PRESENT LAW AND DESCRIPTION OF PROPOSALS RELATING TO FEDERAL INCOME TAX PROVISIONS THAT IMPACT ENERGY, FUEL, AND LAND USE CONSERVATION AND PRESERVATION

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
of the
SENATE COMMITTEE ON FINANCE
on July 25, 2000

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance has scheduled a public hearing on July 25, 2000, on issues relating to the impact of Federal tax law on energy, fuel, and land use conservation and preservation.[1] This document,[2] prepared by the staff of the Joint Committee on Taxation, describes selected Federal Income tax provisions that may effect energy and fuel use, as well as provisions of Federal income, estate, and gift tax law that may effect land use conservation and preservation.

[1] On July 18, 2000, the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance held a hearing related to proposals to lower U.S. dependency on foreign oil used in transportation fuels and to review a variety of legislative proposals, including tax incentives to promote the use of alternative fuel vehicles and to increase domestic oil production.

[2] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Description of Proposals Relating to Federal Income Tax Provisions That Impact Energy, Fuel, and Land Use Conservation and Preservation* (JCX-84-00), July 24, 2000.

I. PRESENT LAW

A. Income Tax Rules Relating to Domestic Oil and Gas Operations

1. Depletion

General rules

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

Depletion is available to any person having an economic interest in a producing property. Treasury Department regulations state that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[3] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because through a contractual relation it possesses an economic or pecuniary advantage derived from production.

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

Under the percentage depletion method generally, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)).[4] Additionally, the

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[3] Treas. Reg. sec. 1.611-1(b)(1).

[4] By contrast, for any other mineral qualifying for the percentage depletion deduction, such deduction may not exceed 50 percent of the taxpayer's taxable income from the depletable

percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[5] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

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

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

The Tax Reduction Act of 1975 (the "1975 Act") repealed the deduction for percentage depletion with respect to much oil and gas production. Following the 1975 Act, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion.

For purposes of the percentage depletion allowance, an independent producer is any producer that is not a "retailer" or "refiner." A retailer is any person that directly, or through a related person, sells oil or natural gas or any product derived therefrom (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or product derived therefrom) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person (sec. 613A(d)(2)). Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales for this purpose. Further, a person is not a retailer within the meaning of this provision if the combined gross receipts of that person and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year.

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property. A similar 50-percent net-income limitation applied to oil and gas properties for taxable years beginning before 1991. Section 11522(a) of the Omnibus Budget Reconciliation Act of 1990 prospectively changed the net-income limitation threshold to 100 percent only for oil and gas properties, for taxable years beginning after 1990. The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December, 31, 1997, and before January 1, 2002.

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

A refiner is any person that directly or through a related person engages in the refining of crude oil, but only if such person or related person has a refinery run in excess of 50,000 barrels per day on any day during the taxable year (sec. 613A(d)(4)).

Percentage depletion for eligible taxpayers is allowed only for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)).[6] For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated (sec. 613A(c)(8)); each group is then treated as one producer for application of the 1,000-barrel limitation.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,[7] are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

Before enactment of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), if an interest in a proven oil or gas property was transferred (subject to certain exceptions), the production from such interest did not qualify for percentage depletion.[8] The 1990 Act repealed the limitation on claiming percentage depletion on transferred properties effective for property transfers occurring after October 11, 1990.

Percentage depletion on marginal production

The 1990 Act also created special percentage depletion provisions for oil and gas production from so-called marginal properties held by independent producers or royalty owners (sec. 613A(c)(6)). Under this provision, the statutory percentage depletion rate is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil (as determined under the provisions of the nonconventional fuels production credit of section 29) for the immediately preceding calendar year is less than $20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year.

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[6] As originally enacted, the depletable oil quantity was 2,000 barrels of average daily production. This was gradually phased down to 1,000 barrels of average daily production for 1980 and thereafter. The 1975 Act also phased down the percentage depletion rate from 22 percent in 1975 to 15 percent in 1984 and thereafter.

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

[8] The exceptions to this rule included transfers at death, certain transfers to controlled corporations, and transfers between controlled corporations or other business entities.

The increased rate applies for the taxpayer's taxable year which immediately follows a calendar year for which the average crude oil price falls below the $20 floor. To illustrate the application of this provision, the average price of a barrel of crude oil for calendar year 1999 (the most recent year for which a determination is available) was $15.56.[9] Thus, the percentage depletion rate for production from marginal wells was increased to 19 percent for taxable years beginning in 1999.

The Code defines the term "marginal production" for this purpose as domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less, corrected to 60 degrees Fahrenheit) (sec. 613A(c)(6)(D)). A stripper well property is any oil or gas property which produces a daily average of 15 or less equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins (sec. 613A(c)(6)(E)).[10]

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, the stripper well property determination is made by a taxpayer for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's. If the property satisfies the requirements of a stripper well property, then that person receives the benefits of this provision with respect to its allocable share of the production from the property. The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

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[9] IRS Notice 2000-23, 2000-17 I.R.B. 952.

[10] The amount of equivalent barrels is computed as the sum of (1) the number of barrels of crude oil produced, and (2) the number of cubic feet of natural gas produced divided by 6,000. If a well produced 10 barrels of crude oil and 12,000 cubic feet of natural gas, its equivalent barrels produced would equal 12 (i.e., 10 + (12,000 / 6,000)).

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

2. Intangible drilling and development costs

In general

In general, costs that benefit future periods must be capitalized and recovered over those periods for income tax purposes, rather than being expensed in the period the costs are incurred. Special rules are provided, however, for the treatment of intangible drilling and development costs ("IDCs"). Under these special rules, an operator or working interest owner[11] that pays or incurs IDCs in the development of an oil or gas property located in the United States, may elect either to expense or capitalize those costs (sec. 263(c)).

IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Such work includes labor, fuel, repairs, hauling, and supplies which are used (1) in the drilling, shooting, and cleaning of wells; (2) in the clearing of ground, draining, road making, surveying, and geological works as necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings) or items which are part of the acquisition price of an interest in the property.[12] They also do not include the cost to operators (1) payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and (2) amounts properly allocable to the cost of depreciable property)

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. In the case of a nonproductive well ("dry hole"), they may be deducted at the election of the operator.[13]

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[11] I.e., a person that holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights.

[12] Treas. Reg. sec. 1.612-4(a).

[13] Treas. Reg. sec. 1.612-4(b)(4).

In the case of an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period (sec. 291(b)(1)(A)).[14]

Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred (sec. 59(e)(1)). This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax.

