TECHNICAL EXPLANATION OF S. 3152, THE "COMMUNITY RENEWAL AND NEW MARKETS ACT OF 2000"

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of the

JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

This document[1] prepared by the staff of the Joint Committee on Taxation provides a technical explanation of S. 3152, the "Community Renewal and New Markets Act of 2000." The Community Renewal and New Markets Act of 2000 provides various tax incentives for distressed communities, affordable housing, urban and rural infrastructure, the production of energy, conservation, tax relief for farmers, and several additional tax provisions.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of S. 3152, the "Community Renewal and New Markets Act of 2000"* (JCX-105-00), October 3, 2000.

I. INCENTIVES FOR DISTRESSED AREAS

A. Tax Incentives for Renewal Zones and Empowerment Zones (secs. 101 and 111-115 of the bill and secs. 1391, 1394, 1396, 1397A-D, and new sec. 1400E of the Code)

Present Law

In recent years, provisions have been added to the Internal Revenue Code that target specific geographic areas for special Federal income tax treatment. As described in greater detail below, empowerment zones and enterprise communities generally provide tax incentives for businesses that locate within certain geographic areas designated by the Secretaries of Housing and Urban Development ("HUD") and Agriculture.

Round I empowerment zones

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") authorized the designation of nine empowerment zones ("Round I empowerment zones") to provide tax incentives for businesses to locate within targeted areas designated by the Secretaries of HUD and Agriculture. The Taxpayer Relief Act of 1997 ("1997 Act") authorized the designation of two additional Round I urban empowerment zones.

Businesses in the 11 Round I empowerment zones qualify for the following tax incentives: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone,[2] (2) an additional $20,000 of section 179 expensing for qualifying zone property, and (3) tax-exempt financing for certain qualifying zone facilities.[3] The tax incentives with respect to the empowerment zones designated by OBRA 1993 generally are available during the 10-year period of 1995 through 2004. The tax incentives with respect to the two additional Round I empowerment zones generally are available during the 10-year period of 2000 through 2009.[4]

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[2] For wages paid in calendar years during the period 1994 through 2001, the credit rate is 20 percent. The credit rate is reduced to 15 percent for calendar year 2002, 10 percent for calendar year 2003, and 5 percent for calendar year 2004. No wage credit is available after 2004 in the original nine empowerment zones.

[3] For purposes of these tax incentives, a qualifying business does not include a trade or business consisting predominantly of the development or holding of intangibles for sale or license (sec. 1397B(d)(4)). While the provision does not modify the definition of a qualifying business, the sponsors of the legislation intend to review this issue.

[4] Except for the wage credit, which is reduced to 15 percent for calendar year 2005, and then reduced by five percentage points in each year in 2006 and 2007, with no wage credit available after 2007.

Round II empowerment zones

The 1997 Act also authorized the designation of 20 additional empowerment zones ("Round II empowerment zones"), of which 15 are located in urban areas and five are located in rural areas. Businesses in the Round II empowerment zones are not eligible for the wage credit, but are eligible to receive up to $20,000 of additional section 179 expensing. Businesses in the Round II empowerment zones also are eligible for more generous tax-exempt financing benefits than those available in the Round I empowerment zones. Specifically, the tax-exempt financing benefits for the Round II empowerment zones are not subject to the State private activity bond volume caps (but are subject to separate per-zone volume limitations), and the per-business size limitations that apply to the Round I empowerment zones and enterprise communities (i.e., $3 million for each qualified enterprise zone business with a maximum of $20 million for each principal user for all zones and communities) do not apply to qualifying bonds issued for Round II empowerment zones. The tax incentives with respect to the Round II empowerment zones generally are available during the 10-year period of 1999 through 2008.

Explanation of Provision

Overview

As described in detail below, the provision conforms the wage credit and tax-exempt bond incentives for the Round I and Round II empowerment zones and extends their designations through December 31, 2009. The provision also increases the incentives to existing empowerment zones by (1) increasing the additional section 179 deduction to $35,000, and (2) providing a zero-percent capital gain rate for qualifying assets held for more than five years.

In addition, the provision authorizes the Secretaries of HUD and Agriculture to designate 30 new "renewal zones" that have the same tax incentives as empowerment zones. The designations of the new renewal zones will take effect on January 1, 2002, and terminate on December 31, 2009.

Thus, once the 30 new renewal zones have been designated there will exist a total of 61 zones providing similar tax incentives for distressed areas, all of whose designations will terminate on December 31, 2009. The renewal zones are treated as empowerment zones for all purposes of the Code.[5] After taking into account existing empowerment zones (and the designation of the new renewal zones), each State shall have at least one zone.

Existing zones

Conforming and enhancing incentives for Round I and Round II empowerment zones.--The provision extends the designation of empowerment zone status for Round I and II empowerment

[5] This would include, for example, the provisions relating to the historic homes credit and the broadband credit described below.

zones through December 31, 2009. In addition, a 15-percent wage credit is made available in all Round I and II empowerment zones, effective in 2002 (except in the case of the two additional Round I empowerment zones, for which the 15-percent wage credit takes effect in 2005 as scheduled under present law). For all the empowerment zones, the 15-percent wage credit expires on December 31, 2009.

In addition, $35,000 (rather than $20,000) of additional section 179 expensing is available for qualified zone property placed in service in taxable years beginning after December 31, 2001, by a qualified business in any of the empowerment zones.[6]

Businesses located in Round I empowerment zones are eligible for the more generous tax-exempt bond rules that apply under present law to businesses in the Round II empowerment zones (sec. 1394(f)). The proposal applies to tax-exempt bonds issued after December 31, 2001. Bonds that have been issued by businesses in Round I zones before January 1, 2002, are not taken into account in applying the limitations on the amount of new empowerment zone facility bonds that can be issued under the provision.

