DESCRIPTION OF THE "CARE ACT OF 2002"

Scheduled for a Markup
By the
SENATE COMMITTEE ON FINANCE
on June 13, 2002

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on June 13, 2002, of the "CARE Act of 2002". This document[1], prepared by the staff of the Joint Committee on Taxation, provides a description of the "CARE Act of 2002."

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the "CARE Act of 2002"* (JCX-57-02), June 11, 2002.

I. CHARITABLE GIVING INCENTIVES

A. Charitable Deduction for Nonitemizers

Present Law

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3)[2] or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[3]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[4]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[5] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity

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[2] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[3] Secs. 170(b) and (e).

[4] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

[5] Sec. 170(f)(8).

and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[6]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

Description of Proposal

In the case of an individual taxpayer who does not itemize deductions, the proposal would allow a direct charitable deduction from adjusted gross income for charitable contributions paid in cash. This deduction would be allowed in addition to the standard deduction. The deduction would be available only for that portion of contributions that in the aggregate exceed $250 ($500 in the case of a joint return). The maximum deduction would be $250 ($500 in the case of a joint return). For example, an individual would not be entitled to a charitable deduction for the first $250 of cash contributions made during the tax year, would be entitled to a deduction on a dollar-for-dollar basis for contributions of $251 to $500 (e.g., a $1 contribution deduction in the case of $251 of contributions, and a $250 deduction in the case of $500 of contributions), and would not be entitled to a deduction for any contributions exceeding $500. The direct charitable deduction generally would be subject to the tax rules normally

[6] Sec. 6115.

governing charitable contribution deductions, such as the substantiation requirements. The deduction would be allowed in computing alternative minimum taxable income.

The Secretary of the Treasury would be required to complete a study by December 31, 2003, of the effect of the proposal on increased charitable giving, and of taxpayer compliance, for example, by comparing compliance by taxpayers who itemize their charitable contributions with compliance by those who claim the direct charitable deduction.

Effective Date

The direct charitable deduction would be effective for taxable years beginning after December 31, 2001, and before January 1, 2004. The Treasury study would be required by December 31, 2003.

B. Tax-Free Distributions From Individual Retirement Arrangements for Charitable Purposes

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity. The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[7]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[8]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[9] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods

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[7] Secs. 170(b) and (e).

[8] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated after 1986.

[9] Sec. 170(f)(8).

or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[10]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2002 is $137,300 ($68,650 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[11] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[12] For

[10] Sec. 6115.

[11] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[12] Sec. 170(f)(2).

such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[13] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[14] (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[15] also are required to file Form 1041A. The

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[13] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

[14] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

[15] Sec. 642(c).

returns are required to be made publicly available.[16] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[17] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Description of Proposal

Qualified charitable distributions from IRAs

The proposal would provide an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Special rules would apply in determining the amount of an IRA distribution that would be otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions would continue to apply to distributions from an IRA that are not qualified charitable distributions.

A qualified charitable distribution would be defined as any distribution from an IRA that is made directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity would mean a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions would be eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2. Distributions to a split interest entity would be eligible for the exclusion only if made on or after the date the IRA owner attains age 59-1/2. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, his or her spouse, or a charitable organization.

The exclusion would apply to direct distributions only if a charitable contribution deduction for the entire distribution would otherwise be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount would be reduced because of a benefit received in exchange, or if a deduction would not be allowable because the donor did not obtain sufficient substantiation, the exclusion would not be available with respect to any part of the distribution. Similarly, the exclusion would apply in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) would be allowable, determined without regard to the generally applicable percentage limitations.

[16] Sec. 6104(b).

[17] Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

If the IRA owner has any IRA that includes nondeductible contributions, a special rule would apply in determining the portion of a distribution that would be includible in gross income (but for the proposal) and thus is eligible for qualified charitable distribution treatment. In such case, the IRA owner would aggregate all IRAs to determine eligibility for the exclusion. Under the special rule, the distribution would be treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the proposal) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions during the year that is includible in income. In determining the amount of subsequent IRA distributions includible in income, proper adjustments would be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules would apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the proposal would provide that subsequent distributions from the charitable remainder trust would be treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally would be treated under section 664(b). In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust would have to be funded exclusively by such distributions. For example, an IRA owner would not be able to make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the proposal, a pooled income fund would be eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions would be treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund would not be includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity would not be an investment in the annuity contract.

Any amount excluded from gross income by reason of the proposal would not be taken into account in determining the deduction for charitable contributions under section 170.

Split-interest trust filing requirements

The proposal would increase the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information, and would impose personal liability for such penalty on certain persons in certain circumstances. The penalty would be $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty would be $100 for each day the failure continues up to a maximum of $50,000. If a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[18] knowingly failed to file the return or include required information, then that person would personally be liable for such penalty. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) would be exempt from the requirement to make information publicly available. In addition, the proposal would repeal the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception would remain available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 2002. The provision relating to information returns of split-interest trusts would be effective for returns for taxable years beginning after December 31, 2002.

[18] Sec. 6652(c)(4)(C).

C. Charitable Deduction for Contributions of Food Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[19] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[20]

Description of Proposal

Under the proposal, any taxpayer, whether or not a C corporation, engaged in a trade or business would be eligible to claim an enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year could not exceed 10 percent of the taxpayer's net income for such year from its trade or business. In addition, a non-C corporate taxpayer would be required to apply separately carryforwards of contributions of food inventory and other charitable contributions.

The proposal would change the amount of the present-law enhanced deduction for eligible contributions of food inventory to the lesser of fair market value or twice the taxpayer's basis in the inventory. For example, a taxpayer who makes an eligible donation of food that has a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value). Under present law, a C corporation's deduction in the first example would be $7 (fair market value less half the appreciation) and in the second example would be $8. (Under present law,

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[19] Sec. 170(e)(3). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income. Sec. 170(b)(2).

[20] *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995).

taxpayers other than C corporations generally could take a deduction for a contribution of food inventory only for the $4 basis in either example.) Taxpayers that do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A would be able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[21]

The enhanced deduction would be available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" would be defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

In addition, the proposal would provide that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market would be determined without regard to such internal standards or lack of market and by taking into account the price at which the same or substantially the same food items are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective Date

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

[21] This would include, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002-28 and 2001-10.

D. Charitable Deduction for Contributions of Book Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[22] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

Description of Proposal

The proposal would modify the present-law enhanced deduction for C corporations so that it would be equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contributions. For example, a C corporation that made a qualified book contribution with a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value).

A qualified book contribution would mean a charitable contribution of books to: (1) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), which is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee's exempt purpose; (2) not transfer the property in exchange for money, other property, or services; (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements and also that the books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

Effective Date

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

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

E. Charitable Deduction for Contributions of Bonds

Present Law

Under present law, a taxpayer's deduction for charitable contributions of property, including a contribution of bonds, to or for the use of a private foundation (other than a private foundation described in section 170(b)(1)(E)) generally is limited to the taxpayer's basis in the property. As an exception to the general rule, a taxpayer's deduction for charitable contributions of qualified appreciated stock for the use of such a private foundation generally is the fair market value of the stock.[23]

Description of Proposal

The proposal would provide for a fair market value deduction for charitable contributions of qualified appreciated bonds to or for the use of a private foundation (other than a private foundation described in section 170(b)(1)(E)). The proposal would define qualified appreciated bonds as United States Treasury securities and such other debt instruments as may be prescribed by the Secretary in regulations.

Effective Date

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

[23] Sec. 170(e)(5)(A).

F. Expand Charitable Contribution Allowed for Scientific Property Used for Research and for Computer Technology and Equipment

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[24]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[25] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis.

