

**DESCRIPTION OF A CHAIRMAN'S AMENDMENT
IN THE NATURE OF A SUBSTITUTE FOR H.R. 2511,
THE "ENERGY TAX POLICY ACT OF 2001"**

Scheduled for Markup
By the
HOUSE COMMITTEE ON WAYS AND MEANS
on July 18, 2001

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on July 18, 2001, on a chairman's amendment in the nature of a substitute for H.R. 2511, the "Energy Tax Policy Act of 2001." This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of chairman's amendment in the nature of a substitute for the "Energy Policy Tax Act of 2001."

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of a Chairman's Amendment in the Nature of a Substitute for H.R. 2511, the "Energy Tax Policy Act of 2001"* (JCX-61-01), July 17, 2001.

I. CONSERVATION

A. Tax Credit for Residential Solar Energy

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law personal tax credit for residential solar energy property.

Description of Proposal

The proposal would provide a personal tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit would be equal to 15 percent of qualified investment up to a maximum credit of \$2,000 for solar water heating property and \$2,000 for rooftop photovoltaic property. This credit would be nonrefundable, and the depreciable basis of the property would be reduced by the amount of the credit.

Qualifying solar water heating property would mean an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property would be property that uses solar energy to generate electricity for use in a dwelling unit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit would be eligible expenditures.

Certain equipment safety requirements would need to be met to qualify for the credit. Special proration rules would apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations.

Effective Date

The credit would apply to purchases in taxable years ending after December 31, 2001 and before January 1, 2007 (January 1, 2009 in the case of qualified photovoltaic property).

B. Extension and Modification of the Section 45 Electricity Production Credit

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified “closed-loop” biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit is 1.7 cents per kilowatt hour for 2001. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

Description of Proposal

The proposal would extend the placed in service date for wind facilities and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass facilities) and before January 1, 2007.

The proposal also would define two new qualifying facilities: open-loop biomass facilities and landfill gas facilities. Open-loop biomass would be defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural

sources. Eligible forest-related resources would be defined as mill as residues, precommercial thinnings, slash, and brush, but not including old-growth timber. Solid wood waste materials would include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources would include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying open-loop biomass would not include municipal solid waste (garbage) or paper that is commonly recycled. Landfill gas would be defined as methane gas derived from the biodegradation of municipal solid waste. Qualifying open-loop biomass facilities and qualifying landfill gas facilities would include facilities used to produce electricity placed in service before January 1, 2007.

In the case of qualifying open-loop biomass facilities and qualifying landfill gas facilities placed in service on or before the date of enactment, the taxpayer could claim the sec. 45 production credit for only five years, commencing on the date of enactment. In the case of qualifying open-loop biomass facilities and qualifying landfill gas facilities placed in service on or before the date of enactment, the taxpayer could claim two-thirds of the otherwise allowable credit for electricity produced at the facility.

In the case of qualifying open-loop biomass facilities, the reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits would not exceed 80 percent.

No facility that previously claimed or currently claims credit under sec. 29 of the Code would be a qualifying facility for purposes of sec. 45.

Effective Date

The proposal would be effective for electricity sold from qualifying facilities after the date of enactment.

C. Tax Incentives for Fuel Cells

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for stationary fuel cell power plant property.

Description of Proposal

The proposal would provide a 10 percent credit for the purchase of qualified stationary fuel cell power plants for businesses and individuals. A qualified stationary fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent. The credit may not exceed \$1,000 for each kilowatt of capacity. For individuals, the qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence. The credit would be nonrefundable. The taxpayer's basis in the property would be reduced by the amount of the credit claimed.

Effective Date

The credit for businesses would apply to property placed in service after December 31, 2001 and before January 1, 2007, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990). The credit for individuals would apply to expenditures made after December 31, 2001 and before January 1, 2007.

D. Modifications and Extensions of Provisions Relating to Electric Vehicles, Clean-Fuel Vehicles, and Clean-Fuel Vehicle Refueling Property

Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of \$4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether). The maximum amount of the deduction is \$50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; \$5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and \$2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction.

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to \$100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location.

The deduction phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.

Description of Proposal

Alternative motor vehicle credits

The proposal would provide a credit for the purchase of a new qualified fuel cell motor vehicle, a new qualified hybrid motor vehicle, a new qualified alternative fuel motor vehicle, and a new advanced lean burn technology motor vehicle. The credit for the purchase of new qualified fuel cell motor vehicles would range between \$4,000 and \$40,000 depending upon the weight class of the vehicle and its fuel efficiency. The credit for the purchase of a new qualified hybrid vehicle would range from \$250 to \$10,000 depending upon the weight of the vehicle, its degree of efficiency, and its emissions performance. The credit for the purchase of a new alternative fuel vehicle would be 50 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between

\$5,000 and \$40,000 depending upon the weight of the vehicle. The credit for the purchase of a new advanced lean burn technology vehicle would range between \$1,000 and \$4,000 depending upon the fuel efficiency of the vehicle.

Credit may not be claimed for qualified fuel cell vehicles purchased after December 31, 2011, and for any other vehicle purchased after December 31, 2007.

Extension of present-law section 179A

The proposal would extend the deduction for costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property through December 31, 2007. The phase-down of present law would begin in 2005.

Modification of credit for qualified electric vehicles

The proposal would modify the present-law credit for electric vehicles to provide that the credit for qualifying vehicles generally ranges between \$4,000 and \$40,000 depending upon the weight of the vehicle and, for certain vehicles, the driving range of the vehicle. The proposal also would extend the expiration date of the credit from December 31, 2004 to December 31, 2007 and would repeal the phaseout schedule of present law

Effective Date

The proposal relating to the credit for new fuel cell vehicles, hybrid vehicles, alternative fuel vehicles, and advanced lean burn technology vehicles would apply to property placed in service after December 31, 2001, in taxable years ending after December 31, 2001.

The proposal relating to the extension of present-law sec. 179A would be effective on the date of enactment.

The proposal relating to the electric vehicle credit would be effective for to property placed in service after December 31, 2001, in taxable years ending after December 31, 2001.

E. Tax Credit for Energy-Efficient Appliances

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment: (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat; or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of: (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the manufacture of energy-efficient appliances.

Description of Proposal

The proposal would provide a credit for the manufacture of certain energy-efficient clothes washers and refrigerators. The credit would equal \$50 per appliance for energy-efficient clothes washers manufactured with a modified energy factor ("MEF") of 1.26 or greater and for refrigerators that consume 10 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy for refrigerators produced during 2001. The credit would equal \$100 for energy-efficient clothes washers manufactured with a MEF of 1.42 or greater (1.5 or greater for washers produced after 2004) and for refrigerators that consume 15 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy for refrigerators produced during 2001. An energy-efficient refrigerator would be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit.

For each category of appliances (i.e., washers that meet the lower MEF standard, washers that meet the higher MEF standard, refrigerators that meet the 10 percent standard, refrigerators that meet the 15 percent standard), only production in excess of average production for each such category during calendar years 1998-2001 would be eligible for the credit. Special proration rules would apply for production in 2001. The taxpayer may not claim credits in excess of \$30 million for all taxable years for appliances that qualify for the \$50 credit, and may not claim credits in excess of \$30 million for all taxable years for appliances that qualify for the \$100

credit. Additionally, the credit allowed for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to energy-efficient appliances may be carried back before the effective date of this provision.

Effective Date

The credit would apply to appliances produced after the date of enactment of the bill and prior to (1) Jan 1, 2005 in the case of refrigerators that only meet the 10 percent credit standard, or (2) January 1, 2007 in the case of all other qualified energy-efficient appliances.

F. Credit for Energy Efficiency Improvements to Existing Homes

Present Law

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present law credit for energy efficiency improvements to existing homes.

Description of Proposal

The proposal would provide a 20-percent nonrefundable credit for the purchase of qualified energy efficiency improvements. The maximum credit for a taxpayer with respect to the same dwelling for all taxable years is \$2,000. A qualified energy efficiency improvement would be any energy efficiency building envelope component that is certified (in the case of expenditures that exceed \$1,000) to meet or exceed the prescriptive criteria for such a component established by the 1998 International Energy Conservation Code, and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component reasonably can be expected to remain in use for at least five years.

Building envelope components would be: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (2) exterior windows (including skylights) and doors; and (3) metal roofs with appropriate pigmented coating which are specifically and primarily designed to reduce the heat loss or gain for a dwelling.

The taxpayer's basis in the property would be reduced by the amount of the credit. Special rules would apply in the case of condominiums and tenant-stockholders in cooperative housing corporations.

Effective Date

The credit would be effective for qualified energy efficiency improvements installed after December 31, 2001 and before January 1, 2007.

G. Business Credit for Construction of New Energy-Efficient Homes

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the construction of new energy-efficient homes.

Description of Proposal

The proposal would provide a credit to an eligible contractor (up to \$2,000 per dwelling) of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction.

The eligible contractor would be the person who constructed the home, or in the case of a manufactured home, the producer of such home. Energy efficiency property would be any energy-efficient building envelope component (insulation materials, exterior windows and doors, metal roofs with appropriate pigmented coatings) and any energy-efficient heating or cooling appliance.

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States; (2) the principal residence of the person who acquires the dwelling from the eligible contractor; and (3) certified to have a level of annual heating and cooling energy consumption that is at least 30 percent below the annual level of heating and cooling energy consumption of a comparable dwelling constructed in accordance with the standards of the 1998 International Energy Conservation Code. Other rules apply.

Effective Date

The credit applies to homes whose construction is substantially completed after December 31, 2001 and which are purchased during the period beginning on January 1, 2002 and ending on December 31, 2006.

H. Allowance of Deduction for Energy-Efficient Commercial Building Property

Present Law

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

Description of Proposal

The proposal would provide a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures would be amounts paid or incurred for energy-efficient commercial building property installed in connection with the new construction or reconstruction of property: (1) which would otherwise be depreciable property; (2) which is located in the United States, and (3) the construction or erection of which is completed by the taxpayer. The deduction would be limited to an amount equal to the product of \$2.25 and the square footage of the property for which such expenditures were made. The deduction would be allowed in the year in which the property is placed in service.