Businesses located in any empowerment zone also qualify for a zero-percent capital gains rate for gain from the sale of a qualifying zone assets acquired after date of enactment and before January 1, 2010, and held for more than five years. Assets that would qualify for this incentive would be similar to the types of assets that qualify for the present-law zero percent capital gains rate for qualifying D.C. Zone assets. The zero-percent capital gains rate is limited to an aggregate amount not to exceed $25 million of gain per taxpayer. Gain attributable to the period before the date of enactment or after December 31, 2014, is not eligible for the zero-percent rate.

Renewal zones

Designation of 30 renewal zones.--The Secretaries of HUD and Agriculture are authorized to designate up to 30 renewal zones from areas nominated by States and local governments. At least six of the designated renewal zones must be in rural areas. The Secretary of HUD is required to publish (within four months after enactment) regulations describing the nomination and selection process. Designations of renewal zones must be made before January 1, 2002, and the designation are effective for the period beginning on January 1, 2002 through December 31, 2009.

Eligibility criteria.--To be designated as a renewal zone, a nominated area must meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty,

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[6] The additional $35,000 of section 179 expensing is available throughout all areas that are part of a designated empowerment zone, including the non-contiguous "developable sites" that were allowed to be part of the designated Round II empowerment zones under the 1997 Act.

unemployment, and general distress.[7] In general, the areas with the highest average ranking of eligibility factors (1), (2) and (3), above will be designated as renewal zones.[8] States without any empowerment zone would be given priority in the designation process. Moreover, the designations of renewal zones must result in (after taking into account existing empowerment zones) each State having at least one zone designation (empowerment or renewal zone).

There are no geographic size limitations placed on renewal zones. Instead, the boundary of a renewal zone must be continuous. In addition, a renewal zone must have a minimum population of 4,000 if the area is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000. The population limitations do not apply to any renewal zone that is entirely within an Indian reservation.

Required State and local commitments.--In order for an area to be designated as a renewal zone, State and local governments are required to submit a written course of action in which the State and local governments promise to take at least four of the following governmental actions: (1) a reduction of tax rates or fees; (2) an increase in the level of efficiency of local services; (3) crime reduction strategies; (4) actions to remove or streamline governmental requirements; (5) involvement by private entities and community groups, such as to provide jobs and job training and financial assistance; and (6) the gift (or sale at below fair market value) of surplus realty by the State or local government to community organizations or private companies.

Enterprise community seeking designation as renewal zones.--An enterprise community can apply for designation as a renewal zone. In selecting a nominated area as a renewal zone, the Secretary shall take into account the status of a nominated area as an enterprise community. If a renewal zone designation is granted, then an area's designation as an enterprise community ceases as of the date the area's designation as a renewal zone takes effect.

Tax incentives for renewal zones.--Businesses in renewal zones will have the same tax incentives as businesses in existing empowerment zones (as modified by this provision), which will be available during the period beginning January 1, 2002 and ending December 31, 2009 (i.e., a zero percent capital gains rate for qualifying assets;[9] a 15-percent wage credit for qualifying wages; $35,000 in additional 179 expensing for qualifying property; and the enhanced tax-exempt bond rules that currently apply to businesses in the Round II empowerment zones).

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[7] For areas not within census tracts, the equivalent county division (as defined by the Bureau of the Census for purposes of defining poverty areas) shall be used for purposes of defining poverty rates and median family income.

[8] In lieu of the poverty, income, and unemployment criteria, outmigration may be taken into account in the designation of one rural renewal zone.

[9] Any gain attributable to the period before January 1, 2002, or after December 31, 2014, would not be eligible for the zero-percent capital gains rate.

GAO report.--The General Accounting Office will audit and report to Congress every three years (beginning on January 31, 2004) on the renewal zone program and its effect on poverty, unemployment, and economic growth within the designated renewal zones.

Effective Date

The extension of the existing empowerment zone designations is effective after the date of enactment.

The additional section 179 expensing and the more generous tax-exempt bond rules for the existing empowerment zones is effective after December 31, 2001. The zero-percent capital gains rate applies to qualifying property purchased after the date of enactment (after December 31, 2001 in the case of renewal zones).

The 15-percent wage credit generally is effective for qualifying wages paid after December 31, 2001. With respect to the two additional Round I empowerment zones, however, the wage credit is effective for qualifying wages paid after December 31, 2004.

The 30 new renewal zones must be designated by January 1, 2002, and the resulting tax benefits will be available for the period beginning January 1, 2002, and ending December 31, 2009.

B. Funding for Round II Empowerment Zones
(sec. 116 of the bill)

The provision provides a one-time grant in fiscal year 2001 of $5,000,000 for each of the 15 urban empowerment zones designated pursuant to the Taxpayer Relief Act of 1997, and $2,000,000 for each of the 5 rural empowerment zones designated pursuant to the Taxpayer Relief Act of 1997.

The provision also provides a one-time grant $250,000 for each of the remaining Round I enterprise communities (i.e., those that have not become empowerment zones).

C. Extension and Expansion of District of Columbia Enterprise Zone ("D.C. Zone")

1. Extension of D.C. Zone (sec. 121 of the bill and secs. 1400 and 1400A of the Code)

Present Law

The 1997 Act designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the "D.C. Zone"), within which businesses and individual residents are eligible for special tax incentives. The D.C. Zone designation remains in effect for the period from January 1, 1998, through December 31, 2002. In addition to the tax incentives available with respect to a Round I empowerment zone (including a wage credit), the D.C. Zone also has a zero-percent capital gains rate that applies to gain from the sale of certain qualified D.C. Zone assets acquired after December 31, 1997 and held for more than five years.

With respect to the tax-exempt financing incentives, the D.C. Zone generally is treated like a Round I empowerment zone;[10] therefore, the issuance of such bonds is subject to the District of Columbia's annual private activity bond volume limitation. However, the aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed $15 million (rather than $3 million, as is the case for Round I empowerment zones).[11]

Explanation of Provision

The provision extends the D.C. Zone designation through December 31, 2006. The provision also conforms the D.C. zone wage credit to the wage credit for existing empowerment zones, so that a 15-percent wage credit applies with respect to qualifying wages beginning in 2003 (and ending on December 31, 2006).