A qualified research contribution means a charitable contribution of inventory that is tangible personal property. The contribution must be to a qualified educational or scientific organization and be made not later than two years after construction of the property is substantially completed. The original use of the property must be by the donee, and be used substantially for research or experimentation, or for research training, in the U.S. in the physical or biological sciences. The property must be scientific equipment or apparatus, constructed by the taxpayer, and may not be transferred by the donee in exchange for money, other property, or services. The donee must provide the taxpayer with a written statement representing that it will use the property in accordance with the conditions for the deduction. For purposes of the enhanced deduction, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer's basis in the property.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is

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

[25] Secs. 170(e)(4) and 170(e)(6).

substantially completed.[26] The original use of the property must be by the donor or the donee,[27] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[28]

Description of Proposal

Under the proposal, property assembled by the taxpayer, in addition to property constructed by the taxpayer, would be eligible for either enhanced deduction.

Effective Date

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

[26] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[27] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[28] Sec. 170(e)(6)(C).

G. Encourage Contributions of Capital Gain Real Property Made for Conservation Purposes

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[29]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain

[29] Secs. 170, 2055, and 2522, respectively.

property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryforward rules of other charitable contributions of capital gain property.

Description of Proposal

In general

Under the proposal, the 30-percent contribution base limitation on contributions of capital gain property by individuals would not apply to qualified conservation contributions (as defined under present law). Thus, individuals could include the fair market value of any qualified conservation contribution of capital gain property in determining the amount of the charitable contributions subject to the 50-percent contribution base limitation. In addition, individuals would be allowed to carryforward any qualified conservation contribution that exceeds the 50-percent limitation for 15 years.

The 50-percent contribution base limitation would apply first to contributions other than qualified conservation contributions and then to qualified conservation contributions. For example, an individual with a contribution base of $100 who made a qualified conservation contribution of $80 and other charitable contributions of $60 would be eligible to deduct $50 of the other contributions (50 percent of the $100 contribution base) and carryforward the excess $10 for 5 years, and would be required to carryforward the entire $80 qualified conservation contribution for 15 years. (By way of illustration, a reverse ordering rule would have limited the deduction to $50 for the qualified conservation contribution, leaving a $30 qualified conservation contribution carryforward for 15 years and $60 of other charitable contributions that could be carried forward for 5 years.)

Farmers and ranchers

In the case of an eligible farmer or rancher, a qualified conservation contribution would be allowable up to 100 percent of the taxpayer's contribution base (after taking into account other charitable contributions). This rule would apply both to individuals and corporations. In addition, corporate (and non-corporate) eligible farmers and ranchers would be allowed to carryforward any excess qualified conservation contributions for 15 years. The 100-percent contribution base limitation would apply first to contributions other than qualified conservation contributions (to the extent allowable under other percentage limitations) and then to qualified conservation contributions. For example, an individual with a contribution base of $100 who made a qualified conservation contribution of $80 and other charitable contributions of $60 would be eligible to deduct $50 of other contributions (50 percent of the $100 contribution base) and carryforward the excess $10 for 5 years, and would be able to deduct $50 of the qualified charitable contribution and carryforward the remaining $30 qualified conservation contribution for 15 years.

For this purpose, an eligible farmer or rancher would mean a taxpayer (other than a publicly traded C corporation) whose gross income from the trade of business of farming is at least 51 percent of the taxpayer's gross income for the taxable year.

Effective Date

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

H. 25 Percent Exclusion for Sales Made for Qualifying Conservation Purposes

Present Law

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

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

Description of Proposal

The proposal would provide a 25-percent exclusion from gross income of capital gain from the qualifying sale of land, or an interest in land or water, provided the land, or interest in land or water, has been held by the taxpayer or the taxpayer's family at all times during the five year period preceding the date of sale. The exclusion would not be available for sales or exchanges of ordinary income property or improvements. Only sales or exchanges of: (1) the entire interest of the taxpayer other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use which may be made of the land or interest in land or water, would qualify for the exclusion. A qualifying sale would be a sale or exchange (excluding a transfer made by order of condemnation or eminent domain or under imminence thereof) to an agency or department of the Federal Government, a State government, or a local government or a section 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In addition, to be a qualifying sale, the person acquiring the land, or interest in land or water, must provide the taxpayer with a letter stating that the intent of the purchase is to further a qualified conservation purpose and that any subsequent transfer of the acquired interest will protect the conservation purpose in perpetuity. A qualified conservation purpose is: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State or local governmental conservation policy and will yield a significant public benefit.

Under the proposal, the exclusion would be available for capital gain from certain sales or exchanges of a controlling stock interest (generally a stock interest of at least 90 percent of the total voting power and total value of the corporation's stock) in a corporation if at least 90 percent of the fair market value of the corporation's assets at all times during the three year period preceding the sale consisted of land or interests in land. Only controlling stock interests held by the taxpayer or the taxpayer's family at all times during the five years preceding the sale would qualify for the 25-percent exclusion.

Effective Date

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

I. Cost Sharing Payments under the Partners for Fish and Wildlife Program

Present Law

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

Description of Proposal

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

Effective Date

The proposal would apply to taxable years beginning after December 31, 2002.

J. Adjust Basis of S Corporation Stock for Certain Charitable Contributions

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining the shareholder's own income tax liability.[30] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[31]

Description of Proposal

The proposal would provide that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation would be an amount equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[32]

Under present law, if an S corporation makes a charitable contribution of appreciated property, the shareholder is taxed on an amount equal to the appreciation in the contributed property when the stock in the S corporation is sold. Under the proposal, the basis in the S corporation stock would be adjusted so that on the sale of the S corporation stock, there would be no tax on the appreciation in the contributed property. The tax consequences under the proposal would be the same as if the individual taxpayer contributed the property directly to the charity without using an S corporation.

Thus, if an S corporation with one shareholder contributes stock with a cost basis of $200 and a fair market value of $500 to a charitable organization, the shareholder would be treated as having made the contribution for purposes of computing the shareholder's charitable contribution deduction (which generally would be $500, assuming section 170(e)(1) does not apply), and the shareholder would reduce the adjusted basis in the S corporation stock by $200. When the shareholder sells the S corporation stock, the shareholder would not recognize gain as a result of the charitable contribution because the basis reduction in the S corporation stock would have been equal to the basis in the contributed property. This is the same result as if a taxpayer contributed such stock directly to a charitable organization -- the taxpayer would receive the same deduction ($500) and would not recognize gain. By contrast, under present law, the shareholder reduces the adjusted basis in the S corporation stock by $500, not $200 as under the proposal, and therefore is taxed on the $300 appreciation as a result of the charitable contribution when the shareholder sells the S corporation stock.

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[30] Sec. 1366(a)(1)(A).

[31] Sec. 1367(a)(2)(B).

[32] Rev. Rul. 96-11 (1996-1 C.B. 140) reaches a similar result in the case of charitable contributions made by a partnership.

Effective Date

The proposal would apply to contributions made in taxable years beginning after December 31, 2002.

II. DISCLOSURE OF INFORMATION RELATING TO TAX-EXEMPT ORGANIZATIONS

A. Disclosure of Written Determinations

Present Law

In general

Three provisions of present law govern the disclosure of information relating to tax-exempt organizations. First, section 6103 provides a general rule that tax returns and return information generally are not subject to public disclosure.[33] Second, in order to allow the public to scrutinize the activities of tax-exempt organizations, section 6104 grants an exception to the confidentiality rule of section 6103 for certain categories of tax-exempt organization documents and information. Section 6104 permits the release in unredacted form of approved applications for tax-exempt status, certain related documents, and annual information returns filed by tax-exempt organizations. As a general rule, to the extent section 6104 specifically provides for the disclosure of tax-exempt organization information, other disclosure provisions do not apply. If tax-exempt organization information does not come within the scope of section 6104, other disclosure provisions will govern whether the information may be disclosed. Third, section 6110 provides that written determinations by the IRS and related background file documents generally are open to public inspection in redacted form. Section 6110 does not apply to any matter to which section 6104 applies.[34]

Disclosure of applications for recognition of tax exemption and annual information returns

Under present law, tax-exempt organizations are required to make a copy of their application for recognition of tax-exempt status (and certain related documents)[35] and their annual information return (Form 990 or Form 990-PF) available for public inspection.