Energy-efficient commercial building property would mean any property that reduces total annual energy and power costs with respect to the lighting, heating, cooling, ventilation, and hot water supply systems of the building by 50 percent or more in comparison to a reference building which meets the requirements of a Standard 90.1-1999 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America.

For public property, such as schools, the Secretary would issue regulations to allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity owner. Other rules would apply.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2001 and for property placed in service before January 1, 2007.

I. Allowance of Deduction for Qualified Energy Management Devices and Retrofitted Qualified Meters

Present Law

No special deduction is currently provided for expenses incurred for qualified energy management devices.

Description of Proposal

The proposal would provide a \$30 deduction for each qualified new or retrofitted energy management device placed in service by any taxpayer who is a supplier of electric energy or natural gas or is a provider of electric energy or natural gas services. A qualified energy management device would be any tangible property eligible for accelerated depreciation under section 168 and which is acquired and used by the taxpayer to enable consumers or others to manage their purchase, sale, or use of electricity in response to energy price and usage signals and which permits reading of energy price and usage signals on at least a daily basis.

The deduction would not be allowed to property used outside of the United States. The taxpayer would have basis reduction for such property equal to the deduction. Other rules would apply.

Effective Date

The proposal would be effective for any qualified energy management device placed in service after the date of enactment of the Act.

J. Three-Year Applicable Recovery Period for Depreciation of Qualified Energy Management Devices

Present Law

No special recovery period is currently provided for depreciation of qualified energy management devices.

Description of Proposal

The proposal would provide a 3-year recovery period for qualified new or retrofitted energy management devices placed in service by any taxpayer who is a supplier of electric energy or natural gas or is a provider of electric energy or natural gas services. A qualified energy management device would be any tangible property eligible for accelerated depreciation under code section 168 and which is acquired and used by the taxpayer to enable consumers or others to manage their purchase, sale, or use of electricity in response to energy price and usage signals and which permits reading of energy price and usage signals on at least a daily basis.

Effective date

The proposal would be effective for any qualified energy management device placed in service after the date of enactment of the Act.

K. Energy Credit for Combined Heat and Power System Property

Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

Description of Proposal

The proposal would provide a 10 percent credit for the purchase of combined heat and power property.

CHP property would mean property: (1) which uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) which has an electrical capacity of more than 50 kilowatts or a mechanical energy capacity of more than 67 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) which produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent (70 percent in the case of a system with an electrical capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower, or an equivalent combination of electrical and mechanical capacities.)

CHP property would not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

If a taxpayer is allowed a credit for CHP property, and the property would ordinarily have a depreciation class life of 15 years or less, the depreciation period for the property is treated as having a 22-year class life. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to combined heat and power property may be carried back before the effective date of this provision.

Effective Date

The credit would apply to property placed in service after December 31, 2001 and before January 1, 2007.

L. Allow Nonbusiness Energy Credits Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, for taxable years beginning after December 31, 2001, nonrefundable personal credits may not exceed the excess of the regular tax liability over the tentative minimum tax.

Description of Proposal

The proposal would allow the personal energy credits added by the bill to offset both the regular tax and the alternative minimum tax.

Effective Date

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

M. 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, fuels 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 tax is scheduled to expire after March 31, 2005.

Description of Proposal

The 4.3-cents-per-gallon General Fund excise tax rates on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system would be repealed over a prescribed phase-out period. The 4.3-cent-per-gallon tax would be reduced by 1 cent per gallon in years beginning on October 1, 2001 and through December 31, 2003. The reduction would be 2 cents per gallon in calendar years 2004 and 2005; 3 cents per gallon in calendar years 2007-2008, and 4 cents per gallon in calendar year 2009. The tax would be fully repealed effective on January 1, 2010.

Effective Date

The proposal would be effective on October 1, 2001.

N. Btu-Based Rate for Diesel/Water Emulsion Fuel

Present Law

A 24.3 cents per gallon excise tax is imposed on diesel fuel to finance the Highway Trust Fund. Gasoline and most special motor fuels are subject to tax at 18.3 cents per gallon for the Trust Fund. 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

No special tax rate is provided for diesel fuel blended in a water emulsion fuel.

Description of Proposal

A special tax rate of 19.7 cents per gallon would be provided for diesel fuel blended with water into a diesel/water emulsion fuel to reflect the reduced Btu content per gallon resulting from the water. Emulsion fuels eligible for the special rate would consist of not more than 86 percent diesel (and other minor chemical additives to enhance combustion) and at least 14 percent water.

Effective Date

The proposal would apply to fuels removed after September 30, 2001.

O. Investment and Production Credits for Clean Coal Technology

Present Law

Present law does not provide an investment credit for electricity generating facilities that use coal as a fuel. Nor does present law provide a production credit for electricity generated at facilities that use coal as a fuel. However, a nonrefundable, 10-percent investment tax credit (“business energy credit”) is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). Also, an income tax credit is allowed for the production of electricity from either qualified wind energy, qualified “closed-loop” biomass, or qualified poultry waste facilities (sec. 45). The credit allowed equals 1.5 cents per kilowatt-hour of electricity sold. The 1.5 cent figure is indexed for inflation and equals 1.7 cents for 2001. The credit is allowable for production during the 10-year period after a facility is originally placed in service. The business energy tax credits and the production tax credit are components of the general business credit (sec. 38(b)(1)).

Description of Proposal

The proposal would provide a 10-percent investment tax credit for qualified investments in advanced clean coal technology facilities. Qualifying advanced clean coal electricity production facilities must utilize advanced pulverized coal or atmospheric fluidized bed combustion technology and must meet certain capacity, thermal efficiency, and emissions standards. In addition, to be a qualified investment in advanced clean coal technology, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to investments only to the point that 7,500 megawatts of electricity production capacity qualifies for the credit.

The proposal also would provide a production credit for electricity produced from a qualified advanced clean coal technology electricity generation unit. The production credit would be claimed on the sum of each kilowatt-hour of electricity produced and the heat value of other fuels or chemicals produced by the taxpayer at the facility. The production credit would be claimed for the 10-year period commencing with the date the qualifying facility is placed in service. The value of the credit (indexed for inflation) would vary depending upon the year the facility was placed in service and the rated thermal efficiency of the facility.

Effective Date

The proposals relating to investments and electricity production related to advanced clean coal technology would be effective for periods after December 31, 2001.

II. RELIABILITY

A. Natural Gas Gathering Pipelines Treated as Seven-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.² Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. Recently, the 10th Circuit Court of Appeals held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 13.2 (i.e., 7-year recovery period).³

Description of Proposal

The proposal would establish a statutory 7-year recovery period and a class life of 10 years for natural gas gathering lines. In addition, the proposal would provide that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer’s alternative minimum taxable income with respect to such property. A natural gas gathering line would be defined to include the pipe, equipment, and appurtenances that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

Effective Date

The proposal would be effective for property placed in service after the date of enactment. No inference is intended as to the proper treatment of natural gas gathering lines placed in service before the date of enactment.

² 1987-2 C.B. 674 (as clarified and modified by Rev. Proc 88-22, 1988-1 C.B. 785).

³ *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev’g* 109 T.C. 416 (1997). See also *True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

B. Natural Gas Distribution Lines Treated as Ten-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.⁴ Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

Description of Proposal

The proposal would establish a statutory 10-year recovery period and a class life of 20 years for natural gas distribution lines. In addition, the proposal would provide that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer’s alternative minimum taxable income with respect to such property.

Effective Date

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

⁴ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc 88-22, 1988-1 C.B. 785).

C. Petroleum Refining Property Treated as Seven-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.⁵ Asset class 13.3, describing petroleum refining, provides a class life of 16 years and a recovery period of 10 years.

Description of Proposal

The proposal would establish a statutory 7-year recovery period and a class life of 10 years for assets used in petroleum refining. In addition, the proposal would provide that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer’s alternative minimum taxable income with respect to such property.

Petroleum refining assets would be defined to include assets used for the distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and its other components.

Effective Date

The proposal would be effective for property placed in service on or after the date of enactment.

⁵ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc 88-22, 1988-1 C.B. 785).

D. Expensing of Capital Costs Incurred and Credit for Production in Complying with Environmental Protection Agency Sulfur Regulations

Present Law

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. Present law does not provide a credit for the production of low-sulfur diesel fuel.

Description of Proposal

The proposal would permit small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency. In addition, the proposal would provide that a small business refiner may claim credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year. The total production credit claimed by the taxpayer would be limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. The taxpayer's basis in such property would be reduced by the amount of production credit claimed. Recapture of the credits would occur for failure to comply with EPA regulations, cessation of operation, or certain changes in ownership.

For these purposes a small business refiner is a taxpayer who within the business of refining petroleum products employs not more than 1,500 employees directly in refining on business days and has less than 155,000 barrels per day of total refinery capacity.

Effective Date

The proposal would be effective for expenses paid or incurred after the date of enactment.

E. Determination of Small Refiner Exception to Oil Depletion Deduction

Present Law

Present law classifies oil and gas producers as independent producers or integrated companies. The Code provides numerous special tax rules for operations by independent producers. One such rule allows independent producers to claim percentage depletion deductions rather than deducting the costs of their asset, a producing well, based on actual production from the well (i.e., cost depletion).

A producer is an independent producer only if its refining and retail operations are relatively small. For example, an independent producer may not have refining operations the runs from which exceed 50,000 barrels on any day in the taxable year during which independent producer status is claimed.

