[JOINT COMMITTEE PRINT]

PRESENT LAW AND BACKGROUND RELATING TO FEDERAL ENVIRONMENTAL TAX POLICY

SCHEDULED FOR HEARINGS

BY THE

COMMITTEE ON WAYS AND MEANS

ON MARCH 6-7 AND 14, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 1, 1990

U.S. GOVERNMENT PRINTING OFFICE

27-105 WASHINGTON : 1990 JCS-6-90

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

JOINT COMMITTEE ON TAXATION

101st CONGRESS, 2D SESSION

SENATE	*HOUSE*
LLOYD BENTSEN, Texas, *Chairman*	DAN ROSTENKOWSKI, Illinois, *Vice Chairman*
SPARK M. MATSUNAGA, Hawaii	SAM GIBBONS, Florida
DANIEL PATRICK MOYNIHAN, New York	J.J. PICKLE, Texas
BOB PACKWOOD, Oregon	BILL ARCHER, Texas
ROBERT DOLE, Kansas	GUY VANDER JAGT, Michigan

RONALD A. PEARLMAN, *Chief of Staff*
STUART L. BROWN, *Deputy Chief of Staff*
MARY M. SCHMITT, *Associate Chief of Staff (Law)*
BERNARD A. SCHMITT, *Associate Chief of Staff (Revenue Analysis)*

CONTENTS

INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on March 6–7 and 14, 1990, on Federal tax policy issues relating to the environment. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief description of present law and legislative background of current Federal tax provisions relating to the environment.

The first part of the pamphlet is an overview of present-law tax rules described in the pamphlet. The second part is a brief description of present law and legislative background of Federal tax provisions relating to the environment: (A) excise taxes on fuels and motor vehicles; (B) other environmental-related excise taxes; (C) income tax treatment of certain individual transportation and energy conservation expenses; (D) income tax treatment of natural resources; and (E) energy tax credits. The pamphlet does not discuss possible alternative Federal tax policy proposals or issues.

The Committee on Ways and Means, in announcing the hearings, stated that testimony was invited on the following subjects: [2]

1. The effect on air pollution and energy conservation of:
    a. an increase in the excise taxes on gasoline and diesel fuel,
    b. modification of employee parking subsidies,
    c. a Federal tax subsidy of van pools and transit passes,
    d. modification of the "gas guzzler" excise tax, and
    e. creation of a Federal tax subsidy for fuel efficient vehicles;
2. Ways in which the Federal tax system can be used to counter the effect of ozone on the Nation's agriculture and forests;
3. The effect on the environment of existing Federal tax subsidies of coal and oil production;
4. The effect on the creation of acid rain of a tax on the emission of sulfur dioxide and nitrogen oxide; [3]
5. The effect on water pollution of:
    a. an increase in the tax on inland waterway barge fuel, and
    b. a groundwater source pollution tax;
6. The desirability of the extension beyond September 30, 1990, of the Federal tax credits for solar, wind, and geothermal property; [4]
7. The desirability of the extension beyond December 31, 1990, of the Federal tax credit for the production of alternative fuels;
8. Other means by which the Federal tax system can encourage the production of alternative fuels;

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Federal Environmental Tax Policy* (JCS–6–90), March 1, 1990.

[2] See Committee on Ways and Means Press Release #23, February 1, 1990.

[3] For prior discussion of an excise tax on the emission of sulfur dioxide and nitrogen oxide, see, Joint Committee on Taxation, *Description of H.R. 2497 (Sulfur and Nitrogen Emissions Tax Act of 1987)* (JCS–20–87), September 9, 1987.

[4] A wind energy tax credit was allowed from October 1, 1978 through December 31, 1985.

9. The desirability of excise taxes on tropical timber imports and certain outdoor recreational equipment; and

10. Ways in which the Federal tax system can encourage recycling, including the denial of deductions for the costs of, and an excise tax upon, the harvesting of virgin materials, for example, old-growth redwoods.

Subsequent to the announcement of the Committee hearings, the Congressional Budget Office, among options for reduction of the Federal budget deficit,[5] has listed possible taxes on various sources of pollution in addition to those identified in the Committee hearing announcement. Among the taxes described in the CBO report are an excise tax on the emission of volatile organic compounds (VOCs) from stationary sources; an excise tax on the sale of new cars and light trucks based upon estimates of their emission of VOCs, carbon monoxide, and nitrogen oxides; an excise tax on the emission of water-born pollutants from publicly owned sewage treatment facilities and large industrial emitters; and an excise tax on the carbon content of fossil fuels.

[5] Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options—Part II*, February 1990.

I. OVERVIEW

There are a variety of present-law Federal excise and income tax provisions that relate to certain environmental issues. As described in Part II, these tax provisions include: (A) excise taxes on fuels and motor vehicles; (B) other environmental-related excise taxes; (C) income tax treatment of certain individual transportation and energy conservation expenses; (D) income tax treatment of natural resources; and (E) energy tax credits. This pamphlet does not discuss possible alternative Federal environmental tax policy proposals or issues.

Excise taxes on fuels and motor vehicles

Motor fuels taxes.—Federal excise taxes are imposed on gasoline, diesel fuel, and special motor fuels used in highway vehicles and motorboats. Revenues from the highway and motorboat fuels taxes are deposited in the Highway Trust Fund and Aquatic Resources Trust Fund, respectively. Revenues from taxes on noncommercial (general) aviation fuels (gasoline and nongasoline fuels) are deposited in the Airport and Airway Trust Fund.

Additional fuels taxes of 0.1 cent per gallon are imposed on highway and motorboat fuels, as well as for trains, commercial and noncommercial aircraft, and inland waterways commercial vessels. Revenues from these additional taxes are deposited in the Leaking Underground Storage Tank Trust Fund.

Also, a separate fuels tax is imposed on commercial vessels using specified U.S. inland or intracoastal waterways; revenues from this tax are deposited in the Inland Waterways Trust Fund.

Gas guzzler tax.—An excise tax is imposed on automobiles produced in or imported into the U.S. that do not meet statutory standards for fuel economy. The tax varies according to the fuel efficiency of the automobile model.

Other environmental-related excise taxes

Superfund taxes.—Taxes for the Hazardous Substance Superfund are imposed on (1) petroleum (domestic or imported crude oil and refined products), (2) listed hazardous chemicals, (3) imported substances containing or using chemical derivatives taxed under (2) above, and (4) modified alternative taxable income of corporations above $2 million.

Petroleum tax for Oil Spill Liability Trust Fund.—An excise tax of 5 cents per barrel is imposed on domestic crude oil and imported petroleum products (including imported crude oil). Revenues from this tax are deposited in the Oil Spill Liability Trust Fund.

Tax on ozone-depleting chemicals.—An excise tax is imposed on certain ozone-depleting chemicals sold or used by the manufacturer, producer or importer. A tax is also imposed on imported products if any ozone-depleting chemical is used as an input in the manufacture or production of such product. The amount of tax is determined by multiplying a base tax amount by an "ozone-depleting factor."

Tax on coal.—An excise tax is imposed on coal from underground and surface mines. Underground mined coal is taxed at a higher rate than surface mined coal. Revenues from the coal excise tax are deposited in the Black Lung Disability Trust Fund.

Taxes on sport fishing equipment, bows and arrows, and firearms.—Excise taxes are imposed on sport fishing equipment, bows and arrows, and firearms and ammunition. Revenues from the tax on sport fishing equipment are deposited in the Sport Fish Restoration Account of the Aquatic Resources Trust Fund. Revenues equivalent to the taxes on bows and arrows and firearms and ammunition are appropriated, in the fiscal year following receipt, to the Federal Aid to Wildlife Restoration Fund.

Income tax treatment of certain individual transportation and energy conservation expenses

Employer-subsidized commuting expenses.—Under prior law (1979–1985), certain employer-provided transportation ("van pooling") between an employee's residence and place of work was excludable from gross income. No exclusion was available to self-employed individuals.

Under present law, gross income does not include a *de minimis* fringe benefit, including employer-provided public transit passes, tokens, fare cards, and reimbursements for such items, provided that the value of the benefit does not exceed $15 per month. In addition, most employer-provided parking may be excluded as a working condition fringe benefit.

Payments by utilities for certain energy conservation expenses.—In 1989, the Internal Revenue Service stated that cash payments made by a utility company to its customers on the installation of an energy-saving heating system, which was purchased from a third party, are to be included in income.