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[33] Sec. 6103(a). A "return" includes any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for, or permitted under the provisions of the Code, which is filed with the IRS. Sec. 6103(b)(1). "Return" also includes any amendment or supplement to the filed return. Sec. 6103(b)(1). "Return information" is defined broadly to include any data received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense under the Code. The term "return information" does not include data in a form that cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. Sec. 6103(b)(2).

[34] Sec. 6110(l)(1).

[35] Section 6104(a)(1)(A) provides that "any papers submitted in support of" an application for tax-exempt status must be available for inspection. Treasury regulations limit the definition of supporting documents to papers submitted by the organization. Treas. Reg. sec. 301.6104(a)-1(e).

Organizations are not required to disclose an application for tax exemption filed by the organization unless the IRS responded favorably to the application.[36] Charitable organizations that are not classified as private foundations are not required to disclose the names of donors to the organization.

The Secretary may withhold disclosure of certain information described in an organization's application for tax-exempt status if disclosure would: (1) divulge a trade secret, patent, process, style of work, or apparatus of the organization, and the Secretary determines that such disclosure would harm the organization; or (2) that the Secretary determines would harm the national defense.[37] The organization must apply to the Commissioner for a determination that the disclosure would violate one of these criteria. The organization will be given 15 days to contest an adverse determination before the information is made available for public inspection.[38]

<u>Disclosure of written determinations</u>

Section 6110 provides that the text of any written determination by the IRS and related background file document is open to public inspection.[39] The term "written determination" means a ruling,[40] determination letter,[41] technical advice memorandum,[42] or Chief Counsel advice.[43] Closing agreements, which are final and conclusive written agreements entered into by

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[36] Treas. Reg. sec. 301.6104(d)-1(b)(3)(iii)(A).

[37] Sec. 6104(a)(1)(D). In the case of a pension plan, information may be withheld if it would identify any particular individual covered under the plan. *Id.*

[38] Treas. Reg. sec. 301.6104(a)-5(a)(1).

[39] Sec. 6110(a).

[40] A ruling is a written statement issued by the National Office to a taxpayer or his or her authorized representative. Treas. Reg. sec. 301.6110-2(d). It generally recites the relevant facts, sets forth the applicable provisions of law, and shows the application of the law to the facts. Treas. Reg. sec. 301.6110-2(d).

[41] A district director issues a "determination letter" in response to a written inquiry from an individual or organization that applies principles and precedents previously announced by the IRS National Office to the particular facts involved. Treas. Reg. sec. 301.6110-2(e).

[42] A "technical advice memorandum" is a written statement issued by the IRS National Office to a district director in connection with the examination of a taxpayer's return or consideration of a taxpayer's claim for refund or credit. Treas. Reg. sec. 301.6110-2(f). Generally, a technical advice memorandum states the relevant facts, sets forth the applicable law, and states a legal conclusion. Treas. Reg. sec. 301.6110-2(f).

[43] Sec. 6110(b)(1). Any IRS National Office component of the Office of Chief Counsel can issue Chief Counsel advice. The IRS National Office component issues the advice to IRS field or service center employees, or to regional or district employees of Chief Counsel. Sec.

the IRS and a taxpayer in order to settle the taxpayer's tax liability with respect to a taxable year, do not constitute written determinations.[44] A background file document includes the request for a written determination, any written material submitted by the taxpayer in support of the request, and any communications between the IRS and other persons in connection with the written determination received before issuance of the written determination.[45]

A background file document is available upon written request to any person requesting a copy of the related written determination.[46] Before releasing any written determination or background file document, the IRS must delete identifying details of the person about whom the written determination pertains and certain other information.[47] With respect to tax-exempt organizations, disclosure under section 6110 is limited to letters and rulings unrelated to an organization's tax-exempt status.[48]

The application of section 6110 to guidance relating to tax-exempt organizations is limited. Section 6110(l)(1) provides, "this section shall not apply to any matter to which section

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6110(i)(A)(i). The definition of Chief Counsel advice does not encompass advice issued from one IRS National Office component of the Office of Chief Counsel to another. The advice by definition conveys: (1) a legal interpretation of a revenue provision; (2) the IRS or Chief Counsel position or policy concerning a revenue provision; or (3) a legal interpretation of any law (Federal, State, or foreign) relating to the assessment or collection of liability under a revenue provision. Sec. 6110(i)(A)(ii).

[44] Sec. 6103(b)(2)(D); sec. 6110(b)(1)(B).

[45] Sec. 6110(b)(2). Communications between the IRS and the Department of Justice relating to a pending civil or criminal case are not considered background file documents.

[46] Sec. 6110(e).

[47] Sec. 6110(c) provides the following exemptions from disclosure: (1) the names, addresses, and other identifying details of the person to whom the written determination pertains and of any other person, other than a person with respect to whom a notation is made under subsection (d)(1) (relating to third party contacts), identified in the written determination or any background file document; (2) information specifically authorized under criteria established by an Executive order to be kept secret in the interest of national defense or foreign policy, and which is in fact properly classified pursuant to such Executive order; (3) information specifically exempted from disclosure by any statute (other than this title) which is applicable to the Internal Revenue Service; (4) trade secrets and commercial or financial information obtained from a person and privileged or confidential; (5) information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy; (6) information contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions; and (7) geological and geophysical information and data, including maps, concerning wells.

[48] Sec. 6110(l)(1); Treas. Reg. sec. 301.6110-1(a).

6104 applies." The regulations under section 6110 clarify which matters are within the ambit of section 6104 and, therefore, are not subject to disclosure under section 6110:

"[a]ny application filed with the Internal Revenue Service with respect to the qualification or exempt status of an organization . . .; any document issued by the Internal Revenue Service in which the qualification or exempt status of an organization is . . . granted, denied or revoked or the portion of any document in which technical advice with respect thereto is given to a district director; . . . the portion of any document issued by the Internal Revenue Service in which is discussed the effect on the qualification or exempt status of an organization . . . of proposed transactions by such organization . . . ; and any document issued by the Internal Revenue Service in which is discussed the qualification or status of a [private foundation or private operating foundation]."[49]

In addition, the regulations under section 6104 provide that some determination letters and other documents relating to tax exemption that are not open to public inspection under section 6104(a)(1)(A) are nevertheless "within the ambit" of section 6104 for purposes of the disclosure provisions of section 6110.[50] The regulation explains that the following documents are, therefore, not available for public inspection under either section 6104 or 6110:

(1) unfavorable rulings or determination letters issued in response to applications for tax exemption;

(2) rulings or determination letters revoking or modifying a favorable determination letter;

(3) technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter;

(4) any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503;

(5) any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and

(6) any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c), does not relate to that organization's application for tax exemption.[51]

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[49] Treas. Reg. sec. 301.6110-1(a).

[50] Treas. Reg. sec. 301.6104(a)-1(i).

[51] *Id.*

The effect of these limitations is that written determinations relating to exempt status issues are not released, even in redacted form. The IRS does, however, release written determinations issued to tax-exempt organizations that include issues that clearly are not within the ambit of section 6104, such as the application of the unrelated business income tax to a particular proposed transaction.

Description of Proposal

The proposal would require disclosure in redacted form of written determinations relating to the tax-exempt status of an organization described in section 501(c) or (d) that are not required to be disclosed by section 6104(a)(1)(A) but that are within the scope of section 6104. Such written determinations (and related background file documents) would be disclosed under the provisions of section 6110 and would include: (1) unfavorable rulings or determination letters issued in response to applications for tax exemption; (2) rulings or determination letters revoking or modifying a favorable determination letter; (3) technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter; (4) any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503; (5) any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and (6) any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c) or (d), does not relate to that organization's application for tax exemption.