Description of Proposal

The proposal would increase the current 50,000 barrel per day limitation to 75,000. In addition, the proposal would change the refinery limitation on claiming independent producer status from a limit based on actual daily production to a limit based on average daily production for the taxable year. Accordingly, the average daily refinery run for the taxable year may not exceed 75,000 barrels. For this purpose, the taxpayer would calculate average daily production by dividing total production for the taxable year by the total number of days in the taxable year.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

F. Modifications to Rules Governing Issuance of Tax-Exempt Bonds for Public Power Facilities

In general

Interest on debt⁶ incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103).⁷ Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person ("private activity bonds") is taxable, unless the purpose of the borrowing is approved specifically in the Code or in another provision of a revenue Act. The term "private person" generally includes the Federal Government and all other individuals and entities other than States or local governments.⁸

The general structure of the rules for determining whether a tax-exempt bond is a governmental or a private activity bond was established in 1968. The Tax Reform Act of 1986 (the "1986 Act") further restricted the amount of private use that may be financed before a State or local government bond is classified as a private activity bond, and enacted extensive additional restrictions on tax-exempt financing generally.

The provision of electric service (generation, transmission, distribution, and retailing) is an activity eligible for financing with governmental tax-exempt bonds when the financed facilities are used by or paid for by a State or local governmental entity (e.g., "public power").⁹

⁶ Hereinafter referred to as "State or local government bonds," even though not all tax-exempt debt results in the issuance of a formal bond (e.g., installment sales agreements are treated as bonds).

⁷ Interest on this debt is included in calculating the "adjusted current earnings" preference of the corporate alternative minimum tax.

⁸ Interest on Federal debt is taxable. However, unlike most State or local government debt, Federal debt benefits from the Federal Government's guarantee of repayment. The Code includes limited exceptions allowing the combination of these benefits, generally for programs that were in existence before enactment of the Tax Reform Act of 1984.

One such exception allows certain tax-exempt financing of State or local government facilities that transmit and distribute electric power supplied by the Bonneville Power Administration (the "BPA"), a Federal instrumentality. In addition, section 1316(d) of the Tax Reform Act of 1986 codified a prior-law Treasury Department regulation that treated the BPA as a State or local government unit rather than as a Federal entity. These exceptions are unique to the BPA; other Federal power agencies are treated as Federal entities and are not permitted to benefit from tax-exempt financing or to guarantee such financing.

⁹ Section 115 also exempts the income that States and local governments derive from the operation of public power systems as governmental activities.

As with other governmental activities, public power entities also are eligible for limited tax-exempt financing of working capital costs (e.g., salaries of employees and similar expenses). Except as described below, IOUs and co-ops generally are not eligible for tax-exempt financing of their facilities. With the exception of certain charitable organizations that are described in Code section 501(c)(3), private businesses are not eligible to finance working capital costs with tax-exempt bonds (except with proceeds of a permitted five-percent "bad money" portion of a bond issue which may be used for any type of expenditure).

Classification of bonds as private activity bonds

Present law provides two tests for determining whether a State or local government bond is, in substance, a private activity bond (sec. 141(b) and (c)).

Private business test.--Private business use and private payments result in State or local government bonds being private activity bonds if both parts of a two-part private business test are violated--

- (1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and
- (2) More than 10 percent of the debt service on the bonds directly or indirectly is secured by an interest in property to be used for a private business use or is to be derived from payments in respect of such property (the "private payment test").

The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. For example, a privately operated cafeteria in a government office building financed as part of the building's construction could represent a related private business use. On the other hand, a separate, private manufacturing facility financed with proceeds of the same bond issue would constitute an unrelated private business use of bond proceeds. Additionally, as described more fully below, since enactment of the 1986 Act, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain "output" facilities. The term output facility includes electric generation, transmission, and distribution facilities.

Private business use generally includes any use by a business entity (including the Federal Government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury Department regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Similarly, in the case of public power entities, if output of an electric generating plant or transmission or distribution facilities is provided to a private business on terms not generally available to other customers of the entity, an allocable portion of bonds financing the facilities is

treated as used in a private business use and as secured by the payments from the private business.¹⁰

Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury Department regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.¹¹ These rules require public power entities to restrict the period of contracts with private businesses as well as the aggregate amount of electric service provided to private businesses on terms that are not generally available to customers of the entity, if interest on their bonds is to remain tax-exempt.

Private loan test.--The second standard for determining whether a State or local government bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) \$5 million is used directly or indirectly to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test.

Present law provides that the substance, rather than the form, of a transaction governs in determining whether a transaction gives rise to a private loan. In general, any transaction, which transfers tax ownership of property to a private person, is treated as a loan. In the context of electric facilities, longer-term contracts for the sale of electricity may violate the private loan test, because these contracts have the substantive characteristics of a loan.

¹⁰ See, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987, stating as follows:

The determination of who uses bond proceeds or bond-financed property generally is made by reference to the ultimate user of the proceeds or property [B]ond proceeds used to satisfy contractual obligations undertaken in connection with general governmental operations, such as payment of government salaries, or to pay legal judgments against a governmental unit, are not treated as used in the business of the payee. This is to be contrasted with the indirect nongovernmental private use of bond proceeds that occurs when a government contracts with a nongovernmental person to supply that person's trade or business with a service (e.g., electric energy) on a basis different from that on which the service is provided to the public generally or to finance property used in that person's business (e.g., a manufacturing plant). In both of these instances a nongovernmental person is considered to use the bond proceeds other than as a member of the general public. (p. 1160)

¹¹ See Treas. Reg. sec. 1.141-3(b)(4) and Revenue Procedure 97-13, 1997-1 C.B. 632.

Special legislative rules for tax-exempt financing of governmental "output" facilities

In addition to the general private business use and payment tests, the Code includes three specific provisions governing the issuance of governmental tax-exempt bonds to finance electric service facilities.

\$15 million limit on private business use.--As stated above, the 1986 Act provided an additional restriction on private business use of State or local government bonds whose proceeds are to be used to finance "output" facilities.¹² Output facilities include, inter alia, facilities for electric and gas generation, transmission, and distribution. A bond is treated as issued to finance an output facility (and subject to this restriction) if five percent or more of the proceeds is to be used with respect to any output facility. Under this restriction, the 10-percent private business use and private payment tests in substance are phased down for facilities that receive more than \$15 million in tax-exempt bond financing. Significantly, unlike most tax-exempt bond restrictions, which are determined on a bond-issue by bond-issue basis, this restriction is measured by reference to all outstanding tax-exempt financing from which a facility benefits.

Special rules disregarding certain private business use under the private activity bond tests.--The legislative history accompanying the 1986 Act further clarified that certain sales of electric power by public power entities to private businesses generally are disregarded in applying the private business and private loan tests. For example, the presence of a nongovernmental person acting solely as a conduit for exchange of electric output among governmentally owned and operated public power entities are to be disregarded. In addition, exchange agreements that provide for "swapping" of electricity between governmentally owned and operated entities and IOUs do not give rise to private business use when (1) the "swapped" amounts are approximately equal over a period of one year or less, (2) the electricity is swapped pursuant to an arrangement which does not involve output-type contracts, and (3) the purpose of the arrangements is to enable the parties to satisfy differing peak load demands or to accommodate temporary outages.¹³ Finally, the legislative history of the 1986 Act provides that "spot sales" of excess power capacity for temporary periods not exceeding 30 days do not violate the private business tests.

Bonds for acquisition of existing output property *per se* private activity.--In general, any bond with respect to which five percent or more (\$5 million if less) of the proceeds is to be used, directly or indirectly, by a governmental entity to acquire existing output property is *per se* a private activity bond.¹⁴ As such, interest on the bond is taxable, unless the use of the acquired

¹² Sec. 141(b)(4).

¹³ See, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, (JCS-10-87), May 4, 1987 at 1164.

¹⁴ Sec. 141(d). A permanent exception allows the Long Island Power Authority to issue governmental tax-exempt bonds for the acquisition of the Long Island Lighting Company ("LILCO") and conversion of that electric utility from a private investor-owned utility to a public power entity. Pub. L. No. 100-203, sec. 10631(c)(3) (1987).

facility satisfies the provisions applicable to tax-exempt private activity bonds for the local furnishing of electricity, including receipt of an allocation of the applicable State's annual private activity bond volume authority (described below). The two-county (or a city and a contiguous county) service area requirement that applies to facilities for the local furnishing of electricity does not apply in this circumstance.

There are two exceptions to the rule regarding the acquisition of existing output property. First, the rule does not apply to bonds for the acquisition of existing facilities that will provide service in a "qualified service area" of the issuer. A qualified service area is defined as an area throughout which the acquiring entity has provided electric service for at least the 10-year period preceding the date of the acquisition. Second, the rule does not apply to bonds issued to acquire existing output property to be used in a "qualified annexed area" of a public power entity. The term qualified annexed area includes only areas (1) that are contiguous to existing service areas, (2) that are annexed for general governmental purposes, and (3) the size of which does not exceed 10 percent of the public power entity's service area before the annexation occurs.

Temporary Treasury regulations

On January 18, 2001, the Treasury Department issued temporary and proposed regulations to provide guidance to issuers of governmental bonds for output facilities ("the regulations"). The regulations provide special rules for determining whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. The regulations replace temporary and proposed regulations issued in January of 1998. The regulations generally apply to bonds sold on or after January 19, 2001, and are scheduled for a public hearing before the IRS on July 24, 2001. The regulations generally allow public power entities to participate in certain electric industry restructuring arrangements without endangering tax-exemption for interest on their bonds.

General rule

The regulations provide that purchase by a private person of available output of an output facility financed with the proceeds of an issue is taken into account under the private business tests if the purchase has the effect of (1) transferring substantial benefits of owning the facility and (2) transferring substantial burdens of paying the debt service on bonds used to finance the facility (the benefits and burdens test).¹⁵ An arrangement transfers substantial benefits if it provides the purchaser with rights to bond-financed property that are preferential to the rights of the general public. An arrangement transfers substantial burdens of paying debt service to the extent the issuer reasonably expects that it is substantially certain that payments will be made under the terms of the contract (disregarding default, insolvency, or other similar circumstances).

Requirements contracts.--The regulations provide that requirements contracts give rise to private use provided the benefits and burden tests are met.¹⁶ Significant factors that tend to

¹⁵ Temp. Treas. Reg. sec. 1.141-7T(c)(1) and (c)(2).