Income tax treatment of natural resources

Oil and gas tax provisions.—Depletable costs incurred with respect to an oil, gas or geothermal property may be recovered using cost depletion. Alternatively, independent producers and royalty owners are permitted to claim percentage depletion on the production of domestic crude oil and domestic natural gas. Excess depletion (over cost depletion) is a preference item for the individual and corporate alternative minimum tax. Also, intangible drilling and development costs (IDCs) incurred with respect to domestic oil and gas wells may either be deducted in the year paid or incurred ("expensed") or may be capitalized and recovered through depletion or depreciation deductions. Certain IDCs are treated as tax preference items for the individual and corporate alternative minimum tax.

For purposes of the limitations on passive loss deductions, a working interest in an oil or gas property is not treated as a passive activity, whether or not the taxpayer materially participates.

Coal and other hard minerals.—Depletable costs incurred with respect to a coal or other hard mineral property may be recovered either by using cost depletion or percentage depletion. Excess depletion (over cost depletion) is a preference item for the individual or corporate alternative minimum tax. Also, taxpayers may elect to expense mine exploration costs and mine development costs.

Timber.—Only the direct costs of acquiring or growing timber must be capitalized and recovered through a depletion allowance or as a cost of timber sold. Indirect costs allocable to timber may be deducted for the year paid or incurred or, alternatively, may be added to the basis of the timber.

A taxpayer may elect to amortize over an 84-month period up to $10,000 of reforestation expenditures incurred during any taxable year. In addition, a 10-percent investment tax credit is allowed for up to $10,000 of reforestation expenditures incurred during any taxable year.

Under the law in effect before the enactment of the Tax Reform Act of 1986, the cutting of timber and the disposition of timber under a contract pursuant to which an economic interest was retained generally qualified for the favorable Federal income tax treatment that was accorded the sale or exchange of capital assets.

Contributions of qualified conservation interests.—Taxpayers who make qualified conservation contributions are allowed a deduction for Federal income, estate, and gift tax purposes. A "qualified conservation contribution" is defined as a contribution of certain real property interests (e.g., a restriction granted in perpetuity on the use of land) to a qualified organization exclusively for conservation purposes.

Energy tax credits

Solar, geothermal, and ocean thermal tax credits.—Nonrefundable business energy tax credits are allowed (through September 30, 1990) for solar, geothermal, and ocean thermal properties. A wind energy credit was allowed from October 1, 1978 through December 31, 1985.

Production credit for alternative fuels.—Alternative (nonconventional) fuels are eligible for a production credit equal to $3 per barrel of BTU oil barrel equivalent. The production credit is available for qualified fuels produced through December 31, 2000, if produced from a well drilled, or a facility placed in service, before January 1, 1991.

II. PRESENT LAW AND BACKGROUND

A. Excise Taxes on Fuels and Motor Vehicles

1. Motor Fuels Excise Taxes for Highway Vehicles, Motorboats and Noncommercial Aviation (secs. 4041, 4042, 4081, 4091, 9503, 9503 and 9508 of the Code)

Present Law

Separate excise taxes are imposed on gasoline, diesel fuel, and special motor fuels. A tax of 9 cents per gallon is imposed on gasoline and special motor fuels and a tax of 15 cents per gallon is imposed on diesel fuel used in highway vehicles. Revenues from these taxes are deposited in the Highway Trust Fund, except that revenues from motorboat fuels taxes are deposited in the Aquatic Resources Trust Fund.

Fuels used in commercial aviation, i.e., passenger and freight transportation, are exempt from the motor fuels taxes. Gasoline used in noncommercial (general) aviation is subject to a tax of 12 cents per gallon. Nongasoline general aviation fuels (generally jet fuels) are taxed at 14 cents per gallon. Revenues from these two taxes are deposited in the Airport and Airway Trust Fund.

A tax of 0.1 cent per gallon is imposed on gasoline, special motor fuels, and diesel fuel, including fuel used in nonhighway uses, and these revenues are deposited in the Leaking Underground Storage Trust Fund. (See separate description of this tax in item A.2., below.)

Fuels used in vessels engaged in commercial transportation on specified inland and intracoastal waterways are subject to a separate excise tax, receipts from which are deposited in the Inland Waterways Trust Fund. This excise tax is 11 cents per gallon for 1990, and the tax rate is scheduled to be increased annually until it becomes 20 cents per gallon beginning in 1995. The waterways fuel tax does not apply to marine water transportation. (See separate description of this tax in item A.3., below.)

Exemptions from some or all these taxes are provided for fuels sold for export, for use by State and local governments, and for use by nonprofit educational organizations. Fuels used in farming are exempt from the Highway Trust fund taxes. A partial exemption is provided from the Highway Trust Fund taxes for certain fuels blended with alcohol.[6]

[6] There is a 5 2/3 cents per gallon exemption for 10 percent or more alcohol-gasoline blend (sec. 4081(c)), a 6 cents per gallon exemption for methanol and ethanol fuels from other than petroleum or natural gas (sec. 4041(b)(2)), a 4 1/2 cents per gallon exemption for methanol and ethanol fuels from natural gas (sec. 4041(m)), and a 9 cents per gallon exemption for 10 percent or more alcohol-diesel blend (secs. 4041(k)(1) and 4091(c)). Methanol and ethanol fuels are alcohol fuels the content of which is at least 85 percent methanol, ethanol or other alcohol.

The Highway Trust Fund and motorboat taxes are scheduled to expire after September 30, 1993. The Airport and Airway Trust Fund taxes are scheduled to expire after December 31, 1990.

Legislative Background

Motor fuels taxes have been deposited in the Highway Trust Fund since enactment of the Highway Revenue Act of 1956, with exceptions for off-highway uses of such fuels. The highway and motorboat fuels taxes were increased from 4 cents per gallon to 9 cents per gallon in the Highway Revenue Act of 1982 ("1982 Act"), effective on April 1, 1983. The 1982 Act provided that one cent per gallon of the highway motor fuel tax revenues are to be set aside in a Mass Transit Account in the Highway Trust Fund for certain mass transit capital expenditures. The Deficit Reduction Act of 1984 provided for an increase in the highway diesel fuel tax to 15 cents per gallon, effective on July 1, 1984. Partial exemptions from the taxes on motor fuels used in highway vehicles have been enacted for fuels containing alcohol.

In 1980, P.L. 96–451 established the National Recreational Boating Safety and Facilities Improvement Fund (Boating Safety Fund) for transfer of taxes on gasoline and other fuels used in motorboats. Previously, the revenues equivalent to the motorboat fuels taxes were transferred from the Highway Trust Fund to the Land and Water Conservation Fund. The Deficit Reduction Act of 1984 replaced the Boating Safety Fund with an Aquatic Resources Trust Fund in the Internal Revenue Code, with two separate Accounts: Boating Safety Account and Sport Fish Restoration Account. For fiscal year 1991 and thereafter, a maximum of $70 million of motorboat fuels tax revenues may be deposited in the Boating Safety Account; any amounts in excess of $70 million and $1 million for the Land and Water Conservation Fund are deposited in the Sport Fish Restoration Account. Two-thirds of the Boating Safety Account revenues may be spent for State boating safety programs and one-third for Coast Guard operating expenses. Amounts in the Sport Fish Restoration Account may be spent for purposes of restoring and managing marine and fresh water sport or recreational fishing in the U.S. (See also item B.5., for discussion of other tax revenues for the Sport Fish Restoration Account.)

The noncommercial aviation fuel taxes were enacted so that general aviation users of the airport and airways system, which is financed through the Airport and Airway Trust Fund, could be assessed for their proportionate share of the costs of constructing and operating the system at rates consistent with general aviation use of the system. General aviation users of the system do not carry passengers or air freight for hire, and thus do not contribute to the Trust Fund through the air passenger ticket tax or the air freight tax. The Airport and Airway Trust Fund and the excise taxes were enacted initially in the Airport and Airway Revenue Act of 1970.

2. Fuels Taxes for Leaking Underground Storage Tank Trust Fund (secs. 4041(d), 4042, 4081, 4091, and 9508 of the Code)

Present Law

A tax of 0.1 cent per gallon is imposed on gasoline, diesel fuel, and special motor fuels sold by a producer or importer; other liquid fuels used in motor vehicles, motor boats, and trains; liquid aviation fuels; and fuels used in commercial transportation.[6a] This tax is imposed in addition to any other taxes on these substances.

The receipts from this 0.1 cent per gallon tax are deposited in the Leaking Underground Storage Tank Trust Fund. Amounts in the Trust Fund are generally available for cleanup and related costs associated with leaking underground storage tanks containing petroleum products where no financially solvent owners can be found.