The election to deduct IDCs applies only to those IDCs associated with domestic properties.[15] For this purpose, the United States includes certain wells drilled offshore.[16]

Exemption from uniform capitalization rules

The uniform capitalization rules, which were enacted as part of the Tax Reform Act of 1986, require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property (sec. 263A). In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale. Pursuant to a special exception, these rules do not apply to IDCs incurred with respect to oil or gas wells which are otherwise deductible under the Code (sec. 263A(c)(3)).

3. Geological and geophysical costs

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[14] The IRS has ruled that if a company that has capitalized and begun to amortize IDCs over a 60-month period pursuant to section 291 ceases to be an integrated oil company, it may not immediately write off the unamortized portion of the capitalized IDCs, but instead must continue to amortize the IDCs so capitalized over the 60-month amortization period. (Rev. Rul. 93-26, 1993-1 C.B. 50.)

[15] In the case of IDCs paid or incurred with respect to an oil or gas well located outside of the United States, the costs, at the election of the taxpayer, are either (1) included in adjusted basis for purposes of computing the amount of any deduction allowable for cost depletion or (2) capitalized and amortized ratably over a 10-year period beginning with the taxable year such costs were paid or incurred (sec. 263(i)).

[16] The term "United States" for this purpose includes the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources (i.e., the Continental Shelf area) (sec. 638).

In general

Geological and geophysical expenditures ("G&G costs") are costs incurred by the taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. A key issue with respect to the tax treatment of such expenditures is whether or not they are capital in nature. Capital expenditures are not currently deductible as ordinary and necessary business expenses, but are allocated to the cost of the property.[17]

Courts have held that G&G costs are capital, and therefore are allocable to the cost of the property[18] acquired or retained.[19] The costs attributable to such exploration are allocable to the cost of the property acquired or retained.[20] As described further below, IRS administrative rulings have provided further guidance regarding the definition and proper tax treatment of G&G costs.

Revenue Ruling 77-188

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

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

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

[20] By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

In Revenue Ruling 77-188[21] (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of G&G costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.

- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.

- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable

[21] 1977-1 C.B. 76.

basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

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

The 1977 ruling further provides that if, an oil or gas property is acquired or retained within or adjacent to that area of interest, the entire G&G exploration expenditures, including those incurred prior to the identification of the particular area of interest but allocated thereto, are to be allocated to the property as a capital cost under section 263(a).[22] If more than one property is acquired, it is proper to determine the amount of the G&G costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

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

In 1983, the IRS issued Revenue Ruling 83-105,[23] which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83-105 explains what constitutes an "abandonment as a potential source of mineral production."

4. Tax credits

a. Credit for producing fuels from nonconventional sources

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[22] This determination is made on the basis of data obtained from a detailed survey that does not relate exclusively to any particular property within a particular area of interest.

[23] 1983-2 C.B. 51.

Taxpayers that produce certain qualifying fuels from nonconventional sources are eligible for a tax credit ("the section 29 credit") equal to $3 per barrel or Btu oil barrel equivalent.[24] Fuels qualifying for the credit must be produced domestically from a well drilled, or a facility treated as placed in service, before January 1, 1993. The section 29 credit generally is available for qualified fuels sold to unrelated persons before January 1, 2003.

A facility that produces gas from biomass or produces liquid, gaseous, or solid synthetic fuels from coal (including lignite) placed in service by the taxpayer before July 1, 1998, pursuant to a written binding contract in effect before January 1, 1997, generally is treated as being placed in service before January 1, 1993. If a facility that qualifies for this binding contract exception is originally placed in service after December 31, 1992, production from the facility may qualify for the credit if sold to an unrelated person before January 1, 2008.

For purposes of the section 29 credit, 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 (i.e., any organic material other than oil, natural gas, or coal (or any product thereof)); and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks. Production attributable to a property from which gas from Devonian shale, coal seams, geopressured brine, or a tight formation was produced in marketable quantities before 1980 does not qualify for the credit.

The amount of the section 29 credit generally is adjusted by an inflation adjustment factor for the calendar year in which the sale occurs. The inflation adjustment factor for the 1999 taxable year was 2.0013. Therefore, the inflation-adjusted amount of the credit for that year was $6.00 per barrel or barrel equivalent.[25] There is no adjustment for inflation in the case of the credit for sales of natural gas produced from a tight formation. The credit begins to phase out if the annual average unregulated wellhead price per barrel of domestic crude oil exceeds $23.50 multiplied by the inflation adjustment factor.[26] For 1999 (the most recent year for which a determination is available), the inflation adjusted threshold for onset of the phase out was $47.03 ($23.50 x 2.0013), and the average wellhead price for 1999 was substantially lower than the indexed threshold.

The amount of the section 29 credit allowable with respect to a project is reduced by any unrecaptured business energy tax credit (sec. 48) or enhanced oil recovery credit (sec. 43) claimed with respect to such project.

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[24] A barrel-of-oil equivalent generally means that amount of the qualifying fuel which has a Btu (British thermal unit) content of 5.8 million.

[25] IRS Notice 2000-23.

[26] *Id.*

As with most other credits, the section 29 credit may not be used to offset alternative minimum tax liability. Any unused section 29 credit generally may not be carried back or forward to another taxable year; however, a taxpayer, under section 53, receives a credit for prior year minimum tax liability to the extent that a section 29 credit is disallowed as a result of the operation of the alternative minimum tax (sec. 53). The credit is limited to what would have been the regular tax liability but for the alternative minimum tax.

b. Enhanced oil recovery credit

Taxpayers are permitted to claim a general business credit for a taxable year, which consists of several different components (sec. 38(a)). One component of the general business credit is the enhanced oil recovery credit (sec. 43). The general business credit for a taxable year may not exceed the excess (if any) of the taxpayer's net income over the greater of (1) the tentative minimum tax, or (2) 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000. Any unused general business credit generally may be carried back three taxable years and carried forward 15 taxable years.

The enhanced oil recovery credit for a taxable year is equal to 15 percent of certain costs attributable to qualified enhanced oil recovery ("EOR") projects undertaken by the taxpayer in the United States during the taxable year. To the extent that a credit is allowed for such costs, the taxpayer must reduce the amount otherwise deductible or required to be capitalized and recovered through depreciation, depletion, or amortization, as appropriate, with respect to these costs. A taxpayer may elect not to have the enhanced oil recovery credit apply for a taxable year.

The amount of the enhanced oil recovery credit is reduced in a taxable year following a calendar year during which the annual average unregulated wellhead price per barrel of domestic crude oil exceeds $28 (adjusted for inflation since 1990).[27] For calendar year 1999, this amount was $33.68 ($28 X 1.2030).[28] If the average unregulated wellhead price exceeds this amount, the credit would be reduced ratably over a $6 phase out range.

For purposes of the credit, qualified enhanced oil recovery costs include the following costs which are paid or incurred with respect to a qualified EOR project: (1) the cost of tangible property which is an integral part of the project and with respect to which depreciation or amortization is allowable; (2) IDCs with respect to which a taxpayer may make an election to

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[27] The average per-barrel price of crude oil for this purpose is determined under the same manner as it is for purposes of the section 29 credit.