¹⁶ Temp. Treas. Reg. sec. 1.141-7T(c)(4).

establish that a wholesale requirements contract results in private business use include, but are not limited to: (1) the purchaser's customer base has significant indicators of stability, (2) the contract covers historical requirements of the purchaser, and (3) the purchaser agrees not to construct or acquire other power resources to meet the requirements covered by the contract.

Payments pursuant to pledged contract.--Payments made or to be made under the terms of an output contract that is pledged as security for an issue are taken into account under the private business tests even if the issuer reasonably expects that it is not substantially certain that payments will be made under the contract (disregarding default, insolvency, or other similar circumstances).

Measuring available output

Generation facilities.--Under the regulations, the private business use of a generating facility is generally measured based on the amount of "output purchased" by the private user divided by the available output of the facility. Available output is generally defined as the annual nameplate capacity of the generating facility multiplied by the number of years in the underlying bond's measurement period.¹⁷ Generally, the regulations provide that nameplate capacity is not reduced for reserves, maintenance or unutilized capacity.¹⁸

Transmission facilities.--For transmission facilities, the regulations provide that the available output of transmission facilities may be determined in a manner consistent with reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission.¹⁹

Certain contracts not taken into account under the private business tests

Small purchases of output.--The regulations provide that an output contract is not taken into account under the private business tests if the average annual payments under a contract that are substantially certain to be made by a private user do not exceed .05 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility determined as of the date of the contract.²⁰

Short term contracts.--Under the regulations, an output contract with a private user is not taken into account under the private business tests if: (1) the term of the contract (including renewal options) is not longer than one year; (2) the contract is an arm's length agreement that provides for compensation at fair market value, or is based on generally applicable and

¹⁷ Temp. Treas. Reg. sec. 1.141-7T(b)(1) and (b)(1)(i).

¹⁸ *Id.*

¹⁹ Temp. Treas. Reg. sec. 1.141-7T(f)(4).

²⁰ Temp. Treas. Reg. sec. 1.141-7T(f)(1).

uniformly applied rates; and (3) the output facility was not financed for a principal purpose of providing that facility for use by a private person.²¹

Excess generating capacity resulting from participation in open access.--The regulations contain an exception to the private use test for the sale of excess generating capacity due to participation in open access.²² Under the regulations, output sales attributable to excess generating capacity from participation in open access are not treated as private use if the following requirements are satisfied: (1) the term of the contract is not longer than three years (including renewal options); (2) the issuer does not make expenditures to increase the generating capacity of its system with tax-exempt bonds by more than three percent during the term of the contract; (3) the issuer offers open access transmission tariffs under rules promulgated by the Federal Energy Regulatory Commission under sections 205 and 206 of the Federal Power Act (or comparable provisions of State law); (4) all of the output sold under the contract is attributable to excess capacity resulting from open access transmission tariffs; and (5) all payments received by the issuer (less operating expenses) are promptly applied to redeem tax-exempt bonds that financed the facility.

Special exceptions for transmission facilities

The regulations include two exceptions for transmission and distribution facilities under which mandated wheeling, and actions taken to implement nondiscriminatory open access, will not be treated as deliberate actions resulting in private business use. The first exception is for contracts entered into in response to (or in anticipation of) an order under sections 211 or 212 of the Federal Power Act (or comparable State laws). The terms of the contract must be bona fide and arm's length and the consideration paid must be consistent with the provisions of section 212(a) of the Federal Power Act. The second exception is for other actions taken by public power entities to implement the offering of non-discriminatory, open-access tariffs for the use of transmission facilities financed by an issue in a manner consistent with rules promulgated by the Federal Energy Regulatory Commission under sections 205 and 206 of the Federal Power Act (or comparable provisions of State law). The exceptions, however, do not apply to the sale, exchange, or other disposition of facilities to a private person.²³

Issuance of tax-exempt bonds for private activities

As stated above, interest on State or local government bonds to finance activities of private persons (both business and personal activities) is taxable unless a specific exception is contained in the Code (or in non-Code provision of a revenue Act). The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued

²¹ Temp. Treas. Reg. sec. 1.141-7T(f)(3).

²² Temp. Treas. Reg. sec. 1.141-7T(f)(4).

²³ Temp. Treas. Reg. sec. 1.141-7T(f)(5)(ii).

by issuers within each State. The Code further imposes several additional restrictions on tax-exempt private activity bonds that do not apply to bonds for governmental activities.

Eligible activities

In general.--States or local governments may issue tax-exempt exempt-facility bonds to finance facilities for certain private businesses.²⁴ Business uses eligible for this financing generally include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and, certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." This provision was enacted to permit tax-exempt financing of certain renovations to the dams and accompanying hydroelectric electric generating facilities along the Columbia River that are a part of the Bonneville Power Administration system.²⁵

Tax-exempt financing is authorized for capital expenditures for certain manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), certain local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses. Further, certain non-business private purposes may be financed with proceeds of these bonds: certain student loans, mortgage loans for first-time home buyers satisfying moderate income and home purchase price requirements, and mortgage loans generally for certain pre-1977 veterans who purchase homes in any of the five States that historically authorized issuance of these bonds.²⁶ Finally, both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt bonds ("qualified 501(c)(3) bonds").

Private activity bonds for the local furnishing of electricity.--Tax-exempt private activity bonds may be issued by States or local governments acting as conduits to finance generation, transmission, and distribution facilities for private businesses engaged in the local furnishing of

²⁴ A separate non-Code exception allows the State of Iowa to issue tax-exempt private activity bonds to finance an industrial new jobs program.

²⁵ Two additional non-Code provisions allow tax-exempt financing for certain electric generating facilities located in the State of Alaska. The first of these treats the Bradley Lake hydro-electric generating plant as a facility for the local furnishing of electricity. The second authorized issue of tax-exempt private activity bonds to finance the sale by the Federal Government of the Snettisham electric generating facility, also in Alaska, without satisfaction of the general rehabilitation requirement applicable to private activity bonds, because after the sale the facility's output is sold to an IOU in Juneau, Alaska.

²⁶ The five States are Alaska, California, Oregon, Texas, and Wisconsin. A non-Code exception allows the State of Texas to issue tax-exempt private activity bonds to finance limited amounts of land for veterans (in addition to any veterans mortgage bonds that Texas may issue).

electricity ("local furnishers"). A business is treated as engaged in local furnishing of electricity if the service territory in which the electricity is provided does not exceed (1) two contiguous counties, or (2) a city and a contiguous county. Historically, local furnishers eligible for this tax-exempt financing have included both IOUs and independent power ventures. These bonds may be issued for the benefit of only those persons that were engaged in local furnishing of electricity in the service territory in which the new facilities will be used as of January 1, 1997, or in qualified expansions of those service territories. A "qualified expansion" is limited to service territory that is a part of a county in which the local furnisher was providing electric service on that date. For example, if a local furnisher was providing electric service to one county and a portion of a contiguous county on January 1, 1997, bonds may be issued for the continued provision of service both within that area and also for service to be provided in the remaining portion of the contiguous county in the future. In addition to persons actually engaged in local furnishing activities on January 1, 1997, the Code allows certain successors in interest to persons that qualified as local furnishers on that date to "step into the shoes" of the predecessor local furnishers provided that the service territories served otherwise satisfy the requirements for local furnishing.

Notwithstanding the general limits on service territories of local furnishers, the Code includes special rules allowing these electric service providers to transmit ("wheel") electricity through their systems, if ordered by the Federal Energy Regulatory Commission to do so under sections 211 or 213 of the Federal Power Act, provided that the size of the transmission lines or other facilities used in these wheeling activities does not exceed the capacity required to serve their otherwise qualified two county or city and a county service area.

In general, if a local furnisher ceases to qualify as such, interest on outstanding tax-exempt bonds issued for its benefit becomes taxable, and interest payments by the local furnisher on loans securing the bonds becomes nondeductible. A special election allows local furnishers to avoid these penalties if the local furnishers do not benefit from any tax-exempt bonds issued after August 19, 1996. If that election is made, in lieu of loss of tax-exemption on outstanding bonds and loss of interest deductions on underlying loans, all outstanding bonds from which the local furnisher benefits must be redeemed no later than six months after the earliest date on which redemption is permitted under the bond covenants (or the date of the election, if later). This election must be made for all local furnishing facilities of the local furnisher rather than on a facility-by-facility or bond-issue by bond-issue basis.

Additional restrictions imposed on private activity tax-exempt bonds

State volume limitations.--Issuance of most tax-exempt private activity bonds is subject to an annual volume limitation that each State receives. Each State (including local governments within the State) is allowed to issue an annual amount of these bonds not exceeding the greater of \$62.50 per resident of the State or \$187.5 million in calendar year 2001. These volume limits are scheduled to increase to \$75 per resident of the State or \$225 million beginning in calendar year 2002. Beginning in calendar year 2003, the volume limit will be adjusted annually for inflation. States may elect to carryover their unused private activity bond volume authority for designated activities for a period of up to three years. Bond authority that is not used within the carryforward period lapses.

This limit also applies to the private business portion of certain larger governmental bond issues; such private business use in excess of \$15 million (and up to the permitted 10 percent of the issue) must receive an allocation of State volume limitation for interest on the overall bond issue to be tax-exempt.²⁷ Exceptions to the volume limitation are provided for bonds to finance airports, ports, solid waste disposal facilities (if governmentally owned), qualified 501(c)(3) bonds, and high speed intercity rail facility bonds (if governmentally owned), and bonds for environmental enhancements of hydro-electric generating facilities. Additionally, bonds for privately owned high-speed intercity rail facilities are required to receive a State volume limitation allocation only for 25 percent of the amount of the bonds.

Miscellaneous other restrictions.--Tax-exempt private activity bonds are subject to several other restrictions that do not apply to governmental bonds. These restrictions include the requirement of a public hearing and approval of their issuance by an appropriate elected governmental official, a prohibition on advance refundings,²⁸ a restriction on the term to maturity of the bonds measured by reference to the economic lives of the property to be financed, minimum rehabilitation requirements for bonds used to finance acquisition of existing property, and, in general, slightly more restrictive limits on arbitrage profits that may be earned.²⁹

²⁷ Unlike this general provision for larger governmental bond issues, the \$15 million limit on private business use of output facility bonds, described above, is an absolute limit which may not be waived by an allocation of State private activity bond volume limitation.

