TECHNICAL EXPLANATION OF H.R. 5095
(THE "AMERICAN COMPETITIVENESS ACT OF 2002")

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INTRODUCTION

H.R. 5095, the "American Competitiveness Act of 2002," was introduced by Chairman William Thomas of the House Committee on Ways and Means on July 11, 2002. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the provisions of the bill. The bill contains four titles - Title I (Provisions Relating to Tax Shelters), Title II (Provisions to Reduce Tax Avoidance Through Corporate Earnings Stripping and Expatriation), Title III (Simplification of Rules Relating to the Taxation of United States Businesses Operating Abroad), and Title IV (Other Provisions).

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 5095 (the "American Competitiveness Act of 2002")* (JCX-78-02), July 19, 2002.

I. PROPOSALS RELATING TO TAX SHELTERS

A. Taxpayer-Related Proposals

1. Clarification of the economic substance doctrine

Present Law

In general

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

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[2]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits in transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[3]

Economic substance doctrine

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

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

[3] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the so-called "sham transaction doctrine" and the "business purpose doctrine". *See, e.g., Knetsch v. U.S.*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions).

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[4]

A court decision often credited for laying the foundation of the economic substance doctrine is the Second Circuit decision in *Gregory v. Helvering*.[5] In *Gregory*, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the Tax Court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough:

> The purpose of the [reorganization] section is plain enough; men engaged in enterprises--industrial, commercial, financial, or any other--might wish to consolidate, or divide, to add to, or subtract from, their holdings . . .But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."[6]

<u>Business purpose doctrine</u>

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[7]

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[4] *ACM*, 73 T.C.M. at 2215.

[5] 69 F.2d 809 (2nd Cir. 1934), *aff'd* 293 U.S. 465 (1935). The *Gregory* decision also is cited as the seminal case for the substance over form and business purpose doctrines. *See e.g.,* Department of Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals,* at 47, 55 (July 1999).

[6] *Gregory*, 69 F.2d at 811.

[7] *ACM*, 157 F.3d at 256 n.48.

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires that a taxpayer establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to sustain court scrutiny.[8] A narrower approach used by some courts is to invoke the economic substance doctrine only after a determination that the transaction lacks both a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).[9] A third approach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[10] And at least one circuit has not directly addressed the elements of the doctrine.

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory*, several courts have

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

[9] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. U.S.,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists" (the economic substance test).") As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

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

denied tax benefits on the grounds that the subject transactions lacked profit potential.[11] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[12] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[13] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Description of Proposal

In general

The proposal would clarify, and in certain situations, enhance the application of the economic substance doctrine. The proposal would provide that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.

Because administrative guidance generally is more comprehensive and more flexible than statutory rules in responding to tax avoidance arrangements, the proposal would not include specific definitions regarding the components that comprise the two-prong economic substance test. Rather, it is intended that the Treasury Department would further define the economic substance doctrine to adequately respond to the various factual circumstances and changing

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

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

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

landscape in which application of the doctrine would be appropriate. In this regard, it is expected that the Treasury Department would provide such guidance (and the courts would interpret the doctrine) in a manner that is consistent with the intent of the legislation (as described below).

Conjunctive analysis

The proposal would clarify that the economic substance doctrine requires a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. The transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance requirement. This clarification would thus eliminate the disparity that exists among the courts regarding the application of the doctrine, and would modify its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.[14]

Definitions

The proposal would not provide specific definitions regarding what constitutes a "change in a meaningful way" or "substantial non-tax purpose." Defining these terms in the Code could prove problematic, be an inadequate deterrent, and could hinder valid business transactions, because a codified definition likely could not properly address the variety of circumstances in which the economic substance doctrine should be applied. For example, requiring a pre-tax profit test as part of an economic substance analysis could raise concerns with respect to certain customary leveraged lease transactions, financing arrangements in general, and transactions where the tax benefits are both intended by Congress and significant, but the transaction itself is expected to yield little (if any) profit. For this reason, the proposal would grant the Treasury Department the authority to further define these terms to carry out the purposes of the proposal.

Nevertheless, it is intended that the Treasury Department would issue guidance that further refines the economic substance doctrine, and that courts would take into account Congressional intent in applying the doctrine. For example, it is intended that a "reasonable possibility of profit," when interpreted to mean a minimal amount of profit, would not be sufficient to establish that a transaction has economic substance.[15] And while the proposal

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[14] *Cf., e.g., Boca Investerings Partnership v. U.S.*, 167 F. Supp. 2d 298, 376-77 (D.D.C. 2001) (in determining whether the transaction in question should be respected under the economic substance doctrine, the test in the D.C. Circuit requires a transaction to be respected under the doctrine unless it lacks both a valid non-tax business purpose and a reasonable possibility of profit). For examples of other courts that have used this approach, *see* note 10, *supra.*

[15] *See* note 14, *supra*, for examples of courts that have applied a "reasonable possibility of profit" test. *See also,* Martin McMahon Jr., *Economic Substance, Purposive Activity, and*

would not codify a test that focuses on the expected pre-tax profit from a transaction, there may be circumstances in which such a test would be an appropriate measure in determining whether a taxpayer's position has changed in a meaningful way. In these situations, it is intended that such a test would require that the present value of the expected pre-tax profit be substantial in relation to the present value of the expected net tax benefits.

The proposal would provide that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis under the proposal) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. A single, statutory definition of what is "substantial" or what constitutes "a reasonable means" could not adequately address the various situations in which the purported business purpose of the transaction may be examined under the economic substance analysis. However, by requiring a substantial non-tax purpose, it is intended that more than a mere showing that a transaction was not motivated solely by tax considerations would be needed to satisfy this standard. Rather, the non-tax purpose for the transaction would have to bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[16] For example, an objective of achieving a favorable accounting treatment for financial reporting purposes generally should not be treated as having a substantial non-tax purpose.[17] Furthermore, a transaction[18] that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[19] would not be considered to

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Corporate Tax Shelters, 94 Tax Notes 1017, 1021 (Feb. 25, 2002) ("The peppercorn of pretax profit theory of the Courts of Appeals in [the *IES* and *Compaq*] cases loses sight of the reason why the guardian judicial doctrines are necessary in the first place.").

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

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

[18] This would include any enabling steps of the overall transaction.

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

have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[20]

By codifying the requirement that a transaction be a "reasonable means" of accomplishing such purpose, the proposal is intended to broaden the ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.

The proposal would direct the Treasury Department to prescribe such regulations as may be appropriate to carry out the purposes of the provision, including regulations on the application of the rules to transactions involving tax-indifferent parties. It is intended that any such guidance would include special rules applicable to transactions (1) in which similar economic results could be achieved without the involvement of the tax-indifferent party (except for the tax benefits to the tax-sensitive party (or parties) involved in the transaction), (2) which involve an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic income, or (3) which result in a basis adjustment or shifting of basis on account of overstating the income or gain of the tax-indifferent party.

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

Effective Date

The proposal would apply to transactions entered into after the date of enactment.

2. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[21]

[20] To assert that this financial accounting benefit is a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and would significantly diminish the purpose for having a substantial non-tax purpose requirement. *See also, American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the MBL COLI VIII plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

There are two categories of reportable transactions. The first category includes any transaction that is the same as (or substantially similar to)[22] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). A taxpayer 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.[23]

The second category of reportable transactions includes 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.[24]

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 income tax understatement

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[21] Temp. Treas. Reg. sec. 1.6011-4T; Prop. Treas. Reg. sec. 1.6011-4. Effective June 14, 2002, the regulations were modified to require non-corporate taxpayers (i.e., individuals, trusts, partnerships, and S corporations) to disclose their participation in reportable transactions that have been specified by the Treasury Department as "listed" transactions. *See* T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002). Disclosure of other reportable transactions under the regulations continues to be limited to corporate taxpayers.

[22] The recently-modified regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure. *See* T.D. 9000, 67 Fed. Reg. 41,324 (June 18, 2002).

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

[24] 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).

attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[25]

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 applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The proposal would not define the terms "listed transaction" or "reportable transaction," [26] nor would the proposal explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the proposal would authorize the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.[27]

Penalty rate

The penalty for failing to disclose a reportable transaction would be $10,000 in the case of a natural person and $50,000 in any other case. The amounts would be increased to $100,000 in the case of a natural person and $200,000 in any other case if the failure is with respect to a listed transaction.

The penalty could not be waived with respect to a listed transaction. As to reportable transactions, the penalty could be rescinded or abated only in exceptional circumstances. All or part of the penalty could be rescinded only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and

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[25] 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.

[26] The proposal states that a "reportable transaction" means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evation. A "listed transaction" means a reportable transaction, which is the same as, or similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.

[27] As described above in connection with present law, current regulations under section 6011 require the disclosure of certain reportable transactions. Until the regulations are modified, the penalty would apply to taxpayers who fail to timely disclose any reportable transaction under the definitions contained in the current regulations.

effective tax administration. The authority to rescind the penalty could only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind could not otherwise be delegated by the Commissioner. Thus, a revenue agent, an appeals officer, or other IRS personnel could not rescind the penalty. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There would be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also would be required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

Effective Date

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

3. Accuracy-related penalty on understatements from listed transactions and reportable transactions with 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.[28] The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.[29] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even for 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.[30] The relevant regulations provide that reasonable cause exists where the taxpayer

[28] Sec. 6662.

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

[30] Sec. 6664(c).

"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.[31]

Description of Proposal

In general

The proposal would enhance the present-law accuracy-related penalty with respect to tax shelters and would augment such penalty with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[32] The penalty rate and the taxpayer defenses that would be available to avoid the new accuracy-related penalty would vary depending on the category of the transaction (i.e., listed or reportable avoidance transaction) and whether the transaction was adequately disclosed.

New penalty applicable to listed and reportable avoidance transactions

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

If the taxpayer does not adequately disclose a listed or reportable avoidance transaction, the strengthened reasonable cause exception would not be available (i.e., a strict-liability penalty applies), and the taxpayer would be subject to a 30-percent (instead of 20-percent) accuracy-related penalty on any understatement attributable to such transaction.

Determination of the understatement amount

The penalty would be applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this proposal, the amount of the understatement would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and

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

[32] The terms "reportable transaction" and "listed transaction" would have the same meanings as previously described in connection with the penalty for failing to disclose a reportable transaction.

the proper treatment of the item (without regard to other items on the tax return),[33] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

Strengthened reasonable cause exception

A penalty would not be imposed under the proposal with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[34] (2) there is or was substantial authority for such treatment, and (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer would be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

Disqualified tax advisor

A disqualified tax advisor would be defined as an advisor who (1) is any material advisor[35] and who participates in the organization, promotion, management, or sale of the

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

[34] *See* the previous proposal regarding the penalty for failing to disclose a reportable transaction.

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

transaction or is related (within the meaning of section 267 or 707(b)) to any person who so participates, (2) is compensated directly or indirectly[36] by another material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction

It is intended that a material advisor would be considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[37] Participation in the "management" of a transaction would mean involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction would mean involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant would be considered to be involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

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

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

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

Coordination with other penalties

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

The penalty imposed under this proposal would not apply to any portion of an understatement to which a fraud penalty is applied under section 6663 or to which a penalty under new section 6662B[38] applies.

Enhancement of accuracy-related penalties with respect to tax shelters

The proposal also would enhance the special accuracy-related penalty rules applicable to tax shelters that are not subject to the accuracy penalty under new section 6662B (transactions lacking economic substance) or subject to the accuracy-related penalty under section 6662A (listed and reportable avoidance transactions). Specifically, the proposal would eliminate the present-law ability of non-corporate taxpayers to avoid the penalty 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. Thus, an understatement penalty attributable to a tax shelter could be abated only in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[39]

Effective Date

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

4. Penalty for understatements from transactions lacking economic substance

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[40] The amount of any understatement is reduced by any portion attributable to an item if (1) the

[38] A separate proposal below describes the application of the new section 6662B penalty (regarding understatements attributable to transactions lacking economic substance).

[39] Sec. 6664(c).

[40] Sec. 6662.

treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.[41] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[42] 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.[43]

Description of Proposal

The proposal would impose a penalty for an understatement attributable to any transaction that lacks economic substance[44] (referred to in the statute as a "noneconomic substance transaction understatement"). The rate of the penalty is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the proposal (i.e., the penalty is a strict-liability penalty).

The enhanced penalty would apply to any understatement attributable to a "noneconomic substance transaction." A "noneconomic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in a separate proposal clarifying the application of the economic substance doctrine),[45] or (2) the transaction fails to meet the requirements of any

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

[42] Sec. 6664(c).

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

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

[45] A separate proposal would provide that a transaction has economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.

similar rule of law. A similar rule of law may include, for example, an understatement attributable to any transaction that is determined to be a "sham transaction."

For purposes of this proposal, the calculation of an "understatement" would be made in the same manner as in the separate proposal relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[46] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty would apply to the amount of any understatement attributable solely to the noneconomic substance transaction.

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

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

Effective Date

The proposal would apply to transactions after the date of enactment.

5. 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.

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

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.