[28] The inflation adjustment factor for 1999 is 1.2030. IRS Notice 99-45, 1999 I.R.B. 415.

deduct under section 263(c);[29] and (3) the cost of tertiary injectants with respect to which a deduction is allowable under section 193, whether or not chargeable to capital account.

A qualified EOR project means any project that is located within the United States and involves the application (in accordance with sound engineering principles) of one or more tertiary recovery methods as defined under section 193(b)(3) which can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which ultimately will be recovered. The tertiary recovery methods referred to in section 193(b)(3) generally include the following nine methods:[30] miscible fluid displacement, steam-drive injection, microemulsion flooding, in situ combustion, polymer-augmented water flooding, cyclic-steam injection, alkaline flooding, carbonated water flooding, and immiscible non-hydrocarbon gas displacement, or any other method approved by the IRS. In addition, for purposes of the EOR credit, immiscible non-hydrocarbon gas displacement generally is considered a qualifying tertiary recovery method, even if the gas injected is not carbon dioxide.

A project is not considered a qualified EOR project unless the project's operator submits to the IRS a certification from a petroleum engineer that the project meets the requirements set forth in the preceding paragraph.

The enhanced oil recovery credit is effective for taxable years beginning after December 31, 1990, with respect to costs paid or incurred in EOR projects begun or significantly expanded after that date.

5. Alternative minimum tax

<u>In general</u>

A taxpayer is subject to an alternative minimum tax ("AMT") to the extent that its tentative minimum tax exceeds its regular income tax liability (sec. 55(a)). A corporate taxpayer's tentative minimum tax generally equals 20 percent of its alternative minimum taxable income (“AMTI”) in excess of an exemption amount. (The marginal AMT rate for a noncorporate taxpayer is 26 or 28 percent, depending on the amount of its AMTI above an exemption amount.) Alternative minimum taxable income ("AMTI") is the taxpayer's taxable income increased by certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

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[29] In the case of an integrated oil company, the credit base includes those IDCs which the taxpayer is required to capitalize under section 291(b)(1).

[30] See, section 212.78(c) of the June 1979 Department of Energy regulations.

The AMTI of a corporation is increased by an amount equal to 75 percent of the amount by which adjusted current earnings ("ACE") of the corporation exceed AMTI (as determined before this adjustment) (sec. 56(g)). In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits.

AMT treatment of depletion

Since the provisions of the Energy Policy Act of 1992 became fully effective, there has been no AMT preference for oil and gas percentage depletion. Before enactment of that Act, oil and gas percentage depletion deductions in excess of the taxpayer's basis in the property were an AMT preference.

AMT treatment of IDCs

As discussed above, in computing its regular tax, a taxpayer who pays or incurs IDCs in the development of domestic oil or gas properties may elect to either expense or capitalize these amounts. The difference between the amount of a taxpayer's IDC deductions and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period may constitute an item of tax preference for the AMT to the extent that this amount exceeds 65 percent of the taxpayer's net income from oil and gas properties for the taxable year (the "excess IDC preference") (sec. 57(a)(2)).

For taxpayers other than integrated oil companies, the Energy Policy Act of 1992 repealed the excess IDC preference for IDCs related to oil and gas wells for taxable years beginning after 1992 (sec. 57(a)(2)(E)). The repeal of the excess IDC preference, however, may not result in the reduction of the amount of the taxpayer's AMTI by more than 40 percent of the amount that the taxpayer's AMTI would have been had the excess IDC preference not been repealed.

In addition, for purposes of computing the an integrated oil company's ACE adjustment to the AMT, IDCs are capitalized and amortized over the 60-month period beginning with the month in which they are paid or incurred (sec. 56(g)(4)(D)(i)). The ACE preference does not apply to independent oil and gas producers since enactment of the Energy Policy Act of 1992.

6. Passive activity loss and credit rules

A taxpayer's deductions from passive trade or business activities, to the extent they exceed income from all such passive activities of the taxpayer (exclusive of portfolio income), generally may not be deducted against other income (sec. 469).[31] Thus, for example, an individual taxpayer generally may not deduct losses from a passive activity against income from

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[31] This provision applies to individuals, estates, trusts, personal service corporations, and certain closely held corporations.

wages. Losses suspended under this "passive activity loss" limitation are carried forward and treated as deductions from passive activities in the following year, and thus may offset any income from passive activities generated in that later year. Suspended losses from a passive activity may be deducted in full when the taxpayer disposes of its entire interest in that activity to an unrelated party in a transaction in which all realized gain or loss is recognized. An activity generally is treated as passive if the taxpayer does not materially participate in the activity. 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.

A working interest in an oil or gas property generally is not treated as a passive activity, whether or not the taxpayer materially participates in the activities related to that property (sec. 469(c)(3) and (4)).[32] In addition, if a taxpayer has any loss for any taxable year from a working interest in an oil or gas property which is treated pursuant to this working interest exception as a loss which is not from a passive activity, then any net income from such property (or any property the basis of which is determined in whole or in part by reference to the basis of such property) for any succeeding taxable year is treated as income of the taxpayer which is not from a passive activity.

Similar limitations apply to the utilization of tax credits attributable to passive activities (sec. 469(a)(1)(B)). Thus, for example, the passive activity rules (and, consequently, the oil and gas working interest exception to those rules) apply to the nonconventional fuels production credit and the enhanced oil recovery credit. However, if a taxpayer has net income from a working interest in an oil and gas property which is treated as not arising from a passive activity, then any tax credits attributable to the interest in that property are treated as credits not from a passive activity (and, thus, not subject to the passive activity credit limitation). The amount of such credits may not exceed the regular tax liability of the taxpayer for the taxable year which is allocable to such net income.

7. Sales and exchanges of property interests

Under present law, individual taxpayers are subject to a maximum statutory income tax rate of 39.6 percent. If an individual recognizes capital gains, however, the gains generally are subject to a maximum tax rate of 20 percent. There currently is no differential between the rates of taxation on capital gains and ordinary income in the case of corporate taxpayers.

Gain recognized from the disposition of an interest in an oil or gas property generally is characterized as capital gain. The Code contains a special recapture provision, however, which mandates that in certain cases a portion of any gain is to be treated as ordinary income and not as capital gain (sec. 1254). Specifically, the Code provides that if a taxpayer disposes of "section

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[32] This exception from the passive activity rules does not apply if the taxpayer holds the working interest through an entity which limits the liability of the taxpayer with respect to the interest.

