# DESCRIPTION OF THE
# "ECONOMIC SECURITY AND RECOVERY ACT OF 2001"

Scheduled for Markup
By the
HOUSE COMMITTEE ON WAYS AND MEANS
on October 12, 2001


Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION



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# INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "Economic Security and Recovery Act of 2001," scheduled for a markup on October 12, 2001, by the House Committee on Ways and Means.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the "Economic Security and Recovery Act of 2001"* (JCX-69-01), October 11, 2001.

# I. COST RECOVERY PROVISIONS

## A. Special Depreciation Allowance for Certain Property

### Present Law

**Depreciation deductions**

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that the capitalized computer software costs, other than computer software to which section 197 applies, is recovered ratably over 36 months.

**Expensing election**

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). Such amount is increased to $25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $24,000 ($25,000 for taxable years beginning in 2003 and thereafter) amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No credit under section 38 shall be allowed with respect to any amount for which a deduction is allowed under section 179.

### Description of Proposal

The proposal would allow an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of certain qualified property that is placed in service before January 1, 2004. The additional depreciation deduction would be allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.

The basis of the property and the depreciation allowances in the year of purchase and later years would be appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer would be allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

Property would qualify for the additional first-year depreciation deduction if the property is (1) property to which MACRS applies with a recovery period of 20 years or less except for leasehold improvements, (2) water utility property as defined in section 168(e)(5), or (3) computer software other than computer software covered by section 197. In order to be qualified property, the original use of the property must commence with the taxpayer on or after September 11, 2001.[2] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

In addition, qualified property would be required to be acquired by the taxpayer (1) after September 10, 2001 and before September 11, 2003, but only if no binding written contract for the acquisition is in effect before September 11, 2001 or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2003. Finally, property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer would qualify if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2003 (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property would be considered to be manufactured, constructed, or produced by the taxpayer.

The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. Except as otherwise provided in treasury regulations, repaired or reconstructed property would be not qualified property.

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) would be increased in the first year by $4,600 for automobiles that qualify (and do not elect out of the increased first year deduction).

The following examples illustrate the operation of the provision.

EXAMPLE 1. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs $1 million. Under the proposal, the taxpayer is allowed an additional first-year depreciation deduction of $300,000. The remaining $700,000 of

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[2] A special rule would apply in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

adjusted basis is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

EXAMPLE 2. -- Assume that on March 1, 2002, a calendar year taxpayer acquires and places in service qualified property that costs $44,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a $24,000 deduction under section 179. The taxpayer then is allowed an additional first-year depreciation deduction of $6,000 based on $20,000 ($44,000 original cost less the section 179 deduction of $24,000) of adjusted basis. Finally, the remaining adjusted basis of $14,000 ($20,000 adjusted basis less $6,000 additional first-year depreciation) is to be recovered in 2002 and subsequent years pursuant to the depreciation rules of present law.

**Effective Date**

The proposal would apply to property placed in service after September 10, 2001.

### B. Temporary Increase in Section 179 Expensing

#### Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 (for taxable years beginning in 2001 or 2002) of the cost of qualifying property placed in service for the taxable year (sec. 179). This amount is increased to $25,000 of the cost of qualified property placed in service for taxable years beginning in 2003 and thereafter. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $24,000 ($25,000 for taxable years beginning in 2003 and thereafter) amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

#### Description of Proposal

The proposal would provide that the maximum dollar amount that may be deducted under section 179 is increased to $35,000 for property placed in service in taxable years beginning after December 31, 2001, and before January 1, 2004. In addition, the proposal would increase the present law $200,000 limit to $325,000. Thus, under the proposal the $35,000 amount would be reduced by the amount by which the cost of qualifying property placed in service exceeds $325,000. As under present law, no general business credit under section 38 would be allowed with respect to any amount for which a deduction is allowed under section 179. For taxable years beginning after December 31, 2003, present law would apply.