6. Disallowance of partnership loss transfers

Present Law

Contributions to a partnership

Under present law, if a partner contributes property to a partnership, generally no gain or loss is recognized to the contributing partner or the partnership at the time of contribution.[47] The partnership takes the property at an adjusted basis equal to the contributing partner's adjusted basis in the property.[48] The contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property.[49] Any items of partnership income, gain, loss and deduction with respect to the contributed property is allocated among the partners to take into account any built-in gain or loss at the time of the contribution.[50] This rule is intended to prevent the transfer of built-in gain or loss from the contributing partner to the other partners by generally allocating income and deductions from the contributed property to the other partners based on its fair market value and by allocating to the contributing partner the remainder of each item.

If the contributing partner transfers its partnership interest, the built-in gain or loss is allocated to the transferee partner as it would have been allocated to the contributing partner (i.e., the transferee partner steps into the shoes of the transferor partner). If the contributing partner's interest is liquidated by the partnership, the built-in loss, if any, will be allocated to the remaining partners.

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[47] Sec. 721.

[48] Sec. 723.

[49] Sec. 722.

[50] Sec. 704(c)(1)(A).

Transfers of partnership interests

Under present law, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under section 754 to make basis adjustments.[51] If an election is in effect, adjustments are made with respect to the transferee partner in order to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[52] These adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner. Under these rules, if a partner purchases an interest in a partnership with an existing built-in loss and no election under section 754 in effect, the transferee partner would be allocated a share of the existing built-in loss when the partnership disposes of the property (or depreciates the property).

Distributions by a partnership

With certain exceptions, in the case of distributions of property, including money, made by a partnership to a partner, gain and loss is not recognized by either the partner or the partnership.[53] In the case of a distribution in liquidation of a partner's interest, the basis of the property distributed in the liquidation is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the transaction).[54] In a distribution other than in liquidation of a partner's interest, the distributee partner's basis in the distributed property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).[55]

Adjustments to the basis of the partnership's undistributed properties are not required unless the partnership has made the election under section 754 to make basis adjustments.[56] If an election is in effect under section 754, adjustments are made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner.[57] To the extent the adjusted basis of the distributed properties increases (or loss is recognized), the partnership's adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of

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[51] Sec. 743(a).

[52] Sec. 743(b).

[53] Sec. 731(a) and (b).

[54] Sec. 732(b).

[55] Sec. 732(a).

[56] Sec. 734(a).

[57] Sec. 734(b).

the distributed properties decreases (or gain is recognized), the partnership's adjusted basis in its properties is increased by a like amount. Under these rules, a partnership with no election in effect under section 754 may distribute property with an adjusted basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

Description of Proposal

Contributions to a partnership

Under the proposal, a built-in loss could be taken into account only by the contributing partner and not by other partners (including any partner purchasing the contributing partner's interest). Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property in the hands of the partnership would be treated as its fair market value immediately after the contribution.

Transfers of partnership interests

The proposal would provide that the basis adjustments for partnership property under section 743(b) are required in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss. For this purpose, a substantial built-in loss exists where the excess of transferee partner's proportionate share of the adjusted basis of the partnership property over the transferee partner's basis in its partnership interest exceeds $250,000 and exceeds 10 percent of the transferee's partner's basis in the partnership interest. The Secretary of the Treasury is authorized to prescribe regulations appropriate to prevent the avoidance of the thresholds, including regulations dealing with related partnerships and acquisitions of property by the partnership.

For example, assume that partner A sells its partnership interest to B for its fair market value of $1 million. Also assume that B's proportionate share of the adjusted basis of the partnership assets is $1.3 million. Under the bill, section 743(b) will apply to require a $300,000 decrease in the adjusted basis of the partnership assets with respect to B, so that B would recognize no gain or loss if the partnership immediately sold all its assets for their fair market value.

Distributions by a partnership

The proposal would also provide that the basis adjustments for partnership property under section 734(b) are required in the case of a distribution with respect to which there is a substantial basis reduction. A substantial basis reduction with respect to any distribution means a decrease in the basis of the remaining partnership assets (had a section 754 election been in effect) in an amount that exceeds $250,000 and exceeds 10 percent of the aggregate adjusted basis of the partnership properties, including money, immediately after the distribution.

For example, assume that A and B each contributed $2.5 million to a newly formed partnership and C contributed $5 million. Assume that the partnership purchased LMN stock for $3 million and XYZ stock for $7 million. Assume that the value of each stock declined to $1

million. Assume the LMN stock is distributed to C in liquidation of its partnership interest. Under the proposal, as under present law, the basis of the LMN stock in C's hands would be $5 million. C would recognize a loss of $4 million if it sold the LMN stock for $1 million.

Under the proposal, there is a substantial basis adjustment because the $2 million increase in the adjusted basis of the distributed LMN stock (sec. 734(b)(2)(B)) is greater than 10 percent of the adjusted basis of the remaining partnership assets of $7 million and is greater than $250,000. The partnership would be required to decrease the basis of the XYZ stock (under sec. 734(b)(2)) by $2 million (the amount by which the basis of the LMN stock was increased), leaving an adjusted basis of $5 million. If the XYZ stock was then sold by the partnership for $1 million, A and B would each recognize a loss of $2 million. The amount of loss recognized by each of the partners on the sale of the stock would be the same regardless of whether the stock was sold by the partnership either before or after the distribution, or was distributed by the partnership and sold by the partners.

Effective Date

The proposal would apply to contributions, transfers, and distributions (as the case may be) after date of enactment.

7. 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).[58]

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.[59]

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

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

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.[60]

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.

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.

Effective Date

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

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

B. Promoter-Related Proposals

1. Disclosure of reportable transactions by material advisors and penalty for failing to furnish information regarding reportable transactions

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[61] A "tax shelter" means any investment with respect to which the tax shelter ratio[62] 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).[63]

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.[64]

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,"[65] 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.[66] Certain exceptions are provided with respect to the second category of transactions.[67]

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

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[61] Sec. 6111(a).

[62] 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.

[63] Sec. 6111(c).

[64] Sec. 6111(d).

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

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

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

features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party 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.[68]

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.[69] 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 Proposal

Disclosure of reportable transactions by material advisors

The proposal would repeal the present law rules regarding the registration of tax shelter arrangements. In its place, the proposal would require each material advisor with respect to any reportable transaction[70] to timely file an information return with the Secretary (in such form as the Secretary may prescribe). The return must be filed no later than the date as specified by the Secretary.

The information return would set forth (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" would mean any person (1) who provides material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any

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[68] 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).

[69] Sec. 6707.

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

reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

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

Penalty for failing to furnish information regarding reportable transactions

The proposal would repeal the present law penalty for failure to register tax shelters. In its place, 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.[71] The amount of the penalty would be $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty would be 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 listed transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income.

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

Effective Date

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

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

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

2. Investor lists and modification of penalty for failure to maintain investor lists

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 participant may not have been subject to confidentiality restrictions).[72] 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).[73] 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.[74] 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.[75]

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 Proposal

Investor lists

The proposal would require each material advisor[76] with respect to a reportable transaction[77] to maintain a list that (1) identifies each person for whom the advisor acted as a

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[72] Sec. 6112.

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

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

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

[76] The term "material advisor" would have the same meaning as when used in connection with the requirement to file an information return under section 6111.

[77] The term "reportable transaction" would have the same meaning as previously described in connection with the taxpayer-related provisions.

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 (but would not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person is 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 material advisor who would be required to maintain an investor list and who fails to make the list available upon written request by the Secretary within 20 business days after the date of such request would be subject to a $10,000 per day penalty. The penalty would apply to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty could be waived if the failure to make the list available is due to reasonable cause.[78]

Effective Date

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

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

3. 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.[79]

Description of Proposal

The proposal would expand this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of tax shelters[80] and the keeping of lists of investors by material advisors.[81] Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a

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[78] In no event would failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

[79] Sec. 7408.

[80] Sec. 6707, as amended by other provisions of this bill.

[81] Sec. 6708, as amended by other provisions of this bill.

reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective Date

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

4. 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.[82] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[83] 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.[84]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[85] This report, which was statutorily required,[86] 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.

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[82] 31 U.S.C. 5314.

[83] 31 U.S.C. 5321(a)(5).

[84] 31 U.S.C. 5322.

[85] *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.

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

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 up to $5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

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

5. 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[87] 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 also would 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 would apply are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. The proposal would permit the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request within 30 days of being given an opportunity to do so.

Effective Date

The proposal would be effective for submissions made and issues raised after the date of enactment.

[87] 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.

6. 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.[88] 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 also would 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.

7. 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.[89] A qualified false or fraudulent statement is any statement with respect to the

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[88] 31 U.S.C. 330.

[89] Sec. 6700.

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 an entity or participating in a 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 rate 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 engaged in after the date of enactment.

C. Other Provisions

1. Treatment of stripped bonds to apply to stripped interests in bond and preferred stock funds

Present Law

Assignment of income in general

In general, an "income stripping" transaction involves a transaction in which the right to receive future income from income-producing property is separated from the property itself. In such transactions, it may be possible to generate artificial losses from the disposition of certain property or to defer the recognition of taxable income associated with such property.

Common law has developed a rule (referred to as the "assignment of income" doctrine) that income may not be transferred without also transferring the underlying property. A leading judicial decision relating to the assignment of income doctrine involved a case in which a taxpayer made a gift of detachable interest coupons before their due date while retaining the bearer bond. The U.S. Supreme Court ruled that the donor was taxable on the entire amount of interest when paid to the donee on the grounds that the transferor had "assigned" to the donee the right to receive the income.[90]

In addition to general common law assignment of income principles, specific statutory rules have been enacted to address certain specific types of stripping transactions, such as transactions involving stripped bonds and stripped preferred stock (which are discussed below).[91] However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests (other than preferred stock).[92]

Both the scope of the assignment of income doctrine and the extent to which the doctrine has been overruled by the subsequent enactment of specific statutory income stripping rules is unclear.

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[90] *Helvering v. Horst*, 311 U.S. 112 (1940).

[91] Depending on the facts, the IRS also could determine that a variety of other Code-based and common law-based authorities could apply to income stripping transactions, including: (1) sections 269, 382, 446(b), 482, 701, or 704 and the regulations thereunder; (2) authorities that recharacterize certain assignments or accelerations of future payments as financings; (3) business purpose, economic substance, and sham transaction doctrines; (4) the step transaction doctrine; and (5) the substance-over-form doctrine. *See* Notice 95-53, 1995-2 C.B. 334 (accounting for lease strips and other stripping transactions).

[92] However, in *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973), the court held that where a taxpayer sold a carved-out interest of stock dividends, with no personal obligation to produce the income, the transaction was treated as a sale of an income interest.

Stripped bonds

Special rules are provided with respect to the purchaser and "stripper" of stripped bonds.[93] A "stripped bond" is defined as a debt instrument in which there has been a separation in ownership between the underlying debt instrument and any interest coupon that has not yet become payable.[94] In general, upon the disposition of either the stripped bond or the detached interest coupons, the retained portion and the portion that is disposed of each is treated as a new bond that is purchased at a discount and is payable at a fixed amount on a future date. Accordingly, section 1286 treats both the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount ("OID") on the date of disposition. Consequently, section 1286 effectively subjects the stripped bond and the detached interest coupons to the general OID periodic income inclusion rules.

A taxpayer who purchases a stripped bond or one or more stripped coupons is treated as holding a new bond that is issued on the purchase date with OID in an amount that is equal to the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date) over the ratable share of the purchase price of the stripped bond or coupon, determined on the basis of the respective fair market values of the stripped bond and coupons on the purchase date.[95] The OID on the stripped bond or coupon is includible in gross income under the general OID periodic income inclusion rules.

A taxpayer who strips a bond and disposes of either the stripped bond or one or more stripped coupons must allocate his basis, immediately before the disposition, in the bond (with the coupons attached) between the retained and disposed items.[96] Special rules apply to require that interest or market discount accrued on the bond prior to such disposition must be included in the taxpayer's gross income (to the extent that it had not been previously included in income) at the time the stripping occurs, and the taxpayer increases his basis in the bond by the amount of such accrued interest or market discount. The adjusted basis (as increased by any accrued interest or market discount) is then allocated between the stripped bond and the stripped interest coupons in relation to their respective fair market values. Amounts realized from the sale of stripped coupons or bonds constitute income to the taxpayer only to the extent such amounts exceed the basis allocated to the stripped coupons or bond. With respect to retained items (either the detached coupons or stripped bond), to the extent that the price payable on maturity, or on the due date of the coupons, exceeds the portion of the taxpayer's basis allocable to such retained

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[93] Section 1286.

[94] Section 1286(e).

[95] Section 1286(a).

[96] Section 1286(b). Similar rules apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis in the hands of a person who strips the bond.

items, the difference is treated as OID that is required to be included under the general OID periodic income inclusion rules.[97]

Stripped preferred stock

"Stripped preferred stock" is defined as preferred stock in which there has been a separation in ownership between such stock and any dividend on such stock that has not become payable.[98] A taxpayer who purchases stripped preferred stock is required to include in gross income, as ordinary income, the amounts that would have been includible if the stripped preferred stock was a bond issued on the purchase date with OID equal to the excess of the redemption price of the stock over the purchase price.[99] This treatment is extended to any taxpayer whose basis in the stock is determined by reference to the basis in the hands of the purchaser. A taxpayer who strips and disposes the future dividends is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to the taxpayer's adjusted basis in the stripped preferred stock.[100]

Description of Proposal

The proposal would authorize the Treasury Department to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to interests in an entity or account substantially all of the assets of which consist of bonds (as defined in section 1286(e)(1)), preferred stock (as defined in section 305(e)(5)(B)), or any combination thereof. The proposal would apply only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests.

