

**DESCRIPTION OF THE
“HIGHWAY REAUTHORIZATION AND EXCISE TAX
SIMPLIFICATION ACT OF 2004”**

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on February 2, 2004

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



January 29, 2004
JCX-5-04

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on February 2, 2004, on the “Highway Reauthorization and Excise Tax Simplification Act of 2004.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the “Highway Reauthorization and Excise Tax Simplification Act of 2004.”

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the “Highway Reauthorization and Excise Tax Simplification Act of 2004”* (JCX-5-04), January 29, 2004.

I. TRUST FUND REAUTHORIZATION

A. Extension of Highway Trust Fund and Aquatic Resources Trust Fund Expenditure Authority and Related Taxes

Present-Law Highway Trust Fund Excise Taxes

In general

Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. The remaining three are a retail sales tax on heavy highway vehicles, a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. A substantial majority of the revenues produced by the Highway Trust Fund excise taxes are derived from the taxes on motor fuels. The six taxes are summarized below.

Except for 4.3 cents per gallon of the Highway Trust Fund fuels tax rates, all of these taxes are scheduled to expire after September 30, 2005. The 4.3-cents-per-gallon portion of the fuels tax rates is permanent.² Highway Trust Fund expenditure authority is scheduled to expire after February 29, 2004.

Highway motor fuels taxes

The Highway Trust Fund motor fuels tax rates are as follows:³

² This portion of the tax rates was enacted as a deficit reduction measure in 1993. Receipts from it were retained in the General Fund until 1997 legislation provided for their transfer to the Highway Trust Fund.

³ These fuels also are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund (secs. 4041(d) and 4081(a)(2)(B)).

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon
Special motor fuels	18.3 cents per gallon generally ⁴

Exemptions

Present law includes numerous exemptions (including partial exemptions) for specified uses of taxable fuels or for specified fuels. Because the gasoline and diesel fuel taxes generally are imposed before the end use of the fuel is known, many exemptions are realized through refunds to end users of tax paid by a taxpayer earlier in the distribution chain. Exempt uses and fuels include:

- (1) use in State and local government and nonprofit educational organization highway vehicles;
- (2) use in buses engaged in transporting students and employees of schools;
- (3) use in local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local governmental unit to furnish the transportation; and
- (4) use in intercity buses serving the general public along scheduled routes. (Such use is totally exempt from the gasoline excise tax and is exempt from 17 cents per gallon of the diesel fuel tax.)

In addition, fuels used in off-highway business use or on a farm for farming purposes generally are exempt from these motor fuels taxes.⁵ The Highway Trust Fund does not receive

⁴ The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from petroleum or natural gas.....	9.15 cents per gallon
Compressed natural gas.....	48.54 cents per MCF

See secs. 4041(a)(2) and (3) and 4041(m).

The compressed natural gas tax rate is equivalent only to 4.3 cents per gallon of the rate imposed on gasoline and other special motor fuels rather than the full 18.3-cents-per-gallon rate. The tax rate for the other special motor fuels is equivalent to the full 18.3-cents-per-gallon gasoline and special motor fuels tax rate.

⁵ Diesel fuel is the same fuel (#2 fuel oil) as that commonly used as home heating oil. Fuel oil used as heating oil is not subject to the Federal excise tax.

excise taxes imposed on fuel used in off-highway activities. Rather, when tax is imposed on off-highway use fuel consumption, it is used to finance other Trust Funds (*e.g.*, motorboat gasoline and special motor fuel taxes from non-business off-highway use dedicated to the Aquatic Resources Trust Fund) or is retained in the General Fund (*e.g.*, tax on diesel fuel used in trains). The Code provides partial exemptions from the motor fuel taxes for alcohol fuels that are used as special motor fuels or are blended with gasoline for use as a highway motor fuel (*e.g.*, “gasohol”).

Non-fuel Highway Fund excise taxes

In addition to the highway motor fuels excise tax revenues, the Highway Trust Fund receives revenues produced by three excise taxes imposed exclusively on heavy highway vehicles or tires. These taxes are:

- (1) A 12-percent excise tax imposed on the first retail sale of heavy highway vehicles, tractors, and trailers (generally, trucks having a gross vehicle weight in excess of 33,000 pounds and trailers having such a weight in excess of 26,000 pounds);
- (2) An excise tax imposed at graduated rates on highway tires weighing more than 40 pounds; and
- (3) An annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more. (The maximum rate for this tax is \$550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds.)

Excise tax revenue

Historically, approximately 90 percent of the revenues for the Highway Trust Fund have been produced by the motor fuel taxes. For example in Fiscal Year 2000, the motor fuels excise taxes yielded gross receipts of \$30.1 billion. The heavy vehicle retail sales tax produced \$3.1 billion, the tire excise tax yielded \$436 million and the annual use tax yielded \$900 million.

Highway Trust Fund Expenditure Provisions

In general

Dedication of excise tax revenues to the Highway Trust Fund and expenditures from the Highway Trust Fund are governed by provisions of the Code (sec. 9503).⁶ The Code authorizes expenditures (subject to appropriations) from the Fund through February 29, 2004, for the purposes provided in authorizing legislation, as in effect on the date of enactment of the Surface Transportation Extension Act of 2003.

Under present law, revenues from the highway excise taxes, as imposed through September 30, 2005, generally are dedicated to the Highway Trust Fund. However, 2.5 cents per

⁶ The Highway Trust Fund statutory provisions were placed in the Internal Revenue Code in 1982.

gallon of the tax imposed on gasohol and 2.8 cents per gallon of the tax imposed on fuel to be blended with alcohol are retained in the General Fund. Also, with respect to gasohol, Highway Trust Fund revenues are reduced by the amount of the tax subsidy claimed through the excise tax system, but not for amounts claimed as income tax credits. In addition, under section 9503(c)(2), certain transfers are made from the Highway Trust Fund into the General Fund, relating to amounts paid in respect of gasoline used on farms, amounts paid in respect of gasoline used for certain nonhighway purposes or by local transit systems, amounts relating to fuels not used for taxable purposes, and income tax credits for certain uses of fuels.

Highway Trust Fund expenditure purposes

Overview

The Highway Trust Fund has a subaccount for Mass Transit. Both the Trust Fund and its subaccount are funding sources for specific programs. The Highway Trust Fund does not receive interest on its unexpended balances.

Highway Trust Fund expenditure purposes have been revised with each authorization Act enacted since establishment of the Highway Trust Fund in 1956. In general, expenditures authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent such authorizing Act) are approved by the Code as Highway Trust Fund expenditure purposes.⁷ Thus, no Highway Trust Fund monies may be spent for a purpose not approved by the tax-writing committees of Congress. The Code provides that authority to make expenditures from the Highway Trust Fund expires after February 29, 2004. Thus, no Highway Trust Fund expenditures may occur after February 29, 2004, without approval by the tax-writing committees of Congress.

Highway Trust Fund expenditure purposes

The Highway Trust Fund receives revenues from all non-fuel highway transportation excise taxes and revenues from all but 2.86 cents per gallon of the highway motor fuels excise taxes transferred to the Highway Trust Fund. Programs financed from the Highway Trust Fund (excluding the Mass Transit account) include:

- (1) Interstate maintenance program;
- (2) National Highway System;
- (3) The bridge program (bridge replacement and repair);
- (4) Surface transportation programs;

⁷ The authorizing Acts which currently are referenced in the Highway Trust Fund provisions of the Code are the Highway Revenue Act of 1956, Titles I and II of the Surface Transportation Assistance Act of 1982, the Surface Transportation and Uniform Relocation Act of 1987, the Intermodal Surface Transportation Efficiency Act of 1991 and the Transportation Equity Act for the 21st Century.

- (5) Congestion mitigation and air quality improvement program;
- (6) Highway safety programs and research and development, including a share of the cost of National Highway Traffic Safety Administration (“NHTSA”) programs and university research centers;
- (7) Appalachian development highway system program;
- (8) Recreational trails program;
- (9) Federal lands highways program;
- (10) National corridor planning and development and coordinated border infrastructure programs;
- (11) Construction of ferry boats and ferry terminal facilities;
- (12) National scenic byways program;
- (13) Value pricing pilot program;
- (14) High priority projects program;
- (15) Highway use tax evasion projects;
- (16) Commonwealth of Puerto Rico highway program.

Certain administrative costs of the Federal Highway Administration and NHTSA are also funded from the Highway Trust Fund.

Mass Transit Account expenditure purposes

The Highway Fund’s Mass Transit Account receives revenues equivalent to 2.86 cents per gallon of the highway motor fuels excise taxes. Mass Transit Account monies are available through February 29, 2004, for capital and capital-related expenditures under sections 5338(a)(1) and (b)(1) of Title 49, United States Code, the Intermodal Surface Transportation Efficiency Act of 1991 or the Transportation Equity Act for the 21st Century as those provisions were in effect on the date of enactment of the TEA 21 Restoration Act.

Anti-deficit provisions (the “Harry Byrd rule”)

Highway Trust Fund spending is limited by anti-deficit provisions internal to the Highway Trust Fund, the so-called “Harry Byrd rule”. The rule requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 24-month period beginning at the close of each fiscal year (sec. 9503(d)). Similar rules apply to unfunded Mass Transit Account authorizations. If unfunded authorizations exceed projected 24-month receipts, apportionments to the States for specified programs funded by the relevant Trust Fund Account are to be reduced proportionately. Because of the Harry Byrd rule, taxes dedicated to the

Highway Trust Fund typically are scheduled to expire at least two years after current authorizing Acts.

The Surface Transportation Extension Act of 2003 created a temporary rule (through February 29, 2004) for purposes of the anti-deficit provisions of the Highway Trust Fund. For purposes of determining 24 months of projected revenues for the anti-deficit provisions, the Secretary of the Treasury is instructed to treat each expiring provision relating to appropriations and transfers to the Highway Trust Fund to have been extended through the end of the 24-month period and to assume that the rate of tax during such 24-month period remains at the same rate in effect on the date of enactment of the provision.

Limitations on transfers to The Highway Trust Fund (the “Basso rule”)

The Code also contains a special enforcement provision, the so-called “Basso rule”, to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503 (*i.e.*, not approved by the tax-writing committees of Congress) (sec. 9503(b)(5)). Should such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that does not amend section 9503's expenditure authorization provisions or otherwise authorize the expenditure as part of a revenue Act.

Interrelationship of the Highway Trust Fund and the Aquatic Resources Trust Fund

The Aquatic Resources Trust Fund is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels, as well as small-engine fuel taxes, that are first deposited into the Highway Trust Fund. As a result, transfers to the Aquatic Resources Trust Fund are governed in part by Highway Trust Fund provisions (sec. 9503(c)(4) and 9503(c)(5)).

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, the Code currently transfers 13 cents per gallon from the Highway Trust Fund to the Aquatics Resources Trust Fund and Land and Water Conservation Fund.⁸ The remainder, 5.3 cents per gallon, is retained in the General Fund.

The Aquatic Resources Trust Fund is comprised of two accounts, the Boat Safety Account and the Sport Fish Restoration Account. Transfers to the Boat Safety Account are limited to amounts not exceeding \$70 million per year. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Account to have an unobligated balance in excess of \$70 million. To the extent there is any excess, the Code transfers the next \$1

⁸ This amount increases to 13.5 cents between October 1, 2003, and September 1, 2005. No transfers from the Highway Trust Fund to the Aquatics Resources Trust Fund are provided for after 2005.

million of motorboat fuel taxes from the Highway Trust Fund to the Land and Water Conservation Fund provided for in title I of the Land and Water Conservation Fund Act of 1965.

The Sport Fish Restoration Account receives the balance of the motorboat gasoline and special motor fuels receipts from the Highway Trust Fund. In addition, the Sport Fish Restoration Account receives 13 cents per gallon of the revenues from the tax imposed on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. This Account also is funded with receipts from an *ad valorem* manufacturer's excise tax on sport fishing equipment.

The expenditure authority for the Aquatic Resources Trust Fund expires after February 29, 2004.

Description of Proposal⁹

The expenditure authority to spend monies from the Highway Trust Fund and Aquatic Resources Trust Fund is extended through September 30, 2009. The Code provisions governing the purposes for which monies in the Highway Trust Fund and Aquatic Resources Trust Fund may be spent is updated to include the extension bill. The taxes supporting the Highway Trust Fund are extended at their current rates through September 30, 2009 and amounts equivalent to those taxes are authorized to be transferred to the respective funds through September 30, 2009. Section 9503(c)(2), relating to certain transfers from the Highway Trust Fund to the General Fund, is repealed. The Byrd rule is changed from a 24-month to a four-year receipt rule. For purposes of the four-year rule, taxes are assumed extended beyond their expiration date. Under the proposal, the Highway Trust Fund is credited with interest on its unexpended balances. The proposal also prohibits the use of Highway Account money for rail projects.¹⁰

Effective Date

The proposal is effective upon date of enactment. The repeal of section 9503(c)(2) is effective March 31, 2004.

⁹ For additional modifications to the Aquatics Resources Trust Fund, see Part V.B.1 (“Aquatic Resources Trust Fund Excise Taxes”).

¹⁰ The Committee understands that no rail projects are financed with funds from the Highway Account. For modifications to excise taxes on diesel fuel used in trains, relieving excise taxes except for those dedicated to the Leaking Underground Storage Tank (“LUST”) Trust Fund, see Part V.B.2 (“Repeal certain excise taxes on rail diesel fuel and inland waterway barge fuels”).

II. THE VOLUMETRIC ETHANOL EXCISE TAX CREDIT ("VEETC")

A. Alcohol and Biodiesel Excise Tax Credit and Extension of Alcohol Fuels Income Tax Credit

Present Law

Alcohol fuels income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2007.¹¹

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel¹²) is an "ethanol blender." Ethanol blenders are eligible for an income tax credit of 52 cents per gallon of ethanol used in the production of a qualified mixture (the "alcohol mixture credit"). A qualified mixture means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the blender as fuel, or used as fuel by the blender in producing the mixture. The term alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150. Businesses also may reduce their income taxes by 52 cents for each gallon of ethanol (not mixed with gasoline or other special fuel) that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). The 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007. For blenders using an alcohol other than ethanol, the rate is 60 cents per gallon.¹³

A separate income tax credit is available for small ethanol producers (the "small ethanol producer credit"). A small ethanol producer is defined as a person whose ethanol production capacity does not exceed 30 million gallons per year. The small ethanol producer credit is 10 cents per gallon of ethanol produced during the taxable year for up to a maximum of 15 million gallons.

¹¹ The alcohol fuels credit is unavailable when, for any period before January 1, 2008, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

¹² A special fuel includes any liquid (other than gasoline) that is suitable for use in an internal combustion engine.

¹³ In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 38.52 cents for sales or uses during calendar year 2003 and 2004, and 37.78 cents for calendar years 2005, 2006, and 2007.

The credits that comprise the alcohol fuels tax credit are includible in income. The credit may not be used to offset alternative minimum tax liability. The credit is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally.

Excise tax reductions for alcohol mixture fuels

Generally, motor fuels tax rates are as follows¹⁴:

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon
Special motor fuels	18.3 cents per gallon generally

Alcohol-blended fuels are subject to a reduced rate of tax. The benefits provided by the alcohol fuels income tax credit and the excise tax reduction are integrated such that the alcohol fuels credit is reduced to take into account the benefit of any excise tax reduction.

Gasohol

Registered ethanol blenders may forgo the full income tax credit and instead pay reduced rates of excise tax on gasoline that they purchase for blending with ethanol. Most of the benefit of the alcohol fuels credit is claimed through the excise tax system.

The reduced excise tax rates apply to gasohol upon its removal or entry. Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. For the calendar year 2003, the following reduced rates apply to gasohol:¹⁵

5.7 percent ethanol	15.436 cents per gallon
7.7 percent ethanol	14.396 cents per gallon
10.0 percent ethanol	13.200 cents per gallon

Reduced excise tax rates also apply when gasoline is being purchased for the production of “gasohol.” When gasoline is purchased for blending into gasohol, the rates above are multiplied by a fraction (*e.g.*, 10/9 for 10-percent gasohol) so that the increased volume of motor fuel will be subject to tax. The reduced tax rates apply if the person liable for the tax is

¹⁴ These fuels are also subject to an additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund. See secs. 4041(d) and 4081(a)(2)(B). In addition, the basic fuel tax rate will drop to 4.3 cents per gallon beginning on October 1, 2005.

¹⁵ These rates include the additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund. These special rates will terminate after September 30, 2007 (sec. 4081(c)(8)).

registered with the IRS and (1) produces gasohol with gasoline within 24 hours of removing or entering the gasoline or (2) gasoline is sold upon its removal or entry and such person has an unexpired certificate from the buyer and has no reason to believe the certificate is false.¹⁶

Qualified methanol and ethanol fuels

Qualified methanol or ethanol fuel is any liquid that contains at least 85 percent methanol or ethanol or other alcohol produced from a substance other than petroleum or natural gas. These fuels are taxed at reduced rates.¹⁷ The rate of tax on qualified methanol is 12.35 cents per gallon. The rate on qualified ethanol in 2003 and 2004 is 13.15 cents. From January 1, 2005, through September 30, 2007, the rate of tax on qualified ethanol is 13.25 cents.¹⁸

Alcohol produced from natural gas

A mixture of methanol, ethanol, or other alcohol produced from natural gas that consists of at least 85 percent alcohol is also taxed at reduced rates.¹⁹ For mixtures not containing ethanol, the applicable rate of tax is 9.25 cents per gallon before October 1, 2005. In all other cases, the rate is 11.4 cents per gallon. After September 30, 2005, the rate is reduced to 2.15 cents per gallon when the mixture does not contain ethanol and 4.3 cents per gallon in all other cases.

Blends of alcohol and diesel fuel or special motor fuels

A reduced rate of tax applies to diesel fuel or kerosene that is combined with alcohol as long as at least 10 percent of the finished mixture is alcohol. If none of the alcohol in the mixture is ethanol, the rate of tax is 18.4 cents per gallon. For alcohol mixtures containing ethanol, the rate of tax in 2003 and 2004 is 19.2 cents per gallon and for 2005 through September 30, 2007, the rate for ethanol mixtures is 19.3 cents per gallon. Fuel removed or entered for use in producing a 10 percent diesel-alcohol fuel mixture (without ethanol), is subject to a tax of 20.44 cents. The rate of tax for fuel removed or entered to produce a 10 percent diesel-ethanol fuel mixture is 21.333 cents per gallon for 2003 and 2004 and 21.444 cents per gallon for the period January 1, 2005, through September 30, 2007.

Special motor fuel (nongasoline) mixtures with alcohol also are taxed at reduced rates.

¹⁶ Treas. Reg. sec. 48.4081-6(c). A certificate from the buyer assures that the gasoline will be used to produce gasohol within 24 hours after purchase. A copy of the registrant's letter of registration cannot be used as a gasohol blender's certificate.

¹⁷ A 0.05-cent-per-gallon Leaking Underground Storage Tank Trust Fund tax is imposed on such fuel. This provision expires on October 1, 2007 (sec. 4041(b)(2)).

¹⁸ These reduced rates terminate after September 30, 2007.

¹⁹ These rates include the additional 0.1 cent-per-gallon excise tax to fund the Leaking Underground Storage Tank Trust Fund (sec. 4041(d)(1)).

Aviation fuel

Noncommercial aviation fuel is subject to a tax of 21.9 cents per gallon.²⁰ Fuel mixtures containing at least 10 percent alcohol are taxed at lower rates.²¹ In the case of 10 percent ethanol mixtures, any sale or use during 2003 and 2004, the 21.9 cents is reduced by 13.2 cents (for a tax of 8.7 cents per gallon), for 2005, 2006, and 2007 the reduction is 13.1 cents (for a tax of 8.8 cents per gallon) and is reduced by 13.4 cents in the case of any sale during 2008 or thereafter. For mixtures not containing ethanol, the 21.9 cents is reduced by 14 cents for a tax of 7.9 cents. These reduced rates expire after September 30, 2007.²²

When aviation fuel is purchased for blending with alcohol, the rates above are multiplied by a fraction (10/9) so that the increased volume of aviation fuel will be subject to tax.

Refunds and payments

If fully taxed gasoline (or other taxable fuel) is used to produce a qualified alcohol mixture, the Code permits the blender to file a claim for a quick excise tax refund. The refund is equal to the difference between the gasoline (or other taxable fuel) excise tax that was paid and the tax that would have been paid by a registered blender on the alcohol fuel mixture being produced. Generally, the IRS pays these quick refunds within 20 days. Interest accrues if the refund is paid more than 20 days after filing. A claim may be filed by any person with respect to gasoline, diesel fuel, or kerosene used to produce a qualified alcohol fuel mixture for any period for which \$200 or more is payable and which is not less than one week.

Ethyl tertiary butyl ether (ETBE)

Ethyl tertiary butyl ether (“ETBE”) is an ether that is manufactured using ethanol. Unlike ethanol, ETBE can be blended with gasoline before the gasoline enters a pipeline because ETBE does not result in contamination of fuel with water while in transport. Treasury regulations provide that gasohol blenders may claim the income tax credit and excise tax rate reductions for ethanol used in the production of ETBE. The regulations also provide a special election allowing refiners to claim the benefit of the excise tax rate reduction even though the fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

Highway Trust Fund

With certain exceptions, the taxes imposed by section 4041 (relating to retail taxes on diesel fuels and special motor fuels) and section 4081 (relating to tax on gasoline, diesel fuel and kerosene) are credited to the Highway Trust Fund. In the case of alcohol fuels, 2.5 cents per

²⁰ This rate includes the additional 0.1 cent-per-gallon tax for the Leaking Underground Storage Tank Trust Fund.

²¹ Sec. 4041(k)(1) and 4091(c).

²² Sec. 4091(c)(1).

gallon of the tax imposed is retained in the General Fund.²³ In the case of a taxable fuel taxed at a reduced rate upon removal or entry prior to mixing with alcohol, 2.8 cents of the reduced rate is retained in the General Fund.²⁴

Biodiesel

If biodiesel is used in the production of blended taxable fuel, the Code imposes tax on the removal or sale of the blended taxable fuel.²⁵ In addition, the Code imposes tax on any liquid other than gasoline sold for use or used as a fuel in a diesel-powered highway vehicle or diesel-powered train unless tax was previously imposed and not refunded or credited.²⁶ If biodiesel that was not previously taxed or exempt is sold for use or used as a fuel in a diesel-powered highway vehicle or a diesel-powered train, tax is imposed.²⁷ There are no reduced excise tax rates for biodiesel.

Description of Proposal

Alcohol and Biodiesel Fuel Excise Tax Credit

Overview

The proposal eliminates reduced rates of excise tax for most alcohol-blended fuels and imposes the full rate of excise tax on alcohol-blended fuels (18.3 cents per gallon on gasoline blends and 24.3 cents per gallon of diesel blended fuel). In place of reduced rates, the proposal creates two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit.²⁸ The sum of these credits may be taken against the tax imposed on taxable fuels (by

²³ Sec. 9503(b)(4)(E).

²⁴ Sec. 9503(b)(4)(F).