1254 property" that was placed in service after 1986, then the lesser of (1) the gain recognized on the disposition or (2) the aggregate amount of (a) depletion deductions which resulted in a reduction in the basis of the property disposed of and (b) IDCs deducted pursuant to an election under section 263(c) and which, but for the deduction, would have been included in the adjusted basis of the property, is characterized as ordinary income.[33] For this purpose, the term "section 1254 property" means any property (within the meaning of sec. 614) if any IDCs are properly chargeable to such property or the adjusted basis of such property includes adjustments for depletion deductions.

8. Net operating losses

A net operating loss ("NOL") is generally the amount by which business deductions of a taxpayer exceed business gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[34] A carryback of an NOL results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year. Special NOL carryback rules apply to (1) casualty and theft losses of individual taxpayers, (2) Presidentially declared disasters for taxpayers engaged in a farming business or a small business, (3) real estate investment trusts, (4) specified liability losses, (5) excess interest losses, and (6) farm losses.

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[33] For dispositions of property placed in service before 1987, taxpayers are not required to recapture depletion deductions and are required to recapture IDC deductions only in excess of the amounts which would have been deductible as depletion if the IDCs had been capitalized.

[34] A taxpayer could elect to forgo the carryback of an NOL.

B. Foreign Tax Rules Relating to Oil and Gas Income

In general, the United States taxes the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[35] Subpart F income includes, among other things, foreign base company oil-related income. Foreign base company oil-related income generally includes all oil-related income derived from foreign sources (as defined in sec. 907(c)(2) and (3) and described below) other than income derived from a source within a foreign country in connection with either (1) oil or gas which was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for that vessel or aircraft (sec. 954(g)). An exception is available for any foreign corporation that, together with related persons, does not constitute a large oil producer.

A credit against U.S. tax on foreign-source income generally is allowed for foreign taxes paid or accrued (or deemed paid). The amount of foreign tax credits that a taxpayer may claim is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The foreign tax credit limitation is calculated on an overall basis and separately for specific categories of income.

Special foreign tax credit rules apply in the case of foreign oil and gas income. Under a special limitation, taxes on foreign oil and gas extraction income are creditable only to the extent that they do not exceed a specified amount (e.g., 35 percent of such income in the case of a corporation) (sec. 907(a)). For this purpose, foreign oil and gas extraction income is income derived from foreign sources from the extraction of minerals from oil or gas wells or the sale or exchange of assets used by the taxpayer in such extraction. A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize excess foreign oil and gas extraction taxes in a carryback or carryforward year.

In the case of taxes paid or accrued to any foreign country with respect to certain foreign oil-related income, discriminatory foreign taxes are not treated as creditable foreign taxes (sec. 907(b)). For this purpose, foreign oil-related income is income derived from foreign sources from (1) the processing of minerals extracted by the taxpayer or any other person from oil or gas wells into their primary products, (2) the transportation of such minerals or primary products, (3) the distribution or sale of such minerals or primary products, (4) the disposition of assets used by the taxpayer in such processing, transportation, or distributions or sales, or (5) the performance of any other related service (sec. 907(c)(2)).

[35] In general, a foreign corporation is a CFC if U.S. 10-percent shareholders own more than 50 percent of such corporation's stock (measured by vote or value) (sec. 957).

C. Income Tax Rules Relating to Cost Recovery of Electric and Clean-Fuel Vehicles

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that (1) is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, (2) the original use of which commences with the taxpayer, and (3) is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.

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

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

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

D. Income and Tax Rules Relating to Land Use Conservation and Preservation

1. Cost Recovery

In general

A taxpayer generally must capitalize the cost of property used in a trade or business.[36] The capitalized cost of business property that is subject to exhaustion, wear, tear, or obsolescence may be recovered over time through allowances for depreciation (sec. 167). Depreciation allowances for tangible property placed in service after 1986 generally are determined under the Modified Accelerated Cost Recovery System ("MACRS") of section 168, which provides that depreciation is computed by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property acquired after July 25, 1991, generally is amortized under section 197, which provides a 15-year recovery period and applies the straight-line method to the cost of applicable property.

Under MACRS, depreciable property is divided into ten classes (3-year property, 5-year property, 7-year property, 10-year property, 15-year property, 20-year property, 25-year water utility property, 27.5-year residential rental property, 39-year nonresidential real property, and 50-year railroad grading or tunnel bores). Personal property generally is included in a property class based upon its class life. The class life of certain assets is provided by statute. The class life of other personal property is determined by reference to their class lives.[37] The 200-percent declining balance method of depreciation is used for 3-year, 5-year, 7-year, and 10-year property; the 150-percent declining balance method is used for 15-year and 20-year property and any property used in a farming business; and the straight-line method is used for other property, including most depreciable real property.[38]

Treatment of land

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[36] Costs that generally are required to be capitalized include purchase costs and direct costs of constructing property. In most cases, allocable indirect costs of constructing property also must be capitalized (sec. 263A(b)(1)). Interest costs generally must be capitalized in the construction of real property or property with a class life of 20 years or more (sec. 263A(f)).

[37] Class lives have been published by the Secretary of the Treasury in Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, l988-1 C.B. 785.

[38] The Secretary of the Treasury (or his delegate) has been directed to conduct a comprehensive study of the recovery periods under section 168 and to submit the results of such study by March 31, 2000, together with recommendations for determining such periods and methods in a more rational manner, to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. (Sec. 2022 of the Tax and Trade Relief Extension Act of 1998, P.L. 105-277.) To date, no study has been submitted.

The cost of land generally may not be depreciated,[39] even if the taxpayer's use of the land may result in its erosion or other type of wear or tear (e.g., in the case of certain farming practices).[40] An interest in land may not be amortized under section 197 (sec. 197(e)(2)). When a taxpayer acquires both land and other property in a single transaction (e.g., the purchase of an apartment building and the underlying land), the acquisition cost must be allocated between the nondepreciable and depreciable assets.

Some improvements to land (such as sidewalks, roads, landscaping, etc.) may be depreciated.[41] However, certain land improvements may be so "inextricably associated" with the land as to be nondepreciable. Examples of nondepreciable land improvements include certain clearing and grading costs associated with land[42] and golf course improvements.[43] The cost of demolishing any structure generally must be charged to the capital account with respect to the land on which the demolished structure was located (sec. 280B).

The cost of minerals and other natural resources imbedded in land are recoverable through depletion allowances (sec. 611).

2. Income tax treatment of dispositions of land

Capital gains treatment

In general, gain or loss reflected in the value of an asset is recognized for income tax purposes at the time the taxpayer disposes of the property. On the sale or exchange of capital assets held for more than one year, gain generally is taxed to an individual taxpayer at a maximum marginal rate of 20 percent. Losses from the sale or exchange of capital assets are deductible only the extent of the gains from the sale or exchange of such assets, plus, in the case of individuals, $3,000.