#### Effective Date

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

## C. Treatment of Leasehold Improvements

### Present Law

**Depreciation of leasehold improvements**

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[3] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[4] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[5]

**Treatment of dispositions of leasehold improvements**

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease.[6] This rule conforms the treatment of

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[3] The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[4] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

[5] If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

[6] The conference report describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.[7]

## Description of Proposal

The proposal would provide that 15-year property for purposes of the depreciation rules of section 168 includes qualified leasehold improvement property. The straight line method would be required to be used with respect to qualified leasehold improvement property.

Qualified leasehold improvement property would be any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) of that portion of the building, or by the lessor of that portion of the building. That portion of the building is to be occupied exclusively by the lessee (or any sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property would not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

A 15-year period would be specified as the class life of qualified leasehold improvement property for purposes of the alternative depreciation system. Therefore, the general rule that the class life for nonresidential real and residential rental property is 40 years would not apply to qualified leasehold improvement property.

For purposes of the proposal, a commitment to enter into a lease would be treated as a lease, and the parties to the commitment would be treated as lessor and lessee. A lease between related persons would not be considered a lease for this purpose.

Under the proposal, an improvement made by the person who was the lessor of the improvement when it was placed in service generally would be treated as qualified leasehold improvement property only so long as the improvement is held by that person. Exceptions would be provided under this rule in the case of certain changes in form of business.

Qualified leasehold improvement property would not be eligible for the 30 percent expensing provided under a separate provision of the proposal.

[7] Under present law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

## Effective Date

The proposal would be effective for qualified leasehold improvement property placed in service on or after September 11, 2001.

# II. NET OPERATING LOSS PROVISION

## A. Five-Year Carryback of Net Operating Losses

### Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally 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.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years. Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster areas). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI.

### Description of Proposal

The proposal would temporarily extend the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending on or after September 11, 2001, and ending before September 11, 2004. In addition, the five-year carryback period would apply to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

The proposal also would allow an NOL deduction attributable to these taxable years to offset 100 percent of a taxpayer's AMTI in a carryback year.

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the proposal.

### Effective Date

The proposal would be effective for NOLs arising in taxable years ending on or after September 11, 2001.

# III. ALTERNATIVE MINIMUM TAX

## A. Repeal Corporate Alternative Minimum Tax

### Present Law

**In general**

Present law imposes an alternative minimum tax ("AMT") on a corporation to the extent the corporation's tentative minimum tax exceeds its regular tax. This tentative minimum tax is computed at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a $40,000 phased-out exemption amount. The exemption amount is phased-out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds $150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less that $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first 3-taxable year period.

**Preference items in computing AMTI**

The corporate minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

**Adjustments in computing AMTI**

The adjustments that corporations must make in computing AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line

method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) The special rules applicable to Merchant Marine construction funds are not applicable.

(6) The special deduction allowable under section 833(b) Blue Cross and Blue Shield organizations is not allowed.

(7) The adjusted current earnings adjustment, described below.

**Adjusted current earning (“ACE”) adjustment**

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction. In determining ACE the following rules apply:

(1) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.

(2) Any amount that is excluded from gross income under the regular tax but is included for purposes of determining earnings and profits is included in determining ACE.

(3) The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).

(4) Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.

(5) The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.

(6) Inventory must be calculated using the FIFO, rather than LIFO, method.

(7) The installment sales method generally may not be used.

(8) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(9) Depletion (other than for oil and gas) must be calculated using the cost, rather than the percentage, method.

(10) In certain cases, the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.

**<u>Other rules</u>**

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's AMT liability by more than 90 percent of the amount determined without these items.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT.

If a corporation is subject to AMT in any year, the amount of AMT is allowed as a credit ("AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in the subsequent year.

## <u>Description of Proposal</u>

The proposal would repeal the corporate AMT.

The proposal would make the AMT credit for corporations refundable.

## <u>Effective Date</u>

The proposal would apply to taxable years beginning after December 31, 2000.