The tax is scheduled to expire after December 31, 1991. However, the tax could cease to apply earlier. It would terminate on the last day of the month in which the net revenues payable into the Trust Fund are estimated by the Secretary of the Treasury to equal or exceed $500 million.[7]

Legislative Background

The Leaking Underground Storage Tank Trust Fund and the related tax were enacted as part of the Superfund Revenue Act of 1986, effective on January 1, 1987.

3. Fuels Tax for Inland Waterways Trust Fund (secs. 4042 and 9504 of the Code)

Present Law

An excise tax is imposed on fuel used by commercial vessels using specified inland and intracoastal waterways. These waterways include the Mississippi River upstream from Baton Rouge, Louisiana, the Mississippi River tributaries, the Gulf and Atlantic Intracoastal Waterways, and the Tennessee-Tombigbee Waterway.

The tax rate is 11 cents per gallon for 1990, 13 cents per gallon for 1991, 15 cents per gallon for 1992, 17 cents per gallon for 1993, 19 cents per gallon for 1994, and 20 cents per gallon for 1995 and thereafter. The tax does not apply to deep-draft ocean-going vessels, passenger or fishing vessels, or certain barges. The tax revenues are deposited in the Inland Waterways Trust Fund.

Legislative Background

The Inland Waterways Trust Fund and fuels tax were enacted in the Inland Waterways Revenue Act of 1978. Under the 1978 Act, the fuels tax rate was set at 4 cents per gallon for October 1, 1980–September 30, 1981, with scheduled increases in the tax rate to 6 cents per gallon for October 1, 1981–September 30, 1983, to 8 cents

---

[6a] For qualified methanol or ethanol fuels, the tax rate is 0.05 cent per gallon. (Sec. 4041(b)(2)).

[7] The Treasury Department currently estimates that the $500 million revenue cap will be reached in August 1990. Thus, the tax would terminate at the end of August 1990, unless Congress increases the revenue cap.

per gallon for October 1, 1983–September 30, 1994, and to 10 cents per gallon thereafter. The Harbor Maintenance Revenue Act of 1986 provided for a modified rate increase schedule: to 10 cents per gallon for January 1, 1989–December 31, 1989, to 11 cents per gallon for January 1, 1990–December 31, 1990, and to the present-law rates mentioned above. The 1986 Act also added the Tennessee-Tombigbee Waterway to the listed of covered waterways subject to the tax, effective on January 1, 1987.

Amounts in the Trust Fund are available, as provided by appropriations Acts, for making construction and rehabilitation expenditures for navigation on the designated inland and intracoastal waterways (such as locks and dams and other eligible navigational expenditures).

4. Gas Guzzler Excise Tax (sec. 4064 of the Code)

Present Law

An excise tax is imposed on automobiles that do not meet statutory standards for fuel economy. The amount of tax varies according to the fuel efficiency of a model of automobile. No gas guzzler tax is imposed if the fuel economy of the automobile model is at least 22.5 miles per gallon (mpg), as determined by the Environmental Protection Agency. For automobiles that do not meet that standard, the tax begins at $500 and increases to $3,850 for the automobile models that are less fuel efficient than 12.5 mpg.

Fuel economy rating (in miles per gallon):	*Tax per vehicle*
At least 22.5	0
At least 21.5 but less than 22.5	$500
At least 20.5 but less than 21.5	650
At least 19.5 but less than 20.5	850
At least 18.5 but less than 19.5	1,050
At least 17.5 but less than 18.5	1,300
At least 16.5 but less than 17.5	1,500
At least 15.5 but less than 16.5	1,850
At least 14.5 but less than 15.5	2,250
At least 13.5 but less than 14.5	2,700
At least 12.5 but less than 13.5	3,200
Less than 12.5	3,850

Legislative Background

The gas guzzler tax was enacted in order to encourage gasoline conservation as part of the national energy policy established in the Energy Tax Act of 1978, effective with respect to 1980 and later model year automobiles. As enacted, both the rate of the tax and the fuel economy standards increased for each model year from 1980 through 1986. Neither the rates nor the fuel economy standards have increased since model year 1986.

B. Other Environmental-Related Excise Taxes

1. Superfund Taxes and Trust Fund (secs. 59A, 4611, 4661, 4671, and 9507 of the Code)

Present Law

Four different Superfund taxes are imposed under the Code. These are in general:

(1) A tax on petroleum, imposed at a rate of 9.7 cents per barrel, on domestic or imported crude oil or refined products;

(2) A tax on listed hazardous chemicals, imposed at a rate that varies from $0.24 to $10.13 per ton;

(3) A tax on imported substances that contain or use chemical derivatives of one or more of the hazardous chemicals described in (2) above; and

(4) An environmental tax equal to 0.12 percent of the amount of modified alternative taxable income of a corporation that exceeds $2 million.

The receipts from these taxes are deposited in the Hazardous Substance Superfund. Amounts in this Trust Fund are generally available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment.

In general, these taxes are scheduled to expire after December 31, 1991. However, these taxes would cease to apply earlier if the unobligated balance in the Trust Fund exceeds $3.5 billion on specified dates, or if the Secretary of the Treasury estimates that more than $6.65 billion of these taxes have been credited into the Trust Fund.

Legislative Background

The Superfund taxes and Trust Fund were enacted as part of the Superfund Revenue Act of 1986. The rate of the tax on domestic or imported crude oil or refined products was modified in 1989 to the present-law rate of 9.7 cents per barrel in the Steel Trade Liberalization Program Implementation Act.

2. Petroleum Excise Tax for Oil Spill Liability Trust Fund (secs. 4611(c)(2)(B), 4611(f), and 9509 of the Code)

Present Law

An excise tax of 5 cents per barrel is imposed on domestic crude oil and imported petroleum products (including imported crude oil) for the purpose of funding the Oil Spill Liability Trust Fund. The excise tax on domestic crude oil is imposed on the operator of any United States refinery receiving such crude oil, while the tax on imported petroleum products is imposed on the person importing the product into the United States for consumption, use, or warehousing.

The Oil Spill Liability Trust Fund financing rate is scheduled to expire on January 1, 1995. However, if the Secretary of the Treasury determines that as of the end of a calendar quarter the unobligated balance of the Oil Spill Liability Trust Fund exceeds $1 billion, no tax will be imposed during the following quarter. Should the Secretary subsequently determine that the unobligated balance of the Oil Spill Liability Trust Fund is less than $1 billion, the tax will be reimposed at a rate of 5 cents per barrel beginning the quarter commencing 90 days after the date of the close of the quarter for which such a determination was made.

Generally, expenditures from the Oil Spill Liability Trust Fund require authorizing legislation which has yet to be enacted.[8] Certain costs incurred by the Federal Government for oil spill removal are authorized by the Federal Water Pollution Control Act and the Intervention on the High Seas Act, and therefore are permissible Trust Fund expenditures. Repayable advances could be made to the Trust Fund from the general fund of the Treasury in a maximum outstanding amount of $500 million. The maximum amount which could be paid from the Trust Fund for any single incident is $500 million, no more than $250 million of which could be used to pay for natural resource damage claims.

Legislative Background

The Comprehensive Environmental Responses, Compensation, and Liability Act of 1980 established the Oil Spill Liability Trust Fund financing rate at 1.3 cents per barrel.[9] However, the tax was never imposed because qualified legislation authorizing expenditures from the Trust Fund was not enacted. The Omnibus Budget Reconciliation Act of 1989 raised the Oil Spill Liability Trust Fund financing rate to 5 cents per barrel and imposed the tax effective January 1, 1990, without requiring further legislation to authorize expenditures. The Congress concluded it was necessary to begin to collect the tax in order to have necessary funds available to clean up future oil spills.[10]

3. Excise Tax on Ozone-Depleting Chemicals (sec. 4681 of the Code)

Present Law

In general

An excise tax is imposed on certain ozone-depleting chemicals sold or used by the manufacturer, producer, or importer. The Code also imposes a tax on imported products if any ozone-depleting chemical was used as an input in the manufacture or production of such product. The amount of tax is determined by multiplying a base tax amount by an "ozone-depleting factor."

Ozone-depleting chemicals

Ozone-depleting chemicals which are subject to tax are:

CFC–11
CFC–12

---

[8] The Code (sec. 4611(f)) requires that the authorizing legislation must be substantially identical to subtitle E of title VI, or subtitle D of title VIII, of H.R. 5300 of the 99th Congress as passed by the House of Representatives.