Land is a capital asset, unless it is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, or it is used in the taxpayer's trade or business. In addition, if the gains from property, including land, used in a taxpayer's trade or business exceeds the losses from such property, the gains and losses are treated as capital gains.

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[39] Treas. Reg. sec. 1.167(a)-2.

[40] Treas. Reg. sec. 1.167(a)-6(b). See also *A. Duda & Sons, Inc. v. United States*, 560 F.2d 669 (5th Cir. 1977).

[41] Rev. Proc. 87-56, *supra.*

[42] Rev. Rul. 65-265, 1965-2 C.B. 52; Rev. Rul. 68-193, 1968-1 C.B. 79.

[43] Rev. Rul. 55-290, 1955-1 C.B. 320.

Deferral of gain or loss

Several provisions allow a taxpayer to defer gain when property, including land, is disposed of. For example, gain or loss is deferred if land held for investment or business use is exchanged for property of a like kind (generally defined to include other real estate) (sec. 1031). Likewise, gain or loss is deferred if land is condemned and replaced with other property of a like kind (sec. 1033).

Principal residence

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under Treasury regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met (sec. 121).

3. Tax credit for rehabilitation expenditures

In general

An income tax credit is provided for a portion of certain expenditures incurred in the rehabilitation of certified historic structures and certain other buildings first placed in service before 1936. The amount of the credit is equal to 20 percent of the qualified rehabilitation expenditures for a certified historic structure and 10 percent of the qualified rehabilitation expenditures for a qualified rehabilitated building other than a certified historic structure.

In order for a rehabilitation to qualify for the credit applicable to certified historic structures, the rehabilitated building must be listed in the National Register of Historic Places or be located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district. In addition, the Secretary of the Interior must certify that the rehabilitation is consistent with the historic character of the building or the historic district in which the building is located.

In the case of other rehabilitations, a building (or its structural components) is a qualified rehabilitated building if: (1) the building is substantially rehabilitated; (2) the building was placed in service before the beginning of the rehabilitation; (3) the rehabilitation meets a 75-percent retention test; (4) depreciation is allowable with respect to the building; and (5) the building was first placed in service before 1936.

A building is substantially rehabilitated if the qualified rehabilitation expenditures incurred during the 24-month period selected by the taxpayer exceed the greater of: (1) the adjusted basis of the building (and its structural components) as of the beginning of the period (or as of the holding of the building, if later); or (2) $5,000.

Qualified rehabilitation expenditures generally include any amounts properly chargeable to capital account in connection with the rehabilitation of a building, but do not include the cost of: (1) acquiring the building or any interest in the building; (2) facilities related to a building (e.g., a parking lot); (3) enlarging an existing building; or (4) rehabilitations allocable to a portion of a building that is (or is reasonably expected to be) tax-exempt use property.

The 75-percent retention test requires the retention, in place, of (1) at least 75 percent of the building's existing external walls (including at least 50 percent as external walls) and (2) at least 75 percent of the building's internal structural framework. In general, a building's internal structural framework includes all load-bearing internal walls and any other structural supports, including the columns, girders, beams, trusses, spandrels, and all other items that are essential to the stability of the building.

Other rules

The rehabilitation credit is part of the investment credit, which, in turn, is part of the general business credit. The general business credit may offset the first $25,000 of a taxpayer's regular tax liability, plus 75 percent of the taxpayer's regular tax liability in excess of $25,000. The general business credit is not allowed to offset a taxpayer's minimum tax liability.

Taxpayers claiming the credit must reduce their adjusted basis in the building by the amount of the credit. Capitalized rehabilitation expenditures must be depreciated using a straight-line method.

The credit is subject to recapture if the rehabilitated building is disposed of, or otherwise ceases to be a qualified property, within five years after the property is placed in service.

4. Environmental remediation expenditures

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to the taxpayer's capital account as deductible in the year paid or incurred (sec. 198).[44] The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. Eligible expenditures are those paid or incurred before January 1, 2001.

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[44] Section 198 was enacted as part of the Taxpayer Relief Act of 1997.

In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*[45] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February 1997 as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to census tracts with a poverty rate of 20 percent or more. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon sale or other disposition of the property.

5. Use of tax-exempt bonds

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of governmental transportation infrastructure projects such as public highways or governmental mass commuting (rail and bus) systems are eligible for this financing.
Interest on bonds that nominally are issued by States or local governments, the proceeds of which, however, are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person, is taxable, unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are

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[45] 418 U.S. 1 (1974), holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1).

called “private activity bonds.” The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

The Code includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities.

States or local governments may issue tax-exempt “exempt-facility bonds” to finance property for certain private businesses. Property eligible for this financing includes transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

Finally, tax-exempt private activity bonds may be issued to finance limited non-business purposes: student loans and mortgage loans for owner-occupied housing (“qualified mortgage bonds” and “qualified veterans’ mortgage bonds”).

Rules governing private activity bonds for transportation facilities

Airports

All tax-exempt-bond-financed airport property must be governmentally owned. Property eligible for this financing includes land, terminals, runways, public parking facilities, and related equipment. Airplanes are not eligible for tax-exempt financing. Additionally, certain real property and related equipment are excluded from this financing:

- Hotels and other lodging facilities;
- Retail facilities (including food and beverage facilities) located in a terminal, if the facilities are in excess of a size necessary to serve passengers and employees at the airport;

- Retail facilities for passengers or the general public (including, but not limited to, rental car lots) located outside the terminal;

- Office buildings for individuals who are not employees of a governmental unit or of the public airport operating authority; and

- Industrial parks or manufacturing facilities.

Ports

Exempt-facility bonds may be issued to finance port ("dock and wharf") facilities and related storage and training facilities. Facilities that are specifically ineligible for financing with airport bonds may not be financed with port bonds. Further, ships and other vessels are not eligible for private activity tax-exempt bond financing. All property financed with these bonds must be governmentally owned.

Mass commuting facilities

Private activity tax-exempt bond financing for mass commuting facilities is subject to similar restrictions as the restrictions that apply to such bonds for airports and ports. All property financed with these bonds must be governmentally owned. Further, "rolling stock" (buses and rail cars) are not eligible for this financing.

High-speed intercity rail facilities

High-speed intercity rail facilities eligible for tax-exempt bond financing include facilities (not including rolling stock) for the fixed guideway rail transportation of passengers and their baggage between metropolitan statistical areas using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops. As with other private transportation facilities receiving tax-exempt financing, these facilities must be available to members of the general public as passengers. Unlike other bond-financed transportation facilities, high-speed intercity rail facilities may be privately owned.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

The Code includes three exceptions applicable to bonds for transportation infrastructure facilities. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance. In the case of governmental bonds (including bonds to finance public highways) the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

Second, in the case of bonds to finance certain construction activities, including governmentally owned transportation infrastructure facilities, the six-month period is extended to 24 months for construction proceeds. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.

Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.

General restrictions on State and local government bond financing for private activities

Like many Federal direct spending programs, issuance of State and local government private activity bonds is subject to general restrictions on amount and use. The following discussion illustrates some of the major restrictions.

State volume limitations.--Issuance of most tax-exempt private activity bonds is subject to annual per-State volume limitations. Each State (including local governments within the State) is allowed to issue an annual amount of these bonds not exceeding the greater of $50 per resident of the State or $150 million.[46] These volume limits are scheduled to increase to $75 per resident of the State or $225 million beginning in calendar year 2007. This increase is phased-in proportionately beginning in calendar year 2003. States may elect to carryover their unused private activity bond volume authority for designated activities for a period of up to three years. Bond authority that is not used within the carryforward period lapses.

The State volume limits do not apply to State and local government bonds for section 501(c)(3) organizations, for airports and ports, for governmentally owned (but privately operated) solid waste disposal facilities, for environmental enhancements of hydro-electric generating

[46] A portion of the private business use financed with certain larger (i.e., over $150 million) governmental bond issues also is subject to these volume limitations.

facilities, for governmentally owned (but privately operated) high-speed intercity rail facilities,[47] for qualified veterans' mortgage loans,[48] and for financing property in "newly designated" empowerment zones.[49]

Other restrictions on private activity bonds.--Among the other Federal restrictions applicable to private activity (but not to governmental) State and local government bonds are the following:

- A requirement that public notice be given and a hearing held before issuance of the bonds;
- A restriction on the costs of issuance (e.g., bond attorney and underwriter fees) that may be financed with bond proceeds to an amount not exceeding two percent of the bond issue;
- A minimum rehabilitation requirement for existing property that is acquired with State and local government bond proceeds;
- A limit on the amount of land that may be financed with any single bond issue;
- A limit on the maximum maturity of the bonds, determined by reference to the economic life of the property being financed; and
- Loss of interest deductions for private borrowers receiving bond proceeds if the bond-financed property ceases to be used in a qualifying use.

Tax credits for interest on qualified zone academy bonds

A nonrefundable income tax credit in the amount equal to a credit rate (set by the Treasury Department) multiplied by the face amount of certain qualified zone academy bonds is allowed to certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) (sec. 1397E). A taxpayer holding a qualified

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[47] Bonds for privately owned high-speed intercity rail facilities must receive a State volume limit allocation equal to 25 percent of the bond amount.

[48] As noted above, qualified veterans' mortgage bonds are subject to separate volume limits based on historical State issuance as part of the 1984-enacted phase-out of that program.

[49] New empowerment zone bonds are subject to separate aggregate limits based on the type of zone: $60 million for a rural zone; $130 million for urban zones in areas with populations of less than 100,000, and $230 million for urban zones in areas having a population of at least 100,000.

zone academy bond on the credit allowance date (i.e., the annual anniversary of the bond's issuance) is entitled to a credit. The credit is includible in gross income (as if it were an interest payment on the bond), and may be claimed against regular income tax liability and alternative minimum tax liability. A qualified zone academy bond is defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds. Issuance of qualified zone academy bonds is subject to an annual national limitation of $400 million for 1998 through 2001, and zero thereafter. The national limitation for a calendar year is allocated by the Secretary of the Treasury among the states based on their respective populations of individuals below the poverty line. This limitation is then allocated by the State education agency to qualified zone academies within such State.

6. Contributions of qualified conservation interests

a. Income tax provisions

<u>Charitable contributions generally</u>

Subject to certain limitations, a deduction is permitted for contributions of property to (1) charitable organizations, (2) the United States, or (3) a State or local government. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes (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 is not allowable as 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. In addition, exceptions to the partial interest rule are provided for gifts of remainder interests in farms or personal residences, gifts of undivided portions of the donor's entire interest in the property, and for gifts of qualified conservation interests.

<u>Qualified conservation contributions</u>

Qualified conservation contributions are contributions of real property interests for any of the following conservation purposes:

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

- The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;

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

- 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. Third, the contribution of the donee's entire interest in the property is deductible. (Sec. 170(h)(2).) The donor may retain his or her interest in subsurface oil, gas, or other minerals and the right of access to such minerals, if the probability of surface mining occurring on such property is so remote as to be negligible. (Sec. 170(h)(5)(B).)

b. Estate tax provisions

Estate tax exclusion for land subject to permanent conservation easement

An executor may elect to exclude, for Federal estate tax purposes, 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). If the value of the conservation easement is less than 30 percent of the value of the land without the easement (reduced by the value of any retained development rights), then the exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land.

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent’s family at all times during the three-year period ending on the date of the decedent’s death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the gross estate, the property is not stepped up to its fair market value on the date of the decedent's death. The basis of such land acquired from a decedent's estate is the same as in the hands of the decedent before death (i.e., a carryover basis). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor.

7. Estate Tax Preferences for Farms and Small Businesses

In general

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax transfers totaling $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter. Both the estate tax and gift tax provide an unlimited deduction for certain amounts transferred from one spouse to another spouse, when the recipient spouse is a citizen of the United States.

Special-use valuation

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at their current qualified use value (i.e., special-use value), rather than full fair market value, provided that the value of the qualified real property is not reduced more than $750,000 (adjusted for inflation) (sec. 2032A).

An estate may elect special-use valuation if: (1) the decedent was a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[50] (4) the real property qualifying

[50] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its special use value.

for current use valuation must pass to a qualified heir;[51] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business ("a qualified use") for five of the last eight years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of his family in five years out of the eight years immediately preceding the decedent's death (sec. 2032A (a) and (b)).[52]

If, within 10 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to non-family members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained from the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

Qualified family-owned business interests

An estate, over 50 percent of which is generally comprised of qualified family-owned business interests of the decedent, is permitted to deduct the adjusted value of the qualified family-owned business interest, up to a total of $675,000. When considered together, the qualified family-owned business interest deduction and the unified credit applicable exclusion amount may not exceed $1.3 million. (Sec. 2057.)

A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if one family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in sec. 543). In the case of a trade or business that owns an interest in another trade or business (i.e., “tiered entities”), special look-through rules apply. The

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[51] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, aunts, uncles, and their descendants.

[52] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse or other residential buildings and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least 5 of the 8 years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) is required to actively participate in the trade or business for at least 10 years following the decedent's death.

The benefit of the exclusion for qualified family-owned business interests is subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements; (2) the qualified heir disposes of any portion of the qualified family-owned business, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution; (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship.