For example, such Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund and disposes either the stripped shares or stripped future dividends by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends.

No inference would be intended as to the treatment under the present-law rules for stripped bonds and stripped preferred stock, or under any other provisions or doctrines of present law, of interests in an entity or account substantially all of the assets of which consist of bonds,

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[97] Special rules are provided with respect to stripping transactions involving tax-exempt obligations that treat OID (computed under the stripping rules) in excess of OID computed on the basis of the bond's coupon rate (or higher rate if originally issued at a discount) as income from a non-tax-exempt debt instrument (sec. 1286(d)).

[98] Section 305(e)(5).

[99] Section 305(e)(1).

[100] Section 305(e)(3).

preferred stock, or any combination thereof. The Treasury regulations, when issued, would be applied prospectively, except in cases to prevent abuse.

Effective Date

The proposal would be effective for purchases and dispositions occurring after the date of enactment.

2. Minimum holding period for foreign tax credit with respect to withholding taxes on income other than dividends

Present Law

In general, U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. taxpayers that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on income that they receive.

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the required stock in the chain of ownership is held for less than these holding periods. Periods during which a taxpayer is protected from risk of loss (e.g., by purchasing a put option or entering into a short sale with respect to the stock) generally are not counted toward the holding period requirement. In the case of a bona fide contract to sell stock, a special rule applies for purposes of indirect foreign tax credits. The disallowance does not apply to foreign tax credits with respect to certain dividends received by active dealers in securities. If a taxpayer is denied foreign tax credits because the applicable holding period is not satisfied, the taxpayer is entitled to a deduction for the foreign taxes for which the credit is disallowed.

Description of Proposal

The proposal would expand the present-law disallowance of foreign tax credits to include credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The proposal would not apply to foreign tax credits that are subject to the present-law disallowance with respect to dividends. The proposal also would not apply to

certain income or gain that is received with respect to property held by active dealers. Rules similar to the present-law disallowance for foreign tax credits with respect to dividends would apply to foreign tax credits that are subject to the proposal. In addition, the proposal would authorize the Treasury Department to issue regulations providing that the proposal does not apply in appropriate cases.

Effective Date

The proposal would be effective for amounts that are paid or accrued more than 30 days after the date of enactment

3. Affirmation of consolidated return regulation authority

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[101]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[102]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[103]

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[101] Sec. 1501.

[102] Sec. 1502.

[103] Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70th Cong., 1st Sess. at 15, describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that "... legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v.United States,* 1 Ct. Cl. 108 (1983), *aff'd* 726 F.2d 1569 (Fed. Cir. 1984), *cert.*

In the recent case of *Rite Aid Corp. v. United States,*[104] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss disallowance regulations, and concluded that the provision was invalid.[105] The particular provision, known as the "duplicated loss" provision,[106] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[107]

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denied 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner,* 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

[104] 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

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

[106] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[107] Treasury Regulation section 1.1502-20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[108]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[109] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." [110]

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result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

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

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

[110] *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's

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

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[111]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[112]

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taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[111] *Rite Aid*, 255 F.3d at 1360.

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

Description of Proposal

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

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid would thus be overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The proposal would nevertheless allow the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the proposal provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary[113] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[114]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[115]

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[113] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[114] The proposal does not overrule the current Treasury Department regulations, which allow taxpayers for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

[115] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (Mar.12, 2002); REG-102740-02, 67 F.R. 11070 (Mar.12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (Mar. 25, 2002). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.

Effective Date

The proposal would be effective for all years, whether beginning before, on, or after the date of enactment of the provision.

No inference is intended that the results following from this proposal are not the same as the results under present law.

II. PROVISIONS TO REDUCE TAX AVOIDANCE THROUGH CORPORATE EARNINGS STRIPPING AND EXPATRIATION

A. Reduction in Potential for Earnings Stripping by Further Limiting Deduction for Interest on Certain Indebtedness

Present Law

Present law provides rules to limit the ability of U.S. corporations (among other taxpayers) to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[116] 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" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

Description of Proposal

The proposal would strengthen the earnings stripping provisions of section 163(j) in two ways. The first involves modifications to the existing interest disallowance rule, based on net interest expense as a percentage of adjusted taxable income. The debt-equity threshold of this rule would be eliminated, and the percentage threshold would be lowered from 50 percent to 35 percent of adjusted taxable income. Carryovers of interest disallowed under this rule would be limited to five years, and the carryover of excess limitation would be eliminated.

The proposal also would strengthen section 163(j) by adding a new interest disallowance rule, which would disallow related-party interest to the extent that the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide corporate group. For purposes of applying this new test, financial corporations would be treated as a separate sub-group. Interest amounts disallowed under this new rule would not be eligible for carryover, nor would any excess limitation. The modified present-law disallowance rule and the new disallowance rule would be coordinated by providing that the rule yielding the greater amount of interest disallowed would determine the overall disallowance.

The new disallowance rule would require a series of calculations. First, the total assets of the U.S. subsidiary (or U.S. affiliated group) would be divided by the total assets of the worldwide group, yielding a fraction. Debt of the U.S. subsidiary (or U.S. affiliated group) then would be defined as "disproportionate" to the extent that such debt exceeded the product of this fraction and the total external debt of the worldwide group. To the extent that disproportionate debt is attributable to related-party debt, the interest on this debt (determined using a blended

[116] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

average interest rate on all related-party debt) would be disallowed. For this purpose, disproportionate debt would be attributed first to related-party debt. Thus, in the calculation, disproportionate debt would be divided by the total related-party debt of the U.S. subsidiary (or U.S. affiliated group), to yield a "disproportionate domestic related party indebtedness percentage" (not to exceed 100 percent), and then the interest disallowed under the rule would be the product of this percentage and the U.S. subsidiary's (or U.S. affiliated group's) related-party interest.

For example, if a worldwide group had $500 of total external debt and $1,000 of total assets, for a debt-assets ratio of 50 percent, and the U.S. affiliated group had $75 of total debt ($45 unrelated and $30 related, all at a 10 percent interest rate) and $100 of total assets, for a debt-assets ratio of 75 percent, then the U.S. affiliated group would be regarded as overleveraged by 25 percentage points, or $25. Using a related-party-first ordering rule, the entire $2.50 of interest on this $25 would be disallowed under the rule. More specifically, under the calculation provided in the new rule, the U.S. affiliated group would have {$75 - [($100 / $1,000) x $500]} = $25 of disproportionate debt. The disproportionate domestic related party indebtedness percentage would be $25/$30 = 83.33 percent. Of the U.S. affiliated group's $3 of interest incurred on its $30 of related-party debt, 83.33 percent of this interest, or $2.50, would be disallowed. If the U.S. affiliated group's $30 of related-party debt had consisted of three $10 loans at interest rates of 8, 9, and 10 percent, for total related-party interest of $2.70, then the amount disallowed would be 83.33 percent of $2.70, or $2.25 (thus effectively applying the average related-party interest rate of 9 percent to $25 of disproportionate related-party debt).

The proposal would continue the present-law rules in the case of taxable REIT subsidiaries.

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 2003. However, the proposal would be effective for taxable years ending after July 10, 2002, for debt incurred after that date. In addition, for taxpayers involved in certain inversion transactions completed after 1996, the proposal would be effective for taxable years ending after March 20, 2002. For purposes of applying the five-year limit on carryovers of interest disallowed under the adjusted taxable income rule, amounts carried to any taxable year beginning after December 31, 2003 would be treated as having been first disallowed for the most recent taxable year beginning on or before such date. The effective date of the elimination of excess limitation carryovers would be governed by the effective date generally applicable to the relevant debt of the taxpayer.

B. Tax Treatment of Expatriated Entities

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (sections 951-964) and the passive foreign investment company rules (sections 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is "effectively connected" with the conduct of a trade or business in the United States. Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a "permanent establishment" in the United States.

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

U.S. tax treatment of inversion transactions

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

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

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

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

Description of Proposal

In general

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

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion would be a transaction in which, pursuant to a plan or a series of related transactions: (1) 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 greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The proposal would deny the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for purposes of the Code. This part of the proposal would not apply to inversion transactions completed after March 20, 2005.

Notwithstanding the general treatment of the top-tier foreign corporation as domestic, the proposal would apply section 367 to the inverting corporation's shareholders as though the top-tier foreign corporation were still treated as foreign.

In determining whether a transaction would meet the definition of an inversion under the provision, 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., so-called "hook" stock), the 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. Stock sold in a public offering related to the transaction 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 provision would be disregarded. In addition, the Treasury Secretary would be granted authority to prevent the avoidance of the purposes of the provision, 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 treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

Transactions involving at least 60 percent identity of stock ownership

The second type of inversion would be a transaction (other than one subject to the 80-percent rules described above) 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; and (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction. In such a case, any applicable corporate-level "toll charges" for establishing the inverted structure would not be offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of 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). This rule would not apply to certain transfers of inventory and similar property. These measures generally would apply for a 10-year period following the inversion transaction.

Partnership transactions

Under the proposal, both types of inversion transactions would include certain partnership transactions. Specifically, both parts 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 60 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), where the other terms of the relevant definition are met. For purposes of applying these tests, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership would apply to inversion transactions completed after March 20, 2002 but before March 21, 2005. The rules for transactions involving at least 60 percent identity of ownership would apply to inversion transactions completed after March 20, 2002.

C. Excise Tax on Stock Compensation of Insiders in Expatriated Corporations

Present Law

The income taxation of a nonstatutory[117] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[118] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

The tax treatment of other forms of stock-based compensation (e.g., restricted stock and stock appreciation rights) is also determined under section 83. The excess of the fair market value over the amount paid (if any) for such property is generally includable in gross income in the first taxable year in which the rights to the property are transferable or are not subject to substantial risk of forfeiture.

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

Description of Proposal

Under the proposal, specified holders of stock options and other stock-based compensation would be subject to an excise tax upon certain inversion transactions. The proposal would impose a 20 percent excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation would be treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual would be any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act

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[117] Nonstatutory stock options refer to stock options other than incentive stock options and employee stock purchase plans, the taxation of which is determined under sections 421-424.

[118] If an individual receives a grant of a nonstatutory option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount paid for the option is included in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or not subject to a substantial risk of forfeiture.

of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[119] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals would generally include officers, directors, and 10-percent owners of private and publicly-held corporations.

The excise tax would be imposed on a disqualified individual of an expatriated corporation (as previously defined in the proposal) only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 60 percent identity of stock ownership corporate inversion transactions previously defined in the proposal.

Specified stock compensation subject to the excise tax would include any payment[120] (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than a non-lapse restriction, would be ignored. Thus, the excise tax would apply, and the value subject to the tax would be determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation would include compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation would also include nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the proposal would apply to a disqualified individual's deferred compensation if company stock were one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation would include a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax would not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax would not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual would be paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years would not be specified stock compensation, even though

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[119] An expanded affiliated group would be an affiliated group (under section 1504) except that such group would be determined without regard to the exceptions for certain corporations and would be determined applying a greater than 50 percent threshold, in lieu of the 80 percent test.

[120] Under the proposal, any transfer of property would be treated as a payment and any right to a transfer of property would be treated as a right to a payment.

the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual would be paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock would be subject to the proposal because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

The excise tax would apply to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the inversion transaction, and to any specified stock compensation awarded in the six-month period beginning with the inversion transaction. As a result, for example, if a corporation were to cancel outstanding options three months before the transaction and then reissue comparable options three months after the transaction, the tax would apply both to the cancelled options and the newly granted options. It would be intended that the Secretary would issue guidance to avoid double counting with respect to specified stock compensation that is cancelled and then regranted during the applicable twelve-month period.

Specified stock compensation subject to the tax would not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, or a simple retirement account. In addition, under the proposal, the excise tax would not apply to any stock option that is exercised during the six-month period before the inversion or to any stock acquired pursuant to such exercise. The excise tax would also not apply to any stock option or stock which is sold or exchanged during such period in a transaction in which gain or loss is recognized in full.

For specified stock compensation held on the expatriation date, the amount of the tax would be determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date would be determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date would be valued on the date granted. Under the proposal, the cancellation of a non-lapse restriction would be treated as a grant.

The value of the specified stock compensation on which the excise tax would be imposed would be the fair value in the case of stock options (including warrants or other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right would be determined using an appropriate option-pricing model, as specified or permitted by the Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation would nevertheless have a fair value and be subject to tax under the proposal. The value of other forms of compensation, such as phantom stock or restricted stock, would be the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock would be the amount that the

disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It would be expected that the Secretary would issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term. Pending the issuance of guidance, it would be intended that taxpayers could rely on the revenue procedures issued under section 280G (except that the full remaining term must be used).

