.

Effective Date

The proposal is effective on the date of enactment.

D. Treatment of Employer-Provided Transit and Van Pooling Benefits

Present Law

Under present law, qualified transportation benefits are excludable from gross income and wages for employment tax purposes. Qualified transportation benefits are: (1) transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment ("van pooling"); (2) transit passes; and (3) qualified parking. For purposes of the exclusion for van pooling benefits, a commuter highway vehicle is any highway vehicle: (1) the seating capacity of which is at least six adults (excluding the driver); and (2) at least 80 percent of the mileage use of which can reasonably be expected to be (a) for purposes of transporting employees in connection with travel between their residences and their place of employment and (b) on trips during which the number of employees transported for such purposes is at least one-half of the adult seating capacity of such vehicle (not including the driver).

The maximum amount of qualified parking that is excludable from income and wages is \$200 per month (for 2005). The maximum amount of transit passes and van pooling benefits that are excludable from income and wages per month is \$105 (for 2005). These dollar amounts are indexed for inflation.

Description of Proposal

Under the proposal, the maximum dollar amount of excludable van pooling and transit benefits is increased to \$155 per month. The maximum amount of excludable qualified parking is \$200 per month. The dollar amounts are indexed for inflation after 2008 (with 2007 as a base year).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2005.

II. REVENUE OFFSET PROVISIONS

A. Treatment of Contingent Payment Convertible Debt Instruments

Present Law

Under present law, a taxpayer generally deducts the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. In the case of original issue discount (“OID”), the issuer of a debt instrument generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the OID may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is equal to the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts that are payable on the debt instrument by maturity. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased or decreased by adjustments prior to the accrual period) by the instrument’s yield to maturity, and then subtracting any payments on the debt instrument (other than non-OID stated interest) during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a particular period, the stated redemption price at maturity and the time of maturity must be known. Issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holders of such instruments accrue and include in gross income the amount of OID as interest income.

Treasury regulations provide special rules for determining the amount of OID allocated to a period with respect to certain debt instruments that provide for one or more contingent payments of principal or interest.⁹ The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt.¹⁰ The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.¹¹

In the case of contingent payment debt instruments that are issued for money or publicly traded property,¹² the regulations provide that interest on a debt instrument must be taken into

⁹ Treas. reg. sec. 1.1275-4.

¹⁰ Treas. reg. sec. 1.1275-4(a)(4).

¹¹ Treas. reg. sec. 1.1275-4(a)(5).

¹² Treas. reg. sec. 1.1275-4(b).

account (as OID) whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument, and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the “noncontingent bond method”). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.¹³

With respect to certain debt instruments that are convertible into the common stock of the issuer and that also provide for contingent payments (other than the conversion feature)--often referred to as “contingent convertible” debt instruments--the IRS has stated that the noncontingent bond method applies in computing the accrual of OID on the debt instrument.¹⁴ In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

Description of Proposal

The proposal provides that, in the case of a contingent convertible debt instrument,¹⁵ any Treasury regulations which require OID to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the proposal, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

Effective Date

The proposal is effective for debt instruments issued on or after date of enactment.

¹³ Treas. reg. sec. 1.1275-4(b)(4)(i)(A).

¹⁴ Rev. Rul. 2002-31, 2002-1 C.B. 1023.

¹⁵ Under the proposal, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

B. Frivolous Tax Submissions

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS.¹⁶ The Code also permits the Tax Court¹⁷ to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless.¹⁸

Description of Proposal

The proposal modifies the IRS-imposed penalty by increasing the amount of the penalty to up to \$5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The proposal also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this proposal applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal permits the IRS to dismiss such requests. Second, the proposal permits the IRS to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The proposal requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these provisions.

Effective Date

The proposal is effective with respect to submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

¹⁶ Sec. 6702.

¹⁷ Because the Tax Court generally is the only pre-payment forum available to taxpayers, it hears most of the frivolous, groundless, or dilatory arguments raised in tax cases.

¹⁸ Sec. 6673(a).

C. Criminal Tax Fraud

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to \$100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to \$25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to \$100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony¹⁹ \$250,000 for an individual or \$500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is \$250,000 or, if greater, twice the amount of gross gain from the offense.

¹⁹ Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. sec. 3559(a)(5).