Effective Date

The proposal would be effective for written determinations issued after December 31, 2002.

B. Disclosure of Internet Web Site and Name Under Which Organization Does Business

Present Law

Most types of tax-exempt organizations are required to file annually an information return.[52] The Internal Revenue Code does not require an exempt organization to furnish on the applicable information return any name under which the organization operates or does business, if such name differs from the legal name of the organization, or the organization's Internet web site address, if any.[53]

Description of Proposal

The proposal would require a tax-exempt organization subject to reporting requirements under section 6033(a) to include on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.

Effective Date

The proposal would be effective for returns filed after December 31, 2002.

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[52] Sec. 6033(a). *See, e.g.*, Form 990 -- Return of Organization Exempt From Income Tax. An organization that is required to file Form 990, but that has gross receipts of less than $100,000 during its taxable year, and total assets of less than $250,000 at the end of its taxable year, may file Form 990-EZ instead of Form 990. Private foundations are required to file Form 990-PF rather than Form 990.

[53] The IRS requires disclosure of an organization's Internet web site address on Forms 990 and 990-EZ.

C. Modification to Reporting of Capital Transactions

Present Law

Private foundations are required to file an annual information return (Form 990-PF).[54] Part IV of the Form 990-PF requires that private foundations report detailed information regarding the gain or loss from the sale or other disposition of property, including a description of the property sold, how it was acquired (purchase or donation), the date acquired, the date sold, the gross sales price, the amount of depreciation allowed or allowable, and the cost or other basis plus expenses of the sale. Such information generally is required for the IRS to calculate the tax on the private foundation's net investment income. The Form 990-PF is required to be made available to the public.

Description of Proposal

The proposal would require that any information regarding capital gains and losses that is required to be furnished by private foundations in order to calculate the tax on net investment income would be furnished also in summary form. Any such information regarding capital gains and losses that is required to be filed with the IRS but that is not in summary form would not be required to be made available to the public except by the explicit request of a member of the public to the organization or to the IRS. Private foundations would be required to state on the furnished summary that the more detailed description is available upon such request.

Effective Date

The proposal would be effective for returns filed after December 31, 2002.

[54] Sec. 6033(a).

D. Disclosure that Form 990 is Publicly Available

Present Law

Under present law, there is no requirement that the IRS notify the public that the Form 990 is publicly available.

Publication 17 (Your Federal Income Tax), Publication 526 (Charitable Contributions), and the Instructions to Schedule A (Itemized Deductions) of Form 1040 do not advise that an exempt organization's Form 990 is publicly available.

Description of Proposal

The proposal would require the IRS to notify the public in Publication 17, Publication 526, and the Instructions to Schedule A of Form 1040 that an exempt organization's Form 990, Form 990-EZ, and Form 990-PF are publicly available.

Effective Date

The proposal would be effective for instructions or publications issued or revised after the date of enactment.

E. Disclosure to State Officials of Proposed Actions Related to Section 501(c)(3) Organizations

Present Law

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.[55] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, return and return information (as such terms are defined in sec. 6103(b)) is confidential and may not be disclosed or inspected unless expressly provided by law.[56] Present law requires the Secretary to keep records of disclosures and requests for inspection[57] and requires that persons authorized to receive return and return information maintain various safeguards to protect such information against unauthorized disclosure.[58] Willful unauthorized disclosure or inspection of return or return information is subject to a fine and/or imprisonment.[59] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[60] Such present-law protections against unauthorized disclosure or inspection of return and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

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[55] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

[56] Sec. 6103(a).

[57] Sec. 6103(p)(3).

[58] Sec. 6103(p)(4).

[59] Secs. 7213 and 7213A.

[60] Sec. 7431.

Description of Proposal

The proposal provides that upon written request by an appropriate State officer, the Secretary may disclose, with respect to a section 501(c)(2) (certain title holding companies), 501(c)(3) (charitable and similar organizations), 501(c)(4) (certain social welfare organizations), 501(c)(6) (certain business leagues and similar organizations), 501(c)(7) (certain recreational clubs), 501(c)(8) (certain fraternal organizations), 501(c)(10) (certain domestic fraternal organizations operating under the lodge system), and 501(c)(13) (certain cemetery companies) organization: (1) a notice of proposed refusal to recognize an organization as an organization exempt from tax; (2) a notice of proposed revocation of tax-exemption; (3) with respect to private foundations, the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names and taxpayer identification numbers of organizations that have applied for recognition as tax-exempt organizations; and (5) return and return information of organizations[61] with respect to which information has been disclosed under (1) through (4) above. Disclosure or inspection would be permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating the applicable tax-exempt organization, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Disclosure or inspection could be made only to or by designated representatives of the appropriate State officer, which includes officers, employees, agents, and contractors of the appropriate State officer. The Secretary also would be permitted to disclose or open to inspection the return and return information of an organization that is recognized as tax-exempt under sections 501(c)(2), 501(c)(3), 501(c)(4), 501(c)(6), 501(c)(7), 501(c)(8), 501(c)(10), and 501(c)(13), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may facilitate the resolution of Federal and State issues relating to the organization. Appropriate State officer would mean the State attorney general or the head of any State agency, body, or commission that is charged under the laws of such State with responsibility for overseeing organizations of the type described in the applicable section.

In addition, the proposal would provide that return and return information disclosed under section 6104(c) may be disclosed in civil administrative and judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information would not be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The proposal would make disclosures of returns and return information under section 6104(c) subject to many of the provisions of section 6103, including that such information remain confidential (sec. 6103(a)(2)), that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)), and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The proposal would provide that the willful unauthorized disclosure of return or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of return or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one

[61] Such information also may be open to inspection by an appropriate State officer.

year (sec. 7213A), and would provide the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

Effective Date

The provision would be effective on the date of enactment but would not apply to requests made before such date.

III. OTHER CHARITABLE AND EXEMPT ORGANIZATION PROVISIONS

A. Modify Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts

Present Law

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year. Taxes imposed on the trust are required to be allocated to corpus.[62]

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.[63]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[64]

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[65]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not

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[62] Treas. Reg. sec. 1.664-1(d)(2).

[63] Sec. 664(b).

[64] Treas. Reg. sec. 1.664-1(d)(4).

[65] Sec. 664(d).

qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Description of Proposal

The proposal would impose a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust. This would replace the present-law rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Consistent with present law, the tax would be treated as paid from corpus. The unrelated business taxable income would be considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

Effective Date

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

B. Modify Section 512(b)(13)

Present Law

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

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

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

Description of Proposal

The proposal would provide that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's UBI, applies only to the portion of payments received in a taxable year that exceed the amount of the specified payment that would have been paid if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's UBI. In addition, the proposal would impose a 20 percent penalty on the excess amount of any such payment.

The proposal would provide that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also would not apply to amounts received or accrued under such contract before January 1, 2001.

Effective Date

The proposal would apply to payments received or accrued after December 31, 2000.

C. Simplification of Lobbying Expenditure Limitation

Present Law

In general

An organization does not qualify for tax-exempt status under section 501(c)(3) unless "no substantial part" of the activities of the organization is "carrying on propaganda, or otherwise attempting, to influence legislation," except as provided by section 501(h).[66] Carrying on propaganda and attempting to influence legislation commonly are referred to as "lobbying" activities. Thus, section 501(c)(3) permits a limited amount of lobbying activity without loss of tax-exempt status.

For purposes of determining whether lobbying activities are a substantial part of an organization's overall functions, an organization may choose between two standards, the "no substantial part" test of section 501(c)(3) or the "expenditure" test of section 501(h).