Effective Date

The provision extending the designation is effective after the date of enactment. For the D.C. Enterprise Zone, the 15-percent wage credit is effective for qualifying wages paid after December 31, 2002.

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[10] Portions of the District of Columbia were designated as an enterprise community under section 1391 in 1994. Accordingly, the District of Columbia was entitled to issue tax-exempt enterprise zone facility bonds.

[11] Section 1400A(a).

2. Extension of zero-percent capital gains rate for D.C. Zone assets (sec. 122 of the bill and sec. 1400B of the Code)

Present Law

Present law provides a zero-percent capital gains rate for capital gains from the sale of certain qualified D.C. Zone assets held for more than five years . In general, a "D.C. Zone asset" means stock or partnership interests held in, or tangible assets held by, a D.C. Zone business. A D.C. Zone business generally refers to certain enterprise zone businesses within the D.C. Zone.[12] For purposes of the zero-percent capital gains rate, the D.C. Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent as determined on the basis of the 1990 Census (sec. 1400B(d)).

Explanation of Provision

The provision eliminates the 10-percent poverty rate limitation for purposes of the zero-percent capital gains rate. Thus, the zero-percent capital gains rate applies to capital gains from the sale of assets held more than five years attributable to certain qualifying businesses located in the District of Columbia.

Effective Date

The provision is effective for D.C. Zone business stock and partnership interests originally issued after, and D.C. Zone business property assets originally acquired by the taxpayer after, December 31, 2000.

3. Gross income test for D.C. Zone businesses (sec. 123 of the bill and sec. 1400B of the Code)

Present Law

A zero-percent capital gains rate applies to gain from the sale of certain qualified D.C. zone assets. In general, a D.C. Zone asset means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. A D.C. Zone business generally refers to certain enterprise zone businesses within the D.C. Zone, except that 80 percent of the total gross income of the entity must be derived from the active conduct of the business (sec. 1400B(c)(2)).

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[12] For purposes of the zero-percent capital gains rate, a D.C. Zone business is defined by reference to the definition of an enterprise zone business in section 1397B, except that (1) the requirement that 35 percent of the employees of the business must be residents of the D.C. Zone does not apply, and (2) the D.C. Zone business must derive at least 80 percent (as opposed to 50 percent) of its total gross income from the active conduct of a qualified business within the D.C. Zone (sec. 1400B(c)).

Explanation of Provision

The provision reduces the level of gross income needed to qualify as a D.C. Zone business to 50 percent.

Effective Date

The provision is effective for D.C. Zone business stock and partnership interest originally issued after, and D.C. Zone business property originally acquired by the taxpayer after, December 31, 2000.

4. Expansion of District of Columbia homebuyer tax credit (sec. 124 of the bill and sec. 1400C of the Code)

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2001.

Explanation of Provision

The provision extends the first-time homebuyer credit for two years, through December 31, 2003. The provision also extends the phase-out range for married individuals filing a joint return so that it is twice that of individuals. Thus, under the provision, the District of Columbia homebuyer credit is phased out for joint filers with adjusted gross income between $140,000 and $180,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

D. New Markets Tax Credit
(section 131 of the bill and new sec. 45D of the Code)

Present Law

Some tax incentives are available to taxpayers making investments and loans in low-income communities. For example, tax incentives are available to taxpayers that invest in specialized small business investment companies licensed by the Small Business Administration to make loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

Explanation of Provision

The provision creates a new tax credit for qualified equity investments made to acquire stock in a selected community development entity ("CDE"). The maximum annual amount of qualifying equity investments is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2002	$1.0 billion
2003-2006	$1.5 billion per year

The amount of the new tax credit to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE, and (2) a six-percent credit on each anniversary date thereafter for the following four years.[13] The taxpayer's basis in the investment is reduced by the amount of the credit (other than for purposes of calculating the zero-percent capital gains rules and section 1202). The credit is subject to the general business credit rules.

A CDE is any domestic corporation or partnership (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities through the representation of the residents on governing or advisory boards of the CDE, and (3) is certified by the Treasury Department as an eligible CDE.[14] No later than 120 days after enactment, the Treasury Department will issue guidance that specifies objective criteria to be used by the Treasury to allocate the

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[13] Thus, a credit would be available on the date on which the investment is made and for each of the six anniversary dates thereafter.

[14] Certain specialized small business investment companies and community development financial institutions are treated as satisfying the requirements for a CDE.

credits among eligible CDEs. In allocating the credits, the Treasury Department will give priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities,[15] as well as to entities that intend to invest substantially all of the proceeds they receive from their investors in businesses in which persons unrelated to the CDE hold the majority equity interest.

If a CDE fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization is canceled. The Treasury Department can authorize another CDE to issue equity interests for the unused portion. No authorization can be made after 2013.

A "qualified equity investment" is defined as stock or a similar equity interest acquired directly from a CDE in exchange for cash. Substantially all of the investment proceeds must be used by the CDE to make "qualified low-income community investments." Qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active businesses located in low-income communities,[16] (2) certain financial counseling and other services specified in regulations to businesses and residents in low-income communities, (3) the purchase from another CDE of any loan made by such entity that is a qualified low income community investment, or (4) an equity investment in, or loans to, another CDE.[17] Treasury Department regulations will provide guidance with respect to the "substantially all" standard.

The stock or equity interest cannot be redeemed (or otherwise cashed out) by the CDE for at least seven years. If the entity ceases to be a qualified CDE during the seven-year period following the taxpayer's investment, or if the equity interest is redeemed by the issuing CDE during that seven-year period, then any credits claimed with respect to the equity interest are recaptured (with interest) and no further credits are allowed.

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[15] A record of having successfully provided capital or technical assistance to disadvantaged businesses or communities could be demonstrated by the past actions of the CDE itself or an affiliate (e.g., in the case where a new CDE is established by a nonprofit organization with a history of providing assistance to disadvantaged communities).