# IV. DEFERRAL OF MULTINATIONAL BUSINESS INCOME

## A. Extend Exceptions under Subpart F for Active Financing Income

### Present Law

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

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

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[8]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In

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[8] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (P.L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002.

addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in sec. 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of sec. 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

Present law also provides a temporary exception from foreign personal holding company income for income from investment of assets equal to 10 percent of reserves (determined for purposes of the provision) for contracts regulated in the country in which sold as life insurance or annuity contracts. This exception does not apply to investment income with respect to excess surplus.

## Description of Proposal

The proposal would extend permanently the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

The proposal generally would retain present law with respect to the determination of an insurance company's reserve for a life insurance or annuity contract under these exceptions. The proposal would, however, permit a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process, to establish that the reserve for such contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). The reserve so established could not exceed the greater of this amount or the net surrender value of the contract (as under present law). IRS approval would be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer would be required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison could be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). Present law would continue to apply with respect to reserve for any life insurance or annuity contract for which the IRS had not approved the use of the foreign statement reserve. The IRS ruling would be subject to the present-law provisions relating to IRS user fees.

## Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 2001, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

# V. PROVISIONS AFFECTING INDIVIDUAL TAXPAYERS

## A. Supplemental Rebate

### Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for a rate reduction credit for 2001. The credit is computed in the following manner. Taxpayers would be entitled to a credit in tax year 2001 of 5 percent (the difference between the 15-percent rate and the 10-percent rate) of the amount of income that would have been eligible for the new 10-percent rate. Taxpayers may not receive this credit in excess of their income tax liability (determined after nonrefundable credits).

Most eligible taxpayers have received this credit in the form of a check issued by the Department of the Treasury. The amount of the check was computed in the same manner as the credit, except that it was done on the basis of tax returns filed for 2000 (instead of 2001).

On their tax returns for 2001, taxpayers will reconcile the amount of the credit with the check they receive in the following manner. They will complete a worksheet calculating the amount of the credit based on their 2001 tax return. They will then subtract from the credit the amount of the check they received. For many taxpayers, these two amounts would be the same. If, however, the result is a positive number (because, for example, the taxpayer paid no tax in 2000 but is paying tax in 2001), the taxpayer may claim that amount as a credit against 2001 tax liability. If, however, the result is negative (because, for example, the taxpayer paid tax in 2000 but owes no tax for 2001), the taxpayer is not required to repay that amount to the Treasury. Otherwise, the checks have no effect on tax returns filed in 2001; the amount is not includible in gross income and it does not otherwise reduce the amount of withholding. In no event may the Department of the Treasury issue checks after December 31, 2001. This is designed to prevent errors by taxpayers who might claim the full amount of the credit on their 2001 tax returns and file those returns early in 2002, at the same time the Treasury check might be mailed to them. Payment of the credit (or the check) is treated, for all purposes of the Code,[9] as a payment of tax. As such, the credit or the check is subject to the refund offset provisions, such as those applicable to past-due child support under section 6402 of the Code.

In general, taxpayers eligible for the credit (and the check) are individuals other than estates or trusts, nonresident aliens, or dependents. The determination of this status for the relevant year is made on the basis of the information filed on the tax return.

### Description of Proposal

The proposal would provide a new supplemental rebate. Individuals who filed income tax returns for 2000[10] before August 16, 2001 (regardless of whether they had any income tax

[9] A special rule provides that no interest will be paid with respect to the checks.

[10] Taxpayers who did not file an income tax return for 2000 but who do file an income tax return for 2001 will continue to be eligible for the rate reduction credit previously enacted,

liability or any payroll tax liability) are eligible for this supplemental rebate. The amount of the rebate would be calculated in the following manner: taxpayers would be eligible for the maximum rebate amount for their filing status ($300 single or married filing separately, $500 head of household, $600 joint filers) minus the amount (if any) of any previous rebate check issued. Thus, if a single person received $100 earlier this year as her rate reduction credit, she would receive an additional $200. Those who earlier received the full amounts for their filing status would receive nothing additional. It is irrelevant whether the taxpayer showed any amount as wages on the 2000 income tax return.