The excise tax would also apply to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax would be determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied would be a payment made in respect of the tax. This would include direct payments of the tax and payments to reimburse the individual for payment of the tax. It is expected that the Secretary would issue guidance on determining when a payment is made in respect of the tax and that such guidance would include certain factors that give rise to a rebuttable presumption that a payment is made in respect of the tax, including a rebuttable presumption that if the payment is contingent on the inversion transaction, it is made in respect to the tax. Any payment made in respect of the tax would be includible in the income of the individual, but would not be deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under section 162(m), the $1,000,000 limit on the deduction allowed for employee remuneration for such employee would be reduced by the amount of any payment (including reimbursements) made in respect of the tax under the proposal. As discussed above, this would include direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax would have no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax would have no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax would not be deductible and would have no effect on any deduction that might be allowed at the time of any future exercise or payment.

Under the proposal, the Secretary would be authorized to issue regulations as may be necessary or appropriate to carry out the purposes of the section.

Effective Date

The proposal would be effective as of July 11, 2002, except that periods before July 11, 2002, would not be taken into account in applying the tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

D. Reporting of Taxable Mergers and Acquisitions

Present Law

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721-6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

Description of Proposal

Under the proposal, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) would be required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above would be required to furnish to each shareholder whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement would be required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements would be extended to failures to comply with the requirements set forth under this proposal.

Effective Date

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

E. Studies

Present Law

No provision.

Description of Proposal

The proposal would require the Treasury Secretary to conduct and submit to the Congress three studies. The first study would examine the effectiveness of the transfer pricing rules of section 482, with an emphasis on transactions involving intangible property. The second study would examine income tax treaties to which the United States is a party, with a view toward identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The third study would examine the impact of the provisions of secs. 201-204 of the bill on earnings stripping and inversion transactions.

Effective Date

The section 482 and tax treaty studies required under the proposal would be due no later than December 31, 2002. The inversion and earnings stripping study required under the proposal would be due no later than December 31, 2004.

III. SIMPLIFICATION OF RULES RELATING TO THE TAXATION OF U.S. BUSINESSES OPERATING ABROAD

A. Treatment of Controlled Foreign Corporations

1. Repeal controlled foreign corporation rules for foreign base company sales and services income

Present Law

In general, the subpart F rules (secs. 951-964) require U.S. 10-percent shareholders of a controlled foreign corporation to include currently in income for U.S. tax purposes certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

Subpart F income includes foreign base company sales and services income (sec. 954(a)). Foreign base company sales income generally consists of sales income of a controlled foreign corporation located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person (sec. 954(d)). Foreign base company services income consists of income from services performed outside the controlled foreign corporation's country of incorporation for or on behalf of a related party (sec. 954(e)).

A special branch rule applies only for purposes of determining a controlled foreign corporation's foreign base company sales income. Under this rule, a branch of a controlled foreign corporation is treated as a separate corporation where the activities of the controlled foreign corporation through the branch outside the controlled foreign corporation's country of incorporation have substantially the same effect as if such branch were a subsidiary (sec. 954(d)(2)).

For purposes of the subpart F rules, a related person is defined as any individual, corporation, trust, or estate that controls or is controlled by the controlled foreign corporation, or any individual, corporation, trust, or estate that is controlled by the same person or persons that control the controlled foreign corporation (sec. 954(d)(3)). Control with respect to a corporation means ownership of more than 50 percent of the corporation's stock (by vote or value). Control with respect to a partnership, trust, or estate means ownership of more than 50 percent of the value of the beneficial interests of the partnership, trust, or estate. Indirect and constructive ownership rules apply.

Description of Proposal

The proposal would repeal the subpart F rules for foreign base company sales and services income. The proposal would continue to treat as subpart F income (as a category of foreign personal holding company income) income of a controlled foreign corporation with respect to sales of property purchased from (or sold to) a related person that is produced in the United States and sold (or purchased) for use in the United States.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2002, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules

Present Law

In general, the rules of subpart F (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include certain income of the controlled foreign corporation (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation is organized, or rents and royalties received by a controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

Description of Proposal

Under the proposal, dividends, interest, rents, and royalties received by one controlled foreign corporation from a related controlled foreign corporation would not be treated as foreign personal holding company income to the extent attributable to non-subpart-F earnings of the payor. For these purposes, a related controlled foreign corporation would be a controlled foreign corporation that controls or is controlled by the other controlled foreign corporation, or a controlled foreign corporation that is controlled by the same person or persons that control the other controlled foreign corporation. Ownership of more than 50 percent of the controlled foreign corporation's stock (by vote or value) would constitute control for these purposes.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2002, and taxable years of U.S. persons owning stock in such corporations with or within which such corporations' taxable years end.

3. Look-through treatment for sales of partnership interests

Present Law

In general, the subpart F rules (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign personal holding company income. Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends. Thus, if a controlled foreign corporation sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10-percent U.S. shareholders of the controlled foreign corporation as subpart F income.

Description of Proposal

The proposal would treat the sale by a controlled foreign corporation of a partnership interest as a sale of the proportionate share of partnership assets attributable to such interest for purposes of determining subpart F foreign personal holding company income. This rule would apply only to partners owning directly, indirectly, or constructively at least 25 percent of a capital or profits interest in the partnership. Thus, the sale of a 25-percent or greater partnership interest by a controlled foreign corporation would constitute subpart F income only to the extent that a proportionate sale of the underlying partnership assets attributable to the partnership interest would constitute subpart F income.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2002, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

4. Repeal certain anti-deferral regimes

Present Law

In general

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. The foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. Detailed rules for coordination among the anti-deferral regimes are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951-964); the passive foreign investment company rules (secs. 1291-1298); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax rules (secs. 531-537); and the foreign investment company rules (secs. 1246-1247). The operation and application of these regimes are described in the following sections.

Controlled foreign corporations

In general

The subpart F rules are applicable to controlled foreign corporations. In general, the subpart F rules require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income for U.S. tax purposes currently certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income for U.S. tax purposes their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in U.S. property (sec. 951(a)(1)(B)). The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

A foreign corporation is a controlled foreign corporation if U.S. 10-percent shareholders own more than 50 percent of such corporation's stock (measured by vote or by value) (sec. 957).

For this purpose, a U.S. 10-percent shareholder is a U.S. person that owns 10 percent or more of the corporation's stock (measured by vote) (sec. 951(b)).

Subpart F income

Subpart F income typically is passive income or income that is relatively movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include income of the controlled foreign corporation that is effectively connected with the conduct of a trade or business within the United States (on which income the controlled foreign corporation is subject to current U.S. tax) (sec. 952(b)).

Foreign base company income

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income (sec. 954(a)). In computing foreign base company income, income in these five categories is reduced by allowable deductions properly allocable to such income (sec. 954(b)(5)).

One category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICS; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Subpart F foreign personal holding company income does not include rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation was organized, and rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

Temporary exceptions from foreign personal holding company income as well as foreign base company services income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income") (sec. 954(h) and (i)).

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime applicable to U.S. persons that hold stock in a passive foreign investment company. A U.S. shareholder of a passive foreign investment company generally is subject to U.S. tax, plus an interest charge, that reflects the value of the deferral of tax, upon receipt of a distribution from the passive foreign investment company or upon a disposition of passive foreign investment company stock. However, if a "qualified electing fund" election is made, the U.S. shareholder is subject to U.S. tax currently on the shareholder's pro rata share of the passive foreign investment company's total earnings; a separate election may be made to defer payment of such tax, subject to an interest charge, on income not currently received by the shareholder. In addition, with respect to passive foreign investment company stock that is marketable, electing shareholders currently take into account as income (or loss) the difference between the fair market value of their passive foreign investment company stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain restrictions).

A foreign corporation is a passive foreign investment company if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average assets of the corporation consist of assets that produce, or are held for the production of, passive income (sec. 1297(a)). For this purpose, passive income generally means income that satisfies the definition of foreign personal holding company income under the subpart F provisions (sec. 1297(b)). However, except as provided in regulations, passive income does not include certain active-business banking or insurance income. Also excluded from the definition of passive income is certain active-business securities income. In addition, interest, dividends, rents, and royalties received from related persons are excepted from treatment as passive income to the extent that such amounts are allocable to income of the payor that is not passive income (sec. 1297(b)(2)(C)).

In determining whether a foreign corporation that owns a subsidiary is a passive foreign investment company, look-through treatment is provided in certain cases. A foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income.

Constructive ownership rules apply in determining whether a U.S. person owns stock in a passive foreign investment company (sec. 1298(a)). Under these rules, a U.S. person generally is treated as owning such person's proportionate share of passive foreign investment company stock (1) owned by a partnership, trust or estate of which the person is a partner or beneficiary, (2) owned by a corporation of which the person is a 50-percent or greater shareholder (measured by value), or (3) owned by another passive foreign investment company of which the person is a shareholder.

Foreign personal holding companies

In general

The foreign personal holding company rules are aimed at preventing U.S. persons from accumulating income tax-free in foreign "incorporated pocketbooks." If a foreign corporation

qualifies as a foreign personal holding company, all the U.S. shareholders of the corporation are subject to U.S. tax currently on their pro rata share of the corporation's undistributed foreign personal holding company income.

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement and a gross income requirement (sec. 552(a)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent (measured by vote or by value) of the stock of the corporation is owned by or for five or fewer individual citizens or residents of the United States. Indirect and constructive ownership rules apply for purposes of the stock ownership requirement (sec. 554). The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation qualifies as a foreign personal holding company, however, the gross income threshold for each subsequent year is only 50 percent, until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold (sec. 552(a)(1)).

If a foreign corporation is a foreign personal holding company, its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders (sec. 551(b)). The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)).

Foreign personal holding company income

Foreign personal holding company income generally includes passive income such as (1) dividends, interest, certain royalties, and annuities; (2) gains from stock and securities transactions (other than gains of dealers); (3) gains from commodities transactions (other than gains from bona fide hedging transactions); (4) income with respect to interests in estates and trusts and gains from the sale of such interests; (5) certain amounts received with respect to certain personal services contracts; (6) certain amounts received as compensation for the use of the corporation’s property by certain shareholders; and (7) rents, unless such income constitutes at least 50 percent of the corporation’s gross income (sec. 553(a)). Look-through rules apply for purposes of characterizing certain dividends and interest received from related persons (sec. 552(c)).

Personal holding companies

In addition to the corporate income tax, a tax is imposed at the highest rate under section 1(c) on the undistributed personal holding company income of a personal holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company.

A corporation generally is a personal holding company if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent (by value) of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)). The definition of a personal holding company is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any passive foreign investment company (sec. 542(c)(5), (7), and (10)). Notwithstanding these exceptions, the personal holding company tax is potentially applicable to a small class of closely-held foreign corporations.

Accumulated earnings tax

In addition to the corporate income tax, a tax is imposed at the highest rate under section 1(c) on the accumulated taxable income of a corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business generally is determinative of the required tax-avoidance motive (sec. 533).

The accumulated earnings tax applies to a foreign corporation with respect to income derived from U.S. sources if any of its shareholders are subject to income tax on distributions by the foreign corporation by reason of being (1) U.S. citizens or residents, (2) nonresident individuals who are not citizens and to whom section 871 is applicable, or (3) foreign corporations with beneficial owners (direct or indirect) described in (1) or (2).

Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation. The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or passive foreign investment company (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. 10-percent shareholders of a controlled foreign corporation, result in only a very limited application of the accumulated earnings tax to foreign corporations.

Foreign investment companies

Gain on a sale or exchange (or a distribution that is treated as an exchange) of stock in a foreign investment company generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). This rule operates not to prevent deferral of U.S. tax, as do the foregoing sets of rules, but rather to prevent the use of a foreign corporation to convert ordinary income into capital gain.

Foreign investment companies that were registered under the Investment Company Act of 1940 could elect before January 1, 1963, to be subject to tax rules similar to that for U.S. mutual funds (sec. 1247). A foreign investment company that made the election under section 1247 must annually distribute to its shareholders at least 90 percent of its taxable income. In addition, the corporation must notify the shareholders within 45 days after the close of the taxable year their pro rata amounts of the corporation's net capital gain for the year (determined as if the corporation were a domestic corporation) and the portion of such gain which is being distributed. U.S. shareholders of the foreign investment company that made the election under section 1247 are not subject to the ordinary income rules of section 1246 unless the shareholder did not report for a year his or her pro rata share of the undistributed net capital gain.

A foreign corporation generally is a foreign investment company if (1) the corporation is registered as a management company or as a unit investment trust, or is engaged primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest in securities or commodities and (2) 50 percent or more (measured by vote or by value) of the stock of the corporation is held (directly or indirectly) by U.S. persons (sec. 1246(b)).

Coordination among the anti-deferral regimes

A series of detailed rules provide coordination among the various anti-deferral regimes. For example, U.S. shareholders that are subject to current inclusion under the subpart F rules with respect to stock of a passive foreign investment company that is also a controlled foreign corporation generally are not also subject to the passive foreign investment company provisions with respect to the same stock (sec. 1297(e)). Certain other coordination rules apply for this purpose.