[9] Under the 1980 Act, the tax was scheduled to expire after December 31, 1991, or earlier, if Trust Fund tax receipts reached $300 million.

[10] See Conference Report on H.R. 3299, House Report 101–386, pp. 603–604, and House Report 101–247, p. 1330.

CFC-113
CFC-114
CFC-115
Halon-1211
Halon-1301
Halon-2402

The chemicals subject to tax are those identified as ozone-depleting under the Montreal protocol as in effect on September 14, 1989. Subsequent changes to the list of ozone-depleting chemicals under the Montreal protocol will not change the list of chemicals subject to tax without further Congressional action.

Base tax amount

For calendar years 1990 and 1991, the base tax amount is $1.37 per pound of ozone-depleting chemical; for 1992, the base tax amount is $1.67 per pound; and for 1993 and 1994, the base tax amount is $2.65 per pound. For calendar years after 1994, the base tax amount is increased by $0.45 per pound per year.

Ozone-depleting factor

The ozone-depleting factor reflects the potential ozone depletion which results from one kilogram of a given chemical compared to the ozone depletion which results from one kilogram of CFC-11 (trichlorofluoromethane). The table below lists the ozone-depleting factors for the ozone-depleting chemicals which are subject to tax.

Ozone-depleting chemical	Ozone-depleting factor:
CFC-11	1.0
CFC-12	1.0
CFC-113	0.8
CFC-114	1.0
CFC-115	0.6
Halon-1211	3.0
Halon-1301	10.0
Halon-2402	6.0

The ozone-depleting factors are those identified in the Montreal protocol as in effect on September 14, 1989. Subsequent changes to the list of ozone-depleting factors under the Montreal protocol will not change the list of ozone-depleting factors for purpose of computation of the tax without further Congressional action.

Reduced rate of tax for certain chemicals

For chemicals used in rigid foam insulation, and for Halon-1211, Halon-1301, and Halon-2402, the tax for 1990-1993 is the product of the base tax rate multiplied by the ozone-depleting factor, multiplied by an "applicable percentage". For 1990, the applicable percentage is zero. The table below presents the applicable percentages for 1991-1993 by chemical.

Chemical	Applicable percentage		
	1991	1992	1993
Halon-1211	6.0	5.0	3.3
Halon-1301	1.8	1.5	1.0
Halon-2402	3.0	2.5	1.6
Chemicals used in rigid foam insulation	18.0	15.0	10.0

Commencing in 1994, regular tax rates apply for these chemicals.

Exemptions and exceptions from tax

Feedstock chemicals.—The tax does not apply to feedstock chemicals used in the production or manufacture of other ozone-depleting or non-ozone-depleting chemicals. This exception applies only to chemicals used as feedstock in such a way that the ozone-depleting chemical is entirely consumed in the production of another chemical. To the extent that production of another chemical involves releasing an ozone-depleting chemical into the atmosphere, the feedstock exception does not apply.

Recycled chemicals.—The tax imposed does not apply to any ozone-depleting chemical which is diverted or recovered in the United States as part of a recycling process. This exception does not apply to any ozone-depleting chemical recovered by the manufacturer as part of the original manufacturing process.

Exported chemicals.—Exported ozone-depleting chemicals generally are subject to tax, although producers of ozone-depleting chemicals may export a certain percentage of their annual production free of tax. The percentage of annual production which may be exported free of tax is determined under regulations promulgated by the Environmental Protection Agency.[11]

Tax on imported derivative products

The tax on ozone-depleting chemicals applies to any product or substance imported into the United States in which a taxable ozone-depleting chemical was used in the manufacture or production. The amount of tax imposed on such imported products is the amount of tax which would have been imposed on the ozone-depleting chemicals used in the manufacture or production of the product had the product been manufactured in the United States.

The Secretary of the Treasury may calculate the tax liability on data provided by the importer, or when such data is insufficient or lacking, the Secretary of the Treasury may calculate the tax liability based on the standards of use of such chemicals in the equivalent domestic industry. If necessary, the Secretary of the Treasury may impose the tax at a rate of 5 percent on the value of the imported product.

The Code grants the Secretary of the Treasury regulatory authority to exempt *de minimis* amounts of ozone-depleting chemicals

[11] See, 40 C.F.R. part 82.

from tax upon import. However, this *de minimis* exception does not apply with respect to any product in which any ozone-depleting chemical is used for purposes of refrigeration or air conditioning, creation of an aerosol or foam, or in the manufacture of electronic components.

Legislative Background

The excise tax on ozone-depleting chemicals was enacted as part of the Omnibus Budget Reconciliation Act of 1989, effective for chemicals sold or used after December 31, 1989.

In the 1989 budget reconciliation provisions (included in the House Committee on the Budget Report on H.R. 3299), the Committee on Ways and Means expressed its concern for depletion of the earth's ozone layer and recommended the tax as a way to "permit market forces to aid the work of finding substitutes and fostering reduced use of ozone-depleting chemicals." [12]

4. Excise Tax on Coal (secs. 4121 and 9501 of the Code)

Present Law

An excise tax is imposed on coal (except lignite) from mines in the United States. Receipts from the tax are credited to the Black Lung Disability Trust Fund and are used to fund benefit payments to eligible coal miners.

The current tax rates on domestic coal are $1.10 per ton on coal from underground mines, and $0.55 per ton on coal from surface mines. The tax is not to exceed 4.4 percent of the price of the coal when sold by the producer.

These tax rates are temporary rates which will decline to prior tax rates of $.50 per ton of underground mined coal, $.25 per ton of surface mined coal, and a ceiling of 2 percent of the producer's selling price. The temporary increases will terminate on the earlier of January 1, 2014, or January 1 of any year if there is no balance of repayable advances in the Black Lung Disability Trust Fund and no unpaid interest on advances to the trust fund.

Legislative Background

The excise tax and the Black Lung Disability Trust Fund were enacted in the Black Lung Benefits Revenue Act of 1977 when the tax rates of $.50 cents and $.25 cents per ton and the 2 percent ceiling were set. In amendments enacted in the Black Lung Benefits Revenue Act of 1981, the tax rates and ceiling were doubled to $1.00 and $.50 cents per ton and 4 percent. In the Consolidated Omnibus Budget Reconciliation Act of 1985, the tax rates were increased to the current level, effective for the period January 1, 1986–December 31, 1995. Under the 1981 and 1985 amendments, the higher tax rates and ceiling were to revert to the initial amounts on January 1, 1996, or earlier if the Trust Fund became solvent before that date. The date for a reversion to the initial tax rates and ceiling was changed to January 1, 2014, in the Omnibus Budget Reconciliation Act of 1987.

---

[12] House Report 101-247, p. 1333.

5. Excise Taxes on Sport Fishing Equipment, Bows and Arrows, and Firearms (secs. 4161(a), 4161(b), 4181, and 9504 of the Code)

Present Law

Fishing equipment

A 10-percent manufacturer's excise tax is imposed on sport fishing equipment; also, a 3-percent excise tax is imposed on electric outboard motors and certain sonar fish finders [13] (sec. 4161(a)). Revenues from these taxes are deposited in the Sport Fish Restoration Account in the Aquatic Resources Trust Fund.

Bows and arrows

An 11-percent manufacturer's excise tax is imposed on bows having a draw weight of 10 pounds or more and on arrows suitable for use in a taxable bow (sec. 4161(b)). Taxable bows include crossbows. The tax is also imposed on related parts or accessories (including arrow quivers). Revenues from this tax are appropriated in the year following receipt to the Federal Aid to Wildlife Restoration Fund (16 U.S.C. 669b).

Firearms

Manufacturer's excise taxes are imposed on pistols and revolvers (10 percent), firearms [14] other than pistols and revolvers (11 percent), and ammunition (11 percent) (sec. 4181). Revenues from these taxes are appropriated in the year following receipt to the Federal Aid to Wildlife Restoration Fund (16 U.S.C. 669b).

Legislative Background

Fishing equipment

The Deficit Reduction Act of 1984 (1984 Act) expanded the articles subject to the 10-percent excise tax on sport fishing equipment, and added the tax on electric boat motors and sonar fish finders. The 1984 Act also established the Sport Fish Restoration Account [15] in a new Aquatic Resources Trust Fund. Amounts in this account may be spent for purposes of restoring and managing marine and fresh water sport or recreational fishing in the U.S.

Under the "Dingell-Johnson" Act of 1950, revenues attributable to the tax on fishing equipment were appropriated for Federal-State fish conservation programs. The fishing equipment tax originated in 1917 at 3 percent, was increased to 10 percent in 1919, repealed in 1922, reimposed at 10 percent in 1983, repealed in 1938, reimposed at 10 percent in 1941, was 15 percent during 1951–1954, and 10 percent after 1954.