Dependents and nonresident aliens would be ineligible for these supplemental rebates (as they were for the previous rebates). IRS would be required to send notices to affected taxpayers explaining the computation of their supplemental rebate amounts and how the taxpayer should properly complete the rebate reconciliation schedule contained in the tax return forms package.

## Effective Date

The proposal would be effective on the date of enactment. Checks for this new supplemental rebate would have to be issued by December 31, 2001. In order to prevent difficulties that could arise in the simultaneous administration of two rebate provisions, the issuance of checks under the previous rebate provision would be required to cease on the date of enactment of these supplemental rebates.

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the amount of which is dependent upon the amount of income subject to the 10-percent rate. They would not, however, be eligible for this supplemental rebate.

### B. Accelerate the 25-Percent Rate Bracket to 2002

**Present Law**

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") reduced the prior-law 28-percent individual regular income tax rate to 25 percent. This rate reduction is phased-in over six years. The rate is 27 percent for taxable years beginning in calendar years 2001-2003,[11] 26 percent for taxable years beginning in calendar years 2004-2005, and 25 percent for taxable years beginning in calendar years 2006 and thereafter.

**Description of Proposal**

The proposal would accelerate this reduction. Therefore, the 25-percent rate would be effective for taxable years beginning in calendar years 2002 and thereafter.

**Effective Date**

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

[11] Effective July 1, 2001.

### C. Alternative Minimum Tax Exemption for Individuals

**Present Law**

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

**Description of Proposal**

The proposal would increase the AMT exemption amount of individuals for taxable years beginning in 2002, 2003, and 2004.

For 2002 and 2003, the $49,000 exemption amount would be increased by $3,200; the $35,750 exemption amount would be increased by $1,600; and the $24,500 exemption amount would be increased by $1,600.

For 2004, the $49,000 exemption amount would be increased by $1,700; the $35,750 exemption amount would be increased by $850; and the $24,500 exemption amount would be increased by $850.

**Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001 and before January 1, 2005.

## D. Increase Deduction of Capital Losses of Individuals Against Ordinary Income

### Present Law

Capital losses of individuals are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 ($1,500 in the case of married individuals filing a separate return) of ordinary income in each taxable year. Any remaining unused capital losses may be carried forward indefinitely to future taxable years.

### Description of Proposal

The amount of capital losses of individuals that may offset ordinary income would be increased from $3,000 to $4,000, in the case of taxable years beginning in 2001 and to $5,000, in the case of taxable years beginning in 2002.

### Effective Date

The proposal would apply to taxable years beginning in 2001 and 2002.

## E. Simplify Individual Capital Gains Rates

### Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

The maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. In addition, any adjusted net capital gain which otherwise would be taxed at a 15-percent rate is taxed at a 10-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock),[12] the net short-

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[12] This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent.

term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 15-percent rate is taxed at the 15-percent rate.

Any gain from the sale or exchange of property held more than five years which would otherwise be taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate.

A taxpayer holding a capital asset or property used in the trade or business on January 1, 2001, may elect to treat the asset as having been sold on that date for an amount equal to its fair market value, and having been reacquired for an amount equal to such value.

## Description of Proposal

The proposal would reduce the 10- and 20-percent rates on the adjusted net capital gain to 8 and 18 percent, respectively. These lower rates would apply to both the regular tax and the alternative minimum tax.

The proposal would repeal the special rules for certain gain from property held more than 5 years and would repeal the election to recognize gain on property held on January 1, 2001. The lower rates would apply to assets held more than one year.

## Effective Date

The proposal would apply to taxable years ending on or after October 12, 2001.