[16] Thus, a qualified low-income community investment may include an investment in a qualifying business in which the CDE (or a related party) holds a significant interest. However, as previously mentioned, in allocating the credits among eligible CDEs, the Treasury Department will give priority to CDEs that intend to invest substantially all of the proceeds they receive from their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest. For purposes of this provision, persons are related to each other if they are described in sections 267(b) or 707(b)(1).

[17] If at least 85 percent of the aggregate gross assets of the CDE are invested (directly or indirectly) in equity interests in, or loans to, qualified active businesses located in low-income communities, then there would be no need to trace the use of the proceeds from the particular stock (or other equity ownership) issuance with respect to which the credit is claimed.

A “low-income community” is defined as census tracts with: (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) median family income which does not exceed 80 percent of the greater of metropolitan area income or statewide median family income (for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income).[18] The Secretary also may designate any area within any census tract as a “low income community” provided that (1) the boundary of the area is continuous,[19] (2) the area (if it were a census tract) would satisfy the poverty rate or median income requirements set forth above within the targeted area, and (3) an inadequate access to investment capital exists in the area.

A “qualified active business” is defined as a business which satisfies the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities; (2) a substantial portion of the use of the tangible property of such business is used within low-income communities; (3) a substantial portion of the services performed for such business by its employees is performed in low-income communities; and (4) less than 5 percent of the average aggregate of unadjusted bases of the property of such business is attributable to certain financial property or to collectibles (other than collectibles held for sale to customers). There is no requirement that employees of the business be residents of the low income community.

Rental of improved commercial real estate located in a low-income community is a qualified active business, regardless of the characteristics of the commercial tenants of the property. The purchase and holding of unimproved real estate is not a qualified active business. In addition, a qualified active business does not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; or (b) operation of any facility described in sec. 144(c)(6)(B). A qualified active business can include an organization that is organized on a non-profit basis.

The General Accounting Office will audit and report to Congress by January 31, 2004 (and again by January 31, 2007) on the new markets program, including on all qualified community development entities that receive an allocation under the new markets tax credit.

Effective Date

The provision is effective for qualified investments made after December 31, 2001.

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[18] For areas not within census tracts, the equivalent county division (as defined by the Bureau of the Census for purposes of defining poverty areas) shall be used for purposes of defining poverty rates and median family income.

[19] It is intended that the continuous boundary that delineates the portion of the census tract as a “low-income community” should be a pre-existing boundary (such as an established neighborhood, political, or geographic boundary).

E. Modification of Puerto Rico Economic Activity Tax Credit (sec. 141 of the bill and sec. 30A of the Code)

Present Law

The Small Business Job Protection Act of 1996 generally repealed the Puerto Rico and possession tax credit. However, certain domestic corporations that had active business operations in Puerto Rico or another U.S. possession on October 13, 1995, may continue to claim credits under section 936 or section 30A for a 10-year transition period. Such credits apply to possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is granted whether or not the corporation pays income tax to the possession.

One of two alternative limitations is applicable to the amount of the credit attributable to possession business income. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes); beginning in 2002, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income adjusted for inflation. Under the alternative limit, the amount of the credit is limited to the applicable percentage (40 percent for 1998 and thereafter) of the credit that would otherwise be allowable with respect to possession business income; beginning in 1998, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporation's pre-1996 possession business income. Special rules apply in computing the credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The credit expires for taxable years beginning after December 31, 2005.

Explanation of Provision

The bill modifies the credit computed under the economic activity limit with respect to operations in Puerto Rico only. First, the proposal expands the lines of business eligible under the credit to include new lines of business established in Puerto Rico after December 31, 2000, and before January 1, 2005 by existing credit claimants. These “new opportunity credit” claimants are eligible to claim credits in taxable years beginning before January 1, 2006. In addition, income eligible for the credit computed under the economic activity limitation is subject to the present-law income limitation. Also, these “new opportunity credit” claimants are required to calculate their credit in each taxable year, but claim that amount of credit over a five-year period (on a pro-rata basis) beginning the year in which the credit is earned.

In addition, for existing credit claimants, the present-law limitation on income eligible for the credit for any taxable year is increased by the ratio of the average number of full-time employees of the taxpayer during the taxable year to the average number of full-time employees of the taxpayer in 1995 and 1996.

Effective Date

The provision applies to taxable years beginning after December 31, 2000.

F. Creation of Individual Development Accounts (secs. 731-741 of the bill and new sec. 530A of the Code)

Present Law

There are no tax benefits to encourage financial institutions to match savings of low-income individuals.

Explanation of Provision

In general

The bill creates individual development accounts ("IDAs") to which eligible individuals can contribute, annually, the lesser of : (1) $2,000; or (2) the individual's taxable compensation for the year. An eligible individual is an individual who is: (1) at least 18 years of age; (2) a citizen or legal resident of the United States; and (3) a member of a household with family gross income of 60 percent or less of national median gross income and a net worth of $10,000 or less.

Contributions to an IDA by eligible individuals

Only eligible individuals are allowed to contribute to an IDA. Contributions to IDAs by individuals are not deductible, and earnings on such contributions are includible in income.

Matching contributions

The bill provides a maximum annual tax credit of $270 (90 percent of $300) to a financial institution that makes matching contributions to the IDAs of individuals. This credit is available in each year that a matching contribution is made. An additional $100 tax credit would be allowed for each account opened. The credit is for the costs incurred to open and maintain the account, as well as to provide financial education. The credits could be claimed by the financial institution or its contractual affiliates. It is anticipated that a financial institution may collaborate with one or more contractual affiliates, non-profits, or Indian tribes to carry out the IDA program. Contractual affiliates who provide matching funds should be eligible to receive the matching tax credit.

Matching contributions (and earnings thereon) are not includible in the gross income of the eligible individual.