---

[13] The tax on fish finders is limited to a maximum of $30 per item.

[14] The other firearms include regular rifles and shotguns. The 11-percent tax does not apply to machine guns, short-barrelled firearms, explosive devices, and certain concealable weapons, which are subject to separate taxes under sections 5811 and 5821.

[15] In addition to the revenues from the tax on sport fishing equipment, the Sport Fish Restoration Account is to receive any motorboat fuels tax revenues in excess of the maximum available for the Boating Safety Account in the Trust Fund and Land and Water Conservation Fund ($70 million and $1 million per year, respectively, for fiscal year 1991 and after).

Bows and arrows

The excise tax on bows and arrows and related parts and accessories was enacted in P.L. 95-588, effective on July 1, 1974. Beginning with fiscal year 1975, revenues from this tax were available for appropriation to the Federal Aid to Wildlife Restoration Fund for State wildlife restoration and management projects.

Firearms

Excise taxes were first imposed on sport firearms and ammunition in 1918 at 10 percent. The 10-percent tax was repealed in 1926 and reimposed for 1932-1940; after 1940, the tax has been 11 percent. The excise tax on pistols and revolvers was imposed at 10 percent in 1926, increased to 11 percent during 1940-1954, and has been 10 percent since then.

In 1937, legislation provided that the revenues from the taxes on sport firearms and ammunition be appropriated to the Federal Aid to Wildlife Restoration Fund. In 1970, P.L. 91-503 added the revenues from the tax on pistols and revolvers to the Fund, beginning in fiscal year 1971. Such funds are appropriated in the fiscal year following receipt for State wildlife restoration and management projects.

C. Income Tax Treatment of Certain Individual Transportation and Energy Conservation Expenses

1. Tax Treatment of Certain Employer-Subsidized Commuting Expenses (secs. 124 and 132 of the Code)

Prior and Present Law

Exclusion for van pool benefits

Under prior law, certain employer-provided transportation ("van pooling") between an employee's residence and place of work was excludable from gross income (Code sec. 124). In order to be eligible for the exclusion, the transportation was required to be provided in a commuter highway vehicle that was capable of carrying at least 9 adults (including the driver) and substantially all the use of which was for the purpose of transporting employees to and from work. The number of employees transported on a regular basis had to be at least equal to one-half of the maximum number of adults (including the driver) that the vehicle was designed to carry.

In order to be excludable from the income of the employee, the van pool transportation had to be provided under a separate written plan of the employer that was not discriminatory in favor of officers, shareholders, or highly compensated employees. In addition, the plan was required to provide that the benefit was in addition to (and not in lieu of) any compensation otherwise payable to the employee. No exclusion was available to a self-employed individual.

The exclusion for van pool benefits was available with respect to benefits provided in taxable years beginning after December 31, 1978, and before January 1, 1986.

Fringe benefit exclusion for public mass transit passes

Under present law, gross income does not include a fringe benefit that qualifies as a de minimis fringe (sec. 132(e)). In general, a de minimis fringe is any property or service the value of which is (after taking into account the frequency with which similar fringe benefits are provided by the employer) so small as to make accounting for it unreasonable or administratively impracticable. Employer-provided transit passes, tokens, fare cards, and reimbursements for such items are considered a de minimis fringe if the employer-provided value of the benefit does not exceed $15 per month. This exclusion does not apply to the provision of any benefit to defray public transit expenses incurred for personal travel other than commuting. If the benefit exceeds $15 per month, then the total value of the benefit is includible in income.

Fringe benefit exclusion for parking

The value of parking provided to an employee on or near the business premises of the employer generally is excludable from the employee's gross income as a working condition fringe benefit (Code sec. 132(h)(4)). This exclusion applies whether or not the employer owns or rents the parking facility or parking space. Certain employer reimbursements of an employee's parking expenses may also be excluded from the employee's gross income.

Legislative Background

Exclusion for van pool benefits

The exclusion for certain employer-provided van pool benefits was added to the Code in the Energy Tax Act of 1978. The provision was included because an increasing number of employers were providing their employees with transportation to and from work by van. The Congress believed that it was appropriate to encourage employer-provided van pooling because such transportation saves energy and believed it desirable to encourage this activity by providing a rule that the value of such transportation in excess of its cost to the employee did not constitute income to the employee.

An exclusion for van pool benefits similar to the exclusion available under prior law was included in the 1989 budget reconciliation provisions as approved by the Senate Finance Committee (included in S. 1750 as reported by the Senate Budget Committee). The provision was deleted from the bill by Senate floor amendment.

Exclusion for public transit passes and parking

Code section 132, providing the exclusion with respect to de minimis and working condition fringe benefits was added to the Internal Revenue Code by the Deficit Reduction Act of 1984 (DEFRA). With its enactment the Congress sought to clarify the treatment of employer-provided fringe benefits for income tax purposes.

The exclusion for de minimis fringes was included because Congress believed that as a matter of administrative convenience, an employer should not have to account for certain fringe benefits if it would be unreasonable to require such accounting in light of the small value of such benefits. The legislative history to DEFRA provided that certain transit passes were to be treated as de minimis fringes.

The exclusion for working condition fringe benefits, including employer-provided parking, was included in DEFRA because the Congress believed that the value of employer-provided property or services should be excluded by the employee to the extent that the costs of such benefit would have been deductible as an ordinary and necessary business expense had the employee paid for such property or services.

The treatment of employer-subsidized transit passes was clarified in the legislative history to the Tax Reform Act of 1986 so that reimbursements to cover the cost of commuting by public transit could qualify as a de minimis fringe, as long as the reimbursement (and the value of other employer-subsidized transit passes) did not exceed $15 per month.

A modification to the exclusion for transit passes was included in the 1989 budget reconciliation provisions as approved by the Senate Finance Committee (included in S. 1750 as reported by the Senate Budget Committee). Under the provision, the exclusion for transit passes would no longer have been a de minimis fringe. However, an employee could have excluded up to $15 in benefits provided or subsidized by the employer without regard to the total value of the employer-provided transit passes received by the employee. In addition, the exclusion would have been available only if the benefit was provided under a separate written plan that did not discriminate in favor of highly compensated employees, and if the plan provided that the benefit was in addition to (and not in lieu of) any compensation otherwise payable to the employee. The provision was deleted from the bill by Senate floor amendment.

2. Tax Treatment of Payments by Utilities for Certain Individual Energy Conservation Expenditures

Present Law

Under section 61, gross income is defined as all income from whatever source it may be derived, except when the Internal Revenue Code provides otherwise.

Grants are included in income unless the Code provides an exception. For example, a grant received by a taxpayer from a State under the State's residential solar hot water program after installing a HUD approved solar hot water system in the taxpayer's principal residence is includible in gross income because no exemption has been provided in the Code.

A rebate may be excluded from gross income when it is received by a buyer of a product or service directly from the seller. In such a situation, the rebate is treated as a reduction in the price of the product or service.

On the basis of court decisions and the historic pattern of reasoning in the rulings it has issued, the Internal Revenue Service has reached the conclusion that a rebate may not be considered as nontaxable unless these characteristics are present: (1) the rebate is based on the item's purchase price; (2) the manufacturer of the item or a dealer in the item must offer the rebate; and (3) the recipient of the rebate must be able to negotiate the purchase price in an arm's length transaction.

In 1989, the IRS stated that cash payments made by a utility company to its customers on the installation of an energy-saving heating system, which was purchased from a third party, are to be included in income.[16]

Legislative Background

There is no legislation which has excluded from income rebate payments made by a third party to a participant in a sales transaction because the third party will benefit from the buyer's use of the items purchased in the transaction.

In analogous circumstances, with respect to the basis for residential energy tax credits, Congress has legislated that the basis for the tax credit does not include portions financed by any governmental subsidy. In the Crude Oil Windfall Profit Tax Act of 1980, the provisions of the residential energy tax credit were amended to provide that the portion of residential expenditures for energy conservation or renewable energy property which is financed by subsidized energy financing is not eligible for a tax credit. Further, the expenditure limits on energy conservation and renewable energy source property for a particular dwelling are reduced by the portion of expenditures financed by subsidized energy financing, as

---

[16] Technical Advice Memorandum, LTR 8924002, February 27, 1989.

well as by the amount of nontaxable Federal, State or local government grants used to purchase the energy conservation or renewable energy source property.