For taxable years which include October 12, 2001, the lower rates would apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after October 12, 2001. In the case of gain taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

## F. Expand Exception from Early Withdrawal Tax for Health Insurance Expenses of Unemployed Individuals

### Present Law

A distribution from an individual retirement account ("IRA") or an employer-sponsored retirement plan generally is includible in gross income in the year it is paid under the rules relating to taxation of annuities, unless the amount distributed represents the individual's investment in the contract (i.e., basis). Special rules apply in the case of Roth IRAs, distributions that are rolled over into another tax-favored retirement plan, distributions of employer securities, and certain other situations.

Taxable distributions made from an IRA or from certain employer-sponsored retirement plans before age 59-1/2, death, or disability generally are subject to an additional 10-percent income tax. Besides IRAs, the early withdrawal tax applies to distributions from a qualified retirement plan (including a section 401(k) plan), a qualified annuity plan, or a tax-deferred annuity plan ("section 403(b) plan"). However, exceptions apply to the early withdrawal tax, depending in part on the specific type of arrangement from which the distribution is made and the purpose for which the distribution is used.

The 10-percent early withdrawal tax does not apply to IRA distributions to an unemployed individual after separation from employment to the extent the distributions do not exceed the amount paid during the year for health insurance for the individual and the individual's spouse and dependents. This exception applies if the individual (including a self-employed individual) has received unemployment compensation under Federal or State law for at least 12 consecutive weeks and if the distribution is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then, to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed.

The exception to the early withdrawal tax ceases to apply if the individual has been reemployed for at least 60 days.

### Description of Proposal

The proposal would expand the present-law exception to the early withdrawal tax for IRA distributions used for health insurance for unemployed individuals. Under the proposal, the exception would apply to distributions made after separation from employment to individuals who receive unemployment compensation for four consecutive weeks during the period from September 11, 2001 to December 31, 2002. As under present law, the exception would apply to the extent distributions do not exceed the amount paid during the year for health insurance for the individual and the individual's spouse and dependents. As under present law, the exception could apply to distributions made in the year following the year in which the unemployment compensation is received, but would not apply to distributions made after the individual has been reemployed for at least 60 days.

Under the proposal, the exception would apply also to distributions from a qualified retirement plan (including a section 401(k) plan), a qualified annuity plan, or a section 403(b) plan, provided the requirements for the exception were otherwise met.

**Effective Date**

The provision would be effective for distributions made after the date of enactment.

## VI. EXTENSION OF EXPIRING PROVISIONS AND ADDITIONAL ITEMS

### A. Two-Year Extension of Provisions Expiring in 2001

#### 1. Extend Alternative Minimum Tax Relief for Individuals

**Present Law**

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit[13], the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the IRA credit, and the D.C. homebuyer's credit). For taxable years beginning after 2001, these credits (other than the adoption credit, child credit and IRA credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

For taxable years beginning in 2001, all the nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 ($49,000 in taxable years beginning before 2005) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($35,750 in taxable years beginning before 2005) in the case of other unmarried individuals; (3) $22,500 ($24,500 in taxable years beginning before 2005) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

**Description of Proposal**

The proposal would allow an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits in 2002 and 2003.

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[13] A portion of the child credit may be refundable.

## Effective Date

The proposal would be effective for taxable years beginning in 2002 and 2003.

## 2. Extend the Work Opportunity Tax Credit

### Present Law

**In general**

The work opportunity tax credit "WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Generally, qualified wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer.

The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

For purposes of the credit, wages are generally defined as under the Federal Unemployment Tax Act, without regard to the dollar cap.

**Targeted groups eligible for the credit**

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families ("TANF") Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income ("SSI") benefits.

The employer's deduction for wages is reduced by the amount of the credit.

**Expiration date**

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2002.

### Description of Proposal

The proposal would extend the work opportunity tax credit for two years (through December 31, 2003).

### Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

### 3. Extend the Welfare-To-Work Tax Credit

**Present Law**

**In general**

The welfare-to-work tax credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within two years after the Federal or State time limits made the family ineligible for family assistance. Family assistance means benefits under the Temporary Assistance to Needy Families ("TANF") program.

For purposes of the credit, wages are generally defined under the Federal Unemployment Tax Act, without regard to the dollar amount. In addition, wages include the following: (1) educational assistance excludable under a section 127 program; (2) the value of excludable health plan coverage but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

The employer's deduction for wages is reduced by the amount of the credit.

**Expiration date**

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2002.

**Description of Proposal**

The proposal would extend the welfare to work credit for two years (through December 31, 2003).

**Effective Date**

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 2002, and before January 1, 2004.

### 4. Extend Section 45 Credit for Production of Electricity from Wind, Closed Loop Biomass, and Poultry Litter

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45).

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

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

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

#### Description of Proposal

The proposal would extend the placed in service date for qualified facilities by two years to include those facilities placed in service prior to January 1, 2004.

#### Effective Date

The proposal would be effective on the date of enactment.

**5. Taxable Income Limit on Percentage Depletion for Marginal Production**

## Present Law

### In general

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

Two methods of depletion are allowable under 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)). The Taxpayer Relief Act of 1997 suspended the 100-percent-of-net-income limitation for production from marginal wells for taxable years beginning after December 31, 1997, and before January 1, 2000. The suspension of the limitation extended to include taxable years beginning before January 1, 2002. Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[14] 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)).

[14] 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.

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

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

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

## Description of Proposal

The proposal would extend the period when the 100-percent net-income limit is suspended to include taxable years beginning after December 31, 2001 and before January 1, 2004.

## Effective Date

The proposal would be effective on the date of enactment.

## 6. Extension of Authority to Issue Qualified Zone Academy Bonds

### Present Law

**Tax-exempt bonds**

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

**Qualified zone academy bonds**

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds" ("QZABs") (sec. 1397E). A total of $400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2001. The $400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

"Qualified zone academy bonds" are 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.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zones enterprise community designated under the Code, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

## Description of Proposal

The proposal would authorize issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

## Effective Date

The proposal would be effective on the date of enactment.

### 7. Extension of Increased Coverover Payments to Puerto Rico and the Virgin Islands

#### Present Law

A $13.50 per proof gallon[15] excise tax is imposed on distilled spirits produced in, or imported or brought into, the United States. The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $13.25 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands during the period July 1, 1999 through December 31, 2001. Effective on January 1, 2002, the coverover rate is scheduled to return to its permanent level of $10.50 per proof gallon.

Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.

#### Description of Proposal

The proposal would extend the $13.25-per-proof-gallon coverover rate for two additional years, through December 31, 2003.

#### Effective Date

The proposal would be effective on the date of enactment.

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[15] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

**8. Delay in Effective Date of Requirement for Approved Diesel or Kerosene Terminal**

**Present Law**

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel.[16] One such exception allows removal of diesel fuel or kerosene without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This "dyed-fuel mandate" was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000, and later until January 1, 2002.

**Description of Proposal**

The effective date of the diesel fuel and kerosene dyeing mandate would be delayed for two additional years, until January 1, 2004.

**Effective Date**

The proposal would be effective on the date of enactment.

[16] Tax is imposed before that point if the motor fuel is transferred (other than in bulk) from a refinery or if the fuel is sold to an unregistered party while still held in the refinery or bulk distribution system (e.g., in a pipeline or terminal facility).

**9. Extend Deduction for Qualified Clean-Fuel Vehicle Property and Qualified Clean-Fuel Vehicle Refueling Property**

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

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

The deduction for clean-fuel vehicle property phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004. The deduction for clean-fuel vehicle refueling property is unavailable for property placed in service after December 31, 2004.