If an individual withdraws his or her own IDA contributions (or earnings thereon) for a purpose other than a qualified purpose, then the matching contribution attributable to such individual contribution is forfeited.[20] Matching contributions can be withdrawn only for the

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[20] The financial institution is to use forfeited amounts to make other matching contributions. No credit is provided with respect to such reallocated contributions.

following qualified purposes: (1) certain educational expenses; (2) first-time homebuyer expenses; (3) business start-up or expansion purposes; and (4) qualified rollovers.

Effect on means-tested programs

Any amounts in the IDA are not to be taken into account for certain Federal means-tested programs.

Effective Date

The tax credit provision is effective for contributions to IDAs and matching contributions made with respect to such IDAs after December 31, 2001, and before January 1, 2006.

G. Additional Incentives

1. Exclusion of certain amounts received under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (sec. 171 of the bill and sec. 117 of the Code)

Present Law

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on condition that the participants provide certain services. In the case of the NHSC Scholarship Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health-care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

Section 117(c) specifically provides that the exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

Section 134 provides that any "qualified military benefit," which includes any allowance, is excluded from gross income if received by a member or former member of the uniformed services if such benefit was excludable from gross income on September 9, 1986.

Explanation of Provision

The provision provides that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient.

Effective Date

The provision is effective for education awards received after December 31, 1993.

2. Extension and modification of enhanced deduction for corporate donations of computer technology (sec. 172 of the bill and sec. 170(e)(6) of the Code)

Present Law

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K-12. Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) tax-exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

The provision is scheduled to expire for contributions made in taxable years beginning after December 31, 2000.

Explanation of Provision

The bill extends the current enhanced deduction for donations of computer technology and equipment through December 31, 2003. In addition, the enhanced deduction is expanded to include donations to public libraries.

Effective date

The provision is effective upon the date of enactment.

3. Extension of the adoption tax credit (sec. 173 of the bill and sec. 23 of the Code)

Present Law

Taxpayers are entitled to a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer (sec. 23). In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). A special needs child is a child who the State has determined: (1) cannot or should not be returned to the home of the birth parents, and (2) has a specific factor or condition because of which the child cannot be placed with adoptive parents without adoption assistance. The adoption of a child who is not a citizen or a resident of the United States is a foreign adoption.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption are qualified adoption expenses. Otherwise qualified adoption expenses paid or incurred in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are paid or incurred in the year the adoption becomes final.

An eligible child is an individual (1) who has not attained age 18 or (2) who is physically or mentally incapable of caring for himself or herself. After December 31, 2001, the credit will be available only for domestic special needs adoptions.

No credit is allowed for expenses incurred (1) in violation of State or Federal law, (2) in carrying out any surrogate parenting arrangement, (3) in connection with the adoption of a child of the taxpayer's spouse, (4) that are reimbursed under an employer adoption assistance program or otherwise, or (5) for a foreign adoption that is not finalized.

The credit is phased out ratably for taxpayers with modified AGI above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933.

Explanation of Provision

The bill extends the adoption credit for the adoption of non-special needs children for two years through December 31, 2003.

Effective Date

The provision is effective on the date of enactment.

4. Tax treatment of Alaska Native Settlement Trusts (sec. 174 of the bill and new secs. 646 and 6039H of the Code)

Present Law

An Alaska Native Settlement Corporation ("ANC") may establish a Settlement Trust ("Trust") under section 39 of the Alaska Native Claims Settlement Act ("ANCSA") [21] and transfer money or other property to such Trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives.

With certain exceptions, once an ANC has made a conveyance to a Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgement, except with respect to the lawful debts and obligations of the Trust.

The Internal Revenue Service has indicated that contributions to a Trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent of earnings and profits as provided under section 301 of the Code. The Trust and its beneficiaries are taxed in accordance with trust rules.

Explanation of Provision

An Alaska Native Corporation may establish a Trust under section 39 of ANCSA and if the Trust makes an election for its first taxable year ending after the date of enactment of the proposal,

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[21] 43 U.S.C. 1601 et. seq.

no amount will be included in the gross income of a beneficiary of such Trust by reason of a contribution to the Trust. In addition, unless the electing Trust fails to meet the transferability requirements of the provision, income of the Trust, whether accumulated or distributed, will be taxed only to the Trust (and not to beneficiaries) at the lowest individual tax rates of 15 percent for ordinary income (and the capital gains rate applicable to individuals subject to such 15 percent rate), rather than at the higher rates generally applicable to trusts or to higher tax bracket beneficiaries.

The earnings and profits of the ANC will not be reduced by the amount of contributions to the electing Trust at the time of the contributions. However, the ANC earnings and profits will be reduced (up to the amount of the contributions) as distributions are thereafter made by the electing Trust that would exceed the Trusts's total undistributed net income (less taxes paid) plus tax-exempt income for all prior years during which an election is in effect plus for the current year, computed under Subchapter J. In addition, such distributions that exceed such amounts are to be reported and taxed to beneficiaries as if distributed by the ANC in the year of the distribution by the electing Trust, and will be treated as dividends to beneficiaries to the extent the ANC then has current or accumulated earnings and profits.

The fiduciary of an electing Trust must report to the IRS, with the Trust tax return, the amount of distributions to each beneficiary, and the tax treatment to the beneficiary of such distributions under the provision (either as exempt from tax to the beneficiary, or as a distribution deemed made by the ANC). The electing Trust must also furnish such information to the ANC. In the case of distributions that are treated as if made by the ANC, as described above, the ANC must then report such amounts to the beneficiaries and must indicate whether they are dividends or not, in accordance with the earnings and profits of the ANC. The reporting thus required by an electing Trust will be in lieu of, and will satisfy, the reporting requirements of section 6034A (and such other reporting requirements as the Secretary of the Treasury may deem appropriate).

If the beneficial interests in the electing Trust or the shares of the ANC may be sold or exchanged to a person in a manner that would not be permitted under ANCSA if the interests were Settlement Common Stock (generally, to a person other than an Alaska Native), then all assets of the Trust that had not been distributed as of the beginning of that taxable year of the Trust are taxed to the extent they would be if they were distributed at that time. Thereafter, the Trust and its beneficiaries are generally subject to the rules of subchapter J and to the generally applicable trust income tax rates.