²⁵ Sec. 4081(b); Rev. Rul. 2002-76, 2002-46 I.R.B. 841 (2002). “Taxable fuels” are gasoline, diesel and kerosene (sec. 4083). Biodiesel, although suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train, contains less than four percent normal paraffins and, therefore, is not treated as diesel fuel under the applicable Treasury regulations. Treas. Reg. secs. 48.4081-1(c)(2)(i) and (ii), and 48.4081-1(b); Rev. Rul. 2002-76, 2002-46 I.R.B. 841 (2002). As a result, biodiesel alone is not a taxable fuel for purposes of section 4081. As noted above, however, tax is imposed upon the removal or entry of blended taxable fuel made with biodiesel.

²⁶ Sec. 4041. The tax imposed under section 4041 also will not apply if an exemption from tax applies.

²⁷ Rev. Rul. 2002-76, 2002-46 I.R.B. 841 (2002).

²⁸ Although eligible mixtures are defined as those (1) sold for use or used as a fuel by the taxpayer producing the mixture or (2) removed from the refinery by a person producing the mixture, the credit for the alcohol or biodiesel used to produce such a mixture may be claimed only once. Thus, if the person selling the mixture is also the same person removing it from the

section 4081). The proposal allows taxpayers to file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture. The amount of the excise tax credit with respect to any alcohol or biodiesel is reduced to take into account the benefit of any payments with respect to such alcohol or biodiesel. Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit or biodiesel fuel mixture credit is claimed with respect to alcohol or biodiesel used in the production of any alcohol or biodiesel mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The proposal also provides for payments based on the use or retail sale of 100 percent biodiesel or alcohol as a fuel. The proposal eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund. The proposal also extends the present-law alcohol fuels income tax credit through December 31, 2010.

Alcohol fuel mixture excise tax credit

The proposal eliminates the reduced rates of excise tax for alcohol-blended fuels. Under the proposal, the full rate of tax for taxable fuels is imposed on both alcohol fuel mixtures and the taxable fuel used to produce an alcohol fuel mixture.

In lieu of the reduced excise tax rates, the proposal provides for an excise tax credit, the alcohol fuel mixture credit. The alcohol fuel mixture credit is 52 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. The credit declines to 51 cents per gallon after calendar year 2004. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon.

For purposes of the alcohol fuel mixture credit, an “alcohol fuel mixture” is a mixture of alcohol and a taxable fuel that is (1) sold for use or used as a fuel by the taxpayer producing the mixture or (2) removed from the refinery by a person producing the mixture. Alcohol for this purpose includes methanol, ethanol, and alcohol gallon equivalents of ETBE or other ethers produced from such alcohol. It does not include alcohol produced from petroleum, natural gas, or coal (including peat), or alcohol with a proof of less than 190 (determined without regard to any added denaturants). Taxable fuel is gasoline, diesel, and kerosene.²⁹

The excise tax credit is coordinated with the alcohol fuels income tax credit and is available through December 31, 2010.

Biodiesel mixture excise tax credit

The proposal provides an excise tax credit for biodiesel mixtures.³⁰ The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for refinery, the credit is available only once with respect to the alcohol or biodiesel contained in the mixture.

²⁹ Sec. 4083(a)(1). Under present law, dyed fuels are taxable fuels that have been exempted from tax.

³⁰ The excise tax credit uses the same definitions as the biodiesel fuels income tax credit.

sale or use in a trade or business of the taxpayer. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold for use or used by the taxpayer producing such mixture as a fuel, or (2) removed from the refinery by a person producing the mixture. In the case of agri-biodiesel, the amount of the credit is \$1.00 per gallon and applies only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the agri-biodiesel that identifies the product produced.

The credit is not available for any sale or use for any period after December 31, 2006. This excise tax credit is coordinated with income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Registration requirements

Under the proposal, registration is required of every person that produces or imports biodiesel or alcohol.

Payments with respect to qualified mixtures and 100 percent alcohol and 100 percent biodiesel used as fuel

If any person produces a qualified alcohol or biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the alcohol fuel mixture credit or the biodiesel mixture credit with respect to such mixture. If 100 percent alcohol (neat excluding denaturant), biodiesel, or agri-biodiesel not mixed with a taxable fuel is (i) used by any person as a fuel in a trade or business or (ii) sold by any person at retail to another person and placed in the fuel tank of such person's vehicle, the Secretary is to pay such person an amount equal to the alcohol credit (as determined under section 40) or the biodiesel credit with respect to such fuel. The proposal does not apply with respect to alcohol fuel or alcohol fuel mixtures sold or used after December 31, 2010. It does not apply to biodiesel, agri-biodiesel or qualified biodiesel mixtures sold or used after December 31, 2006.

Claims for payment.—If claims for payment are not paid within 45 days, the claim is to be paid with interest. The provision also provides that in the case of an electronic claim, if such claim is not paid within 20 days, the claim is to be paid with interest. If claims are filed electronically, the claimant may make a claim for less than \$200. The Secretary is to describe the electronic format for filing claims by September 30, 2004.

Highway Trust Fund

The proposal eliminates the requirement that 2.5 and 2.8 cents per gallon of excise taxes be retained in the General Fund with the result that the full amount of tax on alcohol fuels is credited to the Highway Trust Fund. The proposal also authorizes the full amount of fuel taxes to be appropriated to the Highway Trust Fund without reduction for amounts equivalent to the excise tax credits allowed for alcohol fuel mixtures and biodiesel mixtures.

Alcohol fuels income tax credit

The proposal extends the alcohol fuels credit (sec. 40) through December 31, 2010.

Effective Dates

The proposals generally are effective for fuel sold or used after September 30, 2004. The repeal of the General Fund retention of the 2.5/2.8 cents per gallon regarding alcohol fuels is effective for fuel sold or used after September 30, 2003. The Secretary is to provide electronic filing instructions by September 30, 2004. The extension of section 40 alcohol fuels credit is effective on the date of enactment.

B. Biodiesel Income Tax Credit

Present Law

No income tax credit or excise tax rate reduction is provided for biodiesel fuels under present law. However, a 52-cents-per-gallon income tax credit (the “alcohol fuels credit”) is allowed for ethanol and methanol (derived from renewable sources) when the alcohol is used as a highway motor fuel. Registered blenders may forgo the full income tax credit and instead pay reduced rates of excise tax on gasoline that they purchase for blending with alcohol. These present law provisions are scheduled to expire in 2007.

Description of Proposal

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

The proposal provides a new income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit. The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed above. The credit may not be carried back to a taxable year ending before or on September 30, 2004. The proposal does not apply to fuel sold or used after December 31, 2006.

Agri-biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the agri-biodiesel which identifies the product produced.

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is \$1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

The biodiesel credit is 50 cents for each gallon of 100 percent biodiesel which is not in a mixture with diesel fuel and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person’s vehicle. For agri-biodiesel, the credit is \$1.00 per gallon.

Later separation or failure to use as fuel

In a manner similar to the treatment of alcohol fuels, a tax is imposed if a biodiesel fuels credit is claimed with respect to biodiesel that is subsequently used for a purpose for which the credit is not allowed or that is changed into a substance that does not qualify for the credit.

Effective Date

The biodiesel fuel income tax credit proposal is effective for fuel produced, and sold or used after September 30, 2004, in taxable years ending after such date.

III. FUEL FRAUD PREVENTION

A. Aviation Fuel

Present Law

In general

Aviation fuel is kerosene and any liquid (other than any product taxable under section 4081) that is suitable for use as a fuel in an aircraft.³¹ Unlike other fuels that generally are taxed upon removal from a terminal rack,³² aviation fuel is taxed upon sale of the fuel by a producer or importer.³³ Sales by a registered producer to another registered producer are exempt from tax, with the result that, as a practical matter, aviation fuel is not taxed until the fuel is used at the airport. Use of untaxed aviation fuel by a producer is treated as a taxable sale.³⁴ The producer or importer is liable for the tax. The rate of tax on aviation fuel is 21.9 cents per gallon.³⁵

The tax on aviation fuel is reported by filing Form 720 - Quarterly Federal Excise Tax Return. Generally, semi-monthly deposits are required using Form 8109B - Federal Tax Deposit Coupon or by depositing the tax by electronic funds transfer.

Partial exemptions

In general, aviation fuel sold for use or used in commercial aviation is taxed at a reduced rate of 4.4 cents per gallon.³⁶ Commercial aviation means any use of an aircraft in a business of

³¹ Sec. 4093(a).

³² A rack is a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel. Treas. Reg. sec. 48.4081-1(b).

³³ Sec. 4091(a)(1).

³⁴ Sec. 4091(a)(2).

³⁵ Sec. 4091(b). This rate includes a 0.1 cent per gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax. The LUST Trust Fund tax is set to expire after March 31, 2005, with the result that on April 1, 2005, the tax rate is scheduled to be 21.8 cents per gallon. Secs. 4091(b)(3)(B) & 4081(d)(3). Beginning on October 1, 2007, the rate of tax is reduced to 4.3 cents per gallon. Sec. 4091(b)(3)(A).

³⁶ Sec. 4092(b). The 4.4 cent rate includes 0.1 cent per gallon that is attributable to the LUST Trust Fund financing rate. A full exemption, discussed below, applies to aviation fuel that is sold for use in commercial aviation as fuel supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers. Secs. 4092(a), 4092(b), & 4221(d)(3).

transporting persons or property for compensation or hire by air (unless the use is allocable to any transportation exempt from certain excise taxes).³⁷

In order to qualify for the 4.4 cents per gallon rate, the person engaged in commercial aviation must be registered with the Secretary³⁸ and provide the seller with a written exemption certificate stating the airline's name, address, taxpayer identification number, registration number, and intended use of the fuel. A person that is registered as a buyer of aviation fuel for use in commercial aviation generally is assigned a registration number with a "Y" suffix (a "Y" registrant), which entitles the registrant to purchase aviation fuel at the 4.4 cents per gallon rate.

Large commercial airlines that also are producers of aviation fuel qualify for registration numbers with an "H" suffix. As producers of aviation fuel, "H" registrants may buy aviation fuel tax free pursuant to a full exemption that applies to sales of aviation fuel by a registered producer to a registered producer. If the "H" registrant ultimately uses such untaxed fuel in domestic commercial aviation, the H registrant is liable for the aviation fuel tax at the 4.4 cents per gallon rate.

Exemptions

Aviation fuel sold by a producer or importer for use by the buyer in a nontaxable use is exempt from the excise tax on sales of aviation fuel.³⁹ To qualify for the exemption, the buyer must provide the seller with a written exemption certificate stating the buyer's name, address, taxpayer identification number, registration number (if applicable), and intended use of the fuel.

Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions;⁴⁰ (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing

³⁷ Secs. 4092(b) & 4041(c)(2).

³⁸ Form 637 - Application for Registration (For Certain Excise Tax Activities). A bond may be required as a condition of registration.

³⁹ Sec. 4092(a).

⁴⁰ "Trade" includes the transportation of persons or property for hire. Treas. Reg. sec. 48.4221-4(b)(8).

aircraft for purposes of providing transportation with respect to which certain requirements are met.⁴¹

A producer that is registered with the Secretary may sell aviation fuel tax-free to another registered producer.⁴² Producers include refiners, blenders, wholesale distributors of aviation fuel, dealers selling aviation fuel exclusively to producers of aviation fuel, the actual producer of the aviation fuel, and with respect to fuel purchased at a reduced rate, the purchaser of such fuel.

Refunds and Credits

A claim for refund of taxed aviation fuel held by a registered aviation fuel producer is allowed⁴³ (without interest) if: (1) the aviation fuel tax was paid by an importer or producer (the “first producer”) and the tax has not otherwise been credited or refunded; (2) the aviation fuel was acquired by a registered aviation fuel producer (the “second producer”) after the tax was paid; (3) the second producer files a timely refund claim with the proper information; and (4) the first producer and any other person that owns the fuel after its sale by the first producer and before its purchase by the second producer have met certain reporting requirements.⁴⁴ Refund claims should contain the volume and type of aviation fuel, the date on which the second producer acquired the fuel, the amount of tax that the first producer paid, a statement by the claimant that the amount of tax was not collected nor included in the sales price of the fuel by the claimant when the fuel was sold to a subsequent purchaser, the name, address, and employer identification number of the first producer, and a copy of any required statement of a subsequent seller (subsequent to the first producer but prior to the second producer) that the second producer received. A claim for refund is filed on Form 8849, Claim for Refund of Excise Taxes, and may not be combined with any other refunds.⁴⁵

A payment is allowable to the ultimate purchaser of taxed aviation fuel if the aviation fuel is used in a nontaxable use.⁴⁶ A claim for payment may be made on Form 8849 or on Form 720, Schedule C. A claim made on Form 720, Schedule C, may be netted against the claimant’s excise tax liability.⁴⁷ Claims for payment not so taken may be allowable as income tax credits⁴⁸ on Form 4136, Credit for Federal Tax Paid on Fuels.

⁴¹ Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 4092.

⁴² Sec. 4092(c).

⁴³ Sec. 4091(d).

⁴⁴ Treas. Reg. sec. 48.4091-3(b).

⁴⁵ Treas. Reg. sec. 48.4091-3(d)(1).

⁴⁶ Sec. 6427(l)(1).

⁴⁷ Treas. Reg. sec. 40.6302(c)-1(a)(3).

⁴⁸ Sec. 34.

Description of Proposal

The proposal changes the incidence of taxation of aviation fuel from the sale of aviation fuel to the removal of aviation fuel from a refinery or terminal, or the entry into the United States of aviation fuel. Sales of not previously taxed aviation fuel to an unregistered person also are subject to tax.

Under the proposal, the full rate of tax -- 21.9 cents per gallon -- is imposed upon removal of aviation fuel from a refinery or terminal rack (or entry into the United States). Aviation fuel may be removed at a reduced rate -- either 4.4 or zero cents per gallon -- only if the aviation fuel: (1) is removed directly into the wing of an aircraft that either is registered with the Secretary as a buyer of aviation fuel for use in commercial aviation (a "Y" registrant under current law) or is a foreign airline entitled to the present law exemption for aviation fuel used in foreign trade; or (2) is removed or entered as part of an exempt bulk transfer.⁴⁹ An exempt bulk transfer is a removal or entry of aviation fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the aviation fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.

The proposal does not change the applicable rates of tax under present law -- 21.9 cents per gallon for use in noncommercial aviation, 4.4 cents per gallon for use in commercial aviation, and zero cents per gallon for use by domestic airlines in an international flight, by foreign airlines, or other nontaxable use. The proposal does not change present-law nontaxable uses of aviation fuel, or change the persons or the qualifications of persons who are entitled to purchase fuel at a reduced rate, except that a producer is not permitted to purchase aviation fuel at a reduced rate by reason of such persons' status as a producer.⁵⁰ A person entitled to purchase aviation fuel at a reduced rate may not purchase such fuel at such rate if the person has to remove the fuel to make the purchase, unless one of the two exceptions above apply. Instead, the person would pay 21.9 cents per gallon and be in a refund position.

Under the proposal, a refund is allowable to the ultimate vendor of aviation fuel if such ultimate vendor purchases fuel tax paid and subsequently sells the fuel to a person qualified to purchase at a reduced rate. In such a case, the proposal permits an ultimate vendor to net refund claims against any excise tax liability of the ultimate vendor, in a manner similar to the present law treatment of ultimate purchaser payment claims.

As under present law, if previously taxed aviation fuel is used for a nontaxable use, the user may claim a refund for the tax previously paid. If previously taxed aviation fuel is used for a taxable non aircraft use, the fuel is subject to the tax imposed on kerosene (24.4 cents per gallon) and a refund of the previously paid aviation fuel tax is allowed. Claims by the ultimate

⁴⁹ See sec. 4081(a)(1)(B).

⁵⁰ Accordingly, the present law refund that is provided for a registered producer of aviation fuel that establishes that a prior excise tax was paid, and not credited or refunded, on aviation fuel held by the producer is not allowed under the proposal.

vendor or the purchaser that are not taken as refund claims may be allowable as income tax credits.

For example, for an airport that is not served by a pipeline, aviation fuel generally is removed from a terminal and transported to an airport storage facility for eventual use at the airport. In such a case, the aviation fuel will be taxed at 21.9 cents per gallon upon removal from the terminal. At the airport, if the fuel is purchased by a person registered with the Secretary to use fuel in commercial aviation, the purchaser may buy the fuel at a reduced rate (generally, 4.4 cents per gallon for domestic flights and zero cents per gallon for international flights) and the ultimate vendor may claim a refund for the difference between 21.9 cents per gallon of tax paid upon removal and the rate of tax paid to the vendor by the purchaser. To obtain a zero rate upon purchase, a registered domestic airline must certify to the vendor at the time of purchase that the fuel is for use in an international flight; otherwise, the airline must pay the 4.4 cents per gallon rate and file a claim for refund to the Secretary if the fuel is used for international aviation. If a zero rate is paid and the fuel subsequently is used in domestic and not international travel, the domestic airline is liable for tax at 4.4 cents per gallon. A foreign airline eligible under present law to purchase aviation fuel tax-free would continue to purchase such fuel tax free.

As another example, for an airport that is served by a pipeline, aviation fuel generally is delivered to the wing of an aircraft either by truck (or other vehicle) or by a “hydrant” that runs directly from the pipeline to the airplane wing. If a truck removes aviation fuel from the terminal rack at the airport and delivers the fuel to an aircraft, the aviation fuel is taxed at 21.9 cents per gallon upon removal and the ultimate vendor is entitled to a refund of the difference between 21.9 cents per gallon paid on removal and the rate paid by the airline purchaser. If the fuel is removed from the terminal rack directly to the wing of an aircraft registered to use fuel in commercial aviation by a hydrant or similar device, the person removing the aviation fuel pays 4.4 cents per gallon (or zero in the case of an international flight or qualified foreign airline).

Under the proposal, a floor stocks tax applies to aviation fuel held by a producer, as such term is defined under present law, if: (1) the aviation fuel tax has not been paid with respect to such fuel; and (2) such fuel would have been subject to the aviation fuel tax upon a prior removal, entry, or sale of such fuel if the proposal had been in effect at the time of such removal, entry, or sale. The rate of tax is 4.4 cents per gallon in the case of fuel held for use or sale for use in commercial aviation and 21.9 cents per gallon in any other case. The Secretary shall determine the time at which the tax is to be paid. Under the proposal, 4.3 cents per gallon of such tax collected at the 4.4 cents per gallon rate, and 21.8 cents per gallon of such tax collected at the 21.9 cents per gallon rate are transferred to the Airport and Airway Trust Fund. The remainder is transferred to the LUST Trust Fund.

Effective Date

The proposal is effective for aviation fuel removed, entered, or sold after September 30, 2004.

B. Proposals Relating to Dyed Fuel

Present Law

Statutory Rules

Gasoline, diesel fuel and kerosene are generally subject to excise tax upon removal from a refinery or terminal, upon importation into the United States, and upon sale to unregistered persons unless there was a prior taxable removal or importation of such fuels.⁵¹ However, a tax is not imposed upon diesel fuel or kerosene if all of the following are met: (1) the Secretary determines that the fuel is destined for a nontaxable use, (2) the fuel is indelibly dyed in accordance with regulations prescribed by the Secretary,⁵² and (3) the fuel meets marking requirements prescribed by the Secretary.⁵³ A nontaxable use is defined as (1) any use that is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax, (2) any use in a train, or (3) certain uses in buses for public and school transportation, as described in section 6427(b)(1) (after application of section 6427(b)(3)).⁵⁴

The Secretary is required to prescribe necessary regulations relating to dyeing, including specifically the labeling of retail diesel fuel and kerosene pumps.⁵⁵

A person who sells dyed fuel (or holds dyed fuel for sale) for any use that such person knows (or has reason to know) is a taxable use, or who willfully alters or attempts to alter the dye in any dyed fuel, is subject to a penalty.⁵⁶ The penalty also applies to any person who uses dyed fuel for a taxable use (or holds dyed fuel for such a use) and who knows (or has reason to know) that the fuel is dyed.⁵⁷ The penalty is the greater of \$1,000 per act or \$10 per gallon of dyed fuel

⁵¹ Sec. 4081(a)(1)(A). If such fuel is used for a nontaxable purpose, the purchaser is entitled to a refund of tax paid, or in some cases, an income tax credit. See sec. 6427.

⁵² Dyeing is not a requirement, however, for certain fuels under certain conditions, i.e., diesel fuel or kerosene exempted from dyeing in certain States by the EPA under the Clean Air Act, aviation-grade kerosene as determined under regulations prescribed by the Secretary, kerosene received by pipeline or vessel and used by a registered recipient to produce substances (other than gasoline, diesel fuel or special fuels), kerosene removed or entered by a registrant to produce such substances or for resale, and (under regulations) kerosene sold by a registered distributor who sells kerosene exclusively to ultimate vendors that resell it (1) from a pump that is not suitable for fueling any diesel-powered highway vehicle or train, or (2) for blending with heating oil to be used during periods of extreme or unseasonable cold. Sec. 4082(c), (d).

⁵³ Sec. 4082(a).

⁵⁴ Sec. 4082(b).

⁵⁵ Sec. 4082(e).

⁵⁶ Sec. 6715(a).

⁵⁷ Sec. 6715(a).

involved. In determining the amount of the penalty, the \$1,000 is increased by the product of \$1,000 and the number of prior penalties imposed upon such person (or a related person or predecessor of such person or related person).⁵⁸ The penalty may be imposed jointly and severally on any business entity, each officer, employee, or agent of such entity who willfully participated in any act giving rise to such penalty.⁵⁹ For purposes of the penalty, the term “dyed fuel” means any dyed diesel fuel or kerosene, whether or not the fuel was dyed pursuant to section 4082.⁶⁰

Regulations

The Secretary has prescribed certain regulations under this provision, including regulations that specify the allowable types and concentration of dye, that the person claiming the exemption must be a taxable fuel registrant, that the terminal must be an approved terminal (in the case of a removal from a terminal rack), and the contents of the notice to be posted on diesel fuel and kerosene pumps.⁶¹ However, the regulations do not prescribe the time or method of adding the dye to taxable fuel.⁶² Diesel fuel is usually dyed at a terminal rack by either manual dyeing or mechanical injection.

Description of Proposal

With respect to terminals that offer dyed fuel, the proposal eliminates manual dyeing of fuel and requires dyeing by a mechanical system. On or before June 30, 2004, the Secretary of the Treasury is to prescribe regulations establishing standards for tamper resistant mechanical injector dyeing. Such standards shall be reasonable, cost-effective, and establish levels of security commensurate with the applicable facility.

The proposal adds an additional set of penalties for violation of the new rules. A penalty, equal to the greater of \$25,000 or \$10 for each gallon of fuel involved, applies to each act of tampering with a mechanical dye injection system. The person committing the act is also responsible for any unpaid tax on removed undyed fuel. A penalty of \$1,000 is imposed for each failure to maintain security for mechanical dye injection systems. An additional penalty of \$1,000 is imposed for each day any such violation remains uncorrected after the first day such violation has been or reasonably should have been discovered. For purposes of the daily penalty,

⁵⁸ Sec. 6715(b).

⁵⁹ Sec. 6715(d).

⁶⁰ Sec. 6715(c)(1).