**<u>Description of Proposal</u>**

The proposal would defer the phase down of the deduction for clean-fuel vehicle property by two years. Taxpayers could claim the full amount of the deduction for qualified vehicles placed in service in 2002 and 2003. The phase down of the deduction for clean-fuel vehicles would commence in 2004 and the deduction would be unavailable for purchases after December 31, 2006. A conforming modification would be made to section 280F.

The proposal would extend the placed in service date for clean-fuel vehicle refueling property by one year. The deduction for clean-fuel vehicle refueling property would be available for property placed in service prior to January 1, 2007.

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[17] The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a qualified clean-burning fuel vehicle, the limitation of sec. 280F applies only to that portion of the vehicle's cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel property, without regard to the limitation. These exceptions from sec. 280F apply to vehicles placed in service prior to January 1, 2005.

## Effective Date

The proposal would be effective on the date of enactment.

**10. Extend Credit for Purchase of Electric 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 is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.[18]

**Description of Proposal**

The proposal would defer the phase down of the credit by two years. Taxpayers could claim the full amount of the credit for qualified purchases made in 2002 and 2003. The phase down of the credit value would commence in 2004 and the credit would be unavailable for purchases after December 31, 2006. A conforming modification would be made to section 280F.

**Effective Date**

The proposal would be effective on the date of enactment.

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[18] The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited (sec. 280F). In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the otherwise applicable limitation amounts are tripled. These exceptions from sec. 280F apply to vehicles placed in service prior to January 1, 2005.

## 11. Tax on Failure to Comply with Mental Health Parity Requirements

### Prior Law

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, but do not apply to benefits for services furnished on or after September 30, 2001.

The Taxpayer Relief Act of 1997 added to the Internal Revenue Code the requirements imposed under the Mental Health Parity Act, and imposed an excise tax on group health plans that fail to meet the requirements. The excise tax is equal to $100 per day during the period of noncompliance and is imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

The excise tax is applicable with respect to plan years beginning on or after January 1, 1998, and expired with respect to benefits for services provided on or after September 30, 2001.

### Description of Proposal

The excise tax on failures to comply with mental health parity requirements would be extended for two years.

### Effective Date

The provision would be effective with respect to plan years beginning on or after January 1, 2002, and would not apply to benefits for services furnished on or after January 1, 2004.

## B. One-Year Extension of Provision Expiring in 2002

### 1. Extension of Archer Medical Savings Accounts ("MSAs")

**Present Law**

**In general**

Within limits, contributions to a an Archer medical savings account ("MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

**Eligible individuals**

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan.[19] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

**Tax treatment of and limits on contributions**

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

**Definition of high deductible plan**

A high deductible plan is a health plan with an annual deductible of at least $1,600 and no more than $2,400 in the case of individual coverage and at least $3,200 and no more than $4,800 in the case of family coverage. In addition, the maximum out-of-pocket expenses with

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[19] Self-employed individuals include more than 2-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

respect to allowed costs (including the deductible) must be no more than $3,200 in the case of individual coverage and no more than $5,850 in the case of family coverage.[20] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

**Taxation of distributions**

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.[21] However, in any year for which a contribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[22] For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

**Cap on taxpayers utilizing Archer MSAs**

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the pilot period 1997-2002, only those individuals who (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer MSA participants) or (2) are employed by a participating employer, those individuals are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan

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[20] These dollar amounts are for 2001. These amounts are indexed for inflation in $50 increments.

[21] This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

[22] The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even for an individual who is not an eligible individual.

commences would not be taken into account.[23] However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of Archer MSAs established has not exceeded the threshold level.

**End of Archer MSA pilot program**

After 2002, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made Archer MSA contributions of at least $100 in the year 2001.

Self-employed individuals who made contributions to an Archer MSA during the period 1997-2002 also may continue to make contributions after 2002.

## Description of Proposal

The proposal would extend the Archer MSA program for another year, through December 31, 2003.

## Effective Date

The proposal would be effective on the date of enactment.