Effective Date

The provision is effective for taxable years of Settlement Trusts, their beneficiaries, and sponsoring Alaska Native Corporations ending after the date of enactment, and to contributions made to electing Settlement Trusts during such year and thereafter.

5. Treatment of Indian Tribes as non-profit organizations and State or Local Governments for purposes of the Federal Unemployment Tax ("FUTA") (sec. 175 of the bill and sec. 3306 of the Code)

Present Law

Present law imposes a net tax on employers equal to 0.8 percent of the first $7,000 paid annually to each employee. The current gross FUTA tax is 6.2 percent, but employers in States meeting certain requirements and having no delinquent loans are eligible for a 5.4 percent credit making the net Federal tax rate 0.8 percent. Both non-profit organizations and State and local governments are not required to pay FUTA taxes. Instead they may elect to reimburse the unemployment compensation system for unemployment compensation benefits actually paid to their former employees. Generally, Indian tribes are not eligible for the reimbursement treatment allowable to non-profit organizations and State and local governments.

Explanation of Provision

The bill provides that an Indian tribe (including any subdivision, subsidiary, or business enterprise chartered and wholly owned by an Indian tribe) is treated like a non-profit organization or State or local government for FUTA purposes (i.e., given an election to choose the reimbursement treatment).

Effective Date

The provision generally is effective with respect to service performed beginning on or after the date of enactment. Under a transition rule, service performed in the employ of an Indian tribe is not treated as employment for FUTA purposes if: (1) it is service which is performed before the date of enactment and with respect to which FUTA tax has not been paid; and (2) such Indian tribe reimburses a State unemployment fund for unemployment benefits paid for service attributable to such tribe for such period.

6. Additional funding for the Social Services Block Grant (sec. 176 of the bill)

The provision amends Section 2003(c) of Title XX of the Social Security Act and provides an additional one-time amount of $700,000,000 for fiscal year 2001.

II. TAX INCENTIVES FOR AFFORDABLE HOUSING

A. Increase Low-Income Housing Tax Credit per Capita Amount (secs. 201 and 202 of the bill and sec. 42 of the Code)

Present Law

In general, a maximum 70-percent present value tax credit, claimed over a 10-year period is allowed for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of total qualified expenditures.

To claim low-income housing credits, project owners must receive an allocation of credit from a State or local housing credit agency. However, no allocation is required for buildings at least 50 percent financed with the proceeds of tax-exempt bonds that received an allocation pursuant to the private activity bond volume limitation of Code section 146. Such projects must, however, satisfy the requirements for allocation under the State's qualified allocation plan and meet other requirements.

A building generally must be placed in service during the calendar year in which it receives an credit allocation. However, a housing credit agency can make a binding commitment, not later than the year in which the building is placed in service, to allocate a specified credit dollar amount to such building beginning in a specified later year. In addition, a project can receive a "carryover allocation" if the taxpayer's basis in the project as of the close of the calendar year the allocation is made is more than 10 percent of the taxpayer's reasonably expected basis in the project, and the building is placed in service not later than the close of the second calendar year following the calendar year in which the allocation is made. For purposes of the 10-percent test, basis means the taxpayer's adjusted basis in land and depreciable real property, whether or not these amounts are includible in eligible basis. Finally, an allocation of credit for increases in qualified basis may occur in years subsequent to the year the project is placed in service.

Authority to allocate credits remains at the State (as opposed to local) government level unless State law provides otherwise.[22] Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of: (1) credits claimed on additions to qualified basis; (2) credits allocated in a later year

[22] For example, constitutional home rule cities in Illinois are guaranteed their proportionate share of the $1.25 amount, based on their population relative to that of the State as a whole.

pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and (3) carryover allocations.

Each State annually receives low-income housing credit authority equal to $1.25 per State resident for allocation to qualified low-income projects.[23] In addition to this $1.25 per resident amount, each State's "housing credit ceiling" includes the following amounts: (1) the unused State housing credit ceiling (if any) of such State for the preceding calendar year;[24] (2) the amount of the State housing credit ceiling (if any) returned in the calendar year;[25] and (3) the amount of the national pool (if any) allocated to such State by the Treasury Department.

The national pool consists of States' unused housing credit carryovers. For each State, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused State housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a State which, with respect to the previous calendar year allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1, of the calendar year. The national pool allocation to qualified States is made on a pro rata basis equivalent to the fraction that a State's population enjoys relative to the total population of all qualified States for that year.

The present-law stacking rule provides that a State is treated as using its annual allocation of credit authority ($1.25 per State resident) and any returns during the calendar year followed by any unused credits carried forward from the preceding year's credit ceiling and finally any applicable allocations from the National pool.

Explanation of Provision

The bill increases the annual State credit caps from $1.25 to $1.75 per resident beginning in 2001. Also beginning in 2001, the per capita cap is modified so that small population states are

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[23] A State's population, for these purposes, is the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the year to which the limitation applies. Also, for these purposes, the District of Columbia and the U.S. possessions (i.e., Puerto Rico, the Virgin Islands, Guam, the Northern Marianas and American Samoa) are treated as States.

[24] The unused State housing credit ceiling is the amount (if positive) of the previous year's annual credit limitation plus credit returns less the credit actually allocated in that year.

[25] Credit returns are the sum of any amounts allocated to projects within a State which fail to become a qualified low-income housing project within the allowable time period plus any amounts allocated to a project within a State under an allocation which is canceled by mutual consent of the housing credit agency and the allocation recipient.

given a minimum of $2 million of annual credit cap. The $1.75 per capita credit cap and the $2 million amount are indexed for inflation beginning in calendar year 2002.

The bill also makes two programmatic changes to the credit. First, the bill modifies the stacking rule so that each State is treated as using its allocation of the unused State housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the State) and then finally any National pool allocations. Second, the bill provides that assistance received under the Native American Housing Assistance and Self-Determination Act of 1986 is not taken into account in determining whether a building is Federally subsidized for purposes of the credit.