Whether an organization meets the "no substantial part" test is based on all the facts and circumstances. There is no statutory or regulatory guidance, and it is not clear whether the determination is based on the organization's activities, its expenditures, or both. Alternatively, under section 501(h), certain organizations described in section 501(c)(3) can elect to be subject to the expenditure test,[67] which consists of bright-line rules that specify the dollar amount of permitted expenses on lobbying activities.

Consequences of excess lobbying under section 501(h)

Organizations that make a section 501(h) election ("electing charities") are subject to tax if the electing charity makes either "lobbying expenditures" or "grass roots expenditures" in excess of a certain amount established for each type of expenditure for each taxable year. Lobbying expenditures are the sum of grass-roots expenditures and "direct lobbying" expenditures.[68]

The expenditure limits are based on a "lobbying nontaxable amount" for the taxable year and a "grass roots nontaxable amount" for the taxable year. The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose expenditures.[69] The grass-roots nontaxable amount is 25 percent of the organization's

[66] Sec. 501(c)(3).

[67] Organizations that do not make a section 501(h) election are subject to the "no substantial part" test.

[68] Secs. 501(h)(2)(A), 4911(c)(1), 4911(d).

[69] Exempt purpose expenditures generally are expenses incurred for exempt purposes, such as amounts paid to accomplish exempt purposes, administrative expenses such as overhead, lobbying expenses, and certain fundraising expenses. Exempt purpose expenditures do not include, for example, expenses not for exempt purposes, payments of unrelated business income

lobbying nontaxable amount. An electing charity that exceeds either of the spending limitations is subject to a 25 percent tax on the excess. An electing charity that exceeds both of the spending limitations is subject to a 25 percent tax on the greater of the excess of the lobbying expenditures or the grass-roots expenditures.

An electing charity that normally exceeds either of two "ceiling amounts," which are based on the expenditure limits, will lose its tax exemption.[70] The "lobbying ceiling amount" is 150 percent of the electing charity's lobbying nontaxable amount for the taxable year and the "grass roots ceiling amount" is 150 percent of the grass-roots nontaxable amount for the taxable year. For this purpose, "normal" expenditures are calculated based on a four-year averaging mechanism.[71]

Definitions

Grass-roots expenditures are defined as "any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof."[72] For a communication to constitute grass-roots lobbying, it must refer to "specific legislation," reflect a view on such legislation, and encourage the recipient of the communication to take action with respect to such legislation (a "call to action").[73] A communication includes a call to action if it incorporates one of four elements: (1) it urges the recipient to contact a legislator, employee of a government body, or any other government official or employee who may participate in the formulation of legislation with the principal purpose of influencing legislation; (2) it states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) it provides a petition, tear-off postcard, or similar device for the recipient to communicate with government officials or employees who participate in the formulation of legislation with the principal purpose of influencing legislation; or (4) it states the position of one or more legislators on the legislation, except that a communication may name the main sponsors of legislation for purposes of identifying the legislation without constituting a call to action.[74] In

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tax, or capital expenses in connection with an unrelated business. See Treas. Reg. sec. 56.4911-4.

[70] Sec. 501(h)(1).

[71] Treas. Reg. sec. 1.501(h)-3.

[72] Secs. 501(h)(2)(C) & 4911(d)(1)(A).

[73] Treas. Reg. sec. 56.4911-2(b)(2)(i).

[74] Treas. Reg. sec. 56.4911-2(b)(2)(iii). The regulations provide that the first three elements constitute "direct" encouragement, whereas the fourth element is "indirect" encouragement. This distinction becomes relevant in determining whether a communication meets one of the prescribed exceptions to lobbying, i.e., an indirect call to action in a grass-roots communication may qualify as "nonpartisan analysis, study or research" (Treas. Reg. sec. 56.4911-2(b)(2)(iv)), and in determining the proper allocation of expenses between grass-roots and direct lobbying. Treas. Reg. sec. 56.4911-5(e).

addition, a communication is presumed to be grass-roots lobbying if the communication is a paid advertisement that: (1) appears in the mass media within two weeks before a vote by a legislative body or committee (but not a subcommittee) on a highly publicized piece of legislation; (2) reflects a view on the general subject of the legislation; and (3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of such legislation.[75] The presumption is rebuttable if the electing charity demonstrates that the timing of the communication was not related to the legislation or that the advertisement was of a type regularly made by the electing charity without regard to the timing of the legislation (a customary course of business exception).[76]

Direct lobbying expenditures are "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation" if the principal purpose of the communication is to influence legislation.[77] A communication would constitute direct lobbying only if the communication "refers to specific legislation" and reflects a view on such legislation.

Certain specified activities do not constitute attempts to influence legislation and therefore expenditures for such activities are not subject to the expenditure limits for lobbying expenditures or grass-roots expenditures. In general, such activities include: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or to a committee in response to a written request; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body that might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization (so-called "self-defense" expenditures); (4) certain communications to members of the electing charity; and (5) communications with governmental officials or employees that are not intended to influence legislation.[78]

<u>Special rules for mixed lobbying expenditures</u>

Expenses that serve both direct and grass-roots lobbying purposes, e.g., communications that are sent to members and nonmembers, or "mixed lobbying" expenditures, are subject to special rules. The regulations specify how an electing charity is to allocate mixed lobbying expenditures between direct and grass-roots lobbying purposes.[79] For example, for a mixed lobbying communication that is designed primarily for members (i.e., more than half the recipients are members) and that directly encourages grass-roots lobbying (even if it also

[75] Treas. Reg. sec. 56.4911-2(b)(5)(ii).

[76] *Id.*

[77] Secs. 501(h)(2)(A) and 4911(d)(1)(B) and Treas. Reg. sec. 56.4911-2(b)(1).

[78] Sec. 4911(d)(2).

[79] Treas. Reg. sec. 56.4911-5(e).

encourages direct lobbying), the grass-roots expenditure amount includes all the costs of preparing the material used for purposes of grass-roots lobbying plus the mechanical and distributional costs associated with the communication. If a mixed lobbying communication encourages direct lobbying, but only indirectly encourages grass-roots lobbying, then the entire costs of the communication are allocated based on the proportion of members and nonmembers receiving the communication.

Disclosure of lobbying expenditures

An electing charity must disclose lobbying expenditures annually on Schedule A of Form 990. In order to meet disclosure requirements, electing charities are required to keep detailed records of direct and grass-roots lobbying expenditures. Required records of grass-roots expenditures include: (1) all amounts directly paid or incurred for grass-roots lobbying; (2) payments to other organizations earmarked for grass-roots lobbying; (3) fees and expenses paid for grass-roots lobbying; (4) the printing, mailing, and other costs of reproducing and distributing materials used in grass-roots lobbying; (5) the portion of amounts paid or incurred as current or deferred compensation for an employee's grass-roots lobbying services; (6) any amount paid for out-of-pocket expenditures incurred on behalf of the electing charity for grass-roots lobbying; (7) the allocable portion of administrative, overhead and other general expenditures attributable to grass-roots lobbying; and (8) expenditures for grass-roots lobbying of a controlled organization.[80]

Description of Proposal

The proposal would eliminate the separate limitation for grass-roots lobbying expenditures applicable to electing charities. Electing charities would remain subject to the overall limitation on lobbying expenditures, which would not change in amount, but electing charities would not be required to limit grass roots expenditures as a percentage of overall lobbying. Thus, an electing charity would be able to make tax-free any combination of grass-roots and direct lobbying expenditures up to the lobbying non-taxable amount and would not risk loss of tax-exemption until total lobbying expenditures normally exceeded the lobbying ceiling amount. For purposes of the section 501(h) election, electing charities would no longer be required to distinguish between grass-roots lobbying and direct lobbying, whether for mixed lobbying expenditures or otherwise.

Effective Date

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

[80] *See* Treas. Reg. sec. 56.4911-6.