[23] Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

## C. Technical Amendments

### 1. Limitation on Use of Non-Accrual Experience Method of Accounting

#### Present Law

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

A cash method taxpayer is not required to include an amount in income until it is received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million.

#### Description of Proposal

Under the proposal, the non-accrual experience method of accounting would be available only for amounts to be received for the performance of qualified services and for services provided by certain small businesses. Amounts to be received for all other services would be subject to the general rule regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Under a special rule, the non-accrual experience method of accounting would continue to be available for the performance of services if the average annual gross receipts of the taxpayer (or any predecessor) do not exceed $5 million. The rules of paragraph (2) and (3) section 448(c) (i.e., the rules regarding the aggregation of related taxpayers, taxpayers not in existence for the entire three year period, short taxable years, definition of gross receipts, and treatment of predecessors) would apply for purposes of determining the average annual gross receipts test.

The proposal would require that the Secretary of the Treasury prescribe regulations that would permit a taxpayer to use alternative computations or formulas if such alternative computations or formulas accurately reflect, based on experience, the amount of its year end receivables that will not be collected. In addition, the proposal would permit taxpayers to adopt, or request consent of the Secretary of the Treasury to change to, an alternative computation or formula that clearly reflects the taxpayer's experience. The proposal would require the Secretary of Treasury to approve a request provided that the alternative computation or formula clearly reflects the taxpayer's experience.

## Effective Date

The proposal would be effective for taxable years ending after date of enactment. Any change in the taxpayer's method of accounting required as a result of the limitation on the use of the non-accrual experience method to qualified services would be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any resultant section 481(a) adjustment is to be taken into account over a period not to exceed the lesser of the number of years the taxpayer has used the non-accrual experience method of accounting or four years under principles consistent with those in Rev. Proc. 99-49.

**2. Reverse the Supreme Court's Decision in *Gitlitz v. Commissioner***

**Present Law**

In general, an S corporation is not subject to the corporate income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on their individual income tax returns. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder may deduct losses only to the extent of a shareholder's basis in his or her stock in the S corporation plus the shareholder's adjusted basis in any indebtedness of the corporation to the shareholder. Any loss that is disallowed by reason of lack of basis is "suspended" at the corporate level and is carried forward and allowed in any subsequent year in which the shareholder has adequate basis in the stock or debt.

In general, gross income includes income from the discharge of indebtedness. However, income from the discharge of indebtedness of a taxpayer in a bankruptcy case or when the taxpayer is insolvent (to the extent of the insolvency) is excluded from income.[24] The taxpayer is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income.

In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness by a creditor of the S corporation is excluded from the corporation's income, and the S corporation reduces its tax attributes (including any suspended losses).

To illustrate these rules, assume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows $100 from a third party and losses the entire $100. Because the shareholder has no basis in its stock, the $100 loss is "suspended" at the corporate level. If the $100 debt is forgiven when the corporation is in bankruptcy or is insolvent, the $100 income from the discharge of indebtedness is excluded from income, and the $100 "suspended" loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.

Notwithstanding the economics of the overall transaction, the United States Supreme Court ruled in the case of *Gitlitz v. Commissioner*[25] that, under present law, income from the discharge of indebtedness of an S corporation that is excluded from income is treated as an item of income which increases the basis of a shareholder's stock in the S corporation and allows the

[24] Special rules also apply to certain real estate debt and farm debt.

[25] 121 S. Ct. 701 (2001).

suspended corporate loss to pass thru to a shareholder. Thus, under the decision, an S corporation shareholder is allowed to deduct a loss for tax purposes that it did not economically incur.

## **Description of Proposal**

The proposal would provide that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation.

## **Effective Date**

The proposal would apply to all taxable years beginning before, on, or after October 12, 2001. The proposal would not apply to a shareholder if the shareholder filed an income tax return or claim for refund, with respect to a discharge of indebtedness, before October 12, 2001, and the return or claim took the position upheld by the Supreme Court decision in the *Gitlitz* case.