⁶¹ See Treas. Reg. secs. 48.4082-1, -2.

⁶² In March 2000, the IRS withdrew its Notice of Proposed Rulemaking PS-6-95 (61 F.R. 10490 (1996)) relating to dye injection systems. Announcement 2000-42, 2000-1 C.B. 949. The proposed regulation established standards for mechanical dye injection equipment and required terminal operators to report nonconforming dyeing to the IRS. See also Treas. Reg. sec. 48.4082-1(c), (d).

a violation may be corrected by shutting down the portion of the system causing the violation. If any of these penalties are imposed on any business entity, each officer, employee, or agent of such entity or other contracting party who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty. If such business entity is part of an affiliated group, the parent corporation of such entity shall be jointly and severally liable with such entity for the penalty.

The proposal also limits certain remedies for repeat offenders of present law. In the case of any person who is subject to the present law penalty after a chemical analysis of such fuel, and who has been penalized at least twice under present law after the date of enactment, no administrative appeal or review shall be allowed except in the case of a claim regarding fraud or mistake in the chemical analysis or error in the mathematical calculation of the amount of penalty.

The proposal extends the present law penalties for selling or using dyed fuel for a taxable use. Under the proposal, such penalties apply to any person who knows that untaxed or partially taxed dyed fuel has been chemically altered in an attempt to remove the dye and who sells (or holds for sale) such fuel for any use that the person knows (or has reason to know) is a taxable use.

Effective Date

The proposal requiring the use of mechanical dye injection systems and imposing penalties is effective 180 days after the date that the Secretary issues the required regulations. The Secretary must issue such regulations no later than June 30, 2004. The proposal regarding prohibition of certain administrative review is effective for penalties assessed after the date of enactment. The proposal extending present law penalties is effective on the date of enactment.

C. Modification of Inspection of Records Provisions

1. Authority to inspect on-site records

Present Law

The Internal Revenue Service is authorized to inspect any place where taxable fuel is produced or stored (or may be stored). The inspection is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection, include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.⁶³

In conducting the inspection, the Internal Revenue Service may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks and storage tanks. The scope of the inspection includes the book and records kept to determine the excise tax liability under section 4081.⁶⁴

Description of Proposal

The proposal expands the scope of the inspection to include any books, records or shipping papers pertaining to the sale and transportation of taxable fuel, located in any authorized inspection locations or possessed by any carrier.

Effective Date

The proposal is effective on the date on enactment.

2. Assessable penalty for refusal of entry

Present Law

The Internal Revenue Service is authorized to inspect any place where taxable fuel is produced or stored (or may be stored). As part of the inspection, the Internal Revenue Service is authorized to: (1) examine the equipment used to determine the amount or composition of the taxable fuel and the equipment used to store the fuel; and (2) take and remove samples of taxable fuel. Places of inspection, include, but are not limited to, terminals, fuel storage facilities, retail fuel facilities or any designated inspection site.⁶⁵

In conducting the inspection, the Internal Revenue Service may detain any receptacle that contains or may contain any taxable fuel, or detain any vehicle or train to inspect its fuel tanks

⁶³ Sec. 4083(c)(1)(A).

⁶⁴ Treas. Reg. sec. 48.4083-1(b)(2).

⁶⁵ Sec. 4083(c)(1)(A).

and storage tanks. The scope of the inspection includes the book and records kept to determine the excise tax liability under section 4081.⁶⁶ The Internal Revenue Service is authorized to establish inspection sites. A designated inspection site includes any State highway inspection station, weigh station, agricultural inspection station, mobile station or other location designated by the Internal Revenue Service.⁶⁷

Any person that refuses to allow an inspection is subject to a penalty in the amount of \$1,000 for each refusal.⁶⁸ The IRS is not able to assess this penalty in the same manner as it would a tax. It must first seek the assistance of the Department of Justice to obtain a judgment. Assessable penalties are payable upon notice and demand by the Secretary and are assessed and collected in the same manner as taxes.⁶⁹

Description of Proposal

In addition to the \$1,000 penalty under present law, an assessable penalty is imposed with respect to the refusal of entry of any person with the intent to transport and distribute untaxed, adulterated fuel mixtures or to transport and distribute dyed diesel fuel for taxable use. The assessable penalty is \$1,000 for such refusal. The penalty will not apply if it is shown that such failure is due to reasonable cause. If the penalty is imposed on a business entity, the proposal provides for joint and several liability with respect to each officer, employee, or agent of such entity or other contracting party who willfully participated in the act giving rise to the penalty. If the business entity is part of an affiliated group, the parent corporation also will be jointly and severally liable for the penalty.

Effective Date

The proposal is effective on October 1, 2004.

⁶⁶ Treas. Reg. sec. 48.4083-1(b)(2).

⁶⁷ Sec. 4083(c); Treas. Reg. sec. 48.4083-1(b)(1).

⁶⁸ Sec. 4083(c)(3) and 7342.

⁶⁹ Sec. 6671.

D. Registration and Reporting Requirements

1. Narrow exemption for bulk transfer and provide for penalty

Present Law

In general, gasoline, diesel fuel, and kerosene (“taxable fuel”) are taxed upon removal from a refinery or a terminal.⁷⁰ Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a “bulk transfer”) to a terminal or refinery if the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.⁷¹ For example, if a registered vessel or pipeline operator removes fuel in bulk from a registered refiner and transfers the fuel to a registered terminal operator, tax is not imposed on the bulk transfer. For the bulk transfer exemption to apply, the “position holder” with respect to the taxable fuel, i.e., the person shown on the records of the terminal facility as owning the fuel, must be registered with the Secretary.⁷²

Present law does not require that every vessel or pipeline operator that transfers fuel as part of a bulk transfer be registered in order for the transfer to be exempt. For example, a registered vessel or pipeline operator may remove fuel from a registered refiner and transfer the fuel to an unregistered vessel or pipeline operator who in turn transfers fuel to a registered terminal operator. The transfer is exempt despite the intermediate transfer by an unregistered person.

In general, the position holder is liable for payment of tax with respect to taxable removals from the terminal rack and bulk transfers not received at an approved terminal or refinery.⁷³ The refiner is liable for payment of tax with respect to certain taxable removals from the refinery.⁷⁴

Description of Proposal

The proposal requires that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the bulk transfer be registered with the Secretary. Transfer to an unregistered party will subject the transfer to tax.

⁷⁰ Sec. 4081(a)(1)(A).

⁷¹ Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

⁷² Treas. Reg. sec. 48.4081-3(d).

⁷³ Treas. Reg. sec. 48.4081-2; Treas. Reg. sec. 48.4081-3(d) & (e).

⁷⁴ Treas. Reg. sec. 48.4081-3(b).

With respect to a bulk transfer on which no tax is paid, the proposal imposes a penalty on any person who knowingly transfers taxable fuel in bulk to an unregistered person. The penalty is the greater of \$10,000 or \$1 per gallon. The penalty is increased for multiple prior violations by an amount equal to the amount of the penalty, as determined above, multiplied by the number of prior violations. If the penalty is imposed on any business entity, each officer, employee, or agent of such entity, or contracting party who willfully participated in any act giving rise to the penalty, is jointly and severally liable with such entity for such penalty. If the business entity is part of an affiliated group, the parent corporation also will be jointly and severally liable for the penalty. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The Secretary is required to publish a list of all registered persons. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

Effective Date

The proposal is effective on October 1, 2004, except that the Secretary is required to publish a list of all registered persons by June 30, 2004.

2. Modification of registration requirements

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.⁷⁵ A non assessable penalty for failure to register is \$50.⁷⁶ A criminal penalty of \$5,000, or imprisonment of not more than 5 years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.⁷⁷

Present law does not provide the Secretary with explicit authority to require registration by a person that operates a terminal or refinery within a foreign trade zone.

Description of Proposal

The proposal imposes a new assessable penalty for failure to register of \$10,000 for each initial failure, plus \$1,000 per day that the failure continues. In addition, the proposal increases the present law non assessable penalty for failure to register from \$50 to \$10,000 and the present law criminal penalty for failure to register from \$5,000 to \$10,000.

The proposal requires that every operator of a vessel who is required to register with the Secretary display on each vessel used by the operator to transport fuel, proof of registration through an electronic identification device prescribed by the Secretary. A failure to display such

⁷⁵ Sec. 4101; Treas. Reg. sec. 48.4101-1(a) & (c)(1).

⁷⁶ Sec. 7272(a).

⁷⁷ Sec. 7232.

proof of registration results in a penalty of \$500 per month per vessel. The amount of the penalty is increased for multiple prior violations by an amount equal to the amount determined above multiplied by the number of prior violations. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

Under the proposal, the Secretary shall require that persons that operate a terminal or refinery or a customs bonded storage facility within a foreign trade zone register and report to the Secretary.

Effective Date

The proposal is effective on October 1, 2004.

3. Modification of information reporting

Present Law

A fuel information reporting program, the Excise Summary Terminal Activity Reporting System (“ExSTARS”), requires terminal operators and bulk transport carriers to report monthly on the movement of any liquid product into or out of an approved terminal.⁷⁸ Terminal operators file Form 720-TO - Terminal Operator Report, which shows the monthly receipts and disbursements of all liquid products to and from an approved terminal.⁷⁹ Bulk transport carriers (barges, vessels, and pipelines) that receive liquid product from an approved terminal or deliver liquid product to an approved terminal file Form 720-CS - Carrier Summary Report, which details such receipts and disbursements. In general, the penalty for failure to file a report or a failure to furnish all of the required information in a report is \$50 per report.⁸⁰ ExSTARS reports are not required to be filed electronically.

Description of Proposal

The proposal imposes a new assessable penalty for failure to report information in a report required by the ExSTARS system. The penalty is \$10,000 per failure with respect to each terminal, vessel, or pipeline for which information is required to be furnished. No penalty is imposed upon a showing by the taxpayer of reasonable cause. The proposal authorizes amounts equivalent to the penalties received to be appropriated to the Highway Trust Fund.

⁷⁸ Sec. 4010(d); Treas. Reg. sec. 48.4101-2. The reports are required to be filed by the end of the month following the month to which the report relates.

⁷⁹ An approved terminal is a terminal that is operated by a taxable fuel registrant that is a terminal operator. Treas. Reg. sec. 48.4081-1(b).

⁸⁰ Sec. 6721(a).

The proposal requires that ExSTARs reports be made electronically. Under the proposal, the Secretary is to describe the electronic format for filing such reports 30 days prior to the effective date.

Effective Date

The proposal is effective on October 1, 2004.

4. Information reporting for persons claiming certain tax benefits

Present Law

The Code provides an income tax credit for each gallon of ethanol and methanol derived from renewable sources (*e.g.*, biomass) used or sold as a fuel, or used to produce a qualified alcohol fuel mixture, such as gasohol. The amount of the credit is equal to 52 cents per gallon (ethanol)⁸¹ and 60 cents per gallon (methanol).⁸² This tax credit is provided to blenders of the alcohols with other taxable fuels, or to the retail sellers of unblended alcohol fuels. Part or all of the benefits of the income tax credit may be claimed through reduced excise taxes paid, either in reduced-tax sales or by expedited blender refunds on fully taxed sales of gasoline to obtain the benefit of the reduced rates. The amount of the income tax credit determined with respect to any alcohol is reduced to take into account any benefit provided by the reduced excise tax rates. To obtain a partial refund on fully taxed gasoline, the following requirements apply: (1) the claim must be for gasohol sold or used during a period of at least one week, (2) the claim must be for at least \$200, and (3) the claim must be filed by the last day of the first quarter following the earliest quarter included in the claim. If the blender cannot meet these requirements, the blender must claim a credit on the blender's income tax return.

Description of Proposal

The proposal requires persons claiming the Code benefits related to alcohol fuels to provide such information related to such benefits and the coordination of such benefits as the Secretary may require to ensure the proper administration and use of such benefits. The Secretary may deny, revoke or suspend the registration of any person to enforce this requirement.

Effective Date

The proposal is effective October 1, 2004.

⁸¹ The 52-cents-per-gallon credit is scheduled to decline to 51 cents per gallon beginning in calendar year 2005. The credit is scheduled to expire after the earlier of (1) expiration of the Highway Trust Fund excise taxes or (2) December 31, 2007.

⁸² Ethanol produced by certain "small producers" is eligible for an additional producer tax credit of 10 cents per gallon. Eligible small producers are defined as persons whose production capacity does not exceed 30 million gallons and whose annual production does not exceed 15 million gallons.

E. Imports

1. Tax at point of entry

Present Law

Gasoline, diesel fuel, and kerosene are taxed when the fuels are removed from a refinery or registered pipeline or barge terminal.⁸³ Typically, these fuels are transferred by pipeline or barge in large quantities (“bulk”) to terminal storage facilities that geographically are located closer to destination retail markets. A fuel is taxed when it “breaks bulk,” *i.e.*, when it is removed from the refinery or terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The party liable for payment of the taxes is the “position holder,” *i.e.*, the person shown on the records of the terminal facility as owning the fuel.

Tax is also imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing.⁸⁴ This tax does not apply to any entry of a taxable fuel transferred in bulk to a terminal or refinery if the person entering the taxable fuel and the operator of such terminal or refinery are registered. The “enterer” is liable for the tax. An enterer generally means the importer of record (under customs law) with respect to the taxable fuel. However, if the importer of record is acting as an agent (a broker for example), the person for whom the agent is acting is the enterer. If there is no importer of record for taxable fuel entered into the United States, the owner of the taxable fuel at the time it is brought into the United States is the enterer. An importer’s liability for Customs duties includes a liability for any internal revenue taxes that attach upon the importation of merchandise unless otherwise provided by law or regulation. (19 CFR 141.3).

If the Secretary believes that the collection of any tax under any provision of the internal revenue laws will be jeopardized by delay, the Secretary is required to, whether or not the time otherwise prescribed for making return and paying tax has expired, immediately assess such tax.⁸⁵ Such tax, additions to tax, and interest is immediately due and payable and the Secretary is to make immediate notice and demand for payment. Such jeopardy assessments must have the personal approval of the Chief Counsel or his delegate prior to assessment.

Generally, if a taxpayer fails to pay within 10 days of notice and demand for payment of tax, the Secretary may levy on all property or rights to property belonging to such person.⁸⁶ If the Secretary makes a finding that the collection of such tax is in jeopardy, notice and demand for immediate payment of such tax may be made by the Secretary and, upon failure or refusal to pay such tax, the Secretary may collect such tax by levy.

⁸³ Sec. 4081(a)(1).

⁸⁴ Sec. 4081(a)(1)(A)(iii).

⁸⁵ Sec. 6862.

⁸⁶ Sec. 6331(a).

Description of Proposal

For fuel entering the United States (other than transfers in bulk) for consumption, use, or warehousing, the proposal provides that the tax is immediately due and payable at the time of entry, if the enterer is not registered with the IRS. Upon the failure to pay tax or post bond, the Customs Service is authorized under the proposal to deny entry of the shipment into the United States. The Secretary also may seize the fuel on which the tax is due or detain the vehicle transporting such fuel until such tax is paid. If no tax has been paid or bond filed within five days of the seizure, the Secretary may sell the fuel.

Effective Date

The proposal is effective upon date of enactment.

2. Reconciliation of on-loaded cargo to entered cargo

Present Law

The Trade Act of 2002 directed the Secretary to promulgate regulations pertaining to the electronic transmission to the Bureau of Customs and Border Patrol (“Customs”) of information pertaining to cargo destined for importation into the United States or exportation from the United States, prior to such importation or exportation.⁸⁷ The Department of the Treasury issued final regulations on October 31, 2002. The regulations require the advance and accurate presentation of certain manifest information prior to lading at the foreign port and encourage the presentation of this information electronically. Customs must receive from the carrier the vessel’s Cargo Declaration (Customs Form 1302) or the electronic equivalent within 24 hours before such cargo is laden aboard the vessel at the foreign port.⁸⁸ Certain carriers of bulk cargo, however, are exempt from these filing requirements. Such bulk cargo includes that composed of free flowing articles such as oil, grain, coal, ore and the like, which can be pumped or run through a chute or handled by dumping.⁸⁹ Thus, taxable fuels are not covered by the Cargo Declaration requirement.

Description of Proposal

The proposal requires that, not later than one year after the date of enactment, the Secretary of Homeland Security, together with the Secretary, promulgate regulations providing for the transmission to the Internal Revenue Service of information pertaining to cargo of taxable fuels destined for importation into the United States, prior to such importations. The proposal requires that imports of taxable fuels be subject to the Cargo Declaration and electronic reporting requirements.

⁸⁷ Sec. 343(a) of Pub. L. No. 107-210 (2002).

⁸⁸ 19 CFR sec. 4.7(b)(2).

⁸⁹ 19 CFR sec. 4.7(b)(4)(i)(A).

Effective Date

The proposal is effective upon date of enactment.

F. Miscellaneous Fuel Provisions

1. Tax on sale of diesel fuel whether suitable for use or not in a diesel-powered vehicle or train

Present Law

Under section 4081(a)(1), an excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not a taxable fuel registrant under section 4101, unless there was a prior taxable removal or entry.

Under section 4083(a), taxable fuel includes diesel fuel. Diesel fuel includes any liquid, other than gasoline, that without further processing or blending, is suitable for use as a fuel in a diesel-powered highway vehicle or train.⁹⁰ A liquid is suitable for this use if the liquid has practical and commercial fitness for use in the propulsion engine of a diesel-powered highway vehicle or diesel-powered train. A liquid may possess this practical and commercial fitness even though the specified use is not the liquid's predominant use. However, a liquid does not possess this practical and commercial fitness solely by reason of its possible or rare use as a fuel in the propulsion engine of a diesel-powered highway vehicle or diesel-powered train.

A tax is imposed on the removal or sale of blended taxable fuel by the blender thereof.⁹¹ Tax is computed on the difference between the total number of gallons of blended taxable fuel removed or sold and the number of gallons of previously taxed taxable fuel used to produce the blended taxable fuel.⁹² Blended taxable fuel means any taxable fuel that is produced outside the bulk transfer/terminal system by mixing (1) taxable fuel with respect to which tax has been imposed under section 4041(a)(1) or 4081(a) (other than taxable fuel for which a credit or payment has been allowed); and (2) any other liquid on which tax has not been imposed under section 4081.⁹³

The blender (the person making the blended taxable fuel) is liable for the tax on the increased volume. In addition, on and after April 2, 2003, a person that sells any liquid that is used to produce blended taxable fuel is jointly and severally liable for the tax on the removal or sale of that blended taxable fuel if the liquid is a liquid on which tax has not been imposed under section 4081; and is sold by that person as gasoline, diesel fuel, or kerosene that has been taxed under section 4081.⁹⁴

⁹⁰ Sec. 4083(a)(3).

⁹¹ Sec. 4081(b).

⁹² Treas. Reg. sec. 48.4081-3(g)(1).

⁹³ Treas. Reg. sec. 48.4081-1(c)(1)(i).

⁹⁴ Treas. Reg. sec. 48.4081-3(g)(2).

Description of Proposal

The proposal modifies the definition of diesel fuel to include any liquid (other than gasoline) sold or offered for sale as fuel whether or not the fuel is suitable for use as a fuel in a diesel-powered highway vehicle or train.

Effective Date

The proposal is effective on the date of enactment.

2. Modify ultimate vendor refund claims for diesel fuel and kerosene used on a farm for farming purposes

Present Law

In general, the Code provides that, if diesel fuel, kerosene, or aviation fuel on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) the amount of tax imposed. The refund is made to the ultimate purchaser of the taxed fuel. However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, refund payments are paid to the ultimate, registered vendors (“ultimate vendors”) of such fuels.

Description of Proposal

In the case of diesel fuel or kerosene used on a farm for farming purposes, the proposal limits ultimate vendor claims for refund to sales of such fuel in amounts less than 500 gallons per claim period.

Effective Date

The proposal is effective for fuels sold for nontaxable use after the date of enactment.

3. Permit ultimate vendors to administer credits and refunds of gasoline tax

Present Law

The Code provides that, in the case of gasoline on which tax has been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, a wholesale distributor that sells the gasoline for such exempt purposes is treated as the person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid. In the case of undyed diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, a credit or payment is allowable only to the ultimate, registered vendors (“ultimate vendors”) of such fuels.

In general, refunds are paid without interest. However, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, the Secretary is required to pay interest on certain refunds.

The Secretary must pay interest on refunds of \$200 or more (\$100 or more in the case of kerosene) due to the taxpayer arising from sales over any period of a week or more, if the Secretary does not make payment of the refund within 20 days.

Description of Proposal

For sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed, the proposal conforms the payment of refunds to that procedure established under present law in the case of diesel fuel or kerosene. That is, the ultimate vendor claims for refund.

The proposal modifies the payment of interest on refunds. Under the proposal, in the case of overpayments of tax on gasoline, diesel fuel, or kerosene that is used to produce a qualified alcohol mixture and for refunds due ultimate vendors of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, all refunds unpaid after 45 days must be paid with interest. If the taxpayer has filed for his or her refund by electronic means, refunds unpaid after 20 days must be paid with interest.

Lastly, for claims for refund of tax paid on diesel fuel or kerosene sold to State and local governments or for sales of gasoline to a State or local government for the exclusive use of a State or local government or to a nonprofit educational organization for its exclusive use on which tax has been imposed and for which the ultimate purchaser utilized a credit card, the proposal deems the person extending the credit to the ultimate purchaser to be the ultimate vendor. That is, the person extending credit via a credit card administers claims for refund, and is responsible for supplying all the appropriate documentation currently required from ultimate vendors.

Effective Date

The proposal is effective on October 1, 2004.

4. Two-party exchanges

Present Law

The person who holds the inventory position to the fuel in the terminal, as reflected on the records of the terminal operator is treated as the position holder. One holds the inventory position by having a contractual agreement with the terminal operator for the use of the storage facilities and terminating services with respect to the fuel. A terminal operator who owns the fuel in its terminal is a position holder. The party liable for payment of the taxes when it leaves the terminal rack is the "position holder."

It is common industry practice for oil companies to serve customers of other oil companies under exchange agreements, *e.g.*, where Company A's terminal is more conveniently located for wholesale or retail customers of Company B. In such cases, the exchange agreement party (Company B in the example) owns the fuel when the motor fuel is removed from the terminal and sold to B's customer.

Description of Proposal

The proposal amends the Code to modify the regulatory definition of “position holder” to recognize the provisions of two-party terminal exchange agreements among registered parties. In such an exchange, the delivering person is not liable for the tax imposed by section 4081 on the removal of a taxable fuel from any refinery or terminal. The term two-party exchange means a transaction, other than a sale, in which taxable fuel is transferred from a delivering person registered under section 4101 for exempt bulk transfers of taxable fuel to a receiving person registered under section 4101 for exempt bulk transfers of taxable fuel where all of the following occur:

- (1) The transaction includes a transfer from the delivering person, who holds the original inventory position for taxable fuel in the terminal as reflected in the records of the terminal operator.
- (2) The exchange transaction occurs at the same time as completion of removal across the rack from the terminal by the receiving person or its customer.
- (3) The terminal operator in its books and records treats the receiving person as the person that removes the product across a terminal rack for purposes of reporting the transaction to the Internal Revenue Service.
- (4) The transaction is the subject of a written contract.