D. Expedited Review Process for Certain Tax-Exemption Applications

Present Law

Most organizations that seek tax-exempt status as a charitable organization are required to file an Application for Recognition of Exemption (Form 1023) with the IRS.[81] Organizations that are not required to file Form 1023 include churches, their integrated auxiliaries, and conventions or associations of churches, and any organization (other than a private foundation) that normally has gross receipts of $5,000 or less in a taxable year. Organizations that file Form 1023 within 15 months of the end of the month of the organization's formation will, if the application is approved, be recognized as tax-exempt from the date of formation. The IRS will automatically grant an organization's request for an additional 12-month extension of the 15-month period. Otherwise, exemption normally will be recognized as of the date the application was received by the IRS. In appropriate circumstances, upon written request, the IRS will expedite consideration of applications for tax-exemption. For example, organizations formed to provide relief to victims of disasters or other emergencies often receive expedited consideration.

Description of Proposal

The proposal would allow expedited consideration of applications for exempt status by organizations that are organized and operated for the primary purpose of providing social services. To be eligible, the organization must: (1) be seeking a contract or grant under a Federal, State, or local program that provides funding for social service programs; (2) establish that tax-exempt status is a condition of applying for such contract or grant; (3) include a completed copy of the contract or grant application with the application for exemption; and (4) meet such other criteria as the Secretary may provide. Organizations that meet the eligibility requirements described above (except for the requirement that tax-exempt status is a condition of the contract or grant application), and that certify that the organization's average annual gross receipts over the four year period preceding the application (or during the organization's first four years) was not more than $50,000 would be entitled to a waiver of any fee for application of tax-exempt status.

For this purpose, social services would be defined as services directed at helping people in need, reducing poverty, improving outcomes of low-income children, revitalizing low-income communities, and empowering low-income families and low-income individuals to become self-sufficient, including: (1) child care services, protective services for children and adults, services for children and adults in foster care, adoption services, services related to the management and maintenance of the home, day care services for adults, and services to meet the special needs of children, older individuals, and individuals with disabilities (including physical, mental, or emotional disabilities); (2) transportation services; (3) job training and related services, and employment services; (4) information, referral, and counseling services; (5) the preparation and delivery of meals, and services related to soup kitchens or food banks; (6) health support services; (7) literacy and mentoring programs; (8) services for the prevention and treatment of juvenile delinquency and substance abuse, services for the prevention of crime and the provision

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[81] Sec. 508(a).

of assistance to the victims and the families of criminal offenders, and services related to the intervention in, and prevention of, domestic violence; and (9) services related to the provision of assistance for housing under Federal law. Social services does not include a program having the purpose of delivering educational assistance under the Elementary and Secondary Education Act of 1965 or under the Higher Education Act of 1965.

Effective Date

The proposal would be effective for applications for tax-exempt status filed after December 31, 2002.

E. Clarification of Definition of Church Tax Inquiry

Present Law

Under present law, the IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of the facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.[82] A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

Description of Proposal

The proposal would clarify that the present-law church tax inquiry procedures do not apply to contacts made by the IRS for the purpose of educating churches with respect to the law governing tax-exempt organizations. For example, the proposal would clarify that the IRS does not violate the church tax inquiry procedures when written materials are provided to a church or churches for the purpose of educating such church or churches with respect to the types of activities that are not permissible under section 501(c)(3).

Effective Date

The proposal would be effective on the date of enactment.

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[82] Sec. 7611. Prior to the year 2000 IRS restructuring, the lowest level official who could initiate a church tax inquiry was an IRS Regional Commissioner.

F. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations. The provision would limit jurisdiction over controversies involving such determinations to the United States Tax Court.[83]

Effective Date

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations would be effective for pleadings with respect to determinations made after December 31, 2001.

[83] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

G. Definition of Convention or Association of Churches

Present Law

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[84] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[85] and is subject to certain other provisions generally applicable to churches.[86] The Internal Revenue Code does not define the term "convention or association of churches."

Description of Proposal

The proposal would provide that an organization that otherwise is a convention or association of churches would not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

Effective Date

The proposal would be effective on the date of enactment.

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[84] Sec. 6033(a)(2)(A)(i).

[85] Sec. 7611(h)(1)(B).

[86] *See, e.g.*, Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

H. Charitable Contribution Deduction for Certain Expenses in Support of Native Alaskan Subsistence Whaling

Present Law

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

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

Description of Proposal

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

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

Effective Date

The proposal would be effective for contributions made after December 31, 2002.

I. Payments by Charitable Organizations to Victims of War on Terrorism

Present Law

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible.[87] Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation.[88] For example, it is self-dealing if assets of a private foundation are used for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous.

Description of Proposal

The proposal would provide that organizations described in section 501(c)(3) that make certain payments are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization's exemption, provided that the organization makes the payments in good faith and uses an objective formula that is consistently applied in making the payments.

The proposal would apply to payments to a member of the Armed Forces of the United States (as defined in section 7701(a)(15)), or to a member of such person's immediate family, by reason of the death, injury, wounding, or illness of a member of the Armed Forces of the United States that was incurred as a result of the military response of the United States to the terrorist attacks against the United States on September 11, 2001. As under present law, such payments must be for public and not private benefit and therefore must serve a charitable class. For example, under the proposal, a charitable organization that assists the families of members of the Armed Forces killed in the line of duty would be able to make a pro-rata distribution to the families of those killed, even though the specific financial needs of each family were not directly considered. Similarly, if the amount of a distribution was based on the number of dependents of a charitable class of persons killed in the military response to the attacks and this standard was applied consistently among distributions, the specific needs of each recipient would not have to be taken into account. However, it would not be appropriate for a charity to make pro-rata payments based on the recipients' living expenses before the harm occurred if the result generally would be to provide significantly greater assistance to persons in a better position to

[87] Sec. 170.

[88] Sec. 4941.

provide for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it would not, under the proposal, be a reasonable formula for distributing assistance in an equitable manner. Similarly, although specific assessments of need would not be required, payments that would not further public purposes would not be permitted. The proposal would not change the substantive standards for exemption under section 501(c)(3), including the prohibition on private inurement. The proposal also would provide that if a private foundation makes payments under the conditions described above, the payment would not be treated as made to a disqualified person for purposes of section 4941.

Effective Date

The provision applies to payments made after the date of enactment and before September 11, 2003.

IV. RESTORATION OF SOCIAL SERVICES BLOCK GRANT FUNDING

Present Law

Social Services Block Grant Funding ("SSBG"), also known as "Title XX" (because it is Title XX of the Social Security Act), is a flexible funding stream, providing states with resources to support a variety of social services. SSBG funds can be used to assist the elderly and disabled so that they do not need to enter institutions, to prevent child and elder abuse, to provide child care, to promote and support adoption, and for several other services. There are certain specified limitations so that SSBG cannot fund most medical care, for example, or cash welfare payments. It is a mandatory capped entitlement, distributed by a population-based formula among the states.

States use SSBG in differing ways. Much of the funding supports local social service providers, including faith-related organizations, through contracts with state and local governments. Overall, in fiscal year 1999, SSBG spending was as follows: 13.4 percent for "prevention" and case management; 13 percent for day care; 12.4 percent for child and adult protective services; 10.9 percent for foster care; 7.4 percent for home-based services. There are several other categories in the expenditure data as well.

Prior to the 1996 welfare reform law, SSBG was funded at $2.8 billion. That legislation reduced SSBG to $2.38 billion, as part of achieving budgetary savings, and permitted states to transfer up to 10 percent of their new Temporary Assistance for Needy Families (TANF) welfare block grant allocations to SSBG. (Any transferred funds are required to be spent on behalf of families below 200 percent of poverty.) In 1998, as part of the TEA-21 highway legislation, SSBG funding as further reduced, declining to $1.7 billion for fiscal year 2001 and fiscal year 2002. The TANF transfer was further limited to 4.25 percent.