²⁸ The prohibition does not apply to qualified 501(c)(3) bonds. Governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. An advance refunding occurs when the refunded bonds remain outstanding for a period greater than 90 days after issuance of the refunding bonds. Advance refundings typically are undertaken because an issuer includes provisions in its original bond documents agreeing not to redeem the bonds before expiration of a minimum period. Advance refundings are used to restructure debt service generally, to eliminate restrictive covenants contained in outstanding bond documents, or to hedge against anticipated future interest rate increases by locking in for the future what is believed to be a favorable rate. In an advance refunding both the refunded and the refunding bonds remain outstanding until the refunded bonds may be redeemed under their contractual terms. Proceeds of the refunding bonds are deposited in a yield-restricted escrow account until that time.

²⁹ The Code in general limits the amount of arbitrage profits that may be earned on tax-exempt bonds and requires that most such profits be rebated to the Federal Government. These provisions are designed to preclude issuance of tax-exempt bonds earlier than necessary for the governmental or approved private activity which is the stated purpose of the borrowing or in larger amounts than required for the purpose. Absent such restrictions, State or local governments as tax-exempt entities could borrow at tax-exempt rates and invest in, for example, taxable Federal Government debt, as an income production undertaking. Such as undertaking would reduce Federal revenues by substituting tax-exempt debt for taxable debt in the hands of taxable bond investors.

Penalties for violation of tax-exempt bond restrictions after issuance

General change in use penalties and administrative alternatives

In general, the determination of whether interest on State or local government bonds is tax-exempt is made when the bonds are issued. That is, the determination is made by reference to how the bond proceeds are "to be used" (sec. 141). Intentional acts after the date of issuance to use bond-financed property (indirectly a use of bond proceeds) in a manner not qualifying for tax exemption may render interest on the bonds taxable, retroactive to the date of issuance (the "change in use rules"). Such a prohibited change in use may be illustrated by the subsequent sale of public power electric output to private businesses in a manner not qualifying for tax exemption after the bond-financed property is placed in service. Other privatization programs transferring the operation of State or local government programs to private businesses similarly can give rise to a prohibited change in use as can the sale or lease of bond-financed State or local government facilities to private businesses.

Treasury Department regulations and an accompanying Revenue Procedure, provide alternative remedies to loss of tax-exemption for certain changes in use of governmental bonds.³⁰ The alternative remedies are available only if five conditions are satisfied:

- (3) The issuer of the bonds must have reasonably expected on the date of the borrowing that the bonds would not meet the private business and private loan tests (i.e., would not become private activity bonds) for their entire term;³¹
- (4) The term of the bonds must not be longer than is reasonably necessary for the governmental purposes of the borrowing;
- (5) The change in use must result from a bona fide, arm's length transaction for fair market value;³²
- (6) Any disposition proceeds must be treated as "gross proceeds" of the bond issue, subject to the Code arbitrage rules; and

³⁰ Treas. Reg. sec. 1.141-12; Rev. Proc. 97-15, 1997-1 C.B. 635.

³¹ Absent satisfaction of this reasonable expectations test, bonds are eligible for the alternative remedies only if the issuer (1) on the issue date, reasonably expected to use the bond-financed property in a qualified use for a substantial period, (2) redeems *all* nonqualified bonds within six months of any action changing that use to a nonqualified one, (3) has no arrangement with a private business as of the issue date regarding a nonqualified change in use, and (4) otherwise meets the regulatory remedial actions. The requirement that all nonqualified bonds be redeemed includes redemption in cases where bond-financed property is disposed of for less than the unpaid bond amount. In such cases, the issuer must make up any shortfall in the disposition proceeds from other sources to avoid bond interest being rendered taxable.

³² The determination of fair market value may take into account restrictions on the use of the bond-financed property that serve "a bona fide government purpose."

- (7) The bond proceeds must have been spent for the purpose of the borrowing before the change in use occurs (unless the bonds are redeemed) (Treas. Reg. sec. 1.141-12(a)).

If the five conditions are satisfied, four possible alternative remedies to loss of tax-exemption are available for post-bond-issuance actions violating the private business tests. First, all currently callable bonds may be redeemed within 90 days after the change in use and all other bonds may be defeased with a yield-restricted escrow and called on the first date when that action is permitted under the bond terms (Treas. Reg. sec. 1.141-12(d)).³³ Second, in the case of dispositions entirely for cash where the bond issuer expects to spend the disposition proceeds within two years after the change in use, the disposition proceeds may be treated as bond proceeds and used accordingly, subject to all of the Code's tax-exempt bond provisions (Treas. Reg. sec. 1.141-12(e)). To the extent the disposition proceeds are not used for a qualifying use within the two-year period, bonds must be redeemed.

A third remedy provides that loss of tax-exemption will not occur if bond-financed property is transferred in a transaction constituting a change in use from a governmental use to a use that is eligible for financing with tax-exempt private activity bonds provided that the issuer treats the bonds as reissued on the date the change in use occurs and satisfies rules applicable to the revised use of the bonds (including where applicable, allocation of State private activity bond volume limitation) (Treas. Reg. sec. 1.141-12(f)).³⁴ The final alternative remedy to loss of tax-exemption allows the issuer to pay the Federal Government an amount equal to lost tax revenues from allowing nonqualified tax-exempt bonds to remain outstanding as tax-exempt (Rev. Proc. 97-15).

Additional change in use penalties for private activity tax-exempt bonds

In addition to loss of tax-exemption on bond interest, conduit borrowers receiving tax-exempt private activity bond financing lose interest deductions on their underlying loans if the use of the bond-financed property changes to a non-qualified use after issuance (the "additional change-in-use rules"). For example, if the output of an IOU facility for the local furnishing of electric service is used to provide service beyond the permitted two county or city and a county area, interest paid by the IOU on loans underlying the tax-exempt bonds is nondeductible (sec. 150(b)(4)).³⁵

³³ The maximum period of the escrow account may not exceed 10-1/2 years.

³⁴ Because the original tax-exempt bonds remain outstanding, a purchaser of property financed with tax-exempt bonds qualifying for this remedy is not permitted to finance any acquisition costs with additional tax-exempt bonds (e.g., tax-exempt exempt-facility bonds could not be issued to finance the transfer of a governmental solid waste disposal system to a private business).

³⁵ An exception to this rule, enacted in 1996 and described above, provided that this penalty and loss of tax-exemption on bonds not apply to bonds issued before August 20, 1996, in the case of service territory expansions by local furnishers of electricity or gas that elect to

Description of Proposal

The proposal would provide special, liberalized private business use rules for bonds issued by public power entities to finance electric output facilities when the entities participate in qualifying electric industry restructuring arrangements. These rules would apply both to facilities financed with currently outstanding bonds and to certain facilities financed with bonds issued in the future. The proposal further would allow public power entities that engage in activities beyond those allowed under the liberalized private business use rules to elect to forego certain future issuances of tax-exempt bonds while preserving the tax-exempt status of their previously issued bonds. (This portion of the proposal primarily would affect electric generation facilities.) Finally, the proposal would modify current rules regarding issuance of tax-exempt bonds for the acquisition of existing electric output facilities. The proposal applies only to governmental bonds issued by public power entities. Thus, bond-financed facilities must be governmentally owned, determined under generally applicable tax rules.

Liberalize private business use rules

The proposal would provide that no private business use arises in transactions (that otherwise would violate present-law restrictions) that are either (1) "permitted open access activities," or (2) "permitted sales transactions." The effect of this provision would be to protect the tax-exempt status of interest on previously issued electric output facility bonds and to allow future issuance of such bonds for facilities to be used consistent with the new rules.

Permitted open access transmission and distribution activities would be defined as --

- (1) Activities pursuant to an open access transmission tariff filed with and approved by the FERC relating to whether an entity would join a regional transmission organization ("RTO") (including and independent system operator agreement). Covered tariffs would include tariffs established pursuant to certain voluntarily filed reports by public power entities.
- (2) Activities under an RTO agreement or other regional transmission group agreement approved by FERC (or the Public Utility Commission of Texas in the case of an ERCOT utility). Permitted activities would include the transfer of control (but not ownership) of transmission facilities.
- (3) Delivery on a nondiscriminatory open access basis of electric energy sold to end-users served by distribution facilities owned by the public power entity or of electric energy generated by generation facilities connected to distribution facilities owned by that entity.

forego additional tax-exempt financing from bonds issued after August 19, 1996, and satisfy certain other conditions.

Permitted sales

The category of permitted sales transactions relates to sales from existing generation facilities and is in addition to any sales allowed as an open access activity. Existing generation facilities are defined as facilities that were in operation on or under construction before June 1, 2000, and were owned by the governmental unit on that date. Permitted sales transactions would be defined as --

- (1) Sales to on system purchasers if the seller provides open access distribution services (and transmission services if the seller owns transmission facilities).

The effect of this provision would be to waive completely the private business use restrictions on the types of contracts that public power entities may enter with on-system consumers. On system purchasers are defined as persons whose electric facilities are directly connected to transmission or distribution facilities owned by a public power entity (without regard to whether the governmental unit is the person selling the electricity) that purchase electricity at retail and either (1) were within the unit's distribution area in a defined "base year" or (2) to whom the seller had a "service obligation". A service obligation would be defined as an obligation under State or Federal law to provide electric distribution or sales services.

- (1) Wholesale sales to a "native load" purchaser, defined as a purchaser to whom the seller had a service obligation at wholesale in a defined base year or an obligation in the base year under a requirements contract which has been in effect for at least 10 years (or in the case of newer contracts in existence on the date of the proposal's enactment, had an initial term of at least 10 years). Wholesale purchasers could only re-sell the electricity at retail to persons within their distribution area (i.e., could not be power marketers).
- (2) Load loss mitigation sales, defined as wholesale sales to persons whom the seller did not have a service obligation. These sales could be made without geographic limitation. The amount of load loss mitigation sales would be limited by a formula based on annual sales reductions during a seven-year period following the base year. The sales could be made during the eight-year period following the base year.