Effective Date

The proposal is effective on the date of enactment.

5. Modification of tax on use of certain vehicles

Present Law

An annual use tax is imposed on heavy highway vehicles, at the rates below.⁹⁵

Under 55,000 pounds	No tax
55,000-75,000 pounds	\$100 plus \$22 per 1,000 pounds over 55,000
Over 75,000 pounds	\$550

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers are allowed to pay the tax in installments.⁹⁶ Exemptions and reduced rates are provided for certain “transit-type buses,” trucks used for fewer than 5,000 miles on public highways (7,500

⁹⁵ Sec. 4481.

⁹⁶ Sec. 6156.

miles for agricultural vehicles), and logging trucks.⁹⁷ The tax applies only to use before October 1, 2005.

Description of Proposal

The proposal eliminates the ability to pay the tax in installments and allows no proration of the tax unless the vehicle is destroyed, stolen, or sold. The proposal further requires that every person, agency, or instrumentality that pays the heavy highway vehicle use tax to receive and display on the vehicle either a decal or an electronic identification device prescribed by the Secretary. The decal or device is to be received and displayed not later than October 1 with respect to each taxable period. In addition, confirmation of payment will be deemed an excise tax registration and provided to State agencies with vehicle registration jurisdiction.

Effective Date

The proposal is effective for taxable periods beginning after the date of enactment.

6. Dedication of revenue from certain penalties to the Highway Trust Fund

Present Law

Penalty for improper use of dyed fuel

Generally, diesel fuel and kerosene are exempt from tax if (1) the fuel is indelibly dyed; (2) the fuel is destined for a nontaxable use, and (3) the fuel meets marking requirements prescribed the Secretary (currently there are no marking requirements). The Code imposes a penalty on persons who improperly sell or use dyed fuel for a taxable use.⁹⁸ The penalty applies to:

- (1) any dyed fuel is sold or held for sale by any person for any use which such person knows or has reason to know is not a nontaxable use of such fuel,
- (2) any dyed fuel is held for use or used by any person for a use other than a nontaxable use and such person knew, or had reason to know, that such fuel was so dyed, or
- (3) any person willfully alters, or attempts to alter, the strength or composition of any dye or marking done pursuant to section 4082 in any dyed fuel, then such person shall pay a penalty in addition to the tax (if any).

The amount of the penalty is the greater of: (1) \$1,000, or (2) \$10 for each gallon of dyed fuel involved. The \$1,000 amount is increased by the product of such amount and the number of prior penalties, (if any) imposed on such person (or related persons or predecessors).

⁹⁷ See generally, sec. 4483.

⁹⁸ Sec. 6715.

Penalty for failure to register as required by section 4101

Failure to register as required by section 4101⁹⁹, or a false statement that is registered by a manufacturer or producer of gasoline, diesel fuel, or aviation fuel results in a fine of not more than \$5,000 or imprisonment of not more than five years, or both, together with the costs of prosecution.¹⁰⁰

Penalty for failure to register with the IRS as required by Code or regulations

The Code imposes a \$50 penalty on any person who is required by law or regulations to register with a district director of the IRS and fails to do so.¹⁰¹

Description of Proposal

The proposal dedicates to the Highway Trust Fund amounts equivalent to the penalties assessed under the penalty provisions created by the proposal (*i.e.*, the penalty for tampering with a security system, the penalty for failing to make required reports, the assessable penalty for refusal of entry, the assessable penalty for failure to register, the penalty for making transfers to nonregistered pipelines and vessels, and the penalty for failing to display registration on a vessel) as well as the existing penalties (as increased by the proposal) for failing to register under section 4101 and as otherwise required by law or regulation.

Effective Date

The proposal is effective October 1, 2004.

7. Nonapplication of export exemption to delivery of fuel to motor vehicles removed from United States

Present Law

A manufacturer's excise tax is imposed upon

- (1) The removal of any taxable fuel from a refinery or terminal;
- (2) The entry of any taxable fuel into the United States for consumption, use or warehousing; or
- (3) The sale of any taxable fuel to any person who is not registered, unless there was a prior taxable removal or entry.¹⁰²

⁹⁹ Certain persons must register with the IRS concerning fuel taxes imposed by sections 4041(a)(1), 4081, and 4091.

¹⁰⁰ Sec. 7232.

¹⁰¹ Sec. 7272. This provision does not apply to persons required to register under subtitle E of the Code (relating to liquors and other alcoholic beverages).

The term “taxable fuel” means gasoline, diesel fuel and kerosene.

Special provisions under the Code provide for a refund of tax to any person who sells gasoline to another for exportation.¹⁰³ Section 6421(c) provides “If gasoline is sold to any person for any purpose described in paragraph (2), (3), (4), or (5) of section 4221(a), the Secretary shall pay (without interest) to such person an amount equal to the product of the number of gallons so sold multiplied by the rate at which tax was imposed on such gasoline by section 4081.” Section 4221 provides, in pertinent part, “Under regulations prescribed by the Secretary, no tax shall be imposed under this chapter. . . on the sale by the manufacturer . . . of an article-- . . . for export, or for resale by the purchaser to a second purchaser for export . . . but only if such exportation or use is to occur before any other use . . .”

It is the IRS administrative position that the exemption from manufacturers excise tax by reason of exportation does not apply to the sale of motor fuel pumped into a fuel tank of a vehicle that is to be driven, or shipped, directly out of the United States.¹⁰⁴

A duty-free sales facility that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales facility on which neither Federal duty nor Federal tax has been assessed pending exportation from the customs territory of the United States. The statutes covering duty-free facilities do not contain any limitation on what goods may qualify for duty-free treatment.

The United States Court of Federal Claims (“Claims Court”) and a District Court in Michigan have taken different positions on whether fuel sold from a duty-free facility and placed into the tank of an automobile that is then driven out of the country is exported fuel.¹⁰⁵ Both cases involved the same duty-free facility, which is near the Canadian border and is configured in such a way that anyone leaving the facility must depart the United States and enter into Canada. The District Court agreed with the IRS position that such fuel is not exported, while the Claims Court reached the opposite conclusion. The Claims Court concluded that the act of

¹⁰² Sec. 4081(a)(1).

¹⁰³ Secs. 6421(c) and 4221(a)(2).

¹⁰⁴ Rev. Rul. 69-150.

¹⁰⁵ See, *Ammex Inc. v. United States*, 52 Fed. Cl. 303 (2002) (on cross-motions for summary judgment, the court found that plaintiff established standing to proceed to trial pursuant to sec. 6421(c) respecting its gasoline purchases only); and *Ammex Inc. v. United States*, 2002 U.S. Dist. LEXIS 25771 (E.D. Mich. July 31, 2002) (granting defendant’s motion for summary judgment), reconsideration denied, *Ammex, Inc. v. United States*, 2002 U.S. Dist. LEXIS 22893 (E.D. Mich. Oct. 22, 2002). Although the Claims Court ruled that Ammex had standing to challenge the excise tax on gasoline, it subsequently held that Ammex was not entitled to a payment pursuant to sec. 6421(c) because it failed to prove at trial that it did not pass the tax on to its customers. *Ammex Inc. v. United States*, 2003 U.S. Claims LEXIS 63 (Fed. Cl. Mar. 26, 2003).

exportation began with the consumer's purchase and that the fuel necessarily enters into the stream of exportation at the moment it is placed into the fuel supply tank and the customer drives into Canada.

Description of Proposal

The proposal reaffirms the long-standing IRS position taken in Rev. Rul. 69-150 and restates present law by amending the Code definition of export to exclude the delivery of a taxable fuel into a fuel tank of a motor vehicle that is shipped or driven out of the United States. It also imposes a tax on the sale of taxable fuel at a duty-free sales enterprise unless there was a prior taxable removal, or entry of such fuel.

Effective Date

The proposal applies to sales or deliveries made after the date of enactment.

G. Total Accountability

Present law

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.¹⁰⁶ The tax does not apply to any removal or entry of taxable fuel transferred in bulk to a terminal or refinery if the person removing or entering the taxable fuel and the operator of such terminal or refinery are registered with the Secretary.¹⁰⁷ The term “taxable fuel” means gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.¹⁰⁸

Gasoline is defined to include, to the extent provided in regulations, gasoline blendstocks and products commonly used as additives in gasoline. Under the regulations, gasoline is defined to include all products commonly or commercially known or sold as gasoline and suited for use as a motor fuel, and that have an octane rating of 75 or more. The term “gasoline blendstocks” does not include any product that cannot be blended into gasoline without further processing or fractionation (“off-spec gasoline”).¹⁰⁹

Diesel fuel is any liquid (other than gasoline) that is suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train.¹¹⁰ By regulation, diesel fuel does not include kerosene, gasoline, No. 5 and No. 6 fuel oils (as described in ASTM Specification D 396), or F-76 (Fuel Naval Distillates MIL-F-16884) any liquid that contains less than four percent normal paraffins, or any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur content of 10 ppm or less and minimum color of +27 Saybolt.¹¹¹

By regulation, kerosene is defined as the kerosene described in ASTM Specification D 3699 (No. 1-K and No. 2-K), ASTM Specification D 1655 (kerosene-type jet fuel), and military

¹⁰⁶ Sec. 4081(a)(1).

¹⁰⁷ Sec. 4081(a)(1)(B).

¹⁰⁸ Sec. 4083(a).

¹⁰⁹ Treas. Reg. sec. 48.4081-1(c)(3)(ii). The term “gasoline blendstocks” means alkylate; butane; catalytically cracked gasoline; coker gasoline; ethyl tertiary butyl ether (ETBE); hexane; hydrocrackate; isomerate; methyl tertiary butyl ether (MTBE); mixed xylene (not including any separated isomer of xylene); natural gasoline; pentane; pentane mixture; polymer gasoline; raffinate; reformat; straight-run gasoline; straight-run naphtha; tertiary amyl methyl ether (TAME); tertiary butyl alcohol (gasoline grade) (TBA); thermally cracked gasoline; toluene; and transmix containing gasoline. Treas. Reg. sec. 38.4081-1(c)(3)(i).

¹¹⁰ Sec. 4083(a)(3).

¹¹¹ Treas. Reg. sec. 48.4081-1(c)(2)(ii).

specifications MIL-DTL-5624T (Grade JP-5) and MIL-DTL-~~*~~#133E (Grade JP-8). Kerosene does not include any liquid that contains less than four percent normal paraffins or any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur content of 10 ppm or less, and minimum color of +27 Saybolt, also known as “excluded liquids.”¹¹²

Generally, gasoline is taxed upon removal at the terminal rack. If certain conditions are met, the removal, entry, or sale of gasoline blendstocks is not taxable. Generally, the exemption from tax applies if a gasoline blendstock is not used to produce finished gasoline or is received at an approved terminal or refinery. No tax is imposed on nonbulk removals from a terminal or refinery, or nonbulk entries into the United States or on any gasoline blendstocks if the person liable for the tax is a gasoline registrant, has an unexpired notification certificate, knows of no false information in the certificate, and has verified the accuracy of the notification certificate. The sale of a gasoline blendstock that was not subject to tax on nonbulk removal or entry is taxable unless the seller has an unexpired certificate from the buyer and has no reason to believe that any information in the certificate is false. No tax is imposed on, or purchaser certification required for, off-spec gasoline.

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose. Undyed aviation-grade kerosene also is exempt from tax at the rack if it destined for use as a fuel in an aircraft. The tax does not apply to diesel fuel asserted to be “not suitable for use” or kerosene asserted to qualify as an excluded liquid.

Feedstock kerosene that a registered industrial user receives by pipeline or vessel also is exempt from the dyeing requirement. A kerosene feedstock user is defined as a person that receives kerosene by bulk transfer for its own use in the manufacture or production of any substance (other than gasoline, diesel fuel or special fuels subject to tax). Thus, for example, kerosene is used for a feedstock purpose when it is used as an ingredient in the production of paint and is not used for a feedstock purpose when it is used to power machinery at a factory where paint is produced. The person receiving the kerosene must be registered with the IRS and provide a certificate noting that the kerosene will be used for a feedstock purpose in order the exemption to apply.

The IRS collects data under the ExSTARS reporting system that tracks all removals across the terminal rack regardless of whether or not the product is technically excluded from the definition of gasoline, diesel or blendstocks. ExSTARS reporting identifies the position holder at the time of removal. Below the rack, no information is gathered for exempt or excluded products or uses.

Taxpayers file quarterly excise tax returns showing only net taxable gallons. Taxpayers do not account for gallons they claim to be exempt on such returns. Excise taxes are paid in semimonthly installments.

¹¹² Treas. Reg. sec. 48.4081-1(b).

Description of Proposal

Under the proposal, all gasoline, gasoline blendstocks, diesel fuel (whether or not suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train) and kerosene removed through a terminal rack are taxable subject to available credits or exemptions. The current exclusions for distillates not suitable for use in a highway vehicle, excluded liquids, and gasoline blendstocks requiring further processing (off-spec gasoline) are eliminated. Instead, under the proposal, the removal of all of these products is taxable, unless such products are sold to certain persons for further processing or manufacturing of any substance (other than gasoline, diesel fuel or special fuel) or received at an approved terminal or refinery. The receiving person must be registered with the IRS in order for the credit to be available. Dyed diesel also is taxable unless removed by a taxable fuel registrant.

Taxpayers are to file and pay on a monthly fuel excise tax return due on the 25th day of the month following the month the tax was incurred and would no longer be required to make semimonthly installment payments. In addition, the proposal requires that all persons removing refined product, whether a taxable product or an untaxed product, over the terminal rack to report such products on the monthly fuel excise tax return. The return is to specifically identify the class of product and its quantity.¹¹³

Effective Date

The proposal is effective for fuel sold or used after September 30, 2004.

¹¹³ Persons not liable for tax, will make their reports in the same manner as taxpayers who file fuel excise tax returns as described above.

IV. MOBILE MACHINERY

A. Exemption from Certain Excise Taxes for Mobile Machinery Vehicles

Present Law

Under present law, the definition of a “highway vehicle” affects the application of the retail tax on heavy vehicles, the heavy vehicle use tax, the tax on tires, and fuel taxes.¹¹⁴ Section 4051 of the Code provides for a 12-percent retail sales tax on tractors, heavy trucks with a gross vehicle weight (“GVW”) over 33,000 pounds, and trailers with a GVW over 26,000 pounds. Section 4071 provides for a tax on highway vehicle tires that weigh more than 40 pounds, with higher rates of tax for heavier tires. Section 4481 provides for an annual use tax on heavy vehicles with a GVW of 55,000 pounds or more, with higher rates of tax on heavier vehicles. All of these excise taxes are paid into the Highway Trust Fund.

Federal excise taxes are also levied on the motor fuels used in highway vehicles. Gasoline is subject to a tax of 18.4 cents per gallon, of which 18.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cents per gallon is paid into the Leaking Underground Storage Tank (“LUST”) Trust Fund. Highway diesel fuel is subject to a tax of 24.4 cents per gallon, of which 24.3 cents per gallon is paid into the Highway Trust Fund and 0.1 cents per gallon is paid into the LUST Trust Fund.

The Code does not define a “highway vehicle.” For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition of highway vehicle are (1) certain specially designed mobile machinery vehicles for nontransportation functions (the “mobile machinery exception”); (2) certain vehicles specially designed for off-highway transportation for which the special design substantially limits or impairs the use of such vehicle to transport loads over the highway (the “off-highway transportation vehicle” exception); and (3) certain trailers and semi-trailers specially designed to function only as an enclosed stationary shelter for the performance non-transportation functions off the public highways.¹¹⁵

The mobile machinery exception applies if three tests are met: (1) the vehicle consists of a chassis to which jobsite machinery (unrelated to transportation) has been permanently mounted; (2) the chassis has been specially designed to serve only as a mobile carriage and mount for the particular machinery and (3) by reason of such special design, the chassis could not, without substantial structural modification, be used to transport a load other than the particular machinery. An example of a mobile machinery vehicle is a crane mounted on a truck chassis.

¹¹⁴ Secs. 4051, 4071, 4481, 4041 and 4081.

¹¹⁵ See Treas. Reg. sec. 48.4061-1(d).

On June 6, 2002, the Treasury Department put forth proposed regulations that would eliminate the mobile machinery exception.¹¹⁶ The other exceptions from the definition of highway vehicle would continue to apply. Under the proposed regulations, the chassis of a mobile machinery vehicle would be subject to the retail sales tax on heavy vehicles unless the vehicle qualified under the offhighway transportation vehicle exception. Also, under the proposed regulations, mobile machinery vehicles may be subject to the heavy vehicle use tax. In addition, the tax credits, refunds, and exemptions from tax may not be available for the fuel used in these vehicles.

Description of Proposal

The proposal codifies the present-law mobile machinery exemption for purposes of three taxes: the retail tax on heavy vehicles, the heavy vehicle use tax, and the tax on tires. Thus, if a vehicle can satisfy the three-part test, it will not be treated as a highway vehicle and will be exempt from these taxes.

Fuel taxes for mobile machinery vehicles must be paid and then a refund sought if certain conditions are met. Specifically, in addition to the three-part design test, the vehicle (1) must not have traveled more than 5,000 miles during the owner's taxable year or (2) was not licensed to travel on public roads at anytime during the taxable year. Vehicles owned by an organization described in section 501(c), exempt from tax under section 501(a), need only satisfy the three-part design test. Refunds of fuel taxes are permitted on an annual basis only. For purposes of this rule, a person's taxable year is his taxable year for income tax purposes.

Effective Date

The proposal generally is effective after the date of enactment. As to the fuel taxes, the proposal is effective for taxable years beginning after the date of enactment.

¹¹⁶ Prop. Treas. Reg. sec. 48.4051-1(a), 67 Fed. Reg. 38913, 38914-38915 (2002).

V. EXCISE TAX REFORM AND SIMPLIFICATION

A. Highway Excise Taxes

1. Dedication of gas guzzler tax to the Highway Trust Fund

Present Law

Under present law, the Code imposes a tax (“the gas guzzler tax”) on automobiles that are manufactured primarily for use on public streets, roads, and highways and that are rated at 6,000 pounds unloaded gross vehicle weight or less.¹¹⁷ The tax applies to limousines without regard to the weight requirement. The tax is imposed on the sale by the manufacturer of each automobile of a model type with a fuel economy of 22.5 miles per gallon or less. The tax range begins at \$1,000 and increases to \$7,700 for models with a fuel economy less than 12.5 miles per gallon.

Emergency vehicles and non-passenger automobiles are exempt from the tax. The tax also does not apply to non-passenger automobiles. The Secretary of Transportation determines which vehicles are “non-passenger” automobiles, thereby exempting these vehicles from the gas guzzler tax based on regulations in effect on the date of enactment of the gas guzzler tax.¹¹⁸ Hence, vehicles defined in Title 49 C.F.R. sec. 523.5 (relating to light trucks) are exempt. These vehicles include those designed to transport property on an open bed (e.g., pick-up trucks) or provide greater cargo-carrying than passenger carrying volume including the expanded cargo-carrying space created through the removal of readily detachable seats (e.g., pick-up trucks, vans, and most minivans, sports utility vehicles and station wagons). Additional vehicles that meet the “non-passenger” requirements are those with at least four of the following characteristics: (1) an angle of approach of not less than 28 degrees; (2) a breakover angle of not less than 14 degrees; (3) a departure angle of not less than 20 degrees; (4) a running clearance of not less than 20 centimeters; and (5) front and rear axle clearances of not less than 18 centimeters each. These vehicles would include many sports utility vehicles.

Description of Proposal

The proposal requires that amounts equivalent to the gas guzzler taxes received in the Treasury be transferred to the Highway Trust Fund.

The proposal repeals the tax as it applies to limousines rated at greater than 6,000 pounds unloaded gross vehicle weight.

Effective Date

The proposal is effective on the date of enactment.

¹¹⁷ Sec. 4064.

¹¹⁸ Sec. 4064(b)(1)(A).

2. Repeal certain excise taxes on rail diesel fuel and inland waterway barge fuels

Present Law

Under present law, diesel fuel used in trains is subject to a 4.4-cents-per-gallon excise tax. Revenues from 4.3 cents per gallon of this excise tax are retained in the General Fund of the Treasury. The remaining 0.1cent per gallon is deposited in the Leaking Underground Storage Tank (“LUST”) Trust Fund.

Similarly, fuel used in barges operating on the designated inland waterways system is subject to a 4.3-cents-per-gallon General Fund excise tax. This tax is in addition to the 20.1-cents-per-gallon tax rates that are imposed on fuels used in these barges to fund the Inland Waterways Trust Fund and the Leaking Underground Storage Tank Trust Fund.

In both cases, the 4.3 cents per gallon excise tax rates are permanent. The LUST Trust Fund tax is scheduled to expire after March 31, 2005.

Description of Proposal

The 4.3-cents-per-gallon General Fund excise tax rate on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system is repealed. The 0.1 cent per gallon for the LUST Trust Fund is unchanged by the proposal.

Effective Date

The proposal is effective on October 1, 2004.

B. Aquatic Excise Taxes

1. Eliminate Aquatic Resources Trust Fund and transform Sport Fish Restoration Account

Present Law

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats.¹¹⁹ Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, tax collected in excess of 13.5 cents per gallon (i.e., 4.8 cents per gallon) is retained in the General Fund of the Treasury.¹²⁰ The balance is transferred to the Highway Trust Fund, and retransferred (except with respect to amounts transferred to the fund for land and water conservation, as described below) to the Aquatic Resources Trust Fund.¹²¹ The motorboat gasoline and special motor fuels taxes are collected under the same rules as apply to the Highway Trust Fund excise taxes on those fuels.

The Aquatic Resources Trust Fund is comprised of two accounts.¹²² First, the Boat Safety Account is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels. Transfers to the Boat Safety Account are limited to amounts not exceeding \$70 million per year. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Boat Safety Account to have an unobligated balance in excess of \$70 million.¹²³

Second, the Sport Fish Restoration Account receives the balance of the motorboat gasoline and special motor fuels receipts that are transferred to the Aquatic Resources Trust Fund.¹²⁴ The Sport Fish Restoration Account also is funded with receipts from an excise tax on sport fishing equipment sold by the manufacturer, producer or importer. The excise tax rate on

¹¹⁹ Sec. 4081(a)(2).

¹²⁰ After September 30, 2005, none of the motorboat fuel taxes are to be retained in the General Fund.

¹²¹ See Sec. 9503(b)(4), (c)(4) & (5). Between October 1, 2001 and September 30, 2003, the amount transferred to the Aquatic Resources Trust Fund was 13 cents per gallon. Prior to October 1, 2001, the amount transferred was 11.5 cents per gallon. Sec. 9503(b)(4)(D).

¹²² Sec. 9504(a).

¹²³ Sec. 9503(c)(4)(A). Funding of the Boat Safety Account is scheduled to terminate after September 30, 2005.