Description of Proposal

The proposal would increase SSBG funding to $1.975 billion for fiscal year 2003 and $2.8 billion for fiscal year 2004. In addition, the TANF transfer limit would be restored to 10 percent. These two measures provide additional resources to faith-related social service organizations. Finally, the Secretary of HHS would be required to submit annual reports on SSBG expenditures to the Congress.

Effective Date

The proposal would be effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The proposal requiring annual reports would be with respect to fiscal year 2002 and each fiscal year thereafter.

V. REVENUE RAISING PROPOSALS

A. Tax Shelter Transparency Act

1. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require corporate taxpayers to disclose with their tax return certain information with respect to each "reportable transaction" in which the corporate taxpayer participates.[89]

There are two categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). A corporation must disclose any listed transaction that is expected to reduce the taxpayer's Federal income tax liability by more than $1 million in any single taxable year or more than $2 million in any combination of years.[90]

The second category of reportable transactions is transactions that are expected to reduce a taxpayer's Federal income tax liability by more than $5 million in any single year or $10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained; (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of $100,000, and such fees are contingent on the taxpayer's participation; (4) the transaction results in a reported book/tax difference in excess of $5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference has permitted the transaction to be structured to provide the taxpayer with a more favorable Federal income tax treatment.[91]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize the taxpayer's ability to claim that any

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[89] Temp. Treas. Reg. sec. 1.6011-4T; Prop. Treas. Reg. sec. 1.6011-4.

[90] Temp. Treas. Reg. sec. 1.6011-4T(b)(2) and -(b)(4)(i).

[91] Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(i)(A)-(E). In certain circumstances, a taxpayer can avoid disclosure with respect to the second category of reportable transactions. *See* Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(ii)(A)-(E).

income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[92]

Description of Proposal

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

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the disclosure penalties.

A public entity that is subject to a penalty for failing to disclose a listed transaction (or is subject to an accuracy-related penalty for a nondisclosed listed transaction or a nondisclosed reportable transaction with a significant tax avoidance purpose[93]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission ("SEC") (for such period as the Secretary shall specify). The proposal would treat any failure to disclose a transaction in reports to the SEC as a failure to disclose a listed transaction.

The proposal would define a "listed transaction" and a "reportable transaction" by reference to the definition given to these terms in Treasury regulations under section 6011. A "large entity" would be defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" would be defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

[92] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

[93] This category of transactions is described in greater detail below in connection with the proposal to modify the accuracy-related penalty to tax shelters.

Effective Date

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

2. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[94] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[95]

Special rules apply with respect to tax shelters.[96] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[97] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[98]

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[94] Sec. 6662.

[95] Sec. 6662(d)(2)(B).

[96] Sec. 6662(d)(2)(C).

[97] Sec. 6664(c).

[98] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

Description of Proposal

The proposal would modify the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new set of rules that would apply to listed transactions and reportable transactions with a significant tax avoidance purpose.[99] The rate of the penalty and the defenses that would be available to avoid the penalty would vary depending on the type of transaction and on whether the transaction was adequately disclosed.

Under the proposal, a 20-percent penalty would apply to any understatement attributable to a listed transaction or a reportable transaction with a significant purpose of tax avoidance. The only exception to the penalty would be the reasonable cause and good faith exception of section 6664(c). Under the proposal, the reasonable cause exception would apply only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed treatment, and the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment.

If the taxpayer does not adequately disclose the transaction, the reasonable cause and good faith exception would not be available, and a higher penalty rate would apply. If the understatement is attributable to an undisclosed listed transaction, the penalty rate would be increased to 30 percent. For understatements attributable to an undisclosed reportable transaction with a significant tax avoidance purpose, the penalty rate would be increased to 25 percent.

Rules are provided that would coordinate the interaction of this penalty with the understatement penalty and the fraud penalty.

Reportable transactions that are not listed transactions and do not have a significant purpose of tax avoidance would be subject to the general rules regarding substantial understatements.

The calculation of any penalty arising from a listed or reportable transaction with a tax avoidance purpose would be based on the amount of the understatement attributable to the transaction (without regard to other items on the tax return). Thus, the amount of the understatement would be determined as the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item.

The proposal would clarify what constitutes "reasonable belief," and would provide that a reasonable belief will exist with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised. The proposal also sets forth certain criteria regarding the quality of the legal opinion being relied upon, as well as the

[99] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the disclosure provision.

independence of the advisor who is providing the legal opinion, in establishing whether a taxpayer had a reasonable belief that the tax treatment was more likely than not the correct treatment.

Effective Date

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

3. Modifications to the substantial understatement penalty

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[100]

Reduction of understatement for certain positions

For purposes of a penalty that is attributable to a substantial understatement of tax, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[101]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[102]

Description of Proposal

Definition of substantial understatement

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

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[100] Sec. 6662(a) and -(d)(1)(A).

[101] Sec. 6662(d)(2)(B).

[102] Sec. 6662(d)(2)(D).

Reduction of understatement for certain positions

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

Effective Date

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

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

Present Law

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

Description of Proposal

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

Effective Date

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

5. Disclosure of reportable transactions by material advisors

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[103] A "tax shelter" means any investment with respect to which the tax shelter ratio[104] for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[105]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[106]

A transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[107] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[108] Certain exceptions are provided with respect to the second category of transactions.[109]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party

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[103] Sec. 6111(a).

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

[105] Sec. 6111(c).

[106] Sec. 6111(d).

[107] Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

[108] Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

[109] Temp. Treas. Reg. sec. 301.6111-2T(b)(4).

other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[110]

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500.[111] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

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

Description of Proposals

Disclosure of reportable transactions by material advisors

The proposal would repeal the present law rules with respect to registration of tax shelters. Instead, the proposal would require each material advisor with respect to any reportable transaction[112] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as prescribed by the Secretary.

The information return would include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to promoting, selling, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a

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

[111] Sec. 6707.

[112] A reportable transaction (which would include a listed transaction) has the same meaning as previously described in connection with the taxpayer-related provisions.

reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

Penalty for failing to furnish information regarding reportable transactions

The proposal would repeal the present law penalty for failure to register tax shelters. Instead, the proposal would impose a penalty on any material advisor who fails to file an information return with respect to any reportable transaction, or who files a false or incomplete information return with the Secretary with respect to a reportable transaction. The amount of the penalty would be $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the return that includes the transaction is filed. Intentional disregard of the requirement to register a listed transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty could be rescinded only in exceptional circumstances. The authority to rescind the penalty could only be exercised by the Commissioner or a high-level designee within the Office of Tax Shelter Analysis -- the penalty could not be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty would have to be accompanied by a record describing the facts and reasons for the action. There would be no right to appeal a refusal to rescind a penalty. The IRS also would be required to prepare an annual report to Congress summarizing the application of the information penalty.

The terms "reportable transaction" and "listed transaction" would have the same meaning as previously described in connection with the taxpayer-related provisions.

Effective Date

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

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

6. Investor lists and applicable penalties

Present Law

Investor lists

A promoter must maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[113] Regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).[114] A limited exception is provided for certain shelters if the total fees are less than $25,000 or if the expected reduction in tax liabilities for any single year is less than $1 million for corporations or $250,000 for non-corporate taxpayers.[115]

The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[116]

Penalties for failing to maintain investor lists

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

Description of Proposals

Investor lists

Under the proposal, each material advisor[117] that is required to file an information return with respect to a reportable transaction[118] would be required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal would authorize the Secretary (but not require) to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The proposal would modify the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a person who is required to maintain an investor list and who

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[113] Sec. 6112.

[114] *See* Temp. Treas. Reg. sec. 301.6112-1T Q&A 17.

[115] *See* Temp. Treas. Reg. sec. 301-6112-1T Q&A 8.

[116] Sec. 6112(c)(2).