Description of Proposal

Attempt to evade or defeat tax

The proposal increases the criminal penalty under section 7201 of the Code for individuals to \$500,000 and for corporations to \$1,000,000. The proposal increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The proposal increases the criminal penalty under section 7203 of the Code from a misdemeanor to a felony for aggravated failures to file. Under the proposal, an aggravated failure to file is any case in which the taxpayer fails to file returns for three or more consecutive years and the tax liability during such years is \$100,000 or greater. The proposal imposes a penalty for an aggravated failure to file up to \$500,000 for individuals and up to \$1,000,000 for corporations. The proposal also imposes a maximum prison sentence of ten years.

In misdemeanor cases, the proposal increases the criminal penalty under section 7203 of the Code for individuals to \$50,000.

Fraud and false statements

The proposal increases the criminal penalty under section 7206 of the Code for individuals to \$500,000 and for corporations to \$1,000,000. The proposal increases the maximum prison sentence to five years. The proposal also provides that in no event shall the amount of the monetary penalty under this provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective Date

The proposal is effective for offenses committed after the date of enactment.

D. Double Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related and fraud penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the same statute of limitations.

Delinquency penalties

Failure to file.—Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay.—Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If a return is filed more than 60 days after its due date, then the penalty for failure to file tax shown on a return may not reduce the penalty for failure to pay below the lesser of \$100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax.—The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the day on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

The accuracy-related penalty is imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant, to (1) negligence, (2) any substantial understatement of income tax and (3) any substantial valuation misstatement. In addition, the penalty is doubled for certain gross valuation misstatements. These consolidated penalties are also coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. However, Treasury has issued proposed regulations that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

Negligence or disregard for the rules or regulations.—If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless or intentional disregard of the rules or regulations.

Substantial understatement of income tax.—Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year or (2) \$5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement.—A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Gross valuation misstatements.—The rate of the accuracy-related penalty is doubled (to 40 percent) in the case of gross valuation misstatements.

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not apply to any portion of an underpayment on which the fraud penalty is imposed.

Interest Provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative (“OVCI”) to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer’s introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. Taxpayers eligible under OVCI will not be liable for civil fraud, the fraudulent failure to file penalty or the civil information return penalties. The taxpayer will pay back taxes, interest and certain accuracy-related and delinquency penalties.

Voluntary Disclosure Initiative

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.

Description of Proposal

The proposal increases by a factor of two the total amount of civil penalties, interest and fines applicable for taxpayers who would have been eligible to participate in either the OVCI or the Treasury Department’s voluntary disclosure initiative (which applies to the taxpayer by reason of the taxpayer’s underpayment of U.S. income tax liability through certain financing arrangements) but did not participate in either program.

Effective Date

The proposal generally is effective with respect to a taxpayer's open tax years on or after date of enactment.

E. Modification of Coordination Rules for Controlled Foreign Corporation and Passive Foreign Investment Company Regimes

Present Law

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F²⁰ and the passive foreign investment company rules.²¹ Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad. A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.²²

Subpart F,²³ applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation’s stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).²⁴ Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as “subpart F income”), without regard to whether the income is distributed to the shareholders.²⁵

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base

²⁰ Secs. 951-964.

²¹ Secs. 1291-1298.

²² Secs. 901, 902, 960, 1291(g).

²³ Secs. 951-964.

²⁴ Secs. 951(b), 957, 958.

²⁵ Sec. 951(a).

company income,²⁶ insurance income,²⁷ and certain income relating to international boycotts and other violations of public policy.²⁸ Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income and foreign base company services income.²⁹

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.³⁰

The Tax Reform Act of 1986 established an additional anti-deferral regime, for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.³¹ Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.³² A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.³³ A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year

²⁶ Sec. 954.

²⁷ Sec. 953.

²⁸ Sec. 952(a)(3)-(5).

²⁹ Sec. 954.

³⁰ Secs. 951(a)(1)(B), 956.

³¹ Sec. 1297.

³² Secs. 1293-1295.

³³ Sec. 1291.

and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”³⁴

Under section 1297(e), which was enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. This exception applies regardless of the likelihood that the U.S. shareholder would actually be taxed under subpart F in the event that the controlled foreign corporation earns subpart F income. Thus, even in a case in which a controlled foreign corporation’s subpart F income would be allocated to a different shareholder under the subpart F allocation rules, a U.S. shareholder would still qualify for the exception from the passive foreign investment company rules under section 1297(e).

Description of Proposal

The provision adds an exception to section 1297(e) for U.S. shareholders that face only a remote likelihood of incurring a subpart F inclusion in the event that a controlled foreign corporation earns subpart F income, thus preserving the potential application of the passive foreign investment company rules in such cases.