The portion of the reduction in estate taxes that is recaptured depends upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business between the date of the decedent's death and the date of the recapture event. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than nine years, 40 percent is recaptured; and if the participation was for at least nine years but less than ten years, 20 percent of the reduction in estates taxes is recaptured. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under section 2032A(c)(7)(A), however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

Deferred payment of estate tax

The estate tax is imposed on transfers at death, and the tax generally is due nine months after the date of the decedent's death. The Commissioner may extend the time for payment of the estate tax for up to 12 months. (Sec. 6161(a)(1).) There is, however, an additional rule which provides that the Commissioner has discretion to grant an extension to pay estate tax upon a showing of "reasonable cause" for a period not exceeding 10 years (sec. 6161(a)(2)).

Moreover, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over as many as 14 years (sec. 6166). To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. For purposes of this rule, an interest in a closely-held business is (1) an interest as a proprietor in a trade or business carried on as a proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent or such partnership had 15 or fewer partners, or (3) stock in a corporation carrying on a trade or business if 20 percent or more in value of the voting stock of the corporation is included in determining the gross estate of the decedent or the corporation had 15 or fewer shareholders. (Sec. 6166(b).)

If this election is made, the estate pays only interest during the first five years, then up to ten annual installments of both principal and interest. Interest generally is imposed at a rate equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short term rate plus three percentage points). In addition, a special 2-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 (adjusted for inflation) in value of the closely-held business (i.e., the amount of estate tax on the first $1,000,000 less the amount of any allowable unified credit). (Sec. 6601(j).)

8. Foreign investment in U.S. real property

In general

Nonresidents who are not U.S. citizens and foreign corporations (referred to herein collectively as "foreign persons") are subject to U.S. tax at a flat rate of 30 percent (or a lower rate pursuant to an applicable tax treaty) on certain types of passive income (but generally not capital gains) derived from U.S. sources. Foreign persons are subject to U.S. tax at the regular graduated rates applicable to U.S. persons on income derived from a U.S. trade or business.

Special U.S. tax rules apply to gains of foreign persons attributable to dispositions of interests in U.S. real property. The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA") (secs. 897, 1445, 6039C, and 6652(f)). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. tax upon the eventual disposition of such property.

Imposition of tax

Section 897(a) provides that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a trade or business within the United States during the taxable year.

Accordingly, foreign persons generally are subject to U.S. tax on any gain from a disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons.

In the case of nonresidents who are not U.S. citizens, the alternative minimum tax applies to the lesser of the individual's alternative minimum taxable income or the individual's net real property gains (sec. 897(a)(2)(A)). Losses of nonresidents who are not U.S. citizens are taken into account under the FIRPTA provisions only to the extent that such losses would be taken into account under Code section 165(c), which limits loss deductions to business losses, losses on transactions entered into for profit, and certain casualty or theft losses (sec. 897(b)).

In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate). If a foreign corporation that holds a U.S. real property interest is entitled to nondiscriminatory treatment with respect to such interest under an applicable treaty, the foreign corporation may elect to be treated as a U.S. corporation for purposes of the FIRPTA provisions (sec. 897(i)). This election may be made only if all shareholders of the corporation consent to the election and specifically agree that any gain upon the disposition of the interest that would be taken into account under the FIRPTA provisions will be taxable even if such taxation would be contrary to a treaty. This election to be treated as a domestic corporation is the exclusive remedy for any person claiming treaty protection against discriminatory treatment as a result of the FIRPTA provisions.

Definition of U.S. real property interest

Under the FIRPTA provisions, U.S. tax is imposed on gains from the disposition of an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. The term "interest in real property" includes, with respect to both land and improvements thereon, fee ownership and co-ownership, leaseholds, options to acquire, and options to acquire leaseholds (sec. 897(c)(6)(A)). Moreover, the term includes partial interests in real property, such as life estates, remainders, and reversions. In addition, the term includes any direct or indirect right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, U.S. real property.

Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). This general rule does not apply to investments in a publicly-traded USRPHC. Under a special rule, USRPHC stock of a class that is regularly traded on an established securities market is treated as a U.S. real property interest only in the case of a foreign person that, at some time during the five-year period described above, held more than 5 percent of that class of stock (sec.

897(c)(3)). Rules similar to this special rule apply to treat an interest in a publicly-traded partnership as a U.S. real property interest.

A corporation is a USRPHC if the fair market value of such corporation's U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)). For purposes of this asset test, a corporation that is a partner in a partnership or a beneficiary of an estate or trust generally takes into account its proportionate share of all assets of such partnership, estate or trust (sec. 897(c)(4)(B)). Look-through rules also apply to a controlling interest (50 percent or more of the fair market value of all classes of stock) held by a corporation in another corporation, whether foreign or domestic (sec. 897(c)(5)).

Special rules applicable to certain transactions

Gain recognized by a foreign person on the disposition of an interest in a partnership, trust, or estate generally is subject to tax under the FIRPTA provisions to the extent that the gain is attributable to any appreciation in the value of any U.S. real property interests of the entity (sec. 897(g)).

As a general rule, nonrecognition provisions apply under the FIRPTA provisions only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (sec. 897(e)). This rule is designed to prevent a foreign person from escaping U.S. tax by exchanging a taxable asset for a nontaxable asset in an exchange which would otherwise qualify for nonrecognition treatment under the Code. Specific rules apply to require gain recognition in certain cases. In this regard, foreign corporations are required in certain circumstances to recognize gain upon the distribution (including a distribution in liquidation or redemption) to their shareholders of appreciated U.S. real property interests (sec. 897(d)(1)). Moreover, gain generally is recognized by a foreign person under the FIRPTA provisions on the transfer of a U.S. real property interest to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital.

Withholding on dispositions by foreign persons of U.S. real property interests

The Code generally imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person (sec. 1445). The withholding obligation generally is imposed on the transferee; however, in certain limited circumstances, an agent of the transferor or transferee is required to withhold. Any tax imposed on a foreign person under the FIRPTA provisions in excess of the amount withheld remains the liability of the foreign person.

The amount required to be withheld on the sale by a foreign person of a U.S. real property interest generally is 10 percent of the amount realized on the transaction (i.e., the gross sales price) (sec. 1445(a)). However, a certificate for reduced withholding may be issued by the IRS such that the amount required to be withheld will not exceed the transferor's maximum tax liability (sec. 1445(c)(1)).

There are several exemptions from the obligation to withhold on a disposition of a U.S. real property interest. First, withholding by the transferee generally is not required if the transferor furnishes to the transferee an affidavit stating, under penalty of perjury, that the transferor is not a foreign person and providing the transferor's taxpayer identification number (sec. 1445(b)(2)). Second, withholding is not required on the disposition of an interest in a domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, that the corporation is not a USRPHC and has not been a USRPHC during the five-year period ending on the date of disposition (sec. 1445(b)(3)). Third, withholding may be reduced or eliminated if the transferee receives a qualifying statement issued by the IRS that the transferor is exempt from tax or either the transferor or the transferee has provided adequate security or has made other arrangements for payment of the tax (sec. 1445(b)(4)). Fourth, withholding is not required if the transferee intends to use the transferred real property as a residence, and the amount realized by the transferor on the disposition of the property is $300,000 or less (sec. 1445(b)(5)). Fifth, withholding is not required on a disposition of stock of a class that is regularly traded on an established securities market (sec. 1445(b)(6)).