Description of Proposal

The proposal would (1) eliminate the rules applicable to foreign personal holding companies and foreign investment companies, (2) exclude foreign corporations from the application of the personal holding company rules, and (3) include as subpart F foreign personal holding company income certain personal services contract income targeted under the present-law foreign personal holding company rules.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2002, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

5. Subpart F treatment of pipeline transportation income

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as

"subpart F income"). Subpart F income includes foreign base company income, which in turn includes foreign base company oil related income (sec. 954(a)).

Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign base company oil related income does not include income derived from a source within a foreign country in connection with: (1) oil or gas which was extracted from a well located in such foreign country or, (2), oil, gas, or a primary product of oil or gas which is sold by the controlled foreign corporation or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a controlled foreign corporation that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would provide an additional exception to the definition of foreign base company oil related income. Under the proposal, foreign base company oil related income would not include income derived from a source within a foreign country in connection with the pipeline transportation of oil or gas within such foreign country. Thus, the exception would apply whether or not the controlled foreign corporation that owns the pipeline also owns any interest in the oil or gas transported. In addition, the exception would apply to income earned from the transportation of oil or gas by pipeline in a country in which the oil or gas was neither extracted nor consumed within such foreign country.

Effective Date

The provision would be effective for taxable years of foreign corporations beginning after December 31, 2002, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

6. Exceptions from subpart F foreign personal holding company income with respect to commodities transactions

Present Law

Subpart F foreign personal holding company income

Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on certain income earned by the controlled foreign corporation, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1)

property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); net gains from commodities transactions; net gains from foreign currency transactions; income that is equivalent to interest; income from notional principal contracts; and payments in lieu of dividends.

With respect to transactions in commodities, foreign personal holding company income does not consist of gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others.[121] In addition, foreign personal holding company income does not consist of gains or losses which are comprised of active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[122]

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[121] Treasury regulations currently provide that gains or losses from a commodities hedging transaction generally qualify for exclusion from the definition of subpart F foreign personal holding company income if: (1) the transaction is a bona fide hedging transaction with respect to a sale of commodities in the active conduct of a commodities business by a controlled foreign corporation; and (2) substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities (Treas. Reg. sec. 1.954-2(f)(2)(iii) and (iv)). Treasury regulations define the term "bona fide hedging transaction" to mean a transaction that satisfies the general requirements (including the hedge identification requirements) for hedging transactions under section 1221 and the regulations thereunder, except that the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction (Treas. Reg. sec. 1.954-2(a)(4)(ii)). Recently proposed regulations provide that gains or losses from a commodities hedging transaction generally would be excluded from the definition of foreign personal holding company income if the transaction is with respect to the controlled foreign corporation's business as a producer, processor, merchant or handler of commodities, even if the transaction is not a hedge with respect to a sale of commodities in the active conduct of a commodities business by the controlled foreign corporation (67 Fed. Reg. 31,995 (May 13, 2002)). The proposed regulations also provide that, for purposes of satisfying the requirements for exclusion from the definition of foreign personal holding company income, a producer, processor, merchant or handler of commodities would include (but would not be limited to) a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business. However, the proposed regulations provide that a controlled foreign corporation would not be a producer, processor, merchant or handler of commodities (and therefore would not satisfy the requirements for exclusion) if its business is primarily financial.

[122] Treasury regulations provide that substantially all of a controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities if: (1) the sum of its gross receipts from all of its active sales of commodities in such capacity and its gross receipts from all of its commodities hedging transactions that qualify for exclusion from the definition of foreign personal holding company income, equals or exceeds (2) 85

Hedging transactions

Under present law, the term "capital asset" does not include any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe) (sec. 1221(a)(7)). The term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations (sec. 1221(b)(2)(A)).[123]

Description of Proposal

The proposal would modify the requirements that must be satisfied for gains or losses from a commodities hedging transaction to qualify for exclusion from the definition of subpart F foreign personal holding company income. Under the proposal, gains or losses from a transaction with respect to a commodity would not be treated as foreign personal holding company income if the transaction satisfies the general definition of a hedging transaction under section 1221(b)(2). For purposes of this proposal, the general definition of a hedging transaction under section 1221(b)(2) would be modified to include any transaction with respect to a commodity entered into by a controlled foreign corporation in the normal course of the controlled foreign corporation's trade or business primarily: (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b) which is held or to be held by the controlled foreign corporation; or (2) to manage such other risks as the Secretary may prescribe in regulations. Gains or losses from a transaction that satisfies the modified definition of a hedging transaction would be excluded from the definition of foreign personal holding company income only if the transaction is clearly identified as a hedging transaction in accordance with the hedge identification requirements that apply generally to hedging transactions under section 1221(b)(2) (sec. 1221(a)(7) and (b)(2)(B)).

The proposal also would change the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of foreign personal holding company income. Under the proposal, such gains or losses would not be treated as foreign personal holding company income if substantially all of the controlled foreign corporation's commodities are comprised of: (1) stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year, or property held by the

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percent of its total receipts for the taxable year (computed as though the controlled foreign corporation was a domestic corporation) (Treas. Reg. sec. 1.954-2(f)(2)(iii)(C)).

[123] The Secretary is directed to prescribe regulations to properly characterize any income, gain, expense, or loss arising from transactions that are improperly identified, or not identified, as hedging transactions (sec. 1221(b)(2)(B)).

controlled foreign corporation primarily for sale to customers in the ordinary course of the controlled foreign corporation's trade or business; (2) property that is used in the trade or business of the controlled foreign corporation and is of a character which is subject to the allowance for depreciation under section 167; or (3) supplies of a type regularly used or consumed by the controlled foreign corporation in the ordinary course of a trade or business of the controlled foreign corporation.[124]

Effective Date

The proposal would be effective with respect to transactions entered into on or after the date of enactment.

[124] For purposes of determining whether substantially all of the controlled foreign corporation's commodities are comprised of such property, the 85-percent requirement provided in the current Treasury regulations (as modified to reflect the changes made by the proposal) would continue to apply.

B. Provisions Relating to the Foreign Tax Credit

1. Allocate interest expense on a worldwide basis

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other. Generally, it is left to the Treasury to provide detailed rules for the allocation and apportionment of expenses.

In the case of interest expense, regulations generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below). The Code provides that for interest allocation purposes all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"), and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

In general

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns.

Definition of affiliated group -- consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly at least 80 percent of the total voting power of all classes of stock and at least 80 percent of the total value of all outstanding stock of at least one other includible corporation (except the common parent), stock possessing at least 80 percent of the total voting power of all classes of its stock and at least 80 percent of the total value of all of its outstanding stock must be directly owned by one or more other includible corporations.

Generally, the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Definition of affiliated group -- special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[125] For example, both definitions exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies, subsidiaries of banks and bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Description of Proposal

In general

The proposal would generally replace the present-law method for interest expense allocation (which generally applies for purposes of computing the foreign tax credit limitations) with a concept based on worldwide fungibility. Under this approach, the taxable income of the domestic members of an affiliated group from sources outside the United States would be determined by allocating and apportioning the interest expense of the domestic members of a worldwide affiliated group on a worldwide group basis (i.e., as if all members of the worldwide

[125] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

group were a single corporation). Specifically, subject to certain modifications and exceptions, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States would be determined by allocating and apportioning the interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group, over (2) the interest expense incurred by a foreign member of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[126]

For these purposes, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest allocation purposes)[127] as well as any foreign corporations that would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, under the proposal, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and 80-percent or greater owned foreign corporations were attributable to a single corporation.

Financial institution group election

The proposal would allow taxpayers to continue to apply the present-law bank group rules. The proposal also would provide a one-time "financial institution group" election that expands the present-law bank group. Under the proposal, at the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules would be applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[128] For these purposes, items of income

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[126] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[127] The proposal expands the definition of an affiliated group for interest expense allocation purposes to include certain insurance companies that are generally excluded from an affiliated group under section 1504(b)(2) (without regard to whether such companies are covered by an election under section 1504(c)(2)).

[128] See Treas. Reg. sec. 1.904-4(e)(2).

or gain from a transaction or series of transactions will be disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The election must be made for the first taxable year beginning after December 31, 2002, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, the proposal provides certain anti-abuse rules under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. The proposal provides regulatory authority with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation would be appropriate to carry out the purposes of the provision, prevent assets or interest expense from being taken into account more than once, and dealing with changes in members of any group (through acquisitions or otherwise) treated as affiliated under this provision.

Effective Date

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

2. Recharacterization of overall domestic loss

Present Law

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S.-source income; rather, it should only reduce U.S. tax on foreign-source income. An overall foreign tax credit limitation prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S.-source and foreign-source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign-source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign-source income and, thus, the upper limit on the foreign tax credit for the year. If the taxpayer's foreign-source taxable income exceeds worldwide taxable income (because of a domestic source loss), then the full amount of pre-credit U.S. tax may be offset by the foreign tax credit.

If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess ("overall foreign loss" or "OFL") may offset U.S.-source income. Such an offset reduces the effective rate of U.S. tax on U.S.-source income. To eliminate a double benefit (that is, the reduction of U.S. tax previously noted and, later, full allowance of a foreign tax credit with respect to foreign-source income), an OFL recapture rule was enacted in 1976. Under this rule, a portion of foreign-source taxable income earned after an OFL year is recharacterized as U.S.-source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (sec. 904(f)(1)). Foreign-source taxable income up to the amount of the unrecaptured OFL may be so treated. Unless a taxpayer elects a higher percentage, however, generally no more than 50 percent of the foreign-source taxable income earned in any particular taxable year is recharacterized as U.S.-source taxable income. The effect of the recapture is to reduce the

foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

An overall U.S.-source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign-source income if viewed in isolation. The existence of foreign-source taxable income in the year of the U.S. loss reduces or eliminates any net operating loss carryover that the U.S. loss would otherwise have generated absent the foreign income. In addition, as the pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. As a result, some foreign tax credits in the year of the U.S. loss must be credited, if at all, in a carryover year. Tax on domestic-source taxable income in a subsequent year may be offset by a net operating loss carryforward, but not by a foreign tax credit carryforward. There is presently no mechanism for resourcing such subsequent U.S.-source income as foreign.

Description of Proposal

The proposal would apply a resourcing rule to U.S.-source income where the taxpayer has suffered a reduction in the amount of its foreign tax credit limitation due to a prior overall domestic loss. Under the proposal, in the case of a taxpayer that has incurred an overall domestic loss, that portion of the taxpayer's U.S.-source taxable income for each succeeding taxable year, which is equal to the lesser of (1) the amount of the unrecharacterized overall domestic loss, or (2) 50 percent of the taxpayer's U.S.-source taxable income for such succeeding taxable year, would be recharacterized as foreign-source taxable income.

The proposal would define an overall domestic loss for this purpose as any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback. For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. Under the proposal, an overall domestic loss would not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year.

Any U.S.-source income resourced under the proposal would be allocated among and would increase the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic loss.

It is anticipated that situations could arise where a taxpayer would generate an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The proposal would grant the Secretary of Treasury authority to prescribe such regulations as may be necessary to coordinate the operation of the OFL recapture rules with the operation of the overall domestic loss recapture rules that would be added by the proposal.

Effective Date

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

3. Reduction to three foreign tax credit baskets

Present Law

The United States taxes its citizens and residents on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States provides a credit against U.S. tax liability for foreign income taxes paid, subject to a number of limitations. The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income, in order to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income.

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-taxed) passive income could expand the taxpayer's ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis. Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories (or "baskets"), and the low-taxed passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income.

Separate foreign tax credit limitation categories are provided for the following items of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from a noncontrolled section 902 foreign corporation (a "10/50 company"),[129] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to

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[129] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 company. Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits).

certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income).

Description of Proposal

The proposal would reduce the number of foreign tax credit limitation categories to three: passive income, financial services income, and "general basket" income. Income from the eliminated shipping, high withholding tax interest, and 10/50 limitation categories would fall into one of the remaining three categories, as appropriate. For example, shipping income generally would fall into the general limitation category, whereas high withholding tax interest generally could fall into the passive income or the financial services income limitation categories, depending on the circumstances. Dividends from a domestic international sales corporation or former domestic international sales corporation, income attributable to certain foreign trade income, and certain distributions from a foreign sales corporation or former foreign sales corporation all would be specifically assigned to the passive income limitation category.

Effective Date

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

4. Extension of period to which excess foreign taxes may be carried

Present Law

The foreign tax credit is subject to an overall limitation. That is, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the credit for foreign taxes on income in each separate limitation category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income in that category bears to its worldwide taxable income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back and forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

Description of Proposal

The proposal would extend the excess foreign tax credit carryforward period from 5 to 10 years.

Effective Date

The proposal would be effective for excess foreign tax credits that may be carried to taxable years beginning after December 31, 2002.

5. Repeal of limitation of foreign tax credit under alternative minimum tax

Present Law

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. The maximum rate for noncorporate taxpayers is 28 percent. AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI. Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to total AMTI (sec. 59(a)(4)).