D. Income Tax Treatment of Natural Resources

1. Oil and gas tax provisions

a. Depletion (secs. 611–614 of the Code)

Present Law

Cost depletion

Depletable costs incurred with respect to an oil, gas, or geothermal property may be recovered using cost depletion. Under the cost method of depletion, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units produced or sold from that property during the taxable year to the estimated number of unrecovered (or unsold) units remaining at the beginning of the taxable year.

Percentage depletion

Under present law, independent producers and royalty owners are permitted to claim percentage depletion on the production of domestic crude oil and domestic natural gas. A percentage depletion deduction for a taxable year is claimed with respect to an oil or gas property in lieu of a deduction based on cost depletion if the percentage depletion deduction exceeds the taxpayer's allowable cost depletion deduction for that property. Percentage depletion is computed by multiplying the gross income from the property for a taxable year by a specified percentage. The specified percentage with respect to a domestic oil or gas property is 15 percent.

The allowance for percentage depletion is subject to several limitations. First, an independent producer or royalty owner can only claim percentage depletion on its combined average daily production of domestic crude oil and domestic natural gas that does not exceed 1,000 barrels (or an equivalent amount of natural gas). Second, percentage depletion is further limited (on a property by property basis) to an amount not in excess of 50 percent of the taxpayer's net taxable income from the property, computed without a deduction for depletion (the "net income limitation"). Finally, a taxpayer's overall deduction for percentage depletion is limited to an amount that is equal to 65 percent of the taxpayer's pre-depletion taxable income for the taxable year (the "taxable income limitation").

A taxpayer is prohibited from claiming percentage depletion with respect to an interest in any proven oil or gas property that was transferred after December 31, 1974. A property is considered a proven oil or gas property if at the time of the transfer, the principal value of the property had been demonstrated by prospecting or exploration or discovery work.

Unlike the deduction for cost depletion, which is computed with respect to the taxpayer's adjusted basis in the depletable property, the deduction for percentage depletion is based solely on gross income from the property and is not dependent on, or limited to, the property's adjusted basis. Thus, the deduction for percentage depletion often allows an aggregate amount of deductions in excess of the total amount of depletable costs that the taxpayer incurred with respect to a particular property. Such a deduction is generally referred to as "excess depletion" and it constitutes an item of tax preference for purposes of computing the individual or corporate alternative minimum tax.

Percentage depletion is also permitted with respect to any natural gas that is produced from geopressured brine from any well which was drilled between September 30, 1978 and January 1, 1984. The percentage depletion rate for natural gas from geopressured brine is 10 percent.

Legislative Background

Percentage depletion was originally enacted as part of the Revenue Act of 1926. The purpose of the percentage depletion deduction was generally to provide an incentive for the development of natural resources and to subsidize taxpayers engaged in extractive industries due to the financial risks associated with these enterprises.

The oil and gas percentage depletion rate was originally set at 27.5 percent. The Tax Reform Act of 1969 reduced this rate to 22 percent. The rate was phased down by the Tax Reform Act of 1975 ("the 1975 Act") to the present rate of 15 percent. In addition, the 1975 Act repealed the oil and gas percentage depletion deduction for taxpayers other than independent producers and royalty owners; in the case of such persons, percentage depletion was limited to average daily production of oil and gas of up to 1,000 barrels.

b. Intangible drilling and development costs (sec. 263(c) of the Code)

Present Law

IDCs generally

Under present law, intangible drilling and development costs ("IDCs") incurred with respect to domestic oil and gas wells may either be deducted in the year paid or incurred ("expensed") or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate) at the election of the taxpayer (sec. 263(c)). In general, IDCs include expenditures incident to and necessary for the drilling and the preparation of wells for the production of oil or gas (or geothermal energy), which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property. IDCs include amounts paid for labor, fuel, repairs, hauling, supplies, etc., to clear and drain the well site, construct an access road, and do such survey and geological work as is necessary to prepare for actual drilling. Other IDCs include costs of labor, etc., necessary to construct derricks, tanks, pipelines, and other physical structures necessary to drill the wells and prepare them for production. Finally, IDCs may be paid or accrued to drill, shoot, and clean the wells. IDCs also include amounts paid or accrued by the property operator for drilling and development work done by contractors under any form of contract.[17]

Only persons holding an operating interest in a property are entitled to deduct IDCs. This includes an operating or working inter-

[17] See, Treas. Reg. sec. 1.612-4 (pertaining to oil and gas wells) and sec. 1.612-5 (pertaining to geothermal wells).

est in any tract or parcel of oil, gas, or geothermal property, either as a fee owner, or under a lease or any other form of contract granting working or operating rights. In general, the operating interest in an oil or gas property must bear the cost of developing and operating the property. The term operating interest does not include royalty interests or similar interests such as production payment rights or net profits interests.

If IDCs are capitalized, a separate election may be made to deduct currently IDCs paid or incurred with respect to non-productive wells ("dry holes"), in the taxable year in which the dry hole is completed. Thus, a taxpayer has the option of capitalizing IDCs for productive wells while expensing those related to dry holes.

In the case of a corporation that is an "integrated oil company",[18] the allowable deduction with respect to IDCs that the taxpayer has elected to expense is reduced by 30 percent (sec. 291(b)). The disallowed amount is required to be amortized over a 60-month period, starting with the month in which the costs are paid or incurred. Amounts paid or incurred with respect to non-productive wells (dry hole costs) are not subject to this capitalization requirement.

IDCs paid or incurred with respect to oil, gas, or geothermal wells located outside of the United States are required to be capitalized and, at the election of the taxpayer, may be recovered in either of two manners (sec. 263(i)). A taxpayer can elect to include foreign IDCs in the adjusted basis of the property and thus recover such costs through depletion or depreciation (as appropriate). Alternatively, such capitalized costs can be recovered ratably over the 10-taxable year period beginning with the taxable year during which the costs are paid or incurred. The election to expense IDCs related to a dry hole applies to foreign IDCs as well as to domestic IDCs.

Deductible IDCs are excepted from the rules that require capitalization and inclusion in inventory costs of certain expenses ("the uniform capitalization rules") (sec. 263A(c)(3)).

IDCs and minimum tax preference

For purposes of the individual and corporate alternative minimum tax, certain IDCs are treated as tax preference items (sec. 57(a)(2)). Generally, the amount of tax preference equals the difference between the amount of the taxpayer's "excess IDCs" for the taxable year and 65 percent of the taxpayer's net income from oil, gas, and geothermal properties (without reduction for excess IDCs) for the taxable year. The term excess IDCs means the amount equal to the excess of IDCs (other than IDCs related to dry holes) deducted for the taxable year over the amount which would have been allowable as a deduction if all IDCs had been capitalized and amortized ratably over a 120-month period beginning with the month during which production from the well first occurs.

For purposes of both the regular tax and the alternative minimum tax, a taxpayer is permitted to elect to capitalize any portion of its IDCs, otherwise deductible for the taxable year in which paid

[18] An integrated oil company, for purposes of this provision, is any producer that is not an independent producer (as defined for the purposes of percentage depletion (sec. 613A)).

or incurred, and deduct such costs ratably over the 60-month period beginning with the month the costs were paid or incurred (sec. 59(e)).

Legislative Background

The statutory provision which directed Treasury to prescribe regulations granting taxpayers an option to elect to expense IDCs was first enacted into the Code in 1954. Although there was no specific provision in the Code, prior to 1954, for the expensing of IDCs, Treasury regulations had granted such an election, and these regulations had been held valid by the courts. More recent legislation has been designed to limit the application of the election to expense these costs. For example, the Tax Equity and Fiscal Responsibility Act of 1982 ("the 1982 Act") established the provision which requires integrated oil companies to capitalize a portion of their otherwise deductible IDCs. The 1982 Act provision was since amended by the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986 ("the 1986 Act") to both increase the percentage of IDCs required to be capitalized and to make longer the period for amortization of those capitalized costs. Also, the 1986 Act added to the Code the provision requiring capitalization of foreign IDCs.

c. Passive loss rules for oil and gas working interests (sec. 469(c)(3) of the Code)

Present Law

Present law provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Suspended losses are carried forward and treated as deductions from passive activities in the next year. Suspended losses from a passive activity are allowed in full when the taxpayer disposes of his entire interest in that activity to an unrelated party in a transaction in which all realized gain or loss is recognized. The provision applies to individuals, estates, trusts, and personal service corporations.

An activity generally is treated as passive if the taxpayer does not materially participate in it. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.