Special withholding rules apply in the case of certain dispositions of U.S. real property interests by partnerships, trusts, and estates; certain distributions by foreign or domestic corporations, partnerships, trusts and estates; and certain dispositions of interests in partnerships, trusts, and estates.

Reporting requirements and penalties for noncompliance

Section 6039C of the Code authorizes the IRS to require reporting by foreign persons holding direct investments in U.S. real property interests, and imposes penalties for failure to file any required reports. However, to date no such requirements have been imposed.

II. OVERVIEW OF PROPOSALS

A. Oil and Gas and Alternative Fuel Proposals

1. Oil and gas proposals

Numerous proposals for tax relief to oil and gas producers have been advanced as options to increase domestic production.[53] The following lists the major proposals contained in some or all of these bills:

- Provide a new income tax credit for domestic oil and gas production from marginal wells. The credit typically would be $3 per barrel of oil (or barrel equivalent) produced, and could be claimed against both the regular income tax and the alternative minimum tax. Most proposals would phase out the credit if oil and gas prices exceeded prescribed levels.

- Eliminate remaining alternative minimum tax preferences for income from domestic oil and gas production, including elimination of oil and gas income items from the corporate "adjusted corporate earnings" ("ACE") preference.

- Allow net operating losses attributable to domestic oil and gas production to be carried back for a longer period, typically five or ten years, than under present law, thereby allowing oil and gas producers to receive refunds of taxes paid in prior years when prices were higher during periods of lower prices (i.e., when the losses occurred).

- Allow geological and geophysical costs incurred in domestic oil and gas exploration to be deducted currently (or amortized over prescribed periods). Under present law, these costs are capitalized and recovered as part of deductions generally available for producing wells, or deducted when a field is abandoned as nonproductive.

- Allow delay rental payments to be deducted in the year paid rather than only after production commences.

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[53] Among the bills which have been introduced in the Senate during the 106th Congress are S. 325 (introduced January 28, 1999, by Senators Hutchison, Nickles, Murkowski, Breaux, Conrad, Gramm, Rockefeller, and Lott, and others), S. 595 (introduced March 11, 1999, by Senator Domenici), S. 1042 (introduced May 13, 1999, by Senator Hutchison), S. 1050 (introduced May 13, 1999, by Senator Murkowski), S. 1833 (introduced October 29, 1999, by Senator Daschle), and S. 2265 (introduced March 21, 2000, by Senators Hutchison, Breaux, Lott, and Gramm, and others).

- Exempt from tax income attributable to production from inactive oil wells that are re-opened for production.

- Reduce the depreciable life of natural gas gathering lines to seven years.

- Increase the percentage depletion allowance for stripper well production; repeal or increase the current property income and net income limits that limit allowable percentage depletion deductions.

- Expand the enhanced oil recovery tax credit to include the costs of certain nontertiary recovery methods.

2. Alternative fuels proposals

Numerous proposals for tax incentives relating to alternative fuels and electric vehicles have been advanced.[54] Generally, for purposes of these bills alternative fuel (or clean burning fuel) is defined to include compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid at least 85 percent of the volume of which consists of methanol. The following lists the primary tax incentives from these bills:

- Increase the credit for qualified electric vehicles meeting certain requirements.

- Provide a new income tax credit for alternative fuel vehicles.

- Provide a new income tax credit for retail sale of clean burning or alternative fuel as motor fuel.

- Allow an additional deduction for the cost of installing alternative fueling stations.

- Extend the deduction for certain clean fuel vehicles and refueling property to include qualified electric vehicles as "qualified clean-fuel vehicle property" and extend the tax incentive through 2007.

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[54] Among the bills which have been introduced in the Senate during the 106th Congress is S. 1003 (introduced May 11, 1999, by Senators Rockefeller, Hatch, Bryan, and others).

B. Land Use Conservation and Preservation Proposals

1. Income Tax Proposals

Numerous proposals for income and estate tax benefits for land use conservation and preservation, which promote certain land use and environmental preservation have been advanced.[55] The following lists the major proposals from these bills:

- Provide a 50-percent exclusion of the gain on the sales of land or interests in land or water to eligible entities for conservation purposes.
- Allow a deduction from gross income of a percentage of the gain on the sale of timber.
- Provide an exclusion of gain from the sales of interests in forest land for conservation purposes.
- Provide that passive loss limitations would not apply to timber activities if, by the nature of the timber activity, the total hours devoted to management of the activity generally is less than 100 hours.
- Provide an exclusion for cost-sharing payments under the Partners for Fish and Wildlife Program.
- Expand availability of the income tax deduction for donations of qualified conservation easements.
- Provide a new income tax credit for holders of "Community Open Space" bonds, which would be bonds, 95 percent or more of the proceeds of which must be used for a "qualified environmental infrastructure project." A qualified environmental infrastructure project would include acquisition of qualified property for use as open space, wetlands, public parks, or greenways, or to improve access to public lands by non-motorized means. A qualified environmental infrastructure project also may include the construction, rehabilitation, or repair of a visitor's facility in connection with qualified property including nature centers, campgrounds, or hiking and biking trails.

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[55] Among the bills which have been introduced in the Senate during the 106th Congress are S. 808 (introduced on May 15, 1999, by Senator Jeffords and others), S. 963 (introduced on May 5, 1999, by Senator Gregg), S. 1392 (introduced on June 19, 1999, by Senator Baucus), S. 1558 (introduced on August 5, 1999, by Senator Baucus), and S. 2344 (introduced on April 4, 2000, by Senators Brownback, Kerrey, Conrad, and Grassley, and others).

- Provide that conservation reserve program payments would not be subject to self-employment tax.

2. Estate Tax Proposals

- Expand availability of the estate tax exclusion for qualified conservation easements by providing an unlimited exclusion from the gross estate for land subject to a qualified conservation easement, and by eliminating the requirement that eligible land must be located within a certain distance from a metropolitan area, National Park, wilderness area, or Urban National Forest.

- Expand availability of the estate tax special-use valuation provisions by increasing the maximum aggregate reduction in fair market value eligible for special-use valuation from $750,000 to $1 million (adjusted for inflation), and by providing that qualified woodlands would be eligible for special-use valuation.

- Provide a maximum $10 million estate tax exclusion for land subject to an endangered species conservation agreement.