¹²⁴ After funding of the Boat Safety Account, remaining motorboat fuel taxes, not exceeding \$1,000,000 during any fiscal year, are transferred from the Highway Trust Fund into the land and water conservation fund provided in title I of the Land and Water Conservation Fund Act of 1965. Sec. 9503(c)(4)(B). After the transfer to the land and water conservation fund, motorboat fuel taxes remaining in the Highway Trust Fund are transferred to the Sport Fish Restoration Account. Sec. 9503(c)(4)(C).

sport fishing equipment is 10 percent of the sales price; the rate is reduced to 3 percent for electric outboard motors and sonar devices suitable for finding fish.¹²⁵ Examples of the items of sport fishing equipment subject to the 10-percent rate include fishing rods and poles, fishing reels, fly fishing lines and certain other fishing lines, fishing spears, spear guns, spear tips, items of terminal tackle, tackle boxes and containers designed to hold fish, fishing vests, landing nets, and portable bait containers.¹²⁶ In addition, import duties on certain fishing tackle, yachts and pleasure craft are transferred into the Sport Fish Restoration Account.

A separate sub-account in the Sport Fish Restoration Account, the Wetlands Sub-Account, is funded¹²⁷ with a portion of the general gasoline tax equal to the tax on gasoline used in nonbusiness off-highway use of small-engine outdoor power equipment.

Expenditures from the Boat Safety Account are subject to annual appropriations. Expenditures from the Sport Fish Restoration Account (including the Wetlands Sub-Account) are made pursuant to a permanent appropriation.¹²⁸

Description of Proposal

The proposal eliminates the Aquatics Resources Trust Fund and future transfers to the Boat Safety Account and transforms the Sport Fish Restoration Account into the Sport Fish Restoration Trust Fund. Under the proposal, all taxes on motorboat fuel and gasoline used in nonbusiness off-highway use of small-engine outdoor power equipment (except for the 0.1 cent per gallon amount dedicated to the Leaking Underground Storage Tank Trust Fund) are transferred to the Highway Trust Fund. After funding of the land and water conservation fund as under present law, the balance of the taxes on motorboat fuel and gasoline used in nonbusiness off-highway use of small-engine outdoor power equipment is transferred from the Highway Trust Fund into the Sport Fish Restoration Trust Fund. Amounts in the Boat Safety Account are authorized to be spent down over 5 years.

The proposal does not change the use of amounts in the Sport Fish Restoration Trust Fund, or the Wetlands Account.

Effective Date

The proposal is effective October 1, 2004.

¹²⁵ Sec. 4161(a). The excise tax on any sonar device suitable for finding fish may not exceed \$30.

¹²⁶ Items of “sport fishing equipment” are enumerated in section 4162(a).

¹²⁷ Such funding is scheduled to terminate after September 30, 2005.

¹²⁸ Act of August 9, 1950, 64 Stat. 430 (codified at 16 U.S.C. sec. 777 et seq.) (“An Act to provide that the United States shall aid the States in fish restoration and management projects, and for other purposes.”)

2. Exempt LED devices from sonar devices suitable for finding fish

Present Law

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.¹²⁹ A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.¹³⁰ Further, the tax imposed on the sale of electric outboard motors and sonar devices suitable for finding fish is limited to \$30. A sonar device suitable for finding fish does not include any device that is a graph recorder, a digital type, a meter readout, a combination graph recorder or combination meter readout.¹³¹

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

Description of Proposal

The proposal provides that a sonar device suitable for finding fish does not include a sonar device with an LED (light emitting diode) display.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer on and after October 1, 2004.

3. Repeal of Harbor Maintenance tax on exports

Present Law

The Code contains provisions imposing a 0.125-percent excise tax on the value of most commercial cargo loaded or unloaded at U.S. ports (other than ports included in the Inland Waterway Trust Fund system). The tax also applies to amounts paid for passenger transportation using these U.S. ports. Exemptions are provided for (1) cargo donated for overseas use, (2) cargo shipped between the U.S. mainland and Alaska (except for crude oil), Hawaii, and/or U.S. possessions and (3) cargo shipped between Alaska, Hawaii, and/or U.S. possessions. Receipts from this tax are deposited in the Harbor Maintenance Trust Fund.

The U.S. Supreme Court has held that the harbor maintenance excise tax is unconstitutional as applied to exported cargo because it violates the “Export Clause” of the U.S.

¹²⁹ Sec. 4161(a)(1).

¹³⁰ Sec. 4161(a)(2).

¹³¹ Sec. 4162(b).

Constitution.¹³² The tax remains in effect for imported cargo. Imposition of the tax on passenger transportation with respect to passengers on cruises that originate, stop, or terminate, at U.S. ports has been upheld.

Description of Proposal

The proposal conforms the Code to the Supreme Court decision and exempts exported commercial cargo from the Harbor Maintenance tax.

Effective Date

The proposal is effective before, on, and after the date of enactment.

4. Cap on excise tax on certain fishing equipment

Present Law

In general, the Code imposes a 10 percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.¹³³ A three percent rate, however, applies to the sale of electric outboard motors and sonar devices suitable for finding fish.¹³⁴ Further, the tax imposed on the sale of electric outboard motors and sonar devices suitable for finding fish is limited to \$30. Sport fishing equipment subject to the 10-percent tax includes fishing rods and poles, fishing reels, fly fishing lines, and other fishing lines not over 130 pounds test, fishing spears, spear guns, and spear tips, and tackle items including leaders, artificial lures, artificial baits, artificial flies, fishing hooks, bobbers, sinkers, snaps, drayles, and swivels. In addition the following fishing supplies and accessories are subject to the 10-percent tax: fish stringers; creels; tackle boxes; bags, baskets, and other containers designed to hold fish; portable bait containers; fishing vests; landing nets; gaff hooks; fishing hook disgorgers; dressing for fishing lines and artificial flies; fishing tip-ups and tilts; fishing rod belts, fishing rodholders; fishing harnesses; fish fighting chairs; and fishing outriggers and downriggers.

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

Description of Proposal

The proposal provides that the tax applicable to a fishing rod or fishing pole is the lesser of 10 percent or \$10.00.

¹³² *United States Shoe Corp. v. United States*, 523 U.S. 360, 118 S. Ct. 1290, 140 L. Ed. 2d 453 (1998).

¹³³ Sec. 4161(a)(1).

¹³⁴ Sec. 4161(a)(2).

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer on and after October 1, 2004.

C. Aerial Excise Taxes

1. Clarification of excise tax exemptions for agricultural aerial applicators and exemption for fixed-wing aircraft engaged in forestry operations

Present Law

Excise taxes are imposed on aviation gasoline (19.4 cents per gallon) and jet fuel (21.9 cents per gallon).¹³⁵ All but 0.1 cent per gallon of the revenues from these taxes are dedicated to the Airport and Airway Trust Fund. The remaining 0.1 cent per gallon rate is imposed for the Leaking Underground Storage Tank Trust Fund.

Fuel used on a farm for farming purposes is a nontaxable use. Aerial applicators (crop dusters) are allowed to claim a refund instead of farm owners and operators in the case of aviation gasoline if the owners or operators give written consent to the aerial applicators.¹³⁶ This provision applies only to fuel consumed in the airplane while operating over the farm, i.e., fuel consumed traveling to and from the farm is not exempt.

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus \$3.00 per domestic flight segment.¹³⁷ The tax on transportation by air does not apply to air transportation by helicopter if the helicopter is used for (1) the exploration, or the development or removal of oil, gas, or hard minerals exploration, or (2) certain timber operations (planting, cultivating, cutting, transporting, or caring for trees, including logging operations).¹³⁸ The exemption applies only when the helicopters are not using the Federally funded airport and airway services. Helicopters and fixed-wing aircraft providing emergency medical services also are exempt from the air passenger tax regardless of the type of airport and airway services used.¹³⁹

Description of Proposal

With regard to the exemption for aerial applicators, written consent from the farm owner or operator is no longer needed for the aerial applicator to claim exemption for aviation gasoline. The exemption also is expanded to include fuels consumed when flying between the farms where chemicals are applied and the airport where the airplane takes off and lands. The present exemption for helicopters engaged in timber operations is expanded to include fixed-wing aircraft.

¹³⁵ Secs. 4081 and 4091.

¹³⁶ Sec. 6420(c)(4)).

¹³⁷ Sec. 4261(a) and (b).

¹³⁸ Sec. 4261(f).

¹³⁹ Sec. 4261(g).

Effective Date

The proposal is effective for fuel use or air transportation after the date of enactment.

2. Modify the definition of rural airport

Present Law

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus \$3.00 per domestic flight segment.¹⁴⁰ The \$3.00 tax on flight segments does not apply to a domestic segment beginning or ending at a rural airport.

With respect to any calendar year, a rural airport is an airport that had fewer than 100,000 passengers departing by air during the second preceding calendar year for such airport and such airport either (1) is not located within 75 miles of a larger airport (one that had at least 100,000 passengers departing in the second preceding calendar year), or (2) was receiving essential air service subsidy payments as of August 5, 1997.

Description of Proposal

The proposal expands the definition of qualified rural airport to include an airport that (1) is not connected by paved roads to another airport and (2) had fewer than 100,000 commercial passengers departing by air on flight segments of at least 100 miles during the second preceding calendar year.

Effective Date

The proposal is effective on April 1, 2004.

3. Exemption from ticket taxes for transportation provided by seaplanes

Present Law

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus \$3.00 per domestic flight segment (“air passenger tax”).¹⁴¹ A 6.25-percent tax is imposed on amounts paid for transportation of property by air (“air cargo tax”).¹⁴² The air cargo tax applies only to amounts paid to persons engaged in the business of transporting property by air for hire. The air passenger tax and air cargo tax does not apply to amounts paid for the transportation if furnished on an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less unless the aircraft is operated on an established line.¹⁴³

¹⁴⁰ Sec. 4261(a) and (b).

¹⁴¹ Sec. 4261(a) and (b).

¹⁴² Sec. 4271.

¹⁴³ Sec. 4281.

Description of Proposal

The proposal provides that the air passenger tax and the air cargo tax do not apply to transportation by a seaplane with respect to any segment consisting of a takeoff from, and a landing on, water, but only if the places at which such takeoff and landing occur have not received and are not receiving financial assistance from the Airport and Airway Trust Fund.

Effective Date

The proposal is effective for transportation after March 31, 2004.

4. Certain sightseeing flights exempt from taxes on air transportation

Present Law

Under present law, taxable aviation transportation is subject to a 7.5-percent excise tax on the price of an airline ticket and a \$3.00 segment tax. Beginning on January 1, 2003, the flight segment tax is indexed annually for inflation. An exception to these taxes is provided for transportation by an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less except when the aircraft is operated on an established line. Under the Treasury regulations to be “operated on an established line” means to be operated with “some degree of regularity between definite points. The term implies that the air carrier maintains control over the direction, routes, time, number of passengers carried, etc.” Treasury regulations provide that transportation need not be between two definite points to be taxable: a payment for continuous transportation beginning and ending at the same point is subject to the tax.¹⁴⁴ The IRS position is that the words “between definite points” do not require two separate points for purposes of determining whether an aircraft is operated on an established line. At least one court has agreed.¹⁴⁵

Description of Proposal

For purposes of the exemption for small aircraft operated on nonestablished lines, an aircraft operated on a flight, the sole purpose of which is sightseeing, will not be considered as operated on an established line.

Effective Date

The proposal is effective with respect to transportation beginning on or after the date of enactment but does not apply to any amount paid before the date of enactment for such transportation.

¹⁴⁴ Treas. Reg. sec. 49.4261-1(c).

¹⁴⁵ *Lake Mead Air Inc. v. United States*, 991 F. Supp. 1209 (D. Nev. 1997).

D. Alcoholic Beverage Excise Taxes

1. Repeal special occupational taxes on producers and marketers of alcoholic beverages

Present Law

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

Producers¹⁴⁶:

Distilled spirits and wines (sec. 5081)¹⁴⁷ \$1,000 per year, per premise

Brewers (sec. 5091) \$1,000 per year, per premise

Wholesale dealers (sec. 5111):

Liquors, wines, or beer \$500 per year

Retail dealers (sec. 5121):

Liquors, wines, or beer \$250 per year

Nonbeverage use of distilled spirits (sec. 5131): \$500 per year

Industrial use of distilled spirits (sec. 5276): \$250 per year

The Code requires every wholesale or retail dealer in liquors, wine or beer to keep records of their transactions.¹⁴⁸ A delegate of the Secretary of the Treasury is authorized to inspect the records of any dealer during business hours.¹⁴⁹ There are penalties for failing to comply with the recordkeeping requirements.¹⁵⁰

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

¹⁴⁶ A reduced rate of tax in the amount of \$500.00 is imposed on small proprietors (as defined in the Code) (secs. 5081(b) and 5091(b)).

¹⁴⁷ Proprietors of plants producing distilled spirits exclusively for fuel use, with annual production not exceeding 10,000 proof gallons, are exempt. Secs. 5081(c), 5181(c)(4).

¹⁴⁸ Secs. 5114 and 5124.

¹⁴⁹ Sec. 5146.

¹⁵⁰ Sec. 5603.

- (1) a wholesale dealer in liquors who has paid the special occupational tax as such dealer to cover the place where such purchase is made; or
- (2) a wholesale dealer in liquors who is exempt, at the place where such purchase is made, from payment of such tax under any provision chapter 51 of the Code; or
- (3) a person who is not required to pay special occupational tax as a wholesale dealer in liquors.¹⁵¹

Violation of this restriction is punishable by \$1,000 fine, imprisonment of one year, or both.¹⁵² A violation also makes the alcohol subject to seizure and forfeiture.¹⁵³

Description of Proposal

Under the proposal, the special occupational taxes on producers and marketers of alcoholic beverages are repealed. The recordkeeping and inspection authorities applicable to wholesalers and retailers are retained. For purposes of the recordkeeping requirements for wholesale and retail liquor dealers, the proposal provides a rebuttable presumption that a person who sells, or offers for sale, distilled spirits, wine, or beer, in quantities of 20 wine gallons or more to the same person at the same time is engaged in the business of a wholesale dealer in liquors or a wholesale dealer in beer. In addition, the proposal retains present law that makes it unlawful for any liquor dealer to purchase distilled spirits for resale from any person other than a wholesale liquor dealer subject to the recordkeeping requirements, or a proprietor of a distilled spirits plant subject to recordkeeping requirements.¹⁵⁴ Existing general criminal penalties relating to records and reports apply to wholesalers and retailers who fail to comply with these requirements.

Effective Date

The proposal is effective on July 1, 2004. The proposal does not affect liability for taxes imposed with respect to periods before July 1, 2004.

¹⁵¹ Sec. 5117. For example, purchases from a proprietor of a distilled spirits plant at his principal business office would be covered under item (2) since such a proprietor is not subject to the special occupational tax on account of sales at his principal business office (sec. 5113(a)). Purchases from a State-operated liquor store would be covered under item (3) (sec. 5113(b)).

¹⁵² Sec. 5687.

¹⁵³ Sec. 7302.

¹⁵⁴ Proprietors of distilled spirits plants are subject to present law recordkeeping requirements under section 5207. Under present law, a limited retail dealer in liquors (such as a charitable organization selling liquor at a picnic) may lawfully purchase distilled spirits for resale from a retail dealer in distilled spirits. This rule would not change under the proposal.

2. Suspension of limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands

Present Law

A \$13.50 per proof gallon¹⁵⁵ excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.¹⁵⁶ The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).¹⁵⁷

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.¹⁵⁸ The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon during the period July 1, 1999 through December 31, 2003).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.¹⁵⁹ Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.¹⁶⁰ All of the amounts covered over are subject to the limitation.

Description of Proposal

The proposal temporarily suspends the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the proposal, the cover over amount of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2003 and before October 1, 2004. The amount of \$13.50 per proof gallon is covered over with respect to rum brought into the United States after September 30,

¹⁵⁵ A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

¹⁵⁶ Sec. 5001(a)(1).

¹⁵⁷ Secs. 5062(b), 7653(b) and (c).

¹⁵⁸ Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

¹⁵⁹ Sec. 7652(e)(2).

¹⁶⁰ Secs. 7652(a)(3), (b)(3), and (e)(1).

2004 and before January 1, 2006. After December 31, 2005, the cover over amount reverts to \$10.50 per proof gallon.

The proposal additionally requires that Puerto Rico transfers a portion of the amount covered over to Puerto Rico to the Puerto Rico Conservation Trust Fund (the "Fund").¹⁶¹ After the effective date of the proposal, the treasury of Puerto Rico is required to make a transfer to the Fund in an amount equal to 50 cents per proof gallon of the taxes covered over to Puerto Rico, and attributable to rum imported into the United States that was produced neither in Puerto Rico nor the Virgin Islands. The transfer is required to be made within 30 days of each such cover over payment to Puerto Rico. Each transfer payment is to be treated as principal for an endowment, the income from which is to be used by the Fund for the purposes for which the Fund was established. If Puerto Rico fails to make a timely payment to the Trust Fund, the Secretary of the Treasury shall deduct and withhold such unpaid amount from the next cover over payment, plus interest, and shall transfer such amounts directly to the Fund. Such deduction, withholding, and direct payment will not be made if the Secretary of the Interior, after consultation with the Governor of Puerto Rico, finds that the failure of the treasury of Puerto Rico to make the transfer payment was for good cause.

Effective Date

The changes in the cover over rate are effective for articles brought into the United States after December 31, 2003. The provisions regarding the Puerto Rico Conservation Trust Fund are effective October 1, 2004.

¹⁶¹ The Puerto Rico Conservation Trust Fund was established pursuant to a Memorandum of Understanding, dated December 24, 1968, between the United States Department of the Interior and the Commonwealth of Puerto Rico.

E. Sport Excise Taxes

1. Custom gunsmiths

Present Law

The Code imposes an excise tax upon the sale by the manufacturer, producer or importer of certain firearms and ammunition.¹⁶² Pistols and revolvers are taxable at 10 percent. Firearms (other than pistols and revolvers), shells, and cartridges are taxable at 11 percent. The excise tax for firearms imposed on manufacturers, producers, and importers does not apply to machine guns and short barreled firearms. Sales to the Defense Department of firearms, pistols, revolvers, shells and cartridges also are exempt from the tax.

Description of Proposal

The proposal exempts from the firearms excise tax articles manufactured, produced, or imported by a person who manufactures, produces, and imports less than 50 of such articles during the calendar year. Controlled groups are treated as a single person for determining the 50-article limit.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer on or before the date the first day of the month beginning at least two weeks after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date sales.

2. Modified taxation of imported archery products

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw weight of 10 pounds or more.¹⁶³ An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point,nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches).¹⁶⁴ No tax is imposed on finished arrows. An 11-percent excise tax also is imposed on any part of an accessory for taxable bows and on quivers for use with arrows (1) over 18 inches long or (2) designed for use with a taxable bow (if shorter than 18 inches).¹⁶⁵

¹⁶² Sec. 4181.

¹⁶³ Sec. 4161(b)(1)(A).

¹⁶⁴ Sec. 4161(b)(2).

¹⁶⁵ Sec. 4161(b)(1)(B).

Description of Proposal

The proposal increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more.¹⁶⁶ The proposal also imposes an excise tax of 12 percent on arrows generally. An arrow for this purpose is defined as a taxable arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components is unchanged by the bill. In the case of any arrow comprised of a shaft or any other component upon which tax has been imposed, the amount of the arrow tax is equal to the excess of (1) the arrow tax that would have been imposed but for this exception, over (2) the amount of tax paid with respect to such components.¹⁶⁷ Finally, the proposal subjects certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price instead of 12.4 percent.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer after date of enactment.

3. Treatment of tribal governments for purposes of Federal wagering excise and occupational taxes

Present Law

Two excise taxes generally apply to wagering activities: a wagering tax and an occupational tax. These taxes are contained in Chapter 35 of the Code. The Code imposes a tax of 0.25 percent on any wager authorized under the law of the State in which the wager is accepted (the rate increases to 2.0 percent of any wager that is not so authorized). Each person who is engaged in the business of accepting wagers is liable for the tax on all wagers placed with him. Each person who conducts any wagering pool or lottery is liable for the tax on all wagers placed in such pool or lottery.

Certain wagering activities licensed or conducted by States are exempt from these excise taxes. Wagers placed in a coin-operated device are also exempt from the wagering tax.

The Code also imposes an occupational tax of \$50 per year (\$500 in the case of persons accepting wagers not authorized by the State law) for each person liable for the wagering tax and for each person who is engaged in receiving wagers for or on behalf of a person liable to pay the wagering tax.

¹⁶⁶ Draw weight is the maximum force required to bring the bowstring to a full-draw position not less than 26 1/4-inches, measured from the pressure point of the hand grip to the nocking position on the bowstring.

¹⁶⁷ Section 6416(b)(3) of the Code, which treats tax paid on articles used in the manufacture of another taxable article as an overpayment of tax that is refundable, is rendered inoperable by the provision.

The Indian Regulatory Gaming Act (Gaming Act) provides, in relevant part,

“The provisions of [the Internal Revenue Code of 1986] (including sections 1441, 3402(q), 6041, and 6050I, and chapter 35 of such Code) concerning the reporting and withholding of taxes with respect to the winnings from gaming or wagering operations shall apply to Indian gaming operations conducted pursuant to this chapter, or under a Tribal-State compact entered into under section 2710(d)(3) of this title that is in effect, in the same manner as such provisions apply to State gaming and wagering operations.”¹⁶⁸

The United States Supreme Court resolved a split of authority regarding whether the Indian Gaming Regulatory Act exempted pull-tab games conducted by Indian tribes from these wagering and occupational excise taxes.¹⁶⁹ The Court held that the Indian Gaming Regulatory Act does not exempt tribes from these taxes.¹⁷⁰ The Court noted that Chapter 35 imposes taxes from which it exempts certain State-controlled gambling activities, but says nothing about tax “reporting” or “withholding”. The Court concluded that the mention of Chapter 35 in the parenthetical was a drafting error.

Description of Proposal

The proposal treats Indian tribal governments as States for purposes of Chapter 35 of the Code (relating to the taxes on wagering, including the tax on wagers and the occupational tax).

Effective Date

The proposal is effective on July 1, 2004, but does not apply to taxes imposed for periods before such date.

¹⁶⁸ 25 U.S.C. sec. 2719(d)(i).

¹⁶⁹ The Court of Appeals for the Federal Circuit held in *Little Six, Inc. & Shakopee Mdewakanton Sioux (Dakota) Community v. United States*, 210 F. 3d 1361 (Fed. Cir. 2000) that 25 U.S.C. sec. 2719(d)(i) provided tribes with the same exemption from Federal excise taxes enjoyed by the States for lotteries under Section 4402(3), while the Court of Appeals for the Tenth Circuit held that 25 U.S.C. sec. 2719(d)(i) did not provide tribes with an exemption in *The Chickasaw Nation v. United States*, 208 F. 3d 871 (10th Cir. 2000), cert. granted, January 22, 2001.

¹⁷⁰ *Chickasaw Nation v. United States*, 534 U.S. 84 (2001).

F. Other Provisions

1. Income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control state bailment warehouses

Present Law

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. The excise tax on distilled spirits produced in the United States is imposed when the distilled spirits are removed from the distilled spirits plant where they are produced. Distilled spirits that are bottled before importation into the United States are taxed on removal from the first U.S. custom bonded warehouse to which they are landed (including a warehouse located in a foreign trade zone). Distilled spirits imported in bulk containers from bottling in the United States may be transferred to a domestic distilled spirits plant without payment of tax; subsequently, these distilled spirits are taxed in the same way as domestically produced distilled spirits.