Effective Date

The provision is effective for taxable years of controlled foreign corporations beginning after March 2, 2005, and for taxable years of U.S. shareholders in which or with which such taxable years of controlled foreign corporations end.

³⁴ Sec. 1296.

F. Declaration by Chief Executive Officer Relating to Federal Annual Corporate Income Tax Return

Present Law

The Code requires³⁵ that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

The Code also imposes³⁶ a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than \$100,000³⁷ (\$500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

Description of Proposal

The proposal requires that a corporation's Federal income tax return include a declaration signed under penalties of perjury by the chief executive officer of the corporation that the corporation has in place processes and procedures to ensure that the return complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy of all material aspects of the return. This declaration is part of the income tax return. The proposal is in addition to the requirement of present law as to the signing of the income tax return itself. Because a CEO's duties generally do not require a detailed or technical understanding of the corporation's tax return, it is anticipated that this declaration of the CEO will be more limited in scope than the declaration of the officer required to sign the return itself.

The proposal provides that the Secretary of the Treasury shall prescribe the matters to which the declaration of the CEO applies. It is intended that the declaration help insure that the preparation and completion of the corporation's tax return be given an appropriate level of care. For example, it is anticipated that the CEO would declare that processes and procedures have been implemented to ensure that the return complies with the Internal Revenue Code and all regulations and rules promulgated thereunder. Although appropriate processes and procedures can vary for each taxpayer depending on the size and nature of the taxpayer's business, in every case the CEO should be briefed on all material aspects of the corporation's tax return by the corporation's chief financial officer (or another person authorized to sign the return under present law).

³⁵ Sec. 6062.

³⁶ Sec. 7206.

³⁷ Pursuant to 18 U.S.C. sec. 3571, the maximum fine for an individual convicted of a felony is \$250,000.

If the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the declaration. It is intended that the IRS issue general guidance, such as a revenue procedure, to: (1) address situations when a corporation does not have a chief executive officer; and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title, when a corporation has multiple chief executive officers, or when the corporation is a foreign corporation and the CEO is not a U.S. resident.³⁸ It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign this declaration.

The proposal does not apply to the income tax returns of mutual funds;³⁹ they are required to be signed as under present law.

Effective Date

The proposal applies to Federal tax returns for taxable years ending after the date of enactment.

³⁸ With respect to foreign corporations, it is intended that the rules for signing this declaration generally parallel the present-law rules for signing the return. See Treas. reg. sec. 1.6062-1(a)(3).

³⁹ The proposal does, however, apply to the income tax returns of mutual fund management companies and advisors.

G. Grant Treasury Regulatory Authority to Address Foreign Tax Credit Transactions Involving Inappropriate Separation of Foreign Taxes from Related Foreign Income

Present Law

The United States employs a “worldwide” tax system, under which residents generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the possibility of double taxation arising from overlapping claims of the United States and a source country to tax the same item of income, the United States provides a credit for foreign income taxes paid or accrued, subject to several conditions and limitations.

For purposes of the foreign tax credit, regulations provide that a foreign tax is treated as being paid by “the person on whom foreign law imposes legal liability for such tax.”⁴⁰ Thus, for example, if a U.S. corporation owns an interest in a foreign partnership, the U.S. corporation can claim foreign tax credits for the tax that is imposed on it as a partner in the foreign entity. This would be true under the regulations even if the U.S. corporation elected to treat the foreign entity as a corporation for U.S. tax purposes. In such a case, if the foreign entity does not meet the definition of a controlled foreign corporation or does not generate income that is subject to current inclusion under the rules of subpart F, the income generated by the foreign entity might never be reported on a U.S. return, and yet the U.S. corporation might take the position that it can claim credits for taxes imposed on that income. This is one example of how a taxpayer might attempt to separate foreign taxes from the related foreign income, and thereby attempt to claim a foreign tax credit under circumstances in which there is no threat of double taxation.

Description of Proposal

The proposal provides regulatory authority for the Treasury Department to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income in cases in which taxes are imposed on any person in respect of income of an entity. Regulations issued pursuant to this authority could provide for the disallowance of a credit for all or a portion of the foreign taxes, or for the allocation of the foreign taxes among the participants in the transaction in a manner more consistent with the economics of the transaction.

Effective Date

The proposal generally is effective after the date of enactment.

⁴⁰ Treas. reg. sec. 1.901-2(f)(1).