Effective Date

The provision is effective for calendar years beginning after December 31, 2000 and buildings placed-in-service after such date in the case of projects that also receive financing with proceeds of tax-exempt bonds which are issued after such date subject to the private activity bond volume limit.

B. Tax Credit for Renovating Historic Homes
(sec. 211 of the bill and new sec. 25B of the Code)

Present Law

Present law provides an income tax credit for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings placed in service before 1936 (sec. 47). The amount of the credit is determined by multiplying the applicable rehabilitation percentage by the basis of the property that is attributable to qualified rehabilitation expenditures. The applicable rehabilitation percentage is 20 percent for certified historic structures and 10 percent for qualified rehabilitated buildings (other than certified historic structures) that were originally placed in service before 1936.

A nonresidential building is eligible for the 10-percent credit only if the building is substantially rehabilitated and a specific portion of the existing structure of the building is retained in place upon completion of the rehabilitation. A residential or nonresidential building is eligible for the 20-percent credit that applies to certified historic structures only if the building is substantially rehabilitated (as determined under the eligibility rules for the 10-percent credit). In addition, the building must be listed in the National Register or the building must be located in a registered historic district and must be certified by the Secretary of the Interior as being of historical significance to the district.

Explanation of Provision

The bill permits a taxpayer to claim a 20-percent credit for qualified rehabilitation expenditures made with respect to a qualified historic home which the taxpayer subsequently occupies as his or her principal residence for at least five years. The total credit which can be claimed by the taxpayer is limited to $20,000. Any eligible credit not claimed by the taxpayer in the year in which the qualified rehabilitation expenditures are made may be carried forward to each of the succeeding 10 years.

The bill applies to (1) structures listed in the National Register; (2) structures located in a registered national, State, or local historic district, and certified by the Secretary of the Interior as being of historic significance to the district, but only if the median income of the census tract within which the building is located is less than twice the State median income; (3) any structure designated as being of historic significance under a State or local statute, if such statute is certified by the Secretary of the Interior as achieving the purpose of preserving and rehabilitating buildings of historic significance.

A building generally is considered substantially rehabilitated if the qualified rehabilitation expenditures incurred during a 24-month measuring period exceed the greater of (1) the adjusted basis of the building as of the later of the first day of the 24-month period or the beginning of the taxpayer's holding period for the building, or (2) $5,000. Only the $5,000 expenditure requirement applies in the case of structures (1) in empowerment zones, (2) in enterprise communities, (3) in census tracts in which 70 percent of families have income which is 80 percent or less of the State median family income, and (4) in areas of chronic distress as designated by the State and approved by the Secretary of Housing and Urban Development. In addition, for all structures, at least five percent of the rehabilitation expenditures must to be allocable to the exterior of the structure.

To qualify for the credit, the rehabilitation must be certified by a State or local government subject to conditions specified by the Secretary of the Interior.

A taxpayer who purchases a structure on which qualified rehabilitation expenditures have been made may claim credit for such expenditures if the taxpayer is the first purchaser of the structure within five years of the date the rehabilitation was completed and if no credit was allowed to the seller with respect to the qualified expenditures. Alternatively, a taxpayer may elect to receive a historic rehabilitation mortgage credit certificate in lieu of the credit otherwise allowable. A historic rehabilitation mortgage credit certificate may be transferred to a lending institution in exchange for which the lending institution provides the taxpayer with a reduction in interest rate on a mortgage on a qualifying structure. The lending institution would then claim the allowable credits against its tax liability. In the case of a targeted area or enterprise community or empowerment zone, the taxpayer may elect to allocate all or a portion of the mortgage credit certificate to reduce the down payment required for purchase of the structure.

If a taxpayer ceases to maintain the structure as his or her personal residence within five years from the date of the rehabilitation, the credit would be recaptured on a pro rata basis.

Effective Date

The provision is effective for expenditures paid or incurred beginning after December 31, 2001.

C. Exclusion from Gross Income for Certain Forgiven Mortgage Obligations (sec. 221 of the bill and sec. 108 of the Code)

Present Law

Gross income includes all income from whatever source derived, including income from the discharge of indebtedness. However, gross income does not include discharge of indebtedness income if: (1) the discharge occurs in a Title 11 case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness. No exclusion is provided under present law for qualified residential indebtedness.

Explanation of Provision

In the case of an individual taxpayer, the bill provides an exclusion from discharge of indebtedness income to the extent such income is attributable to the sale of real property securing qualified residential indebtedness. Qualified residential indebtedness is defined as indebtedness incurred or assumed by the taxpayer for the acquisition, construction, reconstruction, or substantial improvement of the taxpayer's residence and which is secured by such residence. The taxpayer may elect to have this exclusion apply. The exclusion does not apply to qualified farm indebtedness or qualified real property business indebtedness.

Effective Date

The provision is effective for discharges of indebtedness after the date of enactment.

D. Mortgage Revenue Bonds

1. Increase in purchase price limitation under mortgage subsidy bond rules based on median family income (sec. 231 of the bill and sec. 143 of the Code)

Present Law

Qualified mortgage bonds (QMBs) are tax-exempt bonds, the proceeds of which generally must be used to make mortgage loans to first-time homebuyers. The recipients of QMB-financed loans must meet purchase price, income, and other restrictions. Generally, the purchase price of an assisted home may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price.

Explanation of Provision

The bill modifies the purchase price rule for QMB financing. Specifically, QMB financing is allowable to qualified residences the purchase price of which does not exceed the greater of (1) 90 percent of the average area purchase price; or (2) 3.5 times the applicable median family income. The applicable median family income is defined as under the present-law QMB income restriction.

Effective Date

The provision is effective for bonds issued after the date of enactment.