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

Description of Proposal

The proposal creates a new income tax credit for eligible wholesalers, distillers, and importers, of distilled spirits. The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of \$25.68 per case of 12 80-proof 750-milliliter bottles.

The wholesaler credit only applies to domestically bottled distilled spirits¹⁷¹ purchased directly from the bottler of such spirits. An eligible wholesaler is any person that holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits that is not a State, or agency or political subdivision thereof.

For distillers and importers that are not eligible wholesalers, the credit is limited to bottled inventory in a warehouse owned and operated by, or on behalf of, a State when title to such inventory has not passed unconditionally. The credit for distillers and importers applies to distilled spirits bottled both domestically and abroad.

The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold.

¹⁷¹ Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

The credit is treated as part of the general business credits, however, the credit cannot be carried back to a taxable year beginning before the date of enactment.

Effective Date

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

2. Credit for taxpayers owning commercial power takeoff vehicles

Present Law

Fuel used in vehicles carrying equipment that is unrelated to the transportation function is subject to the Highway Trust Fund excise taxes without regard to whether the fuel is used for transportation or the unrelated equipment. An exception excepts fuel used by non-transportation equipment if the fuel is used by a separate motor, if the vehicle owner can allocate fuel used in a manner acceptable to the IRS.

Description of Proposal

The proposal provides a \$250 income tax credit per qualifying vehicle to business owners of certain highway vehicles that consume fuel for both transportation and in non-transportation-related equipment, using a single motor. Qualifying highway vehicles are vehicles designed for the daily collection of refuse or recyclables from homes or businesses and vehicles designed to deliver ready mixed concrete. A qualifying vehicle is a vehicle owned by the taxpayer as of the close of the calendar year in which the taxable year of the taxpayer ends. The credit expires after 2006.

The proposal further requires that by January 1, 2007, the Secretary of the Treasury, after consultation with the Secretary of Energy, to provide by regulation a method for exempting from the fuels excise tax fuel used to power equipment attached to such vehicles.

Effective Date

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

VI. MISCELLANEOUS

A. Motor Fuel Tax Enforcement Advisory Commission

Description of Proposal

The proposal establishes a “Motor Fuel Tax Enforcement Advisory Commission” (the “Commission”). The purpose of the Commission is to (1) review motor fuel revenue collections, historical and current, (2) review the progress of investigations (3) develop and review legislative proposals with respect to motor fuel taxes, (4) monitor the progress of administrative regulation projects relating to fuel taxes, (5) review the results Federal and State agency cooperative efforts regarding motor fuel taxes, and (6) review the results of Federal interagency cooperative efforts regarding motor fuel taxes. The Commission also is to evaluate and make recommendations regarding (1) the effectiveness of existing Federal enforcement programs regarding motor fuel taxes, (2) enforcement personnel allocation, and (3) proposals for regulatory projects, legislation, and funding

The Commission is to be composed of the following:

- (1) At least one representative from each of the following Federal entities: the Department of Homeland Security, the Department of Transportation - Office of Inspector General, the Federal Highway Administration, the Department of Defense, and the Department of Justice.
- (2) At least one representative from the Federation of State Tax Administrators,
- (3) At least one representative from any State Department of Transportation,
- (4) Two representatives from the highway construction industry,
- (5) Five representatives from industries relating to fuel distribution: refiners (2 representatives), distributors (1 representative), pipelines (1 representative), terminal operators (2 representatives),
- (6) One representative from the retail fuel industry, and
- (7) Two representatives each from the staff of the Senate Committee on Finance and the House Committee on Ways and Means.

Members of the Commission are to be appointed by the Senate Committee on Finance and the House Committee on Ways and Means. Representatives from the Department of Treasury and the IRS shall be available to consult with the Commission upon request. The Commission is to terminate after September 30, 2009.

Effective Date

The proposal is effective on the date of enactment.

B. National Surface Transportation Infrastructure Financing Commission

Present Law

Present law does not provide for any advisory commissions related Federal highway or mass transit funding.

Description of Proposal

The proposal establishes a “National Surface Transportation Infrastructure Financing Commission” (the “ Financing Commission”). The Financing Commission is to be composed of 15 members drawn from among individuals knowledgeable in the fields of public transportation finance or highway and transit programs, policy, and needs. Financing Commission members may include representatives of State and local governments or other public transportation agencies, representatives of the transportation construction industry, providers of transportation, persons knowledgeable in finance, and users of highway and transit systems. The 15 members will be appointed as follows:

- (1) the Secretary of Transportation, in consultation with the Secretary of the Treasury, will appoint seven members;
- (2) the chairman of the House Committee on Ways and Means will appoint two members;
- (3) the ranking minority member of the House Committee on Ways and Means will appoint two members;
- (4) the chairman of the Senate Committee on Finance will appoint two members; and,
- (5) the ranking minority member of the Senate Committee on Finance will appoint two members.

The Financing Commission will make an investigation and study of revenues flowing into the Highway Trust Fund under present law, including the individual components of the flow of such revenues. The Financing Commission will consider whether the amount of such revenues is likely to increase, decline or remain unchanged absent changes in the law, particularly by taking into account the impact of possible changes in consumers’ vehicle choice, fuel use or travel alternatives that could be expected to reduce or increase revenues in to the Highway Trust Fund. The Financing Commission will consider alternative approaches to generating revenues for the Highway Trust Fund, and the level of revenues that such alternatives would yield. The Financing Commission will consider highway and transit needs and whether additional revenues into the Highway Trust Fund, or other Federal revenues dedicated to highway and transit infrastructure, would be required in order to meet such needs. The Financing Commission’s study should address the period between the present and through the year 2015.

Based on such investigation and study, the Financing Commission will develop a final report, with recommendations and the bases for those recommendations, indicating policies that

the Congress may consider to achieve various levels of annual revenue for the Highway Trust Fund and to enable the Highway Trust Fund to receive revenues sufficient to meet highway and transit needs. The Financing Commission's recommendations will address: (1) what levels of revenue are required by the Highway Trust Fund in order for it to meet needs to maintain and improve the condition and performance of the nation's highway and transit systems; (2) what levels of revenue are required by the Highway Trust Fund in order to ensure that Federal levels of investment in highways and transit do not decline in real terms; and (3) the extent, if any, to which the Highway Trust Fund should be augmented by other mechanisms or funds as a Federal means of financing highway and transit infrastructure investments.

The Financing Commission will submit its report and recommendations within two years of the date of its first meeting to the Secretary of Transportation, the Secretary of the Treasury, the House Committee on Ways and Means, Senate Committee on Finance, the House Committee on Transportation and Infrastructure, the Senate Committee on Environment and Public Works, and Senate Committee on Banking, Housing, and Urban Affairs. The Financing Commission will hold its first meeting within 90 days of the appointment of the eighth individual to the Financing Commission and the Financing Commission will terminate on the 180th day following the transmittal of its report and recommendations.

Effective Date

The proposal is effective on the date of enactment.

C. Treasury Study of Fuel Tax Compliance and Interagency Cooperation

Present Law

Present law requires no specific studies related to fuels tax compliance.

Description of Proposal

The proposal requires the Department of Treasury to submit to the Senate Committee on Finance and the House Committee on Ways and Means a report regarding fuel tax enforcement. Specifically, with respect to audits conducted by the Internal Revenue Service, the Department of Treasury is to report on:

- (1) The number of audits conducted annually, by fiscal year, between October 1, 2001 and September 30, 2005;
- (2) The geographic distribution of such audits;
- (3) The total volume involved for each of the taxable fuels covered by audits (*e.g.*, total gasoline, diesel or kerosene gallons involved) and a comparison to the annual production of such fuels;
- (4) Staff hours and number of personnel devoted to the audits per year; and,
- (5) The results of such audits by year, including total tax collected, total penalties collected, and number of referrals for criminal prosecution.

With respect to enforcement activities, the report is to include:

- (1) The number of criminal investigations and prosecutions annually for the four fiscal year period of October 1, 2001 through September 30, 2005, and results (convictions, penalties, etc.) and geographic distribution;
- (2) To the extent such investigations and prosecutions involved other agencies, State or Federal, a breakdown by agency of the number of joint investigations involved. For example, how many investigations involved joint action with a State department of transportation and how many investigations involved joint action with the U.S. Customs Bureau;
- (3) An assessment of the effectiveness of joint action and cooperation between the Department of Treasury and other Federal and State agencies, including a discussion of the ability and need to share information across agencies for both civil and criminal Federal tax enforcement and enforcement of State laws or Federal laws relating to fuels;
- (4) Staff hours and number of personnel devoted to criminal investigations and prosecutions per year;

- (5) Staff hours and number of personnel devoted to administrative collection of fuel taxes; and,
- (6) The results of administrative collection efforts for the four fiscal year period of October 1, 2001 through September 30, 2005.

The report is also to provide any other information and recommendations the Secretary deem appropriate. The proposal requires the report to be submitted no later than January 31, 2006.

Effective Date

The proposal is effective on the date of enactment.

**D. Expand Highway Trust Fund Expenditure Purposes to Include
Funding for Studies of Supplemental or Alternative
Financing for the Highway Trust Fund**

Present Law

In general

Dedication of excise tax revenues to the Highway Trust Fund and expenditures from the Highway Trust Fund are governed by provisions of the Code (sec. 9503).¹⁷² The Code authorizes expenditures (subject to appropriations) from the Fund through February 29, 2004, for the purposes provided in authorizing legislation, as in effect on the date of enactment of the Surface Transportation Extension Act of 2003.

The Highway Trust Fund has a subaccount for Mass Transit. Both the Trust Fund and its subaccount are funding sources for specific programs.

Highway Trust Fund expenditure purposes have been revised with each authorization Act enacted since establishment of the Highway Trust Fund in 1956. In general, expenditures authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent such authorizing Act) are approved by the Code as Highway Trust Fund expenditure purposes.¹⁷³ Thus, no Highway Trust Fund monies may be spent for a purpose not approved by the tax-writing committees of Congress. The Code provides that authority to make expenditures from the Highway Trust Fund expires after February 29, 2004. Thus, no Highway Trust Fund expenditures may occur after February 29, 2004, without approval by the tax-writing committees of Congress.

Highway Trust Fund expenditure purposes

Highway Trust Fund expenditure purposes

The Highway Trust Fund receives revenues from all non-fuel highway transportation excise taxes and revenues from all but 2.86 cents per gallon of the highway motor fuels excise taxes transferred to the Highway Trust Fund. Programs financed from the Highway Trust Fund (excluding the Mass Transit account) include:

- (1) Interstate maintenance program;

¹⁷² The Highway Trust Fund statutory provisions were placed in the Internal Revenue Code in 1982.

¹⁷³ The authorizing Acts which currently are referenced in the Highway Trust Fund provisions of the Code are the Highway Revenue Act of 1956, Titles I and II of the Surface Transportation Assistance Act of 1982, the Surface Transportation and Uniform Relocation Act of 1987, the Intermodal Surface Transportation Efficiency Act of 1991 and the Transportation Equity Act for the 21st Century.

- (2) National Highway System;
- (3) The bridge program (bridge replacement and repair);
- (4) Surface transportation programs;
- (5) Congestion mitigation and air quality improvement program;
- (6) Highway safety programs and research and development, including a share of the cost of National Highway Traffic Safety Administration (“NHTSA”) programs and university research centers;
- (7) Appalachian development highway system program;
- (8) Recreational trails program;
- (9) Federal lands highways program;
- (10) National corridor planning and development and coordinated border infrastructure programs;
- (11) Construction of ferry boats and ferry terminal facilities;
- (12) National scenic byways program;
- (13) Value pricing pilot program;
- (14) High priority projects program;
- (15) Highway use tax evasion projects;
- (16) Commonwealth of Puerto Rico highway program.

Certain administrative costs of the Federal Highway Administration and NHTSA are also funded from the Highway Trust Fund.

Mass Transit Account expenditure purposes

The Highway Fund’s Mass Transit Account receives revenues equivalent to 2.86 cents per gallon of the highway motor fuels excise taxes. Mass Transit Account monies are available through February 29, 2004, for capital and capital-related expenditures under sections 5338(a)(1) and (b)(1) of Title 49, United States Code, the Intermodal Surface Transportation Efficiency Act of 1991 or the Transportation Equity Act for the 21st Century as those provisions were in effect on the date of enactment of the TEA 21 Restoration Act.

Description of Proposal

The proposal expands the expenditure purposes of the Highway Trust Fund to permit funding of two comprehensive studies of supplemental or alternative funding sources for the

Highway Trust Fund. One study, permitted to receive \$1 million in funding, will review highway funding mechanisms of other industrialized nations and examine the viability of proposals such as congestion pricing, greater reliance on tolls, privatization of facilities, and other funding proposals. This study would be due no later than December 31, 2006. The other study, permitted to receive \$16.5 million in funding, would report on a long-term field test of a new approach to assessing highway use taxes by use of an on-board computer that links to satellites to calculate road mileage traversed and compute the appropriate highway use tax for each of the Federal, State, and local government as the vehicle makes use of the roads. The vehicle owner would periodically download the data from the on-board computer to a collection center and the collection center would assess highway use taxes due in each jurisdiction traversed. The results of this study would be due no later than December 31, 2011. Each study would be delivered to the Secretary of the Treasury and the Secretary of Transportation.

Effective Date

The proposal is effective upon date of enactment.

VII. REVENUE OFFSETS

A. Limitation on Expensing Certain Passenger Automobiles

1. Expansion of limitation on expensing of certain passenger automobiles

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”). Under MACRS, passenger automobiles generally are recovered over five years. However, section 280F limits the annual depreciation deduction with respect to certain passenger automobiles.¹⁷⁴

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.¹⁷⁵ In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sports utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense such investment (sec. 179). The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003¹⁷⁶ increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to \$100,000 of the cost of qualifying property placed in service for the taxable year.¹⁷⁷ In general, qualifying property is defined as depreciable

¹⁷⁴ The limitation is commonly referred to as the “luxury automobile depreciation limitation.” For passenger automobiles (subject to the such limitation) placed in service in 2002, the maximum amount of allowable depreciation is \$7,660 for the year in which the vehicle was placed in service, \$4,900 for the second year, \$2,950 for the third year, and \$1,775 for the fourth and later years. This limitation applies to the combined depreciation deduction provided under present law for depreciation, including section 179 expensing and the temporary 30 percent additional first year depreciation allowance. For luxury automobiles eligible for the 50% additional first depreciation allowance, the first year limitation is increased by an additional \$3,050.

¹⁷⁵ Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

¹⁷⁶ Pub. Law No. 108-27, sec. 202 (2003).

¹⁷⁷ Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)), an empowerment zone (sec. 1397A), or a renewal community (sec. 1400J).

tangible personal property that is purchased for use in the active conduct of a trade or business. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000. Prior to the enactment of JGTRRA (and for taxable years beginning in 2006 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. Passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F.

Description of Proposal

The proposal limits the ability of taxpayers to claim deductions under section 179 for certain vehicles not subject to section 280F to \$25,000. The proposal applies to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less (in place of the present law 6,000 pound rating). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) does not have a primary load device or container attached; (2) has a seating capacity of more than 12 individuals; (3) is designed for more than nine individuals in seating rearward of the driver's seat; (4) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least 72.0 inches in interior length; or (5) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

The following example illustrates the operation of the provision.

Example.—Assume that during 2004, a calendar year taxpayer acquires and places in service a sport utility vehicle subject to the provision that costs \$70,000. In addition, assume that the property otherwise qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a \$25,000 deduction under section 179. The taxpayer is also allowed an additional first-year depreciation deduction (sec. 168(k)) of \$22,500 based on \$45,000 (\$70,000 original cost less the section 179 deduction of \$25,000) of adjusted basis. Finally, the remaining adjusted basis of \$22,500 (\$45,000 adjusted basis less \$22,500 additional first-year depreciation) is eligible for an additional depreciation deduction of \$4,500 under the general depreciation rules (automobiles are five-year recovery property). The remaining \$18,000 of cost (\$70,000 original cost less \$52,000 deductible currently) would be recovered in 2005 and subsequent years pursuant to the general depreciation rules.

Effective Date

The proposal is effective for property placed in service after February 2, 2004.

B. Proposals Designed to Curtail Tax Shelters

1. Clarification of the economic substance doctrine

Present Law

In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, “rule-based” system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.¹⁷⁸

A common-law doctrine applied with increasing frequency is the “economic substance” doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in federal income tax.¹⁷⁹

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress,

¹⁷⁸ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’d* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

¹⁷⁹ Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the “sham transaction doctrine” and the “business purpose doctrine”. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a “sham transaction” whose only purpose was to create the deductions).

by means of transactions that serve no economic purpose other than tax savings.¹⁸⁰

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.¹⁸¹

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.¹⁸² Some courts apply a conjunctive test that requires a taxpayer to establish the presence of *both* economic substance (i.e., the objective component) *and* business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.¹⁸³ A narrower approach used by some courts is to conclude that either a business purpose *or* economic substance is sufficient to respect the transaction).¹⁸⁴ A third approach regards economic

¹⁸⁰ *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

¹⁸¹ *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

¹⁸² “The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.” *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

¹⁸³ *See, e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”)

¹⁸⁴ *See, e.g., Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”); *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001) (“In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists” (the economic substance test).”) As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on

substance and business purpose as “simply more precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits.¹⁸⁵

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory v. Helvering*,¹⁸⁶ several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.¹⁸⁷ In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.¹⁸⁸ Under this analysis, the taxpayer’s profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a “reasonable possibility of profit” from the transaction existed apart from the tax benefits.¹⁸⁹ In these cases, in

Taxation, Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters) (JCS-3-99) at 182.

¹⁸⁵ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) (“Instead, the consideration of business purpose and economic substance are simply more precise factors to consider We have repeatedly and carefully noted that this formulation cannot be used as a ‘rigid two-step analysis’.”).

¹⁸⁶ 293 U.S. 465 (1935).

¹⁸⁷ See, e.g., *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

¹⁸⁸ See, e.g., *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, “potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions”).

¹⁸⁹ See, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, citing *Rice’s Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a “reasonable possibility of profit . . . apart from tax benefits.”).

assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Description of Proposal

In general

The proposal clarifies and enhances the application of the economic substance doctrine. The proposal provides that, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.¹⁹⁰

The proposal does not change current law standards used by courts in determining when to utilize an economic substance analysis.¹⁹¹ Also, the proposal does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.¹⁹² The proposal provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

Conjunctive analysis

The proposal clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the proposal, a transaction must satisfy *both* tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in

¹⁹⁰ If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this proposal.

¹⁹¹ See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

¹⁹² See, e.g., *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-tax business purpose

The proposal provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.¹⁹³

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.¹⁹⁴ Furthermore, a transaction that is expected

¹⁹³ See, e.g., Treas. reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

See also Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

¹⁹⁴ However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)¹⁹⁵ should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.¹⁹⁶

By requiring that a transaction be a “reasonable means” of accomplishing its non-tax purpose, the proposal reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.¹⁹⁷

Profit potential

Under the proposal, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer’s economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.¹⁹⁸ Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit potential test to a lessor of tangible property, depreciation, applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit), and any other deduction as provided in guidance by the Secretary are not taken into account in measuring tax benefits.

¹⁹⁵ This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

¹⁹⁶ Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) (“AEP’s intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings ‘were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,’” citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

¹⁹⁷ *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

¹⁹⁸ Thus, a “reasonable possibility of profit” will not be sufficient to establish that a transaction has economic substance.

Transactions with tax-indifferent parties

The proposal also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of this proposal, and (2) other rules as may be necessary or appropriate to carry out the purposes of the proposal.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the proposal shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and this proposal shall be construed as being additive to any such other doctrine.

Effective Date

The proposal applies to transactions entered into after February 2, 2004.

2. Penalty for failing to disclose reportable transaction

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.¹⁹⁹

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)²⁰⁰ a transaction that is specified by the Treasury

¹⁹⁹ On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

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

²⁰⁰ The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either

Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a “listed transaction”).²⁰¹

The second category is any transaction that is offered under conditions of confidentiality. In general, a transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid a minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies (irrespective if such terms are legally binding).²⁰²

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.²⁰³

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) \$10 million in any single year or \$20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) \$2 million in any single year or \$4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) \$50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.²⁰⁴

The fifth category of reportable transactions refers to any transaction done by certain taxpayers²⁰⁵ in which the tax treatment of the transaction differs (or is expected to differ) by more than \$10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.²⁰⁶

factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1-6011-4(c)(4).

²⁰¹ Treas. Reg. sec. 1.6011-4(b)(2).

²⁰² Treas. Reg. sec. 1.6011-4(b)(3).

²⁰³ Treas. Reg. sec. 1.6011-4(b)(4).

²⁰⁴ Treas. Reg. sec. 1.6011-4(b)(5). IRS Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

²⁰⁵ The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have \$250 million or more in gross assets.

²⁰⁶ Treas. Reg. sec. 1.6011-4(b)(6). IRS Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

The final category of reportable transactions is any transaction that results in a tax credit exceeding \$250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.²⁰⁷

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure can jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.²⁰⁸

Description of Proposal

In general

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

Transactions to be disclosed

The proposal does not define the terms “listed transaction”²⁰⁹ or “reportable transaction,” nor does the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a “listed transaction” and a “reportable transaction” under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is \$50,000. The amount is increased to \$100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., \$100,000 for a reportable

²⁰⁷ Treas. Reg. sec. 1.6011-4(b)(7).

²⁰⁸ Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. Regulations under sections 6662 and 6664 provide that a taxpayer's failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith, which would bar relief under section 6664(c).

²⁰⁹ The proposal states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of “substantially similar” will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of “listed transaction” and “reportable transactions”) as appropriate.

transaction and \$200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

A “large entity” is defined as any entity with gross receipts in excess of \$10 million in the year of the transaction or in the preceding year. A “high net worth individual” is defined as any individual whose net worth exceeds \$2 million, based on the fair market value of the individual’s assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,²¹⁰ or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The proposal applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective Date

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

3. Accuracy-related penalty for listed transactions and other reportable transactions having a significant tax avoidance purpose

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability

²¹⁰ A reportable avoidance transaction is a reportable transaction with a significant tax avoidance purpose.

exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.²¹¹ The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.²¹²

Special rules apply with respect to tax shelters.²¹³ For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.²¹⁴ The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.²¹⁵

Description of Proposal

In general

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a “reportable avoidance transaction”).²¹⁶ The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

²¹¹ Sec. 6662.

²¹² Sec. 6662(d)(2)(B).

²¹³ Sec. 6662(d)(2)(C).

²¹⁴ Sec. 6664(c).

²¹⁵ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

²¹⁶ The terms “reportable transaction” and “listed transaction” have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the “strengthened reasonable cause exception”), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

In addition, a public entity that is required to pay the 30-percent penalty must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once the 30-percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer’s treatment of the item and the proper treatment of the item (without regard to other items on the tax return)²¹⁷, and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer’s treatment of an item and the proper tax treatment of such item.