Special rules for transmission facilities

After date of enactment, tax-exempt bonds for new transmission facilities generally could only be issued for "local transmission facilities." Local transmission facilities would be defined as (1) facilities located within the public power entity's distribution area or (2) a facility "that is or will be necessary to supply electricity to serve retail native load or wholesale load of one or more contiguous public power entities.

The term retail native load would be defined as the load for end-users served by distribution facilities owned by a public power entity, without regard to whether any service obligation to the geographic area currently exists. The term wholesale native load would be defined as the retail native load of a public power entity's wholesale native load purchasers and

other purchasers to whom electricity was being sold under requirements contracts in the base year.

The proposal includes a presumption that sales are necessary to serve retail or wholesale load if national or regional electric reliability organizations or regional transmission organizations (of the Electric Reliability Council of Texas) approve or order the sale.

Exceptions

Notwithstanding the general limitation on future transmission bond issuance, tax-exempt bonds could continue to be issued in the following circumstances, including for facilities that would not qualify as local transmission facilities, if the bonds were issued --

- (1) To refund (including advance refund) outstanding bonds;
- (2) To finance any repair of a transmission facility that was in service on the date of the proposal's enactment, provided that the repair did not increase the voltage level of the facility over its base year level or increase the thermal load limit of the facility by more than three percent;
- (3) To finance any qualifying upgrade of a transmission facility in service on the date of the proposal's enactment;
- (4) To finance a transmission facility necessary to comply with an obligation under a shared or reciprocal transmission agreement in effect on the date of the proposal's enactment

Special rules for start-up distribution facilities

The proposal generally would prohibit issuance of tax-exempt bonds for facilities for newly established public power entities before the date on which the entity has provided electric service in an area for a period of ten years. The proposal would not limit expansions of the service territory of existing public power entities. Similarly, public power entities could commence operations in the service territories of other public power entities without violating the restriction.

Election to forego issuance of certain future tax-exempt bonds for increased generating capacity in exchange for elimination of all private business use restrictions on existing bonds

Public power entities desiring to engage in activities not qualifying under the liberalized private business use restrictions included in the proposal would be allowed to make a special election to be treated as a nongovernmental person without affecting the tax-exemption on outstanding bonds. Nonetheless, tax-exempt bonds that could be issued by these entities following such an election include bonds --

- (1) To refund (including advance refund) outstanding bonds;

- (2) To finance any transmission or distribution facility that continued to be used in qualified open access activities after the date of the election;
- (3) To finance any equipment or facilities "necessary to meet Federal or State environmental requirements" applicable to an existing generation facility;
- (4) To finance any repair of any governmentally owned generation facility the construction of which had commenced before June 1, 2000, provided that the repair did not increase the generating capacity by more than three percent above the greater of its nameplate or rated capacity as of the date of the proposal's enactment.
- (5) To finance any wind, biomass, solar, or geothermal energy generating facility during a period when income tax credits are allowed with respect to production from similar facilities placed in service by taxpayers.

Effective Date

Subject to two exceptions, the proposal would be effective on the date of enactment, applicable both to outstanding bonds and to bonds issued after that date. The first exception would allow public power entities to elect to apply the rules with respect to permitted open access activities occurring on or after April 14, 1996. The second exception would provide that the repeal of certain special exceptions to rules governing bonds for the acquisition of existing electric output property would not apply to any acquisition pursuant to any agreement entered into before the date of the proposal's enactment.

G. Sales or Dispositions under Section 1033 to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy

Present Law

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

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns the replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period").

Section 1033(g) provides that if real property held for productive use in a trade or business or investment is involuntarily converted, then property of a like kind shall be considered similar or related in service or use to real property involuntarily converted. In general, with respect to other business property the Internal Revenue Service takes the position that replacement property will not qualify as similar or related in service or use unless its physical characteristics and end uses are similar to the converted property.³⁶

Section 1245 requires that gain from the disposition of certain types of depreciable property³⁷ be characterized as ordinary income to the extent of previously allowed depreciation deductions. Generally, such gain is recognized in the year of disposition notwithstanding any other provision. An exception from immediate recognition of such gain is provided for involuntary conversions of property. In such cases, the amount of ordinary income is limited to any gain recognized (without regard to section 1245), plus the fair market value of property

³⁶ Revenue Ruling 64-237, 1964-2 C.B. 319.

³⁷ Section 1245 applies generally to property subject to the allowance for depreciation under section 167 that is either personal property or other tangible property used in certain activities (including tangible property used in the furnishing of electrical energy, gas, water or sewage disposal services). Section 1245(a)(3).

acquired in exchange for depreciable property where the latter is exchanged for nondepreciable property or other non-qualifying property.³⁸

Description of Proposal

The proposal would permit a taxpayer to elect to treat an electric transmission transaction as an involuntary conversion and expand the types of replacement property that qualify as related or similar in use to converted electric transmission property.

Under the proposal, a taxpayer may elect to treat the sale or other disposition of property used in the trade or business of providing electric transmission services, or an ownership interest in an entity whose principal trade or business consists of providing electric transmission services, to an independent transmission company³⁹ prior to January 1, 2009 (a “qualifying electric transmission transaction”) as an involuntary conversion.

The proposal would provide that exempt utility property be treated as similar or related in service or use to electric transmission property converted in a qualifying electric transmission transaction. Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

The proposal would also extend the applicable period for a taxpayer to replace the converted property in a qualifying electric transmission transaction from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized.

In addition, if a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the proposal would permit the replacement property to be purchased by any member of the affiliated group (in lieu of the taxpayer).⁴⁰

³⁸ The realization of ordinary income is necessary in such cases since in the case of property, other than depreciable personal property, there is no opportunity for subsequent recovery of the ordinary income element.

³⁹ In general, an independent transmission company is defined as: (1) a regional transmission organization approved by FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act is not a “market participant” and (ii) whose transmission facilities are placed under the operational control of a FERC-approved regional transmission organization before the close of the replacement period for such transaction; or (3) in the case of facilities subject to the exclusive jurisdiction of the Public Utility Commission of Texas, a person that is approved by that commission as consistent with Texas state law regarding an independent transmission organization.

⁴⁰ It is anticipated that the Secretary of the Treasury would issue guidance as may be necessary to ensure that gain shall not be recognized under the consolidated return provisions and to ensure that any investment adjustments, or any other adjustments under the consolidated

The proposal would also provide an exception to section 1245 gain recognition for a qualifying electric transmission transaction if the taxpayer (or any member of the affiliated group) reduces other section 1245 property by the amount of gain that would otherwise (absent this proposal) be recognized solely due to section 1245.⁴¹

A taxpayer electing the provisions of the proposal would be required to attach a statement to that effect in the tax return for the taxable year in which the transaction takes place in the manner as the Secretary shall prescribe. The election shall be binding for that taxable year and all subsequent taxable years.

Effective Date

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

regulations, accurately reflect the implications of permitting another member of the consolidated group to purchase the replacement property or reduce the basis of depreciable property.

⁴¹ The manner and amount of such reduction shall be determined under regulations prescribed by the Secretary of the Treasury.

H. Distributions of Stock under Section 355(e) to Implement Federal Energy Regulatory Commission or State Electric Restructuring Policy

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 of the Internal Revenue Code provides an exception to this rule for certain “spin-off” type distributions of stock of a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation (“distributing”) or the controlled corporation (“controlled”) prior and subsequent to a distribution.

The Taxpayer Relief Act of 1997 adopted additional restrictions under section 355 on acquisitions and dispositions of the stock of the distributing or controlled corporation. Generally, if in connection with a distribution to which section 355 otherwise applies, either the controlled or distributing corporation is acquired pursuant to a plan (or series of related transactions), gain is recognized as of the date of the distribution.⁴² The amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. Acquisitions occurring within the four-year period beginning two years before the date of distribution are presumed to have occurred pursuant to a plan unless the taxpayer establishes otherwise. Certain acquisitions are not taken into account in determining whether a 50-percent or greater interest in distributing or controlled has been acquired for this purpose.⁴³

Description of Proposal

The proposal would, for purposes of section 355(e), except the acquisition of stock (or assets) of any controlled corporation in a qualifying electric transmission transaction. For purposes of the proposal, an electric transmission transaction is defined in the same manner as under the proposal that would amend section 1033.⁴⁴ Thus, for example, a distribution of the stock of a controlled corporation whose principal trade or business consists of providing electric transmission services, to which section 355 otherwise applies, would not result in gain to the

⁴² Section 355(e).

⁴³ Section 355(e)(3)(A). In addition, section 355(e)(3)(B) treats certain asset acquisitions as stock acquisitions for this purpose.

⁴⁴ In general, the proposal to amend section 1033 defines an electric transmission transaction as the sale or other disposition of property used in the trade or business of providing electric transmission services, or an ownership interest in an entity whose principal trade or business consists of providing electric transmission services, to an independent transmission company prior to January 1, 2009.

distributing corporation under section 355(e) if the controlled corporation is acquired by an independent transmission company pursuant to a plan in effect on the date of the distribution.

Effective Date

The proposal would be effective for distributions occurring after the date of enactment.

I. Modification to Special Rules for Nuclear Decommissioning Costs

Present Law

Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 (“1984 Act”), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

Qualified Nuclear Decommissioning Fund

A qualified nuclear decommissioning fund (a “qualified fund”) is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.⁴⁵

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the “cost of service requirement”).⁴⁶ Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer’s income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post 1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant’s estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more

⁴⁵ As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

⁴⁶ Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the “ruling amount”). In certain instances (e.g., change in estimates) a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor’s basis in the fund.⁴⁷ The transferee is required to obtain a new ruling amount from the IRS, or accept a discretionary determination by the IRS.⁴⁸

Nonqualified Nuclear Decommissioning Funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.⁴⁹ The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund’s owner as it is earned.

Description of Proposal

Repeal of Cost of Service Requirement

The proposal would repeal the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified fund.