Under present law, a working interest in an oil or gas property is not treated as a passive activity, whether or not the taxpayer materially participates. A working interest for purposes of this provision means an interest with respect to an oil or gas property that is burdened with the cost of development and operation of the property and with respect to which the taxpayer's form of ownership does not limit the liability of the taxpayer.

Legislative Background

The passive activity loss rules, including the oil and gas working interest exception, were enacted as part of the Tax Reform Act of 1986. The working interest exception was based on the view that in certain situations, for example oil and gas exploration and development, factors such as financial risk, rather than material participation, should be the relevant standard for determining whether losses from passive activities should be allowed. Due to the worldwide decline in oil prices, Congress decided that relief for the oil and gas industry warranted that tax benefits be provided to attract certain outside investors.

2. Coal and other hard minerals

a. Depletion (secs. 611–614 of the Code)

Present Law

Cost depletion

Depletable costs incurred with respect to a mineral property may be recovered using cost depletion. Under the cost method of depletion, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units produced or sold from that property during the taxable year to the estimated number of unrecovered (or unsold) units remaining at the beginning of the taxable year.

Percentage depletion

Under present law, taxpayers who own interests in certain mines, wells, and natural deposits are permitted to claim percentage depletion on the production from such interests. A percentage depletion deduction for a taxable year is claimed with respect to an interest in such a property in lieu of a deduction based on cost depletion if the percentage depletion deduction exceeds the taxpayer's allowable cost depletion deduction for that property. Percentage depletion is computed by multiplying the gross income from the property from mining for a taxable year by a specified percentage. The specified percentages applicable for mineral properties other than oil or gas properties range from 5 percent to 22 percent (sec. 613(b)).

The allowance for percentage depletion is limited (on a property by property basis) to an amount not in excess of 50 percent of the taxpayer's net taxable income from the property, computed without a deduction for depletion.

Unlike the deduction for cost depletion, which is computed with respect to the taxpayer's adjusted basis in the depletable property, the deduction for percentage depletion is based solely on gross income from the property and is not dependent on, or limited to, the property's adjusted basis. Thus, the deduction for percentage depletion often allows an aggregate amount of deductions in excess of the total amount of depletable costs that the taxpayer incurred with respect to a particular property. Such a deduction is generally referred to as "excess depletion" and it constitutes an item of tax preference for purposes of computing the individual or corporate alternative minimum tax.

Legislative Background

Percentage depletion was originally enacted as part of the Revenue Act of 1926. The purpose of the percentage depletion deduction was generally to provide an incentive for the development of natural resources and to subsidize taxpayers engaged in extractive industries due to the financial risks associated with these enterprises. The Tax Reform Act of 1969 generally lowered the percentage depletion rates to their present level.

b. Mining exploration and development expenditures (secs. 616 and 617 of the Code)

Present Law

Under present law, taxpayers may elect to expense exploration costs associated with hard mineral deposits (sec. 617). Taxpayers also may expense development costs associated with the preparation of a mine for production (sec. 616).

Mining exploration costs are expenditures for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other depletable mineral, which are paid or incurred by the taxpayer prior to the development of the mine or deposit. When the mine reaches the producing stage, adjusted exploration expenditures (but not development costs) either (1) are included in income (i.e., recaptured) and recovered through cost depletion; or (2) at the election of the taxpayer, reduce depletion deductions with respect to the property. Adjusted exploration expenditures with respect to a property are expensed exploration costs attributable to the property, reduced by the excess of percentage depletion which would have been allowed but for the deduction for exploration costs, over cost depletion for the corresponding period. Exploration costs are also subject to recapture after expensing these amounts (sec. 617(d)).

Development costs include expenditures incurred for the development of a property after the existence of ores or other minerals in commercially marketable quantities has been determined. These costs typically include costs for construction of shafts and tunnels and, in some cases, costs for drilling and testing to obtain additional information for mining operations.

In the case of a corporation, the allowable deduction with respect to mining exploration and development costs that the taxpayer would otherwise be entitled to expense is reduced by 30 percent (sec. 291(b)). The disallowed amount is required to be amortized over a 60-month period, starting with the month in which the costs are paid or incurred.

Exploration and development costs paid or incurred with respect to mines or other natural deposits located outside of the United States are required to be capitalized and, at the election of the taxpayer, may be recovered in either of two manners (secs. 616(d) and 617(h)). A taxpayer can elect to include such costs in the adjusted basis of the property and thus recover such costs through depletion or depreciation (as appropriate). Alternatively, such capitalized costs can be recovered ratably over the 10-taxable year period beginning with the taxable year during which the costs are paid or incurred.

Deductible mining exploration and development costs are excepted from the rules that require capitalization and inclusion in inventory costs of certain expenses ("the uniform capitalization rules") (sec. 263A(c)(3)).

For purposes of the individual and corporate alternative minimum tax, the computation of alternative minimum taxable income requires mining exploration and development expenditures to be capitalized and amortized ratably over a 10-taxable year period beginning with the taxable year in which the expenditures are incurred (sec. 56(a)(2)).

Legislative Background

The statutory provisions which allow taxpayers to expense mining exploration and development expenditures were enacted in 1951. More recent legislation has been designed to limit the application of the election to expense these costs. For example, the Tax Equity and Fiscal Responsibility Act of 1982 ("the 1982 Act") established the provision which requires capitalization of a portion of otherwise deductible mining exploration and development costs. The 1982 Act provision was since amended by the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986 ("the 1986 Act") to both increase the percentage of these costs required to be capitalized and to make longer the period for amortization of those capitalized costs. Also, the 1986 Act added to the Code the provision requiring capitalization of foreign mining exploration and development expenditures.

3. Timber Tax Provisions (secs. 263A(c)(5), 194, 631(a), 631(b), and 1231(b)(2) of the Code)

Present Law

Treatment of costs incurred in acquiring or growing timber

The uniform cost capitalization rules that were enacted as part of the Tax Reform Act of 1986 do not apply to the costs of acquiring or growing timber. Consequently, under present law, only the direct costs of acquiring or growing timber must be capitalized and recovered through a depletion allowance or as a cost of timber sold. The direct costs of growing timber include amounts paid or incurred for seed or seedlings, for site preparation, and for planting (including the costs of tools and labor, and depreciation on machinery and equipment used for planting).

The indirect costs of a taxpayer that are allocable to timber, such as property taxes, interest, and general administrative expenses, are not required to be capitalized. Instead, such costs may be deducted for the taxable year in which paid or incurred, or, alternatively, may be added to the taxpayer's basis in the timber.

The costs of acquiring or growing timber that are capitalized generally are recovered for Federal income tax purposes as the timber is cut through a depletion deduction. The amount of the depletion deduction that is allowed for any year generally is determined by multiplying the adjusted basis of the timber by a ratio, the numerator of which is the amount of timber cut during the year and the denominator of which is the sum of (1) the amount of timber available for cutting as of the end of such year and (2) the amount of timber cut during the year. Unlike the treatment of oil and gas and mineral properties, percentage depletion does not apply to the capitalized costs of acquiring or growing timber.

Treatment of reforestation expenditures

A taxpayer may elect to amortize over an 84-month period up to $10,000 of reforestation expenditures incurred during any taxable year in connection with qualified timber property. In addition, a 10-percent investment tax credit is allowed for up to $10,000 of reforestation expenditures incurred during any taxable year in connection with qualified timber property.

For purposes of the 84-month amortization election and the 10-percent investment tax credit, qualified timber property is any woodlot or other site located in the United States that will contain trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees, for sale or for use in the commercial production of timber products. Reforestation expenditures are defined as the direct costs incurred to plant or seed for forestation or reforestation purposes. The term includes the costs incurred for site preparation, seed or seedlings, and labor and tools used in planting or seeding.

Treatment of timber cutting and certain timber conveyances

A taxpayer who owns timber or who possesses the right to cut timber may elect to treat the cutting of the timber as a sale or exchange of the timber for Federal income tax purposes if the timber or the right to cut the timber has been held for more than 1 year before the cutting and the timber is cut for sale or for use in the taxpayer's trade or business. In addition, the gain or loss from the disposition of timber by a taxpayer under a contract pursuant to which an economic interest is retained by the taxpayer is treated as if the gain or loss were from the sale or exchange of the timber for Federal income tax purposes if the timber has been held for more than 1 year before the disposition.

The gain or loss from any such sale or exchange is treated as a gain or loss from the sale or exchange of trade or business property for purposes of section 1231. Under section 1231, any gain from the sale or exchange of trade or business property that is held for more than 1 year is treated as long-term capital gain if the total gain from the sale or exchange of such property for any year exceeds the total loss from the sale or exchange of such property for such year.