²¹⁷ For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

Strengthened reasonable cause exception

A penalty is not imposed under the proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,²¹⁸ (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return that includes the item is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor²¹⁹ and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates, (2) is compensated directly or indirectly²²⁰ by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended

²¹⁸ See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

²¹⁹ The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of \$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (\$250,000 in any other case).

²²⁰ This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the “organization” of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.²²¹ Participation in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement upon which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

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

Effective Date

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

²²¹ An advisor should not be treated as participating in the organization of a transaction if the advisor’s only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a “disqualified tax advisor” with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

4. Penalty for understatements attributable to transactions lacking economic substance, etc.

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.²²² The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.²²³ For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.²²⁴ The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.²²⁵

²²² Sec. 6662.

²²³ Sec. 6662(d)(2)(C).

²²⁴ Sec. 6664(c).

²²⁵ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

Description of Proposal

The proposal imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a “non-economic substance transaction understatement”).²²⁶ The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the proposal (i.e., the penalty is a strict-liability penalty).

A “non-economic substance transaction” means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance doctrine),²²⁷ (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier proposal regarding the economic substance doctrine),²²⁸ or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of this proposal, the calculation of an “understatement” is made in the same manner as in the separate proposal relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer’s treatment of the item and the proper treatment of the item (without regard to other items on the tax return),²²⁹ and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer’s treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer’s treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after

²²⁶ Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this proposal applies to any transaction that lacks economic substance.

²²⁷ The provision provides that a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

²²⁸ The provision provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

²²⁹ For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

A public entity that is required to pay a penalty under this proposal (regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Prior to this penalty being asserted in the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals (e.g., a Revenue Agent Report), the IRS Chief Counsel or his delegate at the IRS National Office must approve the inclusion in writing. Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Any understatement to which a penalty is imposed under this proposal will not be subject to the accuracy-related penalty under section 6662 or under new 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under this proposal would be taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under this proposal will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The proposal applies to transactions entered into after February 2, 2004.

5. Modifications of substantial understatement penalty for nonreportable transactions

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A “substantial understatement” exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations).²³⁰

²³⁰ Sec. 6662(a) and (d)(1)(A).

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.²³¹

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.²³²

Description of Proposal

Definition of substantial understatement

The proposal modifies the definition of “substantial” for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or (2) \$10 million.

Reduction of understatement for certain positions

The proposal elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

Effective Date

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

6. Tax shelter exception to confidentiality privileges relating to taxpayer communications

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code

²³¹ Sec. 6662(d)(2)(B).

²³² Sec. 6662(d)(2)(D).

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

Description of Proposal

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

Effective Date

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

7. Disclosure of reportable transactions

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.²³³ A “tax shelter” means any investment with respect to which the tax shelter ratio²³⁴ for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than \$250,000 and involving at least five investors).²³⁵

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of

²³³ Sec. 6111(a).

²³⁴ The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

²³⁵ Sec. 6111(c).

Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of \$100,000 in the aggregate.²³⁶

In general, a transaction has a “significant purpose of avoiding or evading Federal income tax” if the transaction: (1) is the same as or substantially similar to a “listed transaction,”²³⁷ or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.²³⁸ Certain exceptions are provided with respect to the second category of transactions.²³⁹

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter knows, or has reason to know, that the offeree’s use or disclosure of information relating to the transaction is limited in any other manner.²⁴⁰

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500.²⁴¹ However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

²³⁶ Sec. 6111(d).

²³⁷ Treas. Reg. sec. 301.6111-2(b)(2).

²³⁸ Treas. Reg. sec. 301.6111-2(b)(3).

²³⁹ Treas. Reg. sec. 301.6111-2(b)(4).

²⁴⁰ The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree’s disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2(c)(1).

²⁴¹ Sec. 6707.

Description of Proposal

Disclosure of reportable transactions by material advisors

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including any listed transaction)²⁴² to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.²⁴³

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

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

Penalty for failing to furnish information regarding reportable transactions

The proposal repeals the present law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).²⁴⁴ The amount of the penalty is \$50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) \$200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return

²⁴² The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

²⁴³ See the previous discussion regarding the disclosure requirements under new section 6707A.

²⁴⁴ The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances.²⁴⁵ All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, a revenue agent, an Appeals officer, or other IRS personnel cannot rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

Effective Date

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

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

8. Modification of penalties for failure to register tax shelters or maintain lists of investors

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).²⁴⁶ Recently issued regulations under section 6112 contain rules

²⁴⁵ The Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the proposal.

²⁴⁶ Sec. 6112.

regarding the list maintenance requirements.²⁴⁷ In general, the regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, February 28, 2003.²⁴⁸

The regulations provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.²⁴⁹ A material advisor is defined any person who is required to register the transaction under section 6111, or expects to receive a minimum fee of (1) \$250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) \$50,000 for any other transaction that is a potentially abusive tax shelter.²⁵⁰ For listed transactions (as defined in the regulations under section 6011), the minimum fees are reduced to \$25,000 and \$10,000, respectively.

A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the regulations under section 6011), or (3) any transaction that a potential material advisor, at the time the transaction is entered into, knows is or reasonably expects will become a reportable transaction (as defined under the new regulations under section 6011).²⁵¹

The Secretary is required to prescribe regulations which provide that, in cases in which two or more persons are required to maintain the same list, only one person would be required to maintain the list.²⁵²

Penalty for failing to maintain investor lists

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

Description of Proposal

Investor lists

Each material advisor²⁵³ with respect to a reportable transaction (including a listed transaction)²⁵⁴ is required to maintain a list that (1) identifies each person with respect to whom

²⁴⁷ Treas. Reg. sec. 301.6112-1.

²⁴⁸ A special rule applies the list maintenance requirements to transactions entered into after February 28, 2000 if the transaction becomes a listed transaction (as defined in Treas. Reg. 1.6011-4) after February 28, 2003.

²⁴⁹ Treas. Reg. sec. 301.6112-1(c)(1).

²⁵⁰ Treas. Reg. sec. 301.6112-1(c)(2) and (3).

²⁵¹ Treas. Reg. sec. 301.6112-1(b).

²⁵² Sec. 6112(c)(2).

the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

The proposal also clarifies that, for purposes of section 6112, the identity of any person is not privileged under the common law attorney-client privilege (or, consequently, the section 7525 federally authorized tax practitioner confidentiality provision).

Penalty for failing to maintain investor lists

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the request will be subject to a \$10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.²⁵⁵

Effective Date

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

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

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

²⁵³ The term “material advisor” has the same meaning as when used in connection with the requirement to file an information return under section 6111.

²⁵⁴ The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

²⁵⁵ In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

9. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions

Present Law

The Code authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.²⁵⁶

Description of Proposal

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions²⁵⁷ and the keeping of lists of investors by material advisors.²⁵⁸ Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective Date

The proposal is effective on the day after the date of enactment.

10. Understatement of taxpayer's liability by income tax return preparer

Present Law

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of \$250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of \$1,000.

Description of Proposal

The proposal alters the standards of conduct that must be met to avoid imposition of the first penalty. The proposal replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The proposal also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

²⁵⁶ Sec. 7408.

²⁵⁷ Sec. 6707, as amended by other proposals of this bill.

²⁵⁸ Sec. 6708, as amended by other proposals of this bill.

In addition, the proposal increases the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from \$250 to \$1,000. The penalty relating to willful or reckless conduct is increased from \$1,000 to \$5,000.

Effective Date

The proposal is effective for documents prepared after the date of enactment.

11. Penalty on failure to report interests in foreign financial accounts

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.²⁵⁹ In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of \$100,000; the minimum amount of the penalty is \$25,000.²⁶⁰ In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than \$250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to \$500,000 and the maximum length of imprisonment is increased to 10 years.²⁶¹

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.²⁶² This report, which was statutorily required,²⁶³ studies methods for improving compliance with these reporting requirements. It makes several administrative

²⁵⁹ 31 U.S.C. 5314.

²⁶⁰ 31 U.S.C. 5321(a)(5).

²⁶¹ 31 U.S.C. 5322.

²⁶² *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

²⁶³ Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to \$5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

The proposal is effective with respect to failures to report occurring on or after the date of enactment.

12. 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 (sec. 6702). The Code also permits the Tax Court²⁶⁴ 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 (sec. 6673(a)).

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.

²⁶⁴ Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

Effective Date

The proposal is effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

13. Regulation of individuals practicing before the Department of Treasury

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.²⁶⁵ The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

Description of Proposal

The proposal makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory provisions. First, the proposal expressly permits censure as a sanction. Second, the proposal permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

The proposal also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective Date

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

²⁶⁵ 31 U.S.C. 330.

14. Penalty on promoters of tax shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.²⁶⁶ A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A “gross valuation overstatement” means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

Description of Proposal

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

Effective Date

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

²⁶⁶ Sec. 6700.

15. Statute of limitations for taxable years for which required listed transactions not disclosed

Present Law

In general, the Code requires that taxes be assessed within three years²⁶⁷ after the date a return is filed.²⁶⁸ If there has been a substantial omission of items of gross income that totals more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.²⁶⁹ If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.²⁷⁰

Description of Proposal

The proposal extends the statute of limitations with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction²⁷¹ which is required to be included (under section 6011) with such return or statement. The statute of limitations with respect to such a transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is furnished the information so required, or (2) the date that a material advisor (as defined in 6111) satisfies the list maintenance requirements (as defined by section 6112) with respect to a request by the Secretary. For example, if a taxpayer engaged in a transaction in 2005 that becomes a listed transaction in 2007 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, then the transaction is subject to the extended statute of limitations.²⁷²

²⁶⁷ Sec. 6501(a).

²⁶⁸ For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

²⁶⁹ Sec. 6501(e).

²⁷⁰ Sec. 6501(c).

²⁷¹ The term “listed transaction” has the same meaning as described in a previous proposal regarding the penalty for failure to disclose reportable transactions.

²⁷² If the Treasury Department lists a transaction in a year subsequent to the year in which a taxpayer entered into such transaction and the taxpayer’s tax return for the year the transaction was entered into is closed by the statute of limitations prior to the date the transaction became a listed transaction, this proposal does not re-open the statute of limitations with respect to such transaction for such year. However, if the purported tax benefits of the transaction are recognized over multiple tax years, the proposal’s extension of the statute of limitations shall apply to such tax benefits in any subsequent tax year in which the statute of limitations had not closed prior to the date the transaction became a listed transaction.

Effective Date

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

16. Denial of deduction for interest on underpayments attributable to nondisclosed reportable and noneconomic substance transactions

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.²⁷³ Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

Description of Proposal

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from (1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.²⁷⁴

Effective Date

The proposal is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

17. Authorization of appropriations for tax law enforcement

Present Law

There is no explicit authorization of appropriations to the Internal Revenue Service to be used to combat abusive tax avoidance transactions.

Description of Proposal

The proposal includes an authorization of an additional \$300 million to the Internal Revenue Service to be used to combat abusive tax avoidance transactions.

Effective Date

The proposal is effective on the date of enactment.

²⁷³ Sec. 163(a).

²⁷⁴ The definitions of these transactions are the same as those previously described in connection with the proposal to modify the accuracy-related penalty for listed and certain reportable transactions and the proposal to impose a penalty on understatements attributable to transactions that lack economic substance.

C. Other Corporate Governance Proposals

1. Affirmation of consolidated return regulation authority

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.²⁷⁵

Section 1502 states:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.²⁷⁶

Under this authority, the Treasury Department has issued extensive consolidated return regulations.²⁷⁷

In the recent case of *Rite Aid Corp. v. United States*,²⁷⁸ the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

²⁷⁵ Sec. 1501.

²⁷⁶ Sec. 1502.

²⁷⁷ Regulations issued under the authority of section 1502 are considered to be “legislative” regulations rather than “interpretative” regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70th Cong., 1st Sess. at 15 (1928), describing the consolidated return regulations as “legislative in character”. The Supreme Court has stated that “. . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v. United States*, 1 Ct. Cl. 108 (1983), *aff’d* 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied*, 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

²⁷⁸ 255 F.3d 1357 (Fed. Cir. 2001), *reh’g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

disallowance regulations, and concluded that the provision was invalid.²⁷⁹ The particular provision, known as the “duplicated loss” provision,²⁸⁰ would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.²⁸¹

²⁷⁹ Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra. see also Union Carbide Corp. v. United States*, 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States*, 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation*, 31 B.T.A. 978 (1935); *Helvering v. Morgans, Inc.*, 293 U.S. 121 (1934), interpreting the term “taxable year.”

²⁸⁰ Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

²⁸¹ Treasury Regulation section 1.1502-20, generally imposing certain “loss disallowance” rules on the disposition of subsidiary stock, contained other limitations besides the “duplicated loss” rule that could limit the loss available to the group on a disposition of a subsidiary’s stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary’s stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary’s value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: “it is not administratively feasible to differentiate

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.²⁸²

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that “many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns” and that the committee “found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them.”²⁸³ The Court’s opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary “the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;” but that section 1502 “does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed.”²⁸⁴

between loss attributable to built-in gain and duplicated loss.” T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

²⁸² For example, the court stated: “The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary’s potential future deduction, not the parent’s loss on the sale of stock under I.R.C. sec. 165.” 255 F.3d 1357, 1360 (Fed. Cir. 2001).

²⁸³ S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating “The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit.” S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

²⁸⁴ *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation (“WHTC”) deduction under prior law (which deduction would have been computed as a percentage of each WHTC’s taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group’s consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.²⁸⁵

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.²⁸⁶

Description of Proposal

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined

returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

²⁸⁵ *Rite Aid*, 255 F.3d at 1360.

²⁸⁶ See Temp. Reg. Sec. 1.1502-20T(i)(2), Temp. Reg. Sec. 1.337(d)-2T, and Temp. Reg. Sec. 1.1502-35T. The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. See Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); see also Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); and T.D. 9048, 68 F.R. 12287 (March 14, 2003).

and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that the Secretary is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of a Code provision. The Secretary may promulgate consolidated return regulations to change the application of a tax code provision to members of a consolidated group, provided that such regulations are necessary to clearly reflect the income tax liability of the group and each corporation in the group, both during and after the period of affiliation.

The proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary²⁸⁷ to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.²⁸⁸

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.²⁸⁹

Effective Date

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the proposal. No inference is intended that the results following from the proposal are not the same as the results under present law.

²⁸⁷ Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

²⁸⁸ The proposal is not intended to overrule the current Treasury Department regulations, which allow taxpayers in certain circumstances for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

²⁸⁹ See, e.g., Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); Temp. Reg. Sec. 1.337(d)-2T, (T.D. 8984, 67 F.R. 11034 (March 12, 2002) and T.D. 8998, 67 F.R. 37998 (May 31, 2002)); REG-102740-02, 67 F.R. 11070 (March 12, 2002); see also Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002); REG-131478-02, 67 F.R. 65060 (October 18, 2002); Temp. Reg. Sec. 1.1502-35T (T.D. 9048, 68 F.R. 12287 (March 14, 2003)). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

2. Chief Executive Officer required to sign corporate income tax returns

Present Law

The Code requires²⁹⁰ 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 imposes²⁹¹ 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 \$100,000²⁹² (\$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 the chief executive officer of a corporation sign a declaration under penalties of perjury that the corporation's income tax 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 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).

It is also anticipated that, as part of the declaration, the CEO would certify that, to the best of the CEO's knowledge and belief: (1) the processes and procedures for ensuring that the corporation files a tax return that complies with the requirements of the Code are operating effectively; (2) the return is true, accurate, and complete; (3) the officer signing the return did so

²⁹⁰ Sec. 6062.

²⁹¹ Sec. 7206.

²⁹² Pursuant to 18 U.S.C. 3571, the maximum fine for an individual convicted of a felony is \$250,000.

under no compulsion to adopt any tax position with which that person did not agree; (4) the CEO was briefed on all listed transactions as well as all reportable tax avoidance transactions otherwise required to be disclosed on the tax return; and (5) all required disclosures have been filed with the return. The Secretary may by regulations prescribe additional requirements for this declaration.²⁹³

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.²⁹⁴ 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;²⁹⁵ they are required to be signed as under present law.

Effective Date

The proposal is effective for returns filed after the date of enactment.

3. Denial of deduction for certain fines, penalties, and other amounts

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that “allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof.”²⁹⁶

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime

²⁹³ Sec. 6011(a).

²⁹⁴ 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).

²⁹⁵ The proposal does, however, apply to the income tax returns of mutual fund management companies and advisors.

²⁹⁶ S. Rep. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

(felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Description of Proposal

The proposal modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the proposal generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the governmental investigation or inquiry into the potential violation of any law²⁹⁷ are nondeductible under any provision of the income tax provisions.²⁹⁸ The proposal applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.²⁹⁹

The proposal applies only where a government (or other entity treated in a manner similar to a government under the bill) is a complainant or investigator with respect to the violation or potential violation of any law.³⁰⁰

²⁹⁷ The proposal does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raises an issue of compliance and a payment is required in settlement of such issue, the proposal would affect such payment. In such cases, the restitution exception could permit otherwise allowable deductions of amounts paid with respect to specific property or persons to avoid noncompliance or to bring the taxpayer into compliance with the required standards (for example, to bring a machine up to required emissions or other standards).

²⁹⁸ The proposal provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

²⁹⁹ The proposal does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

³⁰⁰ Thus, for example, the proposal would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause a payment to be made "at the direction of a government" for purposes of the proposal.

It is intended that a payment will be treated as restitution only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed (or, in the case of property, not in compliance with the required standards) by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution.³⁰¹ Restitution is limited to the amount that bears a substantial quantitative relationship to the harm (or, in the case of property, to the correction of noncompliance) caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the proposal if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the proposal. The exception for payments that the taxpayer establishes are restitution likewise applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the bill is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective Date

The proposal is effective for amounts paid or incurred on or after April 28, 2003; however the proposal does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained on or before April 27, 2003.

³⁰¹ Similarly, a payment to a charitable organization benefitting a substantially broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the proposal, such a payment not deductible under section 162 would also not be deductible under section 170.

4. Denial of deduction for punitive damages

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.³⁰² However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.³⁰³ In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.³⁰⁴ Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.³⁰⁵

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.³⁰⁶ However, this exclusion does not apply to punitive damages.³⁰⁷

Description of Proposal

The proposal denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

Effective Date

The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment.

³⁰² Sec. 162(a).

³⁰³ Sec. 162(c).

³⁰⁴ Sec. 162(f).

³⁰⁵ Sec. 162(g).

³⁰⁶ Sec. 104(a).

³⁰⁷ Sec. 104(a)(2).

5. Increase the maximum criminal fraud penalty for individuals to the amount of the tax at issue

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 felony³⁰⁸ \$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.

³⁰⁸ Section 7206 states that this offense is a felony. In addition, it is a felony pursuant to the classification guidelines of 18 U.S.C. 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 \$250,000 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 and increases the maximum prison sentence to ten years.

Fraud and false statements

The proposal increases the criminal penalty under section 7206 of the Code for individuals to \$250,000 and for corporations to \$1,000,000. The provision increases the maximum prison sentence to five years. The provision 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 underpayments and overpayments attributable to actions occurring after the date of enactment.

6. Doubling of 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 pay tax shown on a return may not reduce the penalty for failure to file 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 part, 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 means 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.

D. Enron-Related Tax Shelter Proposals

1. Limitation on transfer and importation of built-in losses

Present Law

Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation.³⁰⁹ The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.³¹⁰

The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.³¹¹

Description of Proposal

Importation of built-in losses

The proposal provides that if a net built-in loss is imported into the U.S. in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value. A similar rule applies in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.

Under the proposal, a net built-in loss is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceeds the fair market value of the properties transferred. Thus, for example, if in a tax-free incorporation, some properties are received by a corporation from U. S. persons subject to tax, and some properties are received from foreign persons not subject to U.S. tax, this proposal applies to limit the adjusted basis of each property received from the foreign persons to the fair market value of the property. In the case of a transfer by a partnership (either domestic or foreign), this proposal applies as if each partner had transferred such partner's proportionate share of the property of such partnership.

Limitation on transfer of built-in-losses in section 351 transactions

The proposal provides that if the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the

³⁰⁹ Sec. 351.

³¹⁰ Sec. 358.

³¹¹ Secs. 334(b) and 362(a) and (b).

aggregate fair market value of the property transferred in a tax-free incorporation, the transferee's aggregate bases of the property is limited to the aggregate fair market value of the transferred property. Under the proposal, any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction. In the case of a transfer after which the transferor owns at least 80 percent of the vote and value of the stock of the transferee corporation, any basis reduction required by the proposal is made to the stock received by the transferor and not to the assets transferred.

Effective Date

The proposal applies to transactions after February 13, 2003.

2. No reduction of basis under section 734 in stock held by partnership in corporate partner

Present Law

In general

Generally, a partner and the partnership do not recognize gain or loss on a contribution of property to the partnership.³¹² Similarly, a partner and the partnership generally do not recognize gain or loss on the distribution of partnership property.³¹³ This includes current distributions and distributions in liquidation of a partner's interest.

Basis of property distributed in liquidation

The basis of property distributed in liquidation of a partner's interest is equal to the partner's tax basis in its partnership interest (reduced by any money distributed in the same transaction).³¹⁴ Thus, the partnership's tax basis in the distributed property is adjusted (increased or decreased) to reflect the partner's tax basis in the partnership interest.

Election to adjust basis of partnership property

When a partnership distributes partnership property, generally, the basis of partnership property is not adjusted to reflect the effects of the distribution or transfer. The partnership is permitted, however, to make an election (referred to as a 754 election) to adjust the basis of partnership property in the case of a distribution of partnership property.³¹⁵ The effect of the 754 election is that the partnership adjusts the basis of its remaining property to reflect any change in basis of the distributed property in the hands of the distributee partner resulting from

³¹² Sec. 721(a).

³¹³ Sec. 731(a) and (b).

³¹⁴ Sec. 732(b).

³¹⁵ Sec. 754.

the distribution transaction. Such a change could be a basis increase due to gain recognition, or a basis decrease due to the partner's adjusted basis in its partnership interest exceeding the adjusted basis of the property received. If the 754 election is made, it applies to the taxable year with respect to which such election was filed and all subsequent taxable years.

In the case of a distribution of partnership property to a partner with respect to which the 754 election is in effect, the partnership increases the basis of partnership property by (1) any gain recognized by the distributee partner and (2) the excess of the adjusted basis of the distributed property to the partnership immediately before its distribution over the basis of the property to the distributee partner, and decreases the basis of partnership property by (1) any loss recognized by the distributee partner and (2) the excess of the basis of the property to the distributee partner over the adjusted basis of the distributed property to the partnership immediately before the distribution.

The allocation of the increase or decrease in basis of partnership property is made in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties.³¹⁶ In addition, the allocation rules require that any increase or decrease in basis be allocated to partnership property of a like character to the property distributed. For this purpose, the two categories of assets are (1) capital assets and depreciable and real property used in the trade or business held for more than one year, and (2) any other property.³¹⁷

Description of Proposal

The proposal provides that in applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person. Any decrease in basis that, absent the proposal, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

Effective Date

The proposal applies to distributions after February 13, 2003.