Permit contributions to a qualified fund for pre-1984 decommissioning costs

The proposal also would repeal the limitation that a qualified fund only accumulate an amount sufficient to pay for a nuclear powerplant’s decommissioning costs incurred during the period which the qualified fund is in existence (generally post 1984 decommissioning costs). Thus, any taxpayer would be permitted to accumulate an amount sufficient to cover the present value of 100 percent of a nuclear powerplant’s estimated decommissioning costs in a qualified

⁴⁷ Treas. reg. sec. 1.468A-6.

⁴⁸ Treas. reg. sec. 1.468A-6(f).

⁴⁹ These funds are generally referred to as “nonqualified funds.”

fund. The proposal would not change the requirement that contributions to a qualified fund not be deducted more rapidly than level funding.

Exception to ruling amount for certain decommissioning costs

The proposal also would permit a taxpayer to make contributions to a qualified fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer would be permitted to contribute up to the present value of the amount required to fund a nuclear powerplant's decommissioning costs which, under present law, are not permitted to be accumulated in a qualified fund (generally pre-1984 decommissioning costs).⁵⁰ It is anticipated that the amount that would be permitted to be contributed under this special rule shall be determined using the estimate of total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount. Any amount transferred to the qualified fund under this special rule that has not previously been deducted, or excluded from gross income would be allowed as a deduction over the remaining useful life of the nuclear powerplant.⁵¹ If a qualified fund that has received amounts under this rule is transferred to another person, that person will be entitled to the deduction at the same time and in the same manner as the transferor. Thus, if the transferor was not subject to tax at the time and thus would have been unable to use the deduction, the transferee will similarly not be able to utilize the deduction.

Contributions to a qualified fund after useful life of powerplant

The proposal also would allow deductible contributions to a qualified fund subsequent to the end of a nuclear powerplant's estimated useful life. Such payments would be permitted to the extent such payments do not cause the assets of the qualified fund to exceed the present value of the taxpayer's allocable share (current or former) of the nuclear decommissioning costs of such nuclear powerplant.

Clarify treatment of transfers of qualified funds and deductibility of decommissioning costs

The proposal would clarify the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to

⁵⁰ The ability to transfer property into a qualified fund under this special rule would be available only to the extent the taxpayer has not obtained a new ruling amount incorporating the repeal of the limitation that a qualified fund only accumulate an amount sufficient to pay for decommissioning costs of a nuclear powerplant incurred during the period which the fund is in existence (generally post 1984 decommissioning costs).

⁵¹ There would be no gain or loss recognized by a taxpayer on the contribution of property to a qualified fund under this special rule. The qualified fund will take a carryover basis in such property. Correspondingly, a taxpayer's deduction (over the estimated life of the nuclear powerplant) is to be based on the adjusted tax basis of the property contributed rather than the fair market value of such property.

which such fund was established. In addition, the proposal would provide that all nuclear decommissioning costs are deductible when paid.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

J. Treatment of Certain Income of Electric Cooperatives

Present Law

In general

Generally, cooperatives are formed under State “cooperative statutes.” Federal tax rules only require that the entity operate on a cooperative basis, which is not defined by statute or regulation. Nonetheless, the principal criteria for determining whether an entity is operating on a cooperative basis are ownership of the cooperative by persons who patronize the cooperative and return of earnings to patrons in proportion to their patronage. The Internal Revenue Service requires that cooperatives must operate under the following principles: (1) subordination of capital to control over the cooperative undertaking and financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).⁵² Cooperatives may have several types of members but, in general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. Income from the sale of electric energy by the cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member or non-member of a cooperative.

Tax exemption of rural electric cooperatives

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The Internal Revenue Service takes the position that rural electric cooperatives must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).⁵³ The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as on effect on January 1, 1987). Rural electric cooperatives are subject to tax on any unrelated trade or business taxable income.

Taxation of electric cooperative patrons before enactment of subchapter T

Prior to the enactment of subchapter T, amounts allocated to patrons of a cooperative with respect to purchases of electric energy that were made in a trade or business or for the production of income, were includable as ordinary income to the extent the allocations were paid in (1) cash, (2) the fair market value of any merchandise received, or (3) the fair market value of any revolving fund certificate, retain certificate, certificate of indebtedness, letters of advice,

⁵² Announcement 96-24, Proposed Examination Guidelines Regarding Rural Electric Cooperatives, 1996-16 I.R.B. 35.

⁵³ Rev. Rul. 72-36, 1972-1 C.B. 151.

capital stock, etc., to the extent the allocations were paid with such documents, except that any allocations that were paid under conditions beyond the control of the patron were considered not to have any value.⁵⁴ Amounts allocated by a cooperative to patrons for purchases of electric energy that were not deductible were not includable in the income of the patron.

Taxation of cooperatives and their patrons under subchapter T

Since 1962, cooperatives (including tax-exempt farmers' cooperatives) and their members generally have been subject to special tax rules under subchapter T of the Code.⁵⁵ In general, these provisions operate to treat the cooperative more like a conduit than a separate taxable business enterprise. At the same time, these provisions also ensure that the income of a cooperative is taxed either to the cooperative or its patrons.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may deduct from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. Except for tax-exempt farmers' cooperatives, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members. The availability of these deductions for the cooperative has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with members.

Taxation of electric cooperatives exempt from subchapter T

In general, subchapter T applies to tax-exempt farmers' cooperatives (described in sec. 521(b)) or any other corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities). However, subchapter T does not apply to ". . . an organization . . . which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas".⁵⁶ Instead, taxable electric cooperatives are taxed under the pre-subchapter T rules described above. Thus, an electric cooperative that is not exempt from tax under sec. 501(c)(12) can exclude income that is allocated to its patrons.⁵⁷

⁵⁴ See Treas. Reg. sec. 1.61-5.

⁵⁵ Sec. 1381, *et seq.*

⁵⁶ Sec. 1381(a)(2)(C).

⁵⁷ See Rev. Rul. 83-135, 1983-2 C.B. 149.

Description of Proposal

Treatment of income from open access transactions

Under the proposal, income received or accrued by a rural electric cooperative from any “open access transaction” (other than income received or accrued directly or indirectly from a member of the cooperative) would be excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term “open access transaction” would be defined as any activity that would be a “permitted open access activity” under the proposal concerning the tax-exempt bond rules for government-owned electric output facilities.

As applied to rural electric cooperatives, the term “permitted open access activity” would be defined as--

- (1) the provision of transmission services and ancillary services pursuant to an open access transmission tariff filed with and approved by Federal Energy Regulatory Commission (“FERC”) (including tariffs established pursuant to certain voluntarily filed reports) relating to whether the cooperative would join a regional transmission organization (“RTO”) (including an independent system operator agreement);
- (2) the provision of transmission services and ancillary services under an RTO agreement or other regional transmission group agreement approved by FERC (including the transfer of control--but not ownership--of transmission facilities);
or
- (3) the delivery on a nondiscriminatory open access basis of electric energy sold to end-users served by distribution facilities owned by the cooperative or of electric energy generated by generation facilities directly connected to distribution facilities owned by that cooperative.

Treatment of income from nuclear decommissioning transactions

The proposal would also provide that income received or accrued by a rural electric cooperative from any “nuclear decommissioning transaction” would be excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term “nuclear decommissioning transaction” would be defined as--

- (1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative’s interest in a nuclear powerplant or nuclear powerplant unit;
- (2) any distribution from such a trust, fund, or instrument; or
- (3) any earnings from such a trust, fund, or instrument.

Treatment of income from load loss transactions

Rural electric cooperatives--Under the proposal, income received or accrued by a rural electric cooperative from a “load loss transaction” would be treated under 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to its members. Therefore, income from load loss transactions would be treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The proposal would also provide that income from load loss transactions does not cause a rural electric cooperative to fail to be treated for Federal income tax purposes as a mutual cooperative company under the fundamental cooperative principles described above.

The term “load loss transaction” would be defined as any sale that would be a “load loss sale” under the proposal concerning the tax-exempt bond rules for government-owned electric output facilities. As applied to cooperatives, the term “load loss sale” generally would be defined as any wholesale or retail sale (other than directly or indirectly to members) that does not exceed the annual reduction of sales by the cooperative to members each year during a seven-year period following a base year. The sales could be made during the eight-year period following the base year.

The proposal would also exclude income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business taxable income.

Taxable electric cooperatives--Similar rules would apply to the receipt or accrual of income from load loss transactions of taxable electric cooperatives. For example, income from load loss transactions would be excludible from the income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a non-member patron.

Effective Date

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

K. Repeal of Requirement of Certain Approved Terminals to Offer Dyed Diesel or Kerosene Terminal for Nontaxable Purposes.

Present and Prior Law

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel. One such exception allows removal of diesel fuel without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This “dyed-fuel mandate” was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000 and delayed again through December 31, 2001.

Description of Proposal

The proposal would repeal the diesel fuel and kerosene-dyeing mandate.

Effective Date

The proposal would be effective on the date of enactment.

L. Exempt Certain Prepayments for Natural Gas From Tax-Exempt Bond Arbitrage Rules

Present Law

Interest on bonds issued by States or local governments to finance activities carried out or paid for by those entities generally is exempt from income tax (sec. 103). Restrictions are imposed on the ability of States or local governments to invest the proceeds of these bonds for profit (the "arbitrage restrictions"). One such restriction limits the use of bond proceeds to acquire "investment-type property." The term investment-type property includes the acquisition of property in a transaction involving a prepayment. A prepayment can produce prohibited arbitrage profits when the discount received for prepaying the costs exceeds the yield on the tax-exempt bonds. In general, prohibited prepayments include all prepayments that are not customary in an industry by both beneficiaries of tax-exempt bonds and other persons using taxable financing for the same transaction.

Description of Proposal

The proposal would create a new exception to the general rule that tax-exempt bond-financed prepayments violate the arbitrage restrictions. Under the proposal, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas to be used in the business of one or more governmental utilities would not be treated as the acquisition of investment-type property. The exception would apply only if at least 85 percent of the purchased natural gas was for use by governmental utilities in the State where the issuer of the bonds was located.