Consequently, under the law in effect before the enactment of the Tax Reform Act of 1986, the cutting of timber and the disposition of timber under a contract pursuant to which an economic interest was retained generally qualified for the favorable Federal income tax treatment accorded the sale or exchange of capital assets despite the fact that the gain would otherwise be treated as ordinary income because under general tax principles (1) a sale or exchange had not occurred or (2) the timber was held primarily for sale to customers in the ordinary course of a trade or business.

Legislative Background

Treatment of costs incurred in acquiring or growing timber

The exception to the uniform cost capitalization rules for timber was enacted as part of the Tax Reform Act of 1986.

Treatment of reforestation expenditures

The 84-month amortization election and the 10-percent investment tax credit for reforestation expenditures were enacted in 1980 as part of the Recreational Boating Safety and Facilities Improvement Act of 1980. The Tax Reform Act of 1986 repealed the regular investment tax credit for all property placed in service after December 31, 1985, other than certain transition property and up to $10,000 of reforestation expenditures.

Treatment of timber cutting and certain timber conveyances

The special rules that accorded capital gains treatment to the cutting of timber or the disposition of timber under a contract pursuant to which an economic interest was retained were enacted as part of the Revenue Act of 1943. The legislative history to the Revenue Act of 1943 indicates that the special rules were necessary in order to treat taxpayers who cut their own timber or dispose of their timber under a contract pursuant to which an economic interest is retained in the same manner as taxpayers who sell their timber outright.[19] The favorable Federal income tax treatment of long-term capital gains was repealed as part of the Tax Reform Act of 1986.

4. Contributions of Qualified Conservation Interests (secs. 170, 2055, and 2522 of the Code)

Present Law

Charitable contributions generally

Subject to certain limitations, a deduction is permitted for contributions of property to charitable organizations, to the United States, or to a State or local government. The deduction generally is equal to the fair market value of the property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (Code secs. 170, 2055, and 2522, respectively).

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally does not give rise to a charitable deduction (for income, estate, or gift tax purposes) unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund. Exceptions to the partial interest rule are provided for gifts of remainder interests in farms or personal residences, gifts of undivided por-

---

[19] President Franklin Roosevelt originally vetoed the bill that became the Revenue Act of 1943, stating that "as a grower and seller of timber, I think that timber should be treated as a crop and therefore as income when it is sold." 90 Cong. Rec. 1958 (1944). Congress subsequently passed the bill over his veto.

tions of the donor's entire interest in the property, and for gifts of qualified conservation interests.

Qualified conservation interests

Qualified conservation interests are real property interests donated in perpetuity for any of the following conservation purposes:

(1) The preservation of land areas for outdoor recreation by, or for the education of, the general public;

(2) The protection of a natural habitat of fish, wildlife, plants, or a similar ecosystem;

(3) The preservation of open space (including farmland and forest land) but only if such preservation either (a) is for the scenic enjoyment of the general public, or is pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and (b) will yield a significant public benefit; or

(4) The preservation of an historically important land area or a certified historic structure (sec. 170(h)).

Deductible conservation interests may take any of three forms. First, the value of a remainder interest is deductible. Second, the value of a restriction (e.g., an easement) granted in perpetuity on the use of the property is deductible. Finally, the contribution of the donee's entire property interest is deductible, except that the donor may retain his or her interest in subsurface oil, gas, or other minerals and the right of access to such minerals.

A donor making a qualified conservation contribution generally is not allowed to retain an interest in minerals which may be extracted or removed by any surface mining method. However, deductions for contributions of conservation interests satisfying all of the above requirements (other than the complete prohibition on surface mining) will be permitted if two conditions are satisfied. First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976 (and remain so separated) and, second, the probability of surface mining on the property with respect to which a contribution is made must be so remote as to be negligible (sec. 170(h)(5)(B)).

Legislative Background

The original restrictions on gifts of partial interests in property, such as gifts of conservation easements, were imposed by the Tax Reform Act of 1969 ("the 1969 Act"). The 1969 Act limited deductions to transfers of easements in gross in perpetuity, effective for transfers after July 31, 1969.

The Tax Reform Act of 1976 ("the 1976 Act") restricted the deduction to transfers of easements for a period of not less than 30 years for the following "conservation purposes": (1) the preservation of land areas for public outdoor recreation or education, or scenic enjoyment; (2) the preservation of historically important land areas or structures; or (3) the protection of natural environmental systems. The provisions of the 1976 Act applied to transfers made after June 13, 1976, and before June 14, 1977.

P.L. 95-30 extended the sunset date of the 1976 Act until June 14, 1981, but limited the deduction to easements in perpetuity.

P.L. 96–541 adopted the basic provisions of present law effective for transfers made after December 17, 1980, except that no deduction was allowable if any surface mining of the property was permitted.

The Deficit Reduction Act of 1984 expanded the deduction for qualified conservation contributions to permit surface mining under the present-law rules, effective for transfers made after July 18, 1984.

E. Energy Tax Credits

1. Business Energy Tax Credits for Solar, Geothermal, and Ocean Thermal Property (sec. 46 of the Code)

Present Law

Three nonrefundable business energy tax credits are allowed on the cost incurred by the taxpayer to place in service certain types of energy property. The credits (the rates and the property to which they pertain) are:

(1) Business solar—10% credit;
(2) Geothermal—10%; and
(3) Ocean thermal—15%.

These tax credits are scheduled to expire after September 30, 1990.

These (and other) tax credits may not be used to offset more than 25 percent of regular tax liability above $25,000 or the tentative minimum tax for the taxable year.

Legislative Background

The tax credits for solar and geothermal energy properties were enacted in the Energy Tax Act of 1978, effective after April 20, 1977, through December 31, 1982. The credit for ocean thermal energy property was enacted in the Crude Oil Windfall Profit Tax Act of 1980, effective through 1985. In the same Act, the solar and geothermal credits were extended through 1985. In the Tax Reform Act of 1986, these three credits were extended for three additional years (through 1988) at rates which phased down to the present-law tax credit rates. An additional extension for one year (through 1989) was provided in the Technical and Miscellaneous Revenue Act of 1988.

The business energy tax credits were extended for the nine-month period after December 31, 1989 (through September 30, 1990) in the Omnibus Budget Reconciliation Act of 1989.

A wind energy credit of 15 percent was allowed from October 1, 1978, through December 31, 1985. It expired after 1985 because it was not extended by Congress.

2. Production Credit for Alternative Fuels (sec. 29 of the Code)

Present Law

Nonconventional fuels are eligible for a production credit which is equal to $3 per barrel of BTU oil barrel equivalent. Qualified fuels must be produced from a well drilled, or a facility placed in service, before January 1, 1991. The production credit is available for qualified fuels produced through December 31, 2000.

Qualified fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks. Under section 29, the determination whether gas (item (2) above) qualifies for the credit must be made in accordance with section 503 of the Natural Gas Policy

Act of 1978. Gas produced from a tight formation only included gas whose price was regulated by the United States and for which the maximum lawful price was at least 150 percent of the applicable price under section 103 of the Natural Gas Policy Act of 1978. The Federal Energy Regulating Commission deregulated natural gas in interstate commerce in 1987, and as a result, the production credit no longer was available to gas produced from tight formation.

Legislative Background

The production credit was originally enacted in the Windfall Profit Tax Act of 1980, and the credit was generally available for qualified fuels produced from wells drilled or property placed in service before January 1, 1990. When enacted, the production credit also was available for production of qualifying processed wood fuels sold before October 1, 1983 or three years after the facility was placed in service, and for steam produced from solid agricultural by products (not including timber by products) sold before January 1, 1985.

In the Technical and Miscellaneous Revenue Act of 1988, the placed-in-service date for fuels still eligible for the credit was extended from January 1, 1990, to January 1, 1991.

During consideration of the Omnibus Budget Reconciliation Act of 1989, the Senate Committee on Finance approved an amendment (included in S. 1750 as reported by the Senate Committee on the Budget) that would restore eligibility for the production credit to unregulated gas from tight formations that is produced from wells drilled on or after January 1, 1990, and would restore eligibility for the credit to such gas which had been eligible for the credit before gas was deregulated. This provision was deleted from the bill by Senate floor amendment.

An interagency task force within the Executive Branch, which includes at least representatives of the Departments of Treasury and Energy, is currently attempting to resolve a dispute about the appropriate definition of tar sands and to develop a satisfactory working definition.

O