³¹⁶ Sec. 755(a).

³¹⁷ Sec. 755(b).

3. Repeal of special rules for FASITs

Present Law

Financial asset securitization investment trusts

In 1996, Congress created a new type of statutory entity called a “financial asset securitization trust” (“FASIT”) that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.³¹⁸ A FASIT generally is not taxable; the FASIT’s taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue one or more classes of instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., “high-yield interests”) must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years;³¹⁹ (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called “permitted assets;” (3) have non-ownership interests be certain specified types of debt instruments called “regular interests;” (4) have a single ownership interest which is held by an “eligible holder;” and (5) not qualify as a regulated investment company (“RIC”). Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule that deems regular interests of a FASIT to be debt.

³¹⁸ Sections 860H through 860L.

³¹⁹ Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.

Permitted assets

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following “permitted assets”: (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

“Regular interests” of a FASIT

“Regular interests” of a FASIT are treated as debt for Federal income tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a “regular interest”, an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates, or (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to real estate mortgage investment conduit interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate (“AFR”) for the calendar month in which the instrument is issued.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt (i.e., taxable) domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to FASITs

In general, gain (but not loss) is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT’s owner (or a person related to the FASIT’s owner), the property is treated as being first acquired by the FASIT’s owner for the FASIT’s cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

Valuation rules.—In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. Similarly, in the case of debt instruments that are traded on an established securities market, the market price is used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. However, in the case of debt instruments that are not traded on an established securities market, special valuation rules apply for purposes of computing gain on the transfer of such debt instruments to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations.

Taxation of a FASIT

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining original issue discount ("OID") accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments.

Taxation of holders of FASIT regular interests

In general, a holder of a regular interest is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

Taxation of holders of FASIT ownership interests

Because all of the assets and liabilities of a FASIT are treated as assets and liabilities of the holder of a FASIT ownership interest, the ownership interest holder takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Although the recognition of losses on assets contributed to the FASIT is not allowed upon contribution of the assets, such losses may be allowed to the FASIT owner upon their disposition by the FASIT. Furthermore, the holder of a FASIT ownership interest is not permitted to offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with other losses of the holder. In addition, any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder of a FASIT ownership interest is a member of a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer.

Real estate mortgage investment conduits

In general, a real estate mortgage investment conduit ("REMIC") is a self-liquidating entity that holds a fixed pool of mortgages and issues multiple classes of investor interests. A REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests in the REMIC under detailed rules.³²⁰ In order to qualify as a REMIC, substantially all of the assets of the entity must consist of

³²⁰ See sections 860A through 860G.

qualified mortgages and permitted investments as of the close of the third month beginning after the startup day of the entity. A “qualified mortgage” generally includes any obligation which is principally secured by an interest in real property, and which is either transferred to the REMIC on the startup day of the REMIC in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months after the startup day pursuant to a fixed-price contract in effect on the startup day. A “permitted investment” generally includes any intangible property that is held for investment and is part of a reasonably required reserve to provide for full payment of certain expenses of the REMIC or amounts due on regular interests.

All of the interests in the REMIC must consist of one or more classes of regular interests and a single class of residual interests. A “regular interest” is an interest in a REMIC that is issued with a fixed term, designated as a regular interest, and unconditionally entitles the holder to receive a specified principal amount (or other similar amount) with interest payments that are either based on a fixed rate (or, to the extent provided in regulations, a variable rate) or consist of a specified portion of the interest payments on qualified mortgages that does not vary during the period such interest is outstanding. In general, a “residual interest” is any interest in the REMIC other than a regular interest, and which is so designated by the REMIC, provided that there is only one class of such interest and that all distributions (if any) with respect to such interests are pro rata. Holders of residual REMIC interests are subject to tax on the portion of the income of the REMIC that is not allocated to the regular interest holders.

Description of Proposal

The proposal repeals the special rules for FASITs. The proposal provides a transition period for existing FASITs, pursuant to which the repeal of the FASIT rules would not apply to any FASIT in existence on the date of enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms.

For purposes of the REMIC rules, the proposal also modifies the definitions of REMIC regular interests, qualified mortgages, and permitted investments so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. Specifically, the proposal modifies the present-law definition of a REMIC “regular interest” to provide that an interest in a REMIC does not fail to qualify as a regular interest solely because the specified principal amount of such interest or the amount of interest accrued on such interest could be reduced as a result of the nonoccurrence of one or more contingent payments with respect to one or more reverse mortgages loans, as defined below, that are held by the REMIC, provided that on the startup day for the REMIC, the REMIC sponsor reasonably believes that all principal and interest due under the interest will be paid at or prior to the liquidation of the REMIC. For this purpose, a reasonable belief concerning ultimate payment of all amounts due under an interest is presumed to exist if, as of the startup day, the interest receives an investment grade rating from at least one nationally recognized statistical rating agency.

In addition, the proposal makes three modifications to the present-law definition of a “qualified mortgage.” First, the proposal modifies the definition to include an obligation principally secured by real property which represents an increase in the principal amount under the original terms of an obligation, provided such increase: (1) is attributable to an advance made to the obligor pursuant to the original terms of the obligation; (2) occurs after the REMIC

startup day; and (3) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day. Second, the proposal modifies the definition to generally include reverse mortgage loans and the periodic advances made to obligors on such loans. For this purpose, a “reverse mortgage loan” is defined as a loan that: (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a “balance increase”), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan. Third, the proposal modifies the definition to provide that, if more than 50 percent of the obligations transferred to, or purchased by, the REMIC are (1) originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) and (2) principally secured by an interest in real property, then each obligation transferred to, or purchased by, the REMIC shall be treated as secured by an interest in real property.

In addition, the proposal modifies the present-law definition of a “permitted investment” to include intangible investment property held as part of a reasonably required reserve to provide a source of funds for the purchase of obligations described above as part of the modified definition of a “qualified mortgage.”

Effective Date

Except as provided by the transition period for existing FASITs, the proposal is effective after February 13, 2003.

4. Expanded disallowance of deduction for interest on convertible debt

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount (“OID”) on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Under present law, no deduction is allowed for interest or OID on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is

payable in equity of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including a debt instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into equity of the issuer or a related party.³²¹ In addition, a debt instrument is treated as payable in equity if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of equity of the issuer or related party.³²² A debt instrument also is treated as payable in equity if it is part of an arrangement that is designed to result in the payment of the debt instrument with or by reference to such equity, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such equity, or certain debt instruments that are paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that option will be exercised.³²³

Description of Proposal

The proposal expands the present-law disallowance of interest deductions on certain corporate convertible or equity-linked debt that is payable in, or by reference to the value of, equity. Under the proposal, the disallowance is expanded to include interest on corporate debt that is payable in, or by reference to the value of, any equity held by the issuer (or any related party) in any other person, without regard to whether such equity represents more than a 50-percent ownership interest in such person. The basis of such equity is increased by the amount of interest deductions that is disallowed by the proposal. The proposal directs the Treasury Department to issue regulations that provide rules for determining the manner in which the basis of equity held by the issuer (or related party) is increased by the amount of interest deductions that is disallowed under the proposal.

The proposal does not apply to debt that is issued by an active dealer in securities (or a related party) if the debt is payable in, or by reference to the value of, equity that is held by the securities dealer in its capacity as a dealer in securities.

Effective Date

This proposal applies to debt instruments that are issued after February 13, 2003.

5. Expanded authority to disallow tax benefits under section 269

Present Law

Section 269 provides that if a taxpayer acquires, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation, and the principal purpose of the acquisition

³²¹ Sec. 163(l), enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1005(a).

³²² Sec. 163(l)(3)(B).

³²³ Sec. 163(l)(3)(C).

is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary may disallow the such tax benefits.³²⁴ Similarly, if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders immediately before the acquisition), the basis of such property is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose of the acquisition is the evasion or avoidance of Federal income tax by securing a tax benefit that would not otherwise have been available, the Secretary may disallow such tax benefits.³²⁵

Description of Proposal

The proposal expands section 269 by repealing the requirement that the acquisition of property be from a corporation not controlled by the acquirer. Thus, under the proposal, section 269 disallows the tax benefits of (1) any acquisition of stock sufficient to obtain control of a corporation (as under present law), and (2) any acquisition by a corporation of property from a corporation in which the basis of such property is determined by reference to the basis in the hands of the transferor corporation, if the principal purpose of such acquisition is the evasion or avoidance of Federal income tax.

Effective Date

The proposal applies to stock and property acquired after February 13, 2003.

6. Modification of interaction between subpart F and passive foreign investment company rules

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 F³²⁶ and the passive foreign investment company rules.³²⁷ A foreign tax credit generally is available to offset, in whole or in part, the

³²⁴ Sec. 269(a)(1).

³²⁵ Sec. 269(a)(2).

³²⁶ Secs. 951-964.

³²⁷ Secs. 1291-1298.

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.³²⁸

Generally, income earned indirectly by a domestic corporation through a foreign corporation is subject to U.S. tax only when the income is distributed to the domestic corporation, because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations, in order to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad.

Subpart F,³²⁹ 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).³³⁰ 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.³³¹

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 company income,³³² insurance income,³³³ and certain income relating to international boycotts and other violations of public policy.³³⁴ 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, foreign base company services income, foreign base company shipping income and foreign base company oil-related income.³³⁵

³²⁸ Secs. 901, 902, 960, 1291(g).

³²⁹ Secs. 951-964.

³³⁰ Secs. 951(b), 957, 958.

³³¹ Sec. 951(a).

³³² Sec. 954.

³³³ Sec. 953.

³³⁴ Sec. 952(a)(3)-(5).

³³⁵ Sec. 954.

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.³³⁶

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.³³⁷ 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.³³⁸ 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.³³⁹ 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 and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”³⁴⁰

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).

³³⁶ Secs. 951(a)(1)(B), 956.

³³⁷ Sec. 1297.

³³⁸ Sec. 1293-1295.

³³⁹ Sec. 1291.

³⁴⁰ Sec. 1296.

Description of Proposal

The proposal 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 proposal is effective for taxable years of controlled foreign corporations beginning after February 13, 2003, and for taxable years of U.S. shareholders in which or with which such taxable years of controlled foreign corporations end.

E. Proposals to Discourage Expatriation

1. Tax treatment of inversion transactions

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier “parent” corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation’s “nationality,” such as the location of the corporation’s management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation’s stock is traded, or the residence of the corporation’s managers and shareholders.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F³⁴¹ and the passive foreign investment company rules.³⁴² A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income

³⁴¹ Secs. 951-964.

³⁴² Secs. 1291-1298.

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

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

U.S. tax treatment of inversion transactions

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

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various “earnings stripping” or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain interest paid to related parties, if the payor’s debt-equity ratio exceeds 1.5 to 1 and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income.” More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an “arm’s length” standard, and permit the Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

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

In asset inversions, the U.S. corporation generally recognizes gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally do not recognize gain or loss, assuming the transaction meets the requirements of a reorganization under section 368.

Description of Proposal

In general

The proposal defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;³⁴³ (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The proposal denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.³⁴⁴

³⁴³ It is expected that the Treasury Secretary will issue regulations applying the term "substantially all" in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.

³⁴⁴ Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, with respect to inversion transactions completed before 2004, regulated

Except as otherwise provided in regulations, the proposal does not apply to a direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. In determining whether a transaction would meet the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called “hook” stock), the stock would not be considered in determining whether the transaction meets the definition. Stock sold in a public offering (whether initial or secondary) or private placement related to the transaction also is disregarded for these purposes. Acquisitions with respect to a domestic corporation or partnership are deemed to be “pursuant to a plan” if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the proposal is met with respect to such corporation or partnership.

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

Transactions involving greater than 50 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but: (1) any applicable corporate-level “toll charges” for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits; (2) the accuracy-related penalty is increased; and (3) section 163(j), relating to “earnings stripping” through related-party debt, is strengthened. These measures generally apply for a 10-year period following the inversion transaction. In addition, inverting entities are required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

With respect to “toll charges,” any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the

investment companies and certain similar entities are allowed to elect to recognize gain as if sec. 367(a) did apply.

extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

The 20-percent penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation misstatement is increased to 30 percent with respect to taxpayers related to the inverted entity. In addition, the 40-percent penalty for gross valuation misstatement is increased to 50 percent with respect to such taxpayers.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, are strengthened for inverted corporations. With respect to such corporations, the proposal eliminates the debt-equity threshold generally applicable under section 163(j) and reduces the 50-percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the proposals described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this proposal and to prevent its abuse.

Partnership transactions

Under the proposal, both types of inversion transactions include certain partnership transactions. Specifically, both parts of the proposal apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership (whether or not publicly traded), if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these tests are met, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" proposals apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership applies to inversion transactions completed after March 20, 2002. The rules for inversion transactions involving greater-than-50-percent identity of ownership apply to inversion transactions completed after 1996 that meet the 50-percent test and to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002 date.

2. Impose mark-to-market tax on individuals who expatriate

Present Law

In general

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

Income tax rules with respect to expatriates

An individual who relinquishes his or her U.S. citizenship or terminates his or her U.S. residency with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the 10 taxable years ending after the expatriation or residency termination under section 877. The alternative method of taxation for expatriates modifies the rules generally applicable to the taxation of nonresident noncitizens in several ways. First, the individual is subject to tax on his or her U.S.-source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident noncitizens. Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on foreign-source income. Second, the scope of items treated as U.S.-source income for section 877 purposes is broader than those items generally considered to be U.S.-source income under the Code.³⁴⁵ Third, individuals subject to section 877 are taxed on exchanges of certain types of property that give rise to U.S.-source income for property that gives rise to foreign-source income.³⁴⁶ Fourth, an individual subject to section 877 who contributes property to a controlled foreign corporation is treated as receiving income or gain from such property directly and is taxable on such income or gain. The alternative method of taxation for expatriates applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident noncitizen.

³⁴⁵ For example, gains on the sale or exchange of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S.-source income under the Code. Thus, such gains would not be taxable to a nonresident noncitizen. However, if an individual is subject to the alternative regime under sec. 877, such gains are treated as U.S.-source income with respect to that individual.

³⁴⁶ For example, a former citizen who is subject to the alternative tax regime and who removes appreciated artwork that he or she owns from the United States could be subject to immediate U.S. tax on the appreciation. In this regard, the removal from the United States of appreciated tangible personal property having an aggregate fair market value in excess of \$250,000 within the 15-year period beginning five years prior to the expatriation will be treated as an “exchange” subject to these rules.

The expatriation tax provisions apply to long-term residents of the United States whose U.S. residency is terminated. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying the 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tie-breaker rule (and the individual does not elect to waive the benefits of such treaty).

Subject to the exceptions described below, an individual is treated as having expatriated or terminated residency with a principal purpose of avoiding U.S. taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of the individual's loss of U.S. citizenship or termination of U.S. residency is greater than \$100,000 (the "tax liability test"), or (2) the individual's net worth as of the date of such loss or termination is \$500,000 or more (the "net worth test"). The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996. An individual who falls below these thresholds is not automatically treated as having a principal purpose of tax avoidance, but nevertheless is subject to the expatriation tax provisions if the individual's loss of citizenship or termination of residency in fact did have as one of its principal purposes the avoidance of tax.

Certain exceptions from the treatment that an individual relinquished his or her U.S. citizenship or terminated his or her U.S. residency for tax avoidance purposes may also apply. For example, a U.S. citizen who loses his or her citizenship and who satisfies either the tax liability test or the net worth test (described above) can avoid being deemed to have a principal purpose of tax avoidance if the individual falls within certain categories (such as being a dual citizen) and the individual, within one year from the date of loss of citizenship, submits a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as one of its principal purposes the avoidance of taxes.

Estate tax rules with respect to expatriates

Nonresident noncitizens generally are subject to estate tax on certain transfers of U.S.-situated property at death.³⁴⁷ Such property includes real estate and tangible property located within the United States. Moreover, for estate tax purposes, stock held by nonresident noncitizens is treated as U.S.-situated if issued by a U.S. corporation.

Special rules apply to U.S. citizens who relinquish their citizenship and long-term residents who terminate their U.S. residency within the 10 years prior to the date of death, unless the loss of status did not have as one its principal purposes the avoidance of tax (sec. 2107). Under these rules, the decedent's estate includes the proportion of the decedent's stock in a

³⁴⁷ The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") repealed the estate tax for estates of decedents dying after December 31, 2009. However, the Act included a "sunset" provision, pursuant to which the Act's provisions (including estate tax repeal) do not apply to estates of decedents dying after December 31, 2010.

foreign corporation that the fair market value of the U.S.-situs assets owned by the corporation bears to the total assets of the corporation. This rule applies only if (1) the decedent owned, directly, at death 10 percent or more of the combined voting power of all voting stock of the corporation and (2) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation.

Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

Gift tax rules with respect to expatriates

Nonresident noncitizens generally are subject to gift tax on certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Unlike the estate tax rules for U.S. stock held by nonresidents, however, nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Special rules apply to U.S. citizens who relinquish their U.S. citizenship or long-term residents of the United States who terminate their U.S. residency within the 10 years prior to the date of transfer, unless such loss did not have as one of its principal purposes the avoidance of tax (sec. 2501(a)(3)). Under these rules, nonresident noncitizens are subject to gift tax on transfers of intangibles, such as stock or securities. Taxpayers are deemed to have a principal purpose of tax avoidance if they meet the five-year tax liability test or the net worth test, discussed above. Exceptions from this tax avoidance treatment apply in the same circumstances as those described above (relating to certain dual citizens and other individuals who submit a timely and complete ruling request with the IRS as to whether their expatriation or residency termination had a principal purpose of tax avoidance).

Other tax rules with respect to expatriates

The expatriation tax provisions permit a credit against the U.S. tax imposed under such provisions for any foreign income, gift, estate, or similar taxes paid with respect to the items subject to such taxation. This credit is available only against the tax imposed solely as a result of the expatriation tax provisions, and is not available to be used to offset any other U.S. tax liability.

In addition, certain information reporting requirements apply. Under these rules, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) that includes the individual's social security number, forwarding foreign address, new country of residence and citizenship, a balance sheet in the case of individuals with a net worth of at least \$500,000, and such other information as the Secretary may prescribe. The information statement must be provided no later than the earliest day on which the individual (1) renounces the individual's U.S. nationality before a diplomatic or

consular officer of the United States, (2) furnishes to the U.S. Department of State a statement of voluntary relinquishment of U.S. nationality confirming an act of expatriation, (3) is issued a certificate of loss of U.S. nationality by the U.S. Department of State, or (4) loses U.S. nationality because the individual's certificate of naturalization is canceled by a U.S. court. The entity to which such statement is to be provided is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. A long-term resident whose U.S. residency is terminated is required to attach a similar statement to his or her U.S. income tax return for the year of such termination. An individual's failure to provide the required statement results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year, or (2) \$1,000.

The State Department is required to provide the Secretary of the Treasury with a copy of each certificate of loss of nationality approved by the State Department. Similarly, the agency administering the immigration laws is required to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned. Further, the Secretary of the Treasury is required to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names or certificates of loss of nationality it receives under the foregoing information-sharing provisions.

Immigration rules with respect to expatriates

Under U.S. immigration laws, any former U.S. citizen who officially renounces his or her U.S. citizenship and who is determined by the Attorney General to have renounced for the purpose of U.S. tax avoidance is ineligible to receive a U.S. visa and will be denied entry into the United States. This provision was included as an amendment (the "Reed amendment") to immigration legislation that was enacted in 1996.

Description of Proposal

In general

The proposal generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The \$600,000 amount is increased by a cost of living adjustment factor for calendar years after 2004.

Individuals covered

Under the proposal, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term

resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the termination of residency occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

Election to be treated as a U.S. citizen

Under the proposal, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an “all or nothing” election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

Date of relinquishment of citizenship

Under the proposal, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of

U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

Deemed sale of property upon expatriation or residency termination

The deemed sale rule of the proposal generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the proposal. Regulatory authority is granted to the Treasury to except other types of property from the proposal.

Under the proposal, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Retirement plans and similar arrangements

Subject to certain exceptions, the proposal applies to all property interests held by the individual at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).³⁴⁸ However, the proposal contains a special rule for an interest in a "qualified retirement plan." For purposes of the proposal, a "qualified retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may

³⁴⁸ Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the proposal, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

Deferral of payment of tax

Under the proposal, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

Interests in trusts

Under the proposal, detailed rules apply to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these proposals. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.—If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts.—If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax

amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

Coordination with present-law alternative tax regime

The proposal provides a coordination rule with the present-law alternative tax regime. Under the proposal, the expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose expatriation or residency termination occurs on or after February 2, 2004.

Treatment of gifts and inheritances from a former citizen or former long-term resident

Under the proposal, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then

take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

Information reporting

The proposal provides that certain information reporting requirements under present law (sec. 6039G) applicable to former citizens and former long-term residents also apply for purposes of the proposal.

Immigration rules

The proposal amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the proposal's expatriation tax proposals (regardless of the subjective motive for expatriating). For this purpose, the proposal permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the proposal would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this proposal.

Effective Date

The proposal generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after February 2, 2004. The proposals relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after February 2, 2004, whose expatriation or residency termination occurs on or after such date. The proposals relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

3. Excise tax on stock compensation of insiders of inverted corporations

Present Law

The income taxation of a nonstatutory³⁴⁹ compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.³⁵⁰ Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

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

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

Description of Proposal

Under the proposal, specified holders of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions. The proposal imposes a 20 percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's inversion date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or would be subject to such requirements if the corporation was

³⁴⁹ Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

³⁵⁰ If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),³⁵¹ directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an inverted corporation only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 50 percent identity of stock ownership corporate inversion transactions previously described in the bill.

Specified stock compensation subject to the excise tax includes any payment³⁵² (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group³⁵³) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the proposal applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example,

³⁵¹ An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

³⁵² Under the proposal, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

³⁵³ An expanded affiliated group is an affiliated group (under section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

an arrangement under which a disqualified individual is paid a cash bonus of \$500,000 if the corporation's stock increased in value by 25 percent over two years or \$1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual is paid a cash bonus equal to \$10,000 for every \$1 increase in the share price of the corporation's stock is subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

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

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

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

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the proposal.

The value of other forms of compensation, such as phantom stock or restricted stock, are the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It is expected that the Treasury Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term and would be modified as necessary or appropriate to carry out the purposes of the proposal. Pending the issuance of guidance, it is intended that taxpayers could rely on the revenue procedure issued under section 280G (except that the full remaining term must be used and recalculation is not permitted).

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

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

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

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

Effective Date

The proposal is effective as of July 11, 2002, except that periods before July 11, 2002, are not taken into account in applying the tax to specified stock compensation held or cancelled during the six-month period before the inversion date.

4. Reinsurance agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.³⁵⁴ For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.³⁵⁵ In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority³⁵⁶ be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

³⁵⁴ Sec. 845(a).

³⁵⁵ See S. Rep. No. 97-494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

³⁵⁶ The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.

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

Effective Date

The proposal is effective for any risk reinsured after April 11, 2002.