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without an AMT net operating loss deduction, an AMT energy preference deduction, or an AMT foreign tax credit. For example, assume that a corporation has $10 million of AMTI from foreign sources, has no AMT net operating loss or energy preference deductions, and is subject to the AMT. In the absence of the AMT foreign tax credit, the corporation's tax liability would be $2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below $200,000. Any unused AMT foreign tax credit may be carried back two years and carried forward five years for use against AMT in those years under the principles of the foreign tax credit carry back and carry forward rules set forth in section 904(c).

Description of Proposal

The proposal would repeal the 90-percent limitation on the utilization of the AMT foreign tax credit.

Effective Date

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

6. Look-through rules to apply to dividends from noncontrolled section 902 corporations

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003 are subject to a separate foreign tax credit limitation for each 10/50 company. Dividends paid by a 10/50 company that is not a passive foreign investment company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Description of Proposal

The proposal would apply the look-through approach to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated. In the event that information is not available to apply the look-through approach with respect to all or a portion of the dividend, such portion would be treated as a dividend (not from a 10/50 company) for foreign tax credit basketing purposes.

The proposal would also provide transition rules regarding the use of pre-effective date foreign tax credits associated with a 10/50 company separate limitation category in post-effective date years. In this regard, look-through principles similar to those applicable to post-effective date dividends from a 10/50 company would apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years.

Effective Date

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

7. Foreign tax credits claimed indirectly through partnerships

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns ten percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such a domestic corporation would be eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings and profits.

Foreign income taxes paid or accrued by lower-tier foreign corporations also are eligible for the deemed-paid credit if the foreign corporation falls within a qualified group (sec. 902(b)). A "qualified group" includes certain foreign corporations within the first six tiers of a chain of foreign corporations if, among other things, the product of the percentage ownership of voting stock at each level of the chain (beginning from the U.S. corporation) equals at least five percent. In addition, in order to claim indirect credits for foreign taxes paid by certain fourth-, fifth-, and sixth-tier corporations, such corporations must be controlled foreign corporations (within the meaning of sec. 957) and the U.S. shareholder claiming the indirect credit must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the controlled foreign corporations. The application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a controlled foreign corporation. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

Section 960 similarly permits a domestic corporation with subpart F inclusions from a controlled foreign corporation to claim deemed-paid foreign tax credits with respect to foreign taxes paid or accrued by the controlled foreign corporation on its subpart F income.

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit. However, Rev. Rul. 71-141 held that two U.S. corporations would be attributed the foreign corporation stock held by their U.S. general partnership for purposes of determining eligibility to claim a deemed-paid foreign tax credit with respect to the foreign taxes paid by such foreign corporation. The preamble to the final regulations under section 902 states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity." In recognition of the holding in Rev. Rul. 71-141 that a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership, however, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply.

Under section 901(b)(5), an individual member of a partnership or a beneficiary of an estate or trust generally may claim a direct foreign tax credit with respect to the amount of his or her proportionate share of the foreign taxes paid or accrued by the partnership, estate, or trust. This rule does not specifically apply to corporations that are either members of a partnership or beneficiaries of an estate or trust. However, section 702(a)(6) provides that each partner (including individuals or corporations) of a partnership must take into account separately its distributive share of the partnership's foreign taxes paid or accrued. In addition, under section 703(b)(3), the election under section 901 (whether to credit the foreign taxes) is made by each partner separately.

Description of Proposal

The proposal would clarify that a domestic corporation would be entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock. No inference would be intended as to the treatment of such deemed-paid foreign tax credits under present law.

Effective Date

The proposal would be effective for taxes of foreign corporations for taxable years of such corporations beginning after December 31, 2002.

C. Other Provisions

1. Exceptions from the uniform capitalization rules for determining a foreign corporation's earnings and profits and subpart F income

Present Law

In general

Taxpayers generally may not deduct currently the costs incurred in producing property or acquiring property for resale. Rather, such costs must be capitalized and recovered through an offset to sales price if the property is produced for sale, or though depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. The purpose of this requirement is to match the costs of producing or acquiring goods with the revenues realized from their sale or use in the business or investment activity.

Section 263A

In general, the uniform capitalization rules require that a portion of the direct and indirect costs of producing property or acquiring property for resale be capitalized or included in the cost of inventory (sec. 263A). The determination of which direct and indirect costs constitute capitalized costs, and the calculation of the amount to capitalize is very detailed and complex. Compared to financial statement reporting requirements, the uniform capitalization rules tend to allow fewer costs to be expensed and require additional costs to be capitalized or included in inventories.

Application to foreign corporations

The uniform capitalization rules apply to foreign corporations, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in a trade or business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation may be currently includible on the return of a U.S. shareholder of the controlled foreign corporation. Regardless of whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the amount of taxable dividends and the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The earnings and profits surplus or deficit of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations. However, Prop. Reg. sec. 1.964-1(c)(1)(ii)(B) provides that, for purposes of computing a foreign corporation's earnings and profits, the amount of expenses that must be capitalized into inventory under section 263A may not exceed the amount capitalized in keeping

the taxpayer's books and records. For this purpose, the taxpayer's books and records must be prepared in accordance with accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates. This proposed regulation applies only for purposes of determining a foreign corporation's earnings and profits and would not apply for purposes of determining subpart F income or income effectively connected with a U.S. trade or business of a foreign corporation.

Description of Proposal

The proposal would provide that in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale would be capitalized using U.S. generally accepted accounting principles (i.e., the method used to ascertain income, profit, or loss for purposes of reports or statements to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes) for purposes of determining a U.S.-owned foreign corporation's earnings and profits and subpart F income. The uniform capitalization rules would continue to apply to foreign corporations for purposes of determining income effectively connected with a U.S. trade or business.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2002. Section 481 of the Code (dealing with certain adjustments required by changes in accounting methods) would not apply by reason of this proposal.

2. United States property not to include certain assets acquired by dealers in ordinary course of trade or business

Present Law

In general, the subpart F rules (secs. 951-964) require the U.S. 10-percent shareholders of a controlled foreign corporation to include in income currently their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), whether or not such earnings are distributed currently to the shareholders. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in certain U.S. property (sec. 951(a)(1)(B)).

A shareholder's current income inclusion with respect to a controlled foreign corporation's investment in U.S. property for a taxable year is based on the controlled foreign corporation's average investment in U.S. property for such year. For this purpose, the U.S. property held (directly or indirectly) by the controlled foreign corporation must be measured as of the close of each quarter in the taxable year (sec. 956(a)). The amount taken into account with respect to any property is the property's adjusted basis as determined for purposes of reporting the controlled foreign corporation's earnings and profits, reduced by any liability to which the property is subject. The amount determined for current inclusion is the shareholder's pro rata share of an amount equal to the lesser of (1) the controlled foreign corporation's average investment in U.S. property as of the end of each quarter of such taxable year, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed

on that basis, or (2) the controlled foreign corporation's current or accumulated earnings and profits (but not including a deficit), reduced by distributions during the year and by earnings that have been taxed previously as earnings invested in U.S. property (secs. 956 and 959). An income inclusion is required only to the extent that the amount so calculated exceeds the amount of the controlled foreign corporation's earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B) and 959).

For purposes of section 956, U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets including a patent or copyright, an invention, model or design, a secret formula or process or similar property right which is acquired or developed by the controlled foreign corporation for use in the United States. (sec. 956(c)(1)).

Specified exceptions from the definition of U.S. property are provided for (1) obligations of the United States and U.S. bank deposits, (2) certain export property, (3) certain trade or business obligations, (4) aircraft, railroad rolling stock, vessels, motor vehicles or containers used in transportation in foreign commerce and used predominantly outside of the United States, (5) certain insurance company reserves and unearned premiums related to insurance of foreign risks, (6) stock or debt of certain unrelated U.S. corporations (7) moveable property (other than a vessel or aircraft) used for the purpose of exploring, developing, or certain other activities in connection with the ocean waters of the U.S. Continental Shelf, (8) an amount of assets equal to the controlled foreign corporation's accumulated earnings and profits attributable to income effectively connected with a U.S. trade or business, (9) property (to the extent provided in regulations) held by a foreign sales corporation and related to its export activities, (10) certain deposits or receipts of collateral or margin by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer, and (11) certain repurchase and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer (sec. 956(c)(2)).

Description of Proposal

The proposal would add a new exception from the definition of "United States property" for section 956 purposes for securities acquired and held by a controlled foreign corporation in the ordinary course of its trade or business as a dealer in securities. The exception would apply only if the controlled foreign corporation dealer (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business and (2) disposes of such securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2002, and for taxable years of United States shareholders with or within which such taxable year of the foreign corporation ends.

3. Treatment of certain dividends of regulated investment companies

Present Law

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least $10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

U.S. source investment income of foreign persons

In general

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties or similar types of income, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment

dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)). Original issue discount on obligations maturing in 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax (sec. 871(g)). An additional exception is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). "Portfolio interest" generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (i) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is "foreign targeted"), and (ii) that is not received by a 10-percent shareholder (secs. 871(h)(3) and 881(c)(3)). With respect to a registered obligation, a statement that the beneficial owner is not a U.S. person is required (secs. 871(h)(2), (5) and 881(c)(2)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (secs. 871(h)(4) and 881(c)(4)).

Capital gains

Foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year (sec. 871(a)(2)). A RIC may elect not to withhold on a distribution to a foreign person representing a capital gain dividend. (Treas. Reg. sec. 1.1441-3(c)(2)(D)).

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), as amended, gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business (sec. 897). In addition to an interest in real property located in the United States or the Virgin Islands, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated.[130] Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of nonresident decedents who are not U.S. citizens. Under recent treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Description of Proposal

In general

Under the proposal, a RIC that earns certain interest income which would not be subject to U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as derived from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had realized the excess directly. The estate of a foreign decedent would be exempt from U.S. estate tax on a transfer of stock in the RIC in the proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the proposal, a RIC could, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. An interest-related dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

[130] The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") repealed the estate tax for estates of decedents dying after December 31, 2009. However, the Act included a "sunset" provision, pursuant to which the Act's provisions (including estate tax repeal) do not apply to estates of decedents dying after December 31, 2010.

This exemption would not apply, however, to a dividend on shares of RIC stock in a case where the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption would not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally would not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the controlled foreign corporation) is a related person. Nor would the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original issue discount or bank deposit interest) received by the RIC on indebtedness issued by the RIC-dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10-percent shareholder. In these two cases, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend would be treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country exceptions of subpart F (see sec. 881(c)(5)(A)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of (1) the amount of qualified interest income of the RIC over (2) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is the sum of its U.S.-source income with respect to (1) bank deposit interest, (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871, (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4), and (4) any interest-related dividend from another RIC.

Where the amount designated as an interest-related dividend is greater than the qualified net interest income described above, then the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Short-term capital gain dividends

Under the proposal, a RIC could also, under certain circumstances, designate all or a portion of a dividend as a "short-term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short-term capital gain dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption would not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. In this case, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount qualified to be designated as short-term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in sec. 855) is the excess of the RIC's net short-term capital gains over net long-term capital losses. The short-term capital gain would include short-term capital gain dividends from another RIC. As is provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under sec. 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss would be treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule would apply also for purposes of computing the taxable income of the RIC.

In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. In addition, where the amount designated as short-term capital gain dividends is greater than the amount of qualified short-term capital gain, then the portion of the distribution so designated which constitutes a short-term capital gain dividend will be only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As is true under current law for distributions from REITs, the proposal would provide that any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The proposal also would extend the special rules for domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the proposal, a portion of the stock in a RIC held by the estate of a nonresident decedent who is not a U.S. citizen would be treated as property without the United States. The portion so treated would be based on the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets." Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations,

certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

Effective Date

The proposal generally would apply to dividends with respect to taxable years of RICs beginning after the date of enactment. With respect to the treatment of a RIC for estate tax purposes, the proposal would apply to estates of decedents dying after the date of enactment. With respect to the treatment of RICs under section 897 (dealing with U.S. real property interests), the proposal would be effective on the date of enactment.

4. Exchange rate election for translation of foreign tax paid in nonfunctional currency

Present Law

With respect to taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate (sec. 986(a)(1)). This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period (sec. 986(a)(2)).

Description of Proposal

With respect to taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the proposal would allow such taxpayers to elect to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayer's functional currency.[131] Any election under the proposal would apply to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the

[131] Electing taxpayers would translate foreign income tax payments pursuant to the same present-law rules that apply to taxpayers that are required to translate foreign income taxes using the exchange rates as of the time such taxes are paid.

consent of the Secretary. The proposal would authorize the Secretary to issue regulations that would apply the election to foreign income taxes attributable to a qualified business unit.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 2002.

5. Secondary withholding tax on dividends from certain foreign corporations

Present Law

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general sourcing rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30-percent withholding tax (sec. 861(a)(2)(B)). This rule is sometimes referred to as the "secondary withholding tax." The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation's "dividend equivalent amount," which generally is the earnings and profits of a U.S. branch of a foreign

corporation attributable to its income effectively connected with a U.S. trade or business (secs. 884(a) and (b)).

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

Description of Proposal

The proposal would eliminate the secondary withholding tax with respect to dividends paid by certain foreign corporations.