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

[118] The term “reportable transaction” has the same meaning as previously described in connection with the taxpayer-related provisions.

fails to make the list available upon request by the Secretary within 20 business days after the request would be subject to a $10,000 per day penalty. Thus, this penalty could apply when a person has failed to maintain a list, has maintained an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty could be waived if the failure to make the list available is due to reasonable cause.

Effective Date

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

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

7. Actions to enjoin conduct with respect to tax shelters

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[119]

Description of Proposal

The proposal would expand this rule so that injunctions may also be sought with respect to the requirements of the reporting of tax shelters[120] and of the keeping of lists of investors by the organizers and sellers of potentially abusive tax shelters.[121]

Effective Date

The proposal would be effective on the day after the date of enactment.

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

Present Law

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

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[119] Code sec. 7408.

[120] Code sec. 6707, as amended by other provisions of this proposal.

[121] Code sec. 6708, as amended by other provisions of this proposal.

Description of Proposal

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

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

Effective Date

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

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

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[122] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[123] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[124]

[122] 31 U.S.C. 5314.

[123] 31 U.S.C. 5321(a)(5).

[124] 31 U.S.C. 5322.

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[125] This report, which was statutorily required,[126] studies methods for improving compliance with these reporting requirements. It makes several administrative recommendations, but no legislative recommendations. A further report is required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

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

Effective Date

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

10. Frivolous tax returns and submissions

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[127] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Description of Proposal

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

The proposal would also modify present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision would apply are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the provision would

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

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

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

permit the IRS to dismiss such requests. Second, the provision would permit the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

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

Effective Date

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

11. Regulation of individuals practicing before the Department of the Treasury

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[128] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this provision are contained in Circular 230.

Description of Proposal

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

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

Effective Date

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

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[128] 31 U.S.C. 330.

12. Penalties on promoters of tax shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[129] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

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

Description of Proposal

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

Effective Date

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

[129] Sec. 6700.

B. Tax Treatment of Inversion Transactions

Present Law

Background

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[130] and the passive foreign investment company rules.[131] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes, subject to certain limitations.

In contrast, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law.

Inversion transactions

Some U.S. corporations have reincorporated as foreign corporations in low-tax jurisdictions, thereby replacing the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions, commonly referred to as "inversions," place the corporate group in a position to derive two main U.S. tax benefits: (1) removing some or all of the group's foreign operations and income from the U.S. taxing jurisdiction; and (2) reducing the U.S. taxes that otherwise would be incurred on income from U.S. operations, through the use of various "earnings stripping" strategies (e.g., making excessive payments of deductible interest or royalties to a new foreign parent). Inversion transactions may take many different forms, including stock inversions and asset inversions.

An inversion may be accompanied or followed by further restructuring of the corporate group. For example, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation may transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the post-inversion structure by reducing U.S.

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[130] Secs. 951-964.

[131] Secs. 1291-1298.

tax on U.S.-source income through various “earnings stripping” or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates, subject to certain limitations under present law. These limitations include section 163(j), which limits the deductibility of interest paid to related parties, if the payor’s debt-equity ratio exceeds 1.5 to 1 and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income.” More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an “arm’s length” standard, and permit the Treasury Secretary to reallocate income and deductions among such parties if that standard is not met.

Inversion transactions themselves may give rise to U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation’s share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this “toll charge” is reduced.

The transfer by the U.S. corporation of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions). The tax on any income recognized as a result of these restructurings may be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

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

Description of Proposal

In general

The proposal would define two different types of corporate inversion transactions and would establish a different set of consequences for each type. Certain partnership transactions also would be covered.

Transactions involving at least 80 percent ownership

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

In determining whether a transaction would meet the definition of an inversion under the proposal, stock held by members of the expanded affiliated group that includes the foreign incorporated entity would be disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., "hook" stock), this stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded, and the definition would not be met. Stock sold in a public offering related to the transaction at issue also would be disregarded for these purposes.

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

Transactions involving greater than 50 percent but less than 80 percent ownership

The second type of inversion covered by the proposal would be a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules would apply to the inversion. Under these rules, the inversion transaction would be respected (i.e., the foreign corporation would be treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure would be strengthened; (2) the IRS would be given expanded power to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to "earnings stripping" through related-party debt, would be strengthened. These measures generally would apply for a 10-year period following the inversion transaction.

Specifically, any applicable corporate-level "toll charge" imposed under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person would be taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits).

With respect to monitoring, the proposal would establish a new pre-filing procedure. Under this procedure, the taxpayer would be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 482, 845, 163(j), and 267(a)(3). The Treasury Secretary would be given the authority to specify the form, content, and supporting information required for this application, as well as the timing for its submission.

The IRS would be required to take one of the following three actions within 90 days of receiving a complete application from a taxpayer: (1) conclude an agreement with the taxpayer that the return positions to be taken with respect to related-party transactions comply with all relevant provisions of the Code; (2) advise the taxpayer that the IRS is satisfied that the application was made in good faith and substantially complies with the requirements set forth by the Treasury Secretary for such an application, but that the IRS reserves substantive judgment as to the tax treatment of the relevant transactions pending the normal audit process; or (3) advise the taxpayer that the IRS has concluded that the application was not made in good faith or does not substantially comply with the requirements set forth by the Treasury Secretary.

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions would apply: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties would be permitted; (2) any transfers or licenses of intangible property to related foreign parties would be disregarded; and (3) any cost-sharing arrangements would not be respected for the taxable year for which the application was required.

If the IRS fails to act on the taxpayer's application within 90 days of receiving it, then the taxpayer would be treated as having submitted an application that substantially complies with the above-referenced requirements. Thus, the deduction-disallowance and other sanctions described above would not apply, but the IRS could examine the transactions at issue under the normal audit process. The IRS would be authorized to request that the taxpayer extend this 90-day deadline in cases in which the IRS believes that such an extension might help the parties to reach an agreement.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, would be strengthened as to inverted corporations. With respect to such corporations, the proposal would eliminate the debt-equity threshold generally applicable under that provision and reduce the 50 percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

Partnership transactions

Under the proposal, both types of inversion transactions are defined to include certain partnership transactions. Specifically, both prongs of the proposal would apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these definitions are met, all partnerships that are under common control within the meaning of section 482 would be treated as one partnership, except as provided otherwise in regulations. In addition, in situations in which the strengthened "toll charge" provisions would apply, those provisions would apply at the partner level.

Effective Date

The first prong of the proposal would apply to inversion transactions meeting the 80-percent test that are completed after March 20, 2002. The second prong of the proposal, limiting the benefits of other inversions, would apply to inversion transactions meeting the 50-percent test that are completed after 1996. The measures set forth in the second prong also would apply to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002, effective date of the first prong.

C. Reinsurance Agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[132] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[133] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal would modify the rules of section 845, relating to authority for the Treasury Secretary to allocate among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal would authorize such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[134] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties, including in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items.

Effective Date

The provision would be effective for any risk reinsured after April 11, 2002.

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[132] Sec. 845(a).

[133] See S. Rep. No. 97-494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

[134] The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.

D. Extension of IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[135] extended the statutory authorization for these user fees[136] through September 30, 2003.

Description of Proposal

The proposal would extend the statutory authorization for these user fees. The proposal would also move the statutory authorization for these fees into the Internal Revenue Code.

Effective Date

The provision, including moving the statutory authorization for these fees into the Code and repealing the off-Code statutory authorization for these fees, would be effective for requests made after the date of enactment.

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[135] An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

[136] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100-203, December 22, 1987).

E. Imposition of Custom User Fees

Present Law

Section 13031(j)(3) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(j)(3)) authorizes the temporary imposition and collection of custom user fees in connection with services provided by the United States Customs Service. The authorization is scheduled to expire on September 30, 2003.

Description of Proposal

The proposal would extend the authority to impose and collect custom user fees, provided, however, that any revenue generated from such custom user fees may be used only to fund the operations of the United States Customs Service.

Effective Date

The proposal would be effective on the date of enactment.