Effective Date

The proposal would apply to bonds issued after October 22, 1986 (the date of enactment of the Tax Reform Act of 1986) except the requirement that at least 85 percent of the purchased gas be for use in the State where the issuer is located would not apply to bonds issued before the date of the proposal's enactment.

III. PRODUCTION

A. Tax Credit for Oil and Gas Production From Marginal Wells

Present Law

There is no credit for the production of oil and gas from marginal wells. The costs of such production may be recovered under the Code's depreciation and depletion rules and in other cases as a deduction for ordinary and necessary business expenses.

Description of Proposal

The proposal would create a new, \$3 per barrel credit for the production of crude oil and a \$0.50 per 1,000 cubic feet of qualified natural gas production. The maximum amount of production on which credit could be claimed would be 1,095 barrels or barrel equivalents. In both cases, the credit would be available only for production from a "qualified marginal well." The credit would not be available to production occurring if the reference price of oil exceeded \$18 (\$2.00 for natural gas). The credit would be reduced proportionately as for reference prices between \$15 and \$28 (\$1.67 and \$2.00 for natural gas). Reference prices would be determined on a one-year look-back basis.

A qualified marginal well would be defined as (1) a well production from which was marginal production for purposes of the Code percentage depletion rules or (2) a well that during the taxable year had (a) average daily production of not more than 25 barrel equivalents and (b) produced water at a rate of not less than 95 percent of total well effluent.

The credit would be treated as a general business credit. Additionally, unused credits could be carried back for up to 10 years rather than the generally applicable carryback period of one year.

**B. Temporary Suspension of Limitation Based on 65 Percent of Taxable
Income and Extension of Suspension of Taxable Income Limit
With Respect to Marginal Production**

Present Law

In general

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

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.⁵⁸ Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

Cost depletion

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

Percentage depletion and related income limitations

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.⁵⁹ Generally, under the percentage depletion method 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec.

⁵⁸ Treas. Reg. sec. 1.611-1(b)(1).

⁵⁹ Sec. 613A.

613(a)). By contrast, for any other mineral qualifying for the percentage depletion deduction, such deduction may not exceed 50 percent of the taxpayer's taxable income from the depletable property. A similar 50-percent net-income limitation applied to oil and gas properties for taxable years beginning before 1991. Section 11522(a) of the Omnibus Budget Reconciliation Act of 1990 prospectively changed the net-income limitation threshold to 100 percent only for oil and gas properties, effective for taxable years beginning after 1990. The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2002.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).⁶⁰ Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

Limitation of oil and gas percentage depletion to independent producers and royalty owners

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,⁶¹ are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Description of Proposal

The limit on percentage depletion deductions to no more than 65 percent of the taxpayer's overall taxable income would be suspended for taxable years beginning after December 31, 2001, and before January 1, 2007. The suspension of the 100-percent net-income

⁶⁰ Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

⁶¹ This exception is limited to wells, the drilling of which began between September 30, 1978, and January 1, 1984.

limitation for marginal wells would be extended an additional five years, through taxable years beginning before January 1, 2007.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2001.

C. Deduction for Delay Rental Payments

Present Law

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

Description of Proposal

The proposal would allow delay rental payments incurred in connection with the development of oil or gas within the United States to be deducted currently.

Effective Date

The proposal would apply to delay rental payments paid or incurred in taxable years beginning after December 31, 2001. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

D. Election to Expense Geological and Geophysical Expenditures

Present Law

In general

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. A key issue with respect to the tax treatment of such expenditures is whether or not they are capital in nature. Capital expenditures are not currently deductible as ordinary and necessary business expenses, but are allocated to the cost of the property.⁶²

Courts have held that G&G costs are capital, and therefore are allocable to the cost of the property⁶³ acquired or retained.⁶⁴ The costs attributable to such exploration are allocable to the cost of the property acquired or retained. As described further below, IRS administrative rulings have provided further guidance regarding the definition and proper tax treatment of G&G costs.

Revenue Ruling 77-188

In Revenue Ruling 77-188⁶⁵ (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of G&G costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after

⁶² Under section 263, capital expenditures are defined generally as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treasury regulations define capital expenditures to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use. Treas. Reg. sec. 1.263(a)-1(b).

⁶³ "Property" means an interest in a property as defined in section 614 of the Code, and includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proved at the time the costs are incurred.

⁶⁴ See, e.g., *Schermerhorn Oil Corporation v. Commissioner*, 46 B.T.A. 151 (1942). By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

⁶⁵ 1977-1 C.B. 76.

analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.
- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.
- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

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

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

A taxpayer may acquire or retain a property within or adjacent to an area of interest, based on data obtained from a detailed survey that does not relate exclusively to any discrete property within a particular area of interest. Generally, under the 1977 ruling, the taxpayer allocates the entire amount of G&G costs to the acquired or retained property as a capital cost under section 263(a). If more than one property is acquired, it is proper to determine the amount

of the G&G costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

If, however, no property is acquired or retained within or adjacent to that area of interest, the entire amount of the G&G costs allocable to the area of interest is deductible as a loss under section 165 for the taxable year in which such area of interest is abandoned as a potential source of mineral production.

In 1983, the IRS issued Revenue Ruling 83-105,⁶⁶ which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83-105 explains what constitutes "abandonment as a potential source of mineral production."

Description of Proposal

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

Effective Date

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

⁶⁶ 1983-2 C.B. 51.

E. Allow Net Operating Losses From Oil and Gas Properties To Be Carried Back for Up to Five Years

Present Law

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

Description of Proposal

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

Effective Date

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

F. Extension and Modification of Credit for Producing Fuel From a Non-Conventional Source

Present Law

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

Qualified fuels include:

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

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

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

Description of Proposal

The proposal would permit taxpayers to claim the sec. 29 credit for production of certain non-conventional fuels produced at wells placed in service after the date of enactment and before January 1, 2007. Qualifying fuels would be oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams or a tight formation. The value of the credit would be \$3.00 for production in 2001 and 2002 and would be indexed for inflation commencing with the credit amount for 2003. The credit could be claimed for production from the well for each of the first four years of production, but not for any production occurring after December 31, 2009

The proposal further would permit production from certain existing wells (any well drilled after December 31, 1979 and before January 1, 1993) to claim a credit equal to the newly, re-indexed value of \$3.00 for production in 2003 through 2006.

The proposal also would permit landfill gas sold to a third party from facilities placed in service after June 30, 1998 and before January 1, 2007 to be eligible for the taxpayer to claim five years of credit from the later of the date of enactment or the date the facility is placed in service. The amount of credit is \$3.00 per barrel equivalent in 2001 and 2002 and would be

indexed for inflation commencing with the credit amount for 2003. In the case of a landfill subject to the Environmental Protection Agency's 1996 New Source Performance Standards/Emissions Guidelines the amount of credit would be \$2.00 per barrel equivalent in 2001 and 2002 and would be indexed for inflation commencing with the credit amount for 2003.

Under the proposal, the taxpayer would not be able to claim any credit for production in excess of a daily average of 200,000 cubic feet of gas (or barrel of oil equivalent) from a qualifying well or facility.⁶⁷

Effective Date

The proposal would apply to fuel sold from qualifying wells and facilities after the date of enactment.

⁶⁷ The daily average would be computed as total production divided by the total number of days the well or facility was in production during the year.

G. Allow Business Energy Credits Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals and corporations in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, business credits may not exceed the excess of the regular tax liability over the tentative minimum tax.

Description of Proposal

The proposal would make the minimum tax limitation inapplicable to the business energy credits added by the bill.

Effective Date

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

H. Repeal Alternative Minimum Tax Intangible Drilling Costs ("IDC") Preference for Oil and Gas Production

Present Law

Taxpayers who pay or incur intangible drilling or development costs ("IDCs") in the development of domestic oil or gas production may elect to either expense or capitalize these amounts. If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred.

The difference between the amount of a taxpayer's IDC deduction and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period is an item of tax preference for the alternative minimum tax ("AMT") to the extent that this amount exceeds 65 percent of the taxpayer's net income from oil and gas properties for the taxable year. This preference applies to taxpayers other than integrated oil companies only to the extent that the failure to apply the preference would result in a reduction of the taxpayer's alternative minimum taxable income by more than 40 percent.

Description of Proposal

The proposal would repeal the AMT preference for intangible drilling costs for oil and gas wells for taxpayers other than integrated oil companies.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2001, and beginning before January 1, 2005

I. Allow Enhanced Oil Recovery Credit Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals and corporations in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, business credits may not exceed the excess of the regular tax liability over the tentative minimum tax. One of these credits is the enhanced oil recovery credit (sec. 43).

Description of Proposal

The proposal would repeal the minimum tax limitation on the enhanced oil recovery credit.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2001, and beginning before January 1, 2005.

J. Extension of Tax Incentives for Energy-Related Businesses on Indian Reservations

Present Law

Present law includes the following tax incentives for businesses located within Indian reservations.

Accelerated depreciation

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) will be determined using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property.....	22 years

"Qualified Indian reservation property" eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not "qualified Indian reservation property" if it is placed in service for purposes of conducting gaming activities. Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before December 31, 2003.

Indian employment credit

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (sec. 45A). The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee

health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An employee will not be treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of \$30,000 (adjusted for inflation after 1993).

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before December 31, 2003.

Description of Proposal

Accelerated depreciation

The proposal would extend the accelerated depreciation incentive for three years (to property placed in service before January 1, 2007), but only with respect to property that is part of a facility for (1) the generation or transmission of electricity (including from any qualified energy resource), (2) an oil or gas well, (3) the transmission or refining of oil or gas, or (4) the production of any qualified fuel (as defined in section 29(c)).

Indian employment credit

The proposal would extend the Indian employment credit incentive for three years (to taxable years beginning before January 1, 2007), but only in the case of wages paid for services performed at a facility for (1) the generation or transmission of electricity (including from any qualified energy resource), (2) an oil or gas well, (3) the transmission or refining of oil or gas, or (4) the production of any qualified fuel (as defined in section 29(c)).

Effective Date

The proposals are effective on the date of enactment.