Effective Date

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

6. Increase in section 179 expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 ($25,000 for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $24,000 ($25,000 for taxable years beginning in 2003 and thereafter) amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

Additional section 179 incentives are provided with respect to a qualified zone property used by a business in an empowerment zone (sec. 1397A). Such a business may elect to deduct an additional $35,000 of the cost of qualified zone property placed in service. In addition, the phase-out range is applied by taking into account only 50 percent of the cost of qualified zone property that is section 179 property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Description of Proposal

For taxable years beginning after December 31, 2004, the proposal would increase for inflation both the maximum amount of qualified property that a taxpayer may deduct each year and the present law $200,000 limit.[132]

The proposal also would increase the maximum dollar amount that may be deducted under section 179 to $40,000 for taxable years beginning after December 31, 2012. In addition, the proposal would increase the $200,000 inflation adjusted amount to $325,000 for taxable years beginning after December 31, 2012. The $40,000 and $325,000 amounts also would be adjusted for inflation.

As under present law, no general business credit under section 38 would be allowed with respect to any amount for which a deduction is allowed under section 179.

Effective Date

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

7. Repeal exclusion for extraterritorial income

Present Law

Gross income does not include extraterritorial income. For these purposes, extraterritorial income is the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in sec. 942). Extraterritorial income is eligible for the exclusion to the extent it is qualifying foreign trade income (as defined in sec. 941). Deductions and credits attributable to excluded extraterritorial income are not allowed.

In general, qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, (2) 15 percent of the foreign trade income derived by the taxpayer from the transaction, or (3) 30 percent of the foreign sale and leasing income derived by the taxpayer from the transaction.

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside the United States. Specifically, the gross receipts generally must be (1) from the sale, exchange, or other disposition of qualifying foreign trade property, (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States, (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property, (4) for engineering or architectural services for construction projects located outside the United States, or (5) for the performance of certain managerial services for unrelated persons.

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[132] Increases to these amounts would correspondingly increase the annual amount of qualified zone property that may be deducted by a business located in an empowerment zone.

Foreign trade income is the taxable income of the taxpayer (determined without regard to the exclusion for extraterritorial income) attributable to foreign trading gross receipts. Foreign sale and leasing income is the amount of the taxpayer's foreign trade income with respect to a transaction that is properly allocable to activities that constitute certain foreign economic processes, as well as foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted ("manufactured") within or outside the United States that is held for use primarily for sale, lease, or rental in the ordinary course of a trade or business, for direct use, consumption, or disposition outside the United States. In addition, not more than 50 percent of the fair market value of such property can be attributable to the sum of (1) the fair market value of articles manufactured outside the United States, plus (2) the direct costs of labor performed outside the United States. Certain exclusions from qualifying foreign trade property apply.

Certain other detailed rules apply for purposes of the exclusion for extraterritorial income. This includes certain limitations for sourcing taxable income attributable to sales transactions that give rise to foreign trading gross receipts, special rules for foreign withholding taxes with respect to qualifying foreign trade income, certain assets not taken into account for interest allocation purposes, and special rules for qualifying foreign trade income of shared partnerships and cooperatives.

Description of Proposal

The proposal would repeal the exclusion for extraterritorial income.

Effective Date

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

8. Repeal of foreign sales corporation transition rules

Present Law

The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 provided for certain transition rules with respect to certain existing foreign sales corporations ("FSCs") and certain binding contractual arrangements. Specifically, the transition rules provide that for FSCs in existence on September 30, 2000, the FSC rules may apply to transactions in the ordinary course of business involving a FSC before January 1, 2002. In addition, the FSC rules may apply to transactions in the ordinary course of business after December 31, 2001, if such transactions are pursuant to a binding contract between a FSC (or a person related to the FSC on September 30, 2000) and any other unrelated person, and such contract is in effect on September 30, 2000. For this purpose, binding contracts include purchase options, renewal options, and replacement options that are enforceable against a lessor or seller (provided that the options are a part of a contract that is binding and in effect on September 30, 2000).

Description of Proposal

The proposal would repeal the FSC transition rules.

Effective Date

The proposal would be effective for taxable years beginning after the calendar year which includes the date of enactment.

IV. OTHER PROVISIONS

A. 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[133] extended the statutory authorization for these user fees[134] through September 30, 2003.

Description of Proposal

The proposal would extend the statutory authorization for these user fees through December 31, 2012. The bill also moves 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, is effective for requests made after the date of enactment.

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[133] 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).

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

B. Extension of Customs Service 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 provision extends the authority to impose and collect Customs user fees through December 31, 2012. The proposal also would provide an authorization for the appropriation of $350 million per year for fiscal years 2003, 2004, and 2005 for the design and building of the new Customs computer system; these amounts are to be taken from the Customs user fees.

Effective Date

The proposal would be effective on the date of enactment.

C. Inclusion in Gross Income of Funded Deferred Compensation of Corporate Insiders

Present Law

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[135] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income in situations where nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451. Income is constructively received when it is credited to an individuals' account, set apart, or otherwise made available so that it can be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. The IRS

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[135] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

has ruled that the use of certain grantor trust arrangements in connection with unfunded deferred compensation arrangements does not cause an employee to be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust. Such trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of these grantor trusts, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[136] As a result, no amount is included in income by reason of the trust; generally income inclusion occurs as payments are made from the trust.

The Internal Revenue Service has issued guidance setting forth model trust provisions of such trusts.[137] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy. Since the concept of this trust was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which effectively allow deferred amounts to be available to individuals, while still meeting the safe harbor requirements set forth by the IRS.

Description of Proposal

Under the proposal, if an employer maintains a funded deferred compensation plan,[138] compensation of any disqualified individual which is deferred under the plan would be includible in the gross income of the individual or beneficiary for the first taxable year in which there is no substantial risk of forfeiture.[139]

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[136] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." PLR 8113107 (Dec. 31, 1980).

[137] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

[138] A plan would include an agreement or arrangement.

[139] Compensation would be treated as subject to a substantial risk of forfeiture if the rights to such compensation are conditioned upon the future performance of substantial services by any individual. If an arrangement is treated as a funded deferred compensation plan under the proposal, amounts may be includible in gross income before they are paid or made available. In

Under the proposal, a plan would be treated as a funded deferred compensation plan unless (1) the employee's rights to the compensation deferred under the plan, and all income attributable to such amounts, are no greater than the rights of a general creditor of the employer; (2) until made available to the participant or beneficiary, all amounts set aside (directly or indirectly) for the purposes of paying the deferred compensation, and all income attributable to such amounts, remain solely the property of the employer and are not restricted to the provision of benefits under the plan; and (3) at all times (not merely after bankruptcy or insolvency), all amounts set aside are available to satisfy the claims of the employer's general creditors. Under the proposal, if amounts are set aside for the exclusive purpose of paying deferred compensation benefits, the plan would be treated as a funded plan. Amounts set aside in an employer's general assets, even if such assets are segregated for bookkeeping or accounting purposes, which are not restricted to the payment of deferred compensation, but are subject to the claims of general creditors, would not be treated as funded if the other requirements under the proposal are satisfied.

An employee's right to deferred compensation would be treated as greater than the rights of general creditors unless (1) the deferred compensation, and all income attributable to such amounts, is payable only upon separation from service, death, or at a specified time (or pursuant to a fixed schedule) and (2) the plan does not permit the acceleration of the time of such payments by reason of any event. Amounts payable upon a specified event would not be treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 would be payable at a specified time, while amounts payable when an individual's child begins college would be payable by reason of an event. A plan which allows payment of deferred compensation or earnings other than upon separation from service, death, or specified time, or allows for any acceleration of payments, would be treated as funded and compensation deferred under such plan would be includible in income when the rights to such compensation are not subject to a substantial risk of forfeiture.

Even if an employee's rights are treated as no greater than the rights of general creditors in compliance with the previously discussed criteria, if the employer and employee agree to a modification of the plan that accelerates the time for payment of deferred compensation, then all compensation previously deferred would be includible in gross income for the taxable year of the modification. In addition, upon such a modification, the taxpayer would be required to pay interest at the underpayment rate on the underpayments that would have occurred had the deferred compensation been includible in gross income on the earliest date that there is no substantial risk of forfeiture of the right to the compensation. Such interest would be treated as interest on an underpayment of tax.

With respect to amounts set aside in a trust, a plan would be treated as failing to meet the requirement that amounts set aside remain solely the property of the employer and are not restricted to the payment of benefits under the plan unless certain specified criteria are met. The employee must have no beneficial interest in the trust. In addition, assets in the trust must be available to satisfy the claims of general creditors at all times (not merely after bankruptcy or

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determining the tax treatment of amounts available under the plan, the rules applicable to the taxation of annuities would apply.

insolvency). No factor could exist which would make it more difficult for general creditors to reach the assets in the trust than it would be if the trust assets were held directly by the employer in the United States. The location of the trust outside of the United States would be such a prohibited factor, unless otherwise provided in regulations prescribed by the Secretary. If any of the criteria are not satisfied, the trust would be treated as a funded arrangement and compensation deferred would be includible in gross income when such compensation is not subject to a substantial risk of forfeiture.

A disqualified individual would be any individual who, with respect to a corporation, is subject to the requirements of section 16(a) of the Securities Act of 1934, or would be subject to such requirements if such corporation were an issuer of equity securities referred to in that section. Generally, disqualified individuals would include officers, directors, or 10-percent owners of both private and publicly-held corporations.

A funded deferred compensation plan would not include a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, a simple retirement account, certain plans funded solely by employee contributions, a governmental plan, or a plan of a tax-exempt organization.

It would not be intended that the proposal would change the tax treatment of trusts under section 402(b) or of any arrangements under which amounts are otherwise includible in income.

Effective Date

The proposal would be effective for amounts deferred after July 10, 2002.

D. Simplification of Excise Tax Imposed on Bows and Arrows

Present Law

The Code imposes an excise tax of 11 percent on the sale by a manufacturer, producer or importer of any bow with a draw rate of 10 pounds or more (sec. 4161(b)(1)(A)). An 11-percent excise tax also is imposed on any part of an accessory for bows and on quivers for use with arrows (sec. 4161(b)(1)(B)). An excise tax of 12.4 percent is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which after its assembly (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches) (sec. 4161(b)(2)). No tax is imposed on finished arrows.

Description of Proposal

The proposal would increase the minimum draw weight for a taxable bow from 10 pounds to 30 pounds. The proposal also would impose an excise tax of 12 percent on arrows generally. An arrow for this purpose would be defined as an arrow shaft to which additional components are attached. The present law 12.4-percent excise tax on certain arrow components would be unchanged by the proposal. The proposal provides that the 12-percent excise tax on arrows would not apply if the arrow contains an arrow shaft that was subject to the tax on arrow components. Finally, the proposal would subject certain broadheads (a type of arrow point) to an excise tax equal to 11 percent of the sales price.

Effective Date

The proposal would be effective for articles sold by the manufacturer, producer, or importer after December 31, 2001.

E. Exclusion from Gross Income for Interest on Overpayments of Income Tax by Individuals

Present Law

Overpayment interest

Interest is included in the list of items that are required to be included in gross income (sec. 61(a)(4)). Interest on overpayments of Federal income tax is required to be included in taxable income in the same manner as any other interest that is received by the taxpayer.[140]

Cash basis taxpayers are required to report overpayment interest as income in the period the interest is received. Accrual basis taxpayers are required to report overpayment interest as income when all events fixing the right to the receipt of the overpayment interest have occurred and the amount can be estimated with reasonable accuracy.[141] Generally, this occurs on the date the appropriate IRS official signs the pertinent schedule of overassessments.[142]

Underpayment interest

A corporate taxpayer is allowed to currently take into account interest paid on underpayments of Federal income tax as an ordinary and necessary business expense. Typically, this results in a current deduction. However, the deduction may be deferred if the interest is required to be capitalized[143] or may be disallowed if and to the extent it is determined to be a cost of earning tax exempt income under section 265.

Section 163(h) of the Code prohibits the deduction of personal interest by taxpayers other than corporations. Noncorporate taxpayers, including individuals, generally are not allowed to deduct interest on the underpayment of Federal income taxes.

Temporary regulations[144] provide that personal interest includes interest paid on underpayments of individual Federal, State or local income taxes, regardless of the source of the income generating the tax liability. This is consistent with the statement in the General Explanation of the Tax Reform Act of 1986 that "(p)ersonal interest also includes interest on underpayments of individual Federal, State, or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not

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[140] Treas. Reg. sec. 1.61-7.

[141] Treas. Reg. sec. 1.451-1(a).

[142] Rev. Rul. 62-160, 1962-2 C.B. 451.

[143] Interest may be required to be capitalized under section 263A and similar sections.

[144] Treas. Reg. sec. 1.163-9T.

considered derived from conduct of a trade or business."[145] The validity of the temporary regulation has been upheld in those Circuits that have considered the issue, including the Fourth,[146] Sixth,[147] Seventh,[148] Eighth,[149] and Ninth Circuits.[150]

Personal interest also includes interest that is paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes. Personal interest does not include interest that is paid with respect to sales, excise or similar taxes that are incurred in connection with a trade or business or an investment activity.[151]

Description of Proposal

The proposal would exclude overpayment interest that was paid to individual taxpayers on overpayments of Federal income tax from gross income. Interest excluded under the proposal would not be considered disqualified income that could limit the earned income credit. Interest to be excluded under the proposal also would not be considered in determining what portion of a taxpayer's social security or tier 1 railroad retirement benefits are subject to tax (sec. 86), whether a taxpayer has sufficient taxable income to be required to file a return (sec. 6012(d)), or for any other computation in which interest exempt from tax is otherwise required to be added to adjusted gross income.

The exclusion from income of overpayment interest would not apply if the Secretary determines that the taxpayer's principal purpose for overpaying his or her tax is to take advantage of the exclusion.

For example, a taxpayer prepares his return without taking into account significant itemized deductions of which he is, or should be, aware. Before the expiration of the statute of limitations, the taxpayer files an amended return claiming these itemized deductions and requesting a refund with interest. Unless the taxpayer can establish a principal purpose for originally overpaying the tax other than collecting excludible interest, the Secretary may determine that the principal purpose of waiting to claim the deductions on an amended return was to earn interest that would be excluded from income. In that case, the interest on the overpayment could not be excluded from income.

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[145] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), p. 266.

[146] *Allen v. U.S.*, 173 F. 3d 533 (1999).

[147] *McDonnell v. U.S.*, 1999 U.S. app. LEXIS 10842 (1999).

[148] *Kikalos v. Commissioner,* 190 F.3d 791 (1999).

[149] *Miller v. U.S.*, 65 F. 3d 687 (1995).

[150] *Redlark v. U.S.*, 141 F. 3d 936 (1998).

[151] Treas. Reg. sec. 1.163-9T(b)(2)(iii)(A).

The Secretary would be expected to indicate whether the interest would be eligible to be excluded from income on the Form 1099 it provides that taxpayer for taxable year in which the underpayment interest was paid.

Effective Date

The proposal would be effective for interest received in calendar years beginning after 2006.

F. Deposits Made to Suspend the Running of Interest on Potential Underpayments

Present Law

Generally, interest on underpayments and overpayments continues to accrue during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner,[152] but interest will begin to accrue once the taxpayer is properly notified. No similar suspension is available for other taxpayers.

A taxpayer that wants to limit its exposure to underpayment interest has a limited number of options. The taxpayer can continue to dispute the amount owed and risk paying a significant amount of interest. If the taxpayer continues to dispute the amount and ultimately loses, the taxpayer will be required to pay interest on the underpayment from the original due date of the return until the date of payment.

In order to avoid the accrual of underpayment interest, the taxpayer may choose to pay the disputed amount and immediately file a claim for refund. Payment of the disputed amount will prevent further interest from accruing if the taxpayer loses (since there is no longer any underpayment) and the taxpayer will earn interest on the resultant overpayment if the taxpayer wins. However, the taxpayer will generally lose access to the Tax Court if it follows this alternative.[153] Amounts paid generally cannot be recovered by the taxpayer on demand, but must await final determination of the taxpayer's liability. Even if an overpayment is ultimately determined, overpaid amounts may not be refunded if they are eligible to be offset against other liabilities of the taxpayer.[154]

The taxpayer may also make a deposit in the nature of a cash bond. The procedures for making a deposit in the nature of a cash bond are provided in Rev. Proc. 84-58.[155]

A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest. A deposit in the nature of a cash bond is not a payment of tax and is not subject to a claim for credit or refund. A deposit in the nature of a cash bond may be made for all or part of the disputed liability and generally may be recovered by the taxpayer prior to a final determination. However, a deposit

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[152] Sec. 6404(g).

[153] The taxpayer may, however, sue the IRS for the refund in either the U.S. District Court or the U.S. Court of Federal Claims.

[154] The amount of any overpayment, including interest thereon, may be credited against any other internal revenue tax liability of the taxpayer (sec. 6402(a)). In addition, the overpayment and any overpayment interest may be used to offset past due support payments (sec. 6402(c)), debts owed to other Federal agencies (sec. 6402(d)), and past due, legally enforceable State income tax obligations of residents of the same State (sec. 6402(e)).

[155] 1984-2 C.B. 501.

in the nature of a cash bond need not be refunded to the extent the Secretary determines that the assessment or collection of the tax determined would be in jeopardy, or that the deposit should be applied against another liability of the taxpayer in the same manner as an overpayment of tax.[156] If the taxpayer recovers the deposit prior to final determination and a deficiency is later determined, the taxpayer would not receive credit for the period in which the funds were held as a deposit. The taxable year to which the deposit in the nature of a cash bond relates must be designated, but the taxpayer may request that the deposit be applied to a different year under certain circumstances.[157]

Description of Proposal

In general

The proposal would allow a taxpayer to deposit cash with the IRS that subsequently could be used to pay an underpayment of income, gift, estate, generation-skipping, or certain excise taxes. Interest would not be charged on the portion of the underpayment that was paid by the deposited amount for the period the amount was on deposit. Generally, deposited amounts that had not been used to pay a tax could be withdrawn at any time if the taxpayer so requests in writing. The withdrawn amounts would earn interest at the applicable Federal rate to the extent they were attributable to a disputable tax.

The Secretary would be permitted to issue rules relating to the making, use, and return of the deposits.

Use of a deposit to offset underpayments of tax

Any amount on deposit could be used to pay an underpayment of tax that was ultimately assessed. If an underpayment were paid in this manner, the taxpayer would not be charged underpayment interest on the portion of the underpayment that was so paid for the period the funds were on deposit.

For example, assume a calendar year individual taxpayer deposits $20,000 on May 15, 2003, with respect to a disputable item on its 2002 income tax return. On April 15, 2005, an examination of the taxpayer's year 2002 income tax return is completed, and the taxpayer and the IRS agree that the taxable year 2002 taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and the taxpayer also pays the remaining $5,000. In this case, the taxpayer would owe underpayment interest from April 15, 2003 (the original due date of the return) to the date of payment (April 15, 2005) only with respect to the $5,000 of the underpayment that was not paid by the deposit. The taxpayer would owe underpayment interest on the remaining $20,000 of the underpayment only from April 15, 2003, to May 15, 2003, the date the $20,000 was deposited.

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[156] Rev. Proc. 84-58, sec. 4.02(1).

[157] *Id*. sec. 4.02(4).

Withdrawal of amounts

A taxpayer could request the withdrawal of any amount of deposit at any time. The Secretary would be required to comply with the withdrawal request unless the amount had been used already to pay tax or the Secretary properly determines that collection of tax is in jeopardy. Interest would be paid on deposited amounts that were withdrawn at a rate equal to the short-term applicable Federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal.[158] Interest would not be payable to the extent the deposit was not attributable to a disputable tax.

For example, assume a calendar year individual taxpayer receives a 30-day letter showing a deficiency of $20,000 for taxable year 2002 and deposits $20,000 on May 15, 2004. On April 15, 2005, an administrative appeal is completed, and the taxpayer and the IRS agree that the 2002 taxes were underpaid by $15,000. $15,000 of the deposit is used to pay the underpayment. In this case, the taxpayer would owe underpayment interest from April 15, 2003 (the original due date of the return) to May 15, 2004, the date the $20,000 was deposited. Simultaneously with the use of the $15,000 to offset the underpayment, the taxpayer requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed by the taxpayer from April 15, 2001, to May 15, 2002). This amount would be returned to the taxpayer with interest determined at the short-term applicable Federal rate from the May 15, 2004, to a date not more than 30 days preceding the date of the check repaying the deposit to the taxpayer.

Limitation on amounts for which interest may be allowed

Interest on a deposit that would be returned to a taxpayer would be allowed for any period only to the extent attributable to a disputable item for that period. A disputable item would be any item for which the taxpayer 1) has a reasonable basis for the treatment used on its return and 2) reasonably believes that the Secretary also has a reasonable basis for disallowing the taxpayer's treatment of such item.

All items included in a 30-day letter to a taxpayer would be deemed disputable for this purpose. Thus, once a 30-day letter had been issued, the disputable amount could not be less than the amount of the deficiency shown in the 30-day letter. A 30-day letter is the first letter of proposed deficiency that allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

Deposits are not payments of tax

A deposit would not be a payment of tax prior to the time the deposited amount was used to pay a tax. Thus, the interest received on withdrawn deposits would not be eligible for the proposed exclusion from income of an individual. Similarly, withdrawal of a deposit would not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

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[158] This 30-day period would be consistent with other determinations of interest owed to a taxpayer.

Effective Date

The proposal would apply to deposits made after the date of enactment. Amounts already on deposit as of the date of enactment would be treated as deposited (for purposes of applying this proposal) on the date the taxpayer identifies the amount as a deposit made pursuant to this proposal.

G. Authorize IRS to Enter into Installment Agreements that Provide for Partial Payment

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (sec. 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.[159]

Prior to 1998, the IRS administratively entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

Description of Proposal

The proposal would clarify that the IRS is authorized to enter into installment agreements with taxpayers that do not provide for full payment of the taxpayer's liability over the life of the agreement. The proposal also would require the IRS to review partial payment installment agreements at least every two years. The primary purpose of this review would be to determine whether the financial condition of the taxpayer had significantly changed so as to warrant an increase in the value of the payments being made.

Effective Date

The proposal would be effective for installment agreements entered into on or after the date of enactment.

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[159] Sec. 6331(k).

H. Extension of Transfers of Excess Pension Assets to Retiree Health Accounts

Reversions of defined benefit pension plan assets

Defined benefit pension plan assets generally may not revert to an employer before termination of the plan and the satisfaction of all plan liabilities. In addition, no reversion can occur unless the plan so provides. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is generally 20 percent, but increases to 50 percent if the employer does not maintain a replacement plan or make certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be fully vested. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan.

Use of excess plan assets for retiree health benefits

A qualified transfer of excess assets of a defined benefit pension plan may be made to a separate account that is part of such plan in order to provide for retiree health benefits. A qualified transfer does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Amounts transferred in a qualified transfer are not includible in the gross income of the employer and are not subject to the excise tax on reversions.[160] No deduction is allowed to the employer for a qualified transfer or the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Excess assets generally means the excess, if any, of the fair market value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 165 percent of the plan's current liability (for 2002), or (2) 125 percent of the plan's current liability. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts may not be used to provide retiree health benefits of key employees.

In order for the transfer to be qualified, accrued retirement benefits under the defined benefit pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation). In addition, under a cost maintenance requirement, the employer must maintain health care expenditures at a minimum

[160] Title I of the Employee Retirement Income Security Act ("ERISA") requires that plan participants, the Secretary of the Treasury, the Secretary of Labor, the plan administrator, and each employee organization representing plan participants must be notified 60 days in advance of a qualified transfer (ERISA sec. 103(e)). ERISA also provides that a qualified transfer is not a prohibited transfer under ERISA (ERISA sec. 408(b)(13) or a prohibited reversion of assets to the employer (ERISA sec. 403(c)(1)).

level (based on prior experience) for the year of the transfer and the following four years. No more than one qualified transfer may be made per year.

No transfer after December 31, 2005, is a qualified transfer.

Description of Proposal

The proposal would extend the provision permitting quailed transfers of excess defined benefit pension plan assets to provide retiree health benefits through December 31, 2012.

Effective Date

The provision would be effective on the date of enactment.

I. Clarification of Rules for Payment of Estimated Tax for Certain Deemed Asset Sales

Present Law

In certain circumstances, taxpayers can make an election under section 338(h)(10) to treat a qualifying purchase of 80 percent of the stock of a target corporation by a corporation from a corporation that is a member of an affiliated group (or a qualifying purchase of 80 percent of the stock of an S corporation by a corporation from S corporation shareholders) as a sale of the assets of the target corporation, rather than as a stock sale. The election must be made jointly by the buyer and seller of the stock and is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. An agreement for the purchase and sale of stock often may contain an agreement of the parties to make a section 338(h)(10) election.

Section 338(a) also permits a unilateral election by a buyer corporation to treat a qualified stock purchase of a corporation as a deemed asset acquisition, whether or not the seller of the stock is a corporation (or an S corporation is the target). In such a case, the seller or sellers recognize gain or loss on the stock sale (including any estimated taxes with respect to the stock sale), and the target corporation recognizes gain or loss on the deemed asset sale.

Section 338(h)(13) provides that, for purposes of section 6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under section 338(a)(1) shall not be taken into account. Some taxpayers may be taking the position that this exception applies to a section 338(h)(10) election and that when such an election is made, neither any stock sale nor any asset sale needs to be taken into account for estimated tax purposes.

Description of Proposal

The proposal would clarify section 338(h)(13) to provide that the exception for estimated tax purposes with respect to tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10).

Under the proposal, if a transaction eligible for the election under section 338(h)(10) occurs, estimated tax would be determined based on a stock sale unless and until there is an agreement of the parties to make a section 338(h)(10) election.

If at the time of the sale there is an agreement of the parties to make a section 338(h)(10) election, then estimated tax would be computed based on an asset sale. If the agreement to make a section 338(h)(10) election is concluded after the stock sale, such that the original computation was based on a stock sale, estimated tax would be recomputed based on the asset sale election.

No inference is intended as to present law.

Effective Date

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