2. Mortgage financing for residences located in Presidentially declared disaster areas (sec. 232 of the bill and sec. 143 of the Code)

Present Law

Qualified mortgage bonds are private activity tax-exempt bonds issued by States and local governments acting as conduits to provide mortgage loans to first-time home buyers who satisfy specified income limits and who purchase homes that cost less than statutory maximums. The income and purchase price limits are increased for homes purchased in economically distressed areas, and a portion of loans made in such areas is exempt from some requirements.

Present law waives the three buyer targeting requirements (the first-time homebuyer, purchase price, and income limit requirements) for a portion of the loans made with proceeds of a qualified mortgage bond issue if the loans are made to finance homes in statutorily prescribed economically distressed areas.

For bonds issued during 1997 and 1998, a special exception exempted loans made in Presidentially declared disaster areas within two years of the declaration from the first-time homebuyer limit. In addition, the more liberal income and purchase price rules applicable to economically distressed areas applied to such loans. There was no requirement that the specially treated loans be made to repair or replace housing damaged or destroyed by the disaster.

Explanation of Provision

The bill reinstates, with modifications, the prior-law exception for certain qualified mortgage bond financed loans in Presidentially declared disaster areas. First, the bill: (1) allows loans for replacement housing for housing destroyed in the disaster without regard to the first-time homebuyer requirement; and (2) increases the borrower income and house purchase price requirements to those that apply in targeted areas of economic distress. Second, the bill increases the per-borrower “home improvement loan” maximum from $15,000 to $100,000 and extends the more liberal borrower income limits for targeted areas to loans for repair of housing damaged by the disaster. In both cases, the exception applies only to loans made during the two-year period after the area was declared a qualified disaster area. A qualified disaster area is defined as an area determined by the President (1) to warrant assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act and (2) with respect to which the Federal share of disaster payments exceeds 75 percent.

Effective Date

The provision is effective for bonds issued after December 31, 2000.

E. Provide Tax Exemption for Organizations Created by a State to Provide Property and Casualty Insurance Coverage for Property for Which Such Coverage Is Otherwise Unavailable (sec. 241 of the bill and new sec. 501(c)(28) of the Code)

Present Law

In general

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance income reduced by life insurance deductions (sec. 801). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). Present law provides that the term "corporation" includes an insurance company (sec. 7701(a)(3)).

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organization or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function or accruing to a State or any political subdivision thereof.

Certain specific provisions provide tax-exempt status to organizations meeting statutory requirements.

Health coverage for high-risk individuals

Section 501(c)(26) provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Explanation of Provision

The provision provides tax-exempt status for any association created before January 1, 1999, by State law and organized and operated exclusively to provide property and casualty insurance coverage for property located within the State for which the State has determined that coverage in the authorized insurance market is limited or unavailable at reasonable rates, provided certain requirements are met.

Under the provision, no part of the net earnings of the association may inure to the benefit of any private shareholder or individual. Except as provided in the case of dissolution, no part of the assets of the association may be used for, or diverted to, any purpose other than: (1) to satisfy, in whole or in part, the liability of the association for, or with respect to, claims made on policies written by the association; (2) to invest in investments authorized by applicable law; (3) to pay reasonable and necessary administration expenses in connection with the establishment and operation of the association and the processing of claims against the association; or (4) to make remittances pursuant to State law to be used by the State to provide for the payment of claims on policies written by the association, purchase reinsurance covering losses under such policies, or to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The provision requires that the State law governing the association permit the association to levy assessments on insurance companies authorized to sell property and casualty insurance in the State, or on property and casualty insurance policyholders with insurable interests in property located in the State to fund deficits of the association, including the creation of reserves. The provision requires that the plan of operation of the association be subject to approval by the chief executive officer or other official of the State, by the State legislature, or both. In addition, the provision requires that the assets of the association revert upon dissolution to the State, the State's designee, or an entity designated by the State law governing the association, or that State law not permit the dissolution of the association.

The provision provides a special rule in the case of any entity or fund created before January 1, 1999, pursuant to State law and organized and operated exclusively to receive, hold, and invest remittances from an association exempt from tax under the provision, to make disbursements to pay claims on insurance contracts issued by the association, and to make disbursements to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The special rule provides that the entity or fund may elect to be disregarded as a separate entity and be treated as part of the association exempt from tax under the provision, from which it receives such remittances. The election is required to be made no later than 30 days following the date on which the association is determined to be exempt from tax under the provision, and would be effective as of the effective date of that determination.

An organization described in the provision is treated as having unrelated business taxable income in the amount of its taxable income (computed as if the organization were not exempt from tax under the proposal), if at the end of the immediately preceding taxable year, the organization's net equity exceeded 15 percent of the total coverage in force under insurance contracts issued by the organization and outstanding at the end of that preceding year.

Under the provision, no income or gain is recognized solely as a result of the change in status to that of an association exempt from tax under the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000. No inference is intended as to the tax status under present law of associations described in the provision.

III. TAX INCENTIVES FOR URBAN AND RURAL INFRASTRUCTURE

A. Increase State Volume Limits on Tax-Exempt Private Activity Bonds (sec. 301 of the bill and sec. 146 of the Code)

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that States and local governments may issue for most of these purposes in each calendar year is limited by State-wide volume limits. The current annual volume limits are $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

The current annual volume limits that apply to private activity tax-exempt bonds increase to $75 per resident of each State or $225 million, if greater, beginning in calendar year 2007. The increase is, ratably phased in, beginning with $55 per capita or $165 million, if greater, in calendar year 2003.

Explanation of Provision

The bill increases the present-law annual State private activity bond volume limits to $75 per resident of each State or $225 million (if greater) beginning in calendar year 2001. In addition, the $75 per resident and the $225 million State limit will be indexed for inflation beginning in calendar year 2002.

Effective Date

The provisions are effective for calender years after December 31, 2000.

B. Extension and Modification to Expensing of Environmental Remediation Costs (sec. 302 of the bill and sec. 198 of the Code)

Present Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

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

Eligible expenditures are those paid or incurred before January 1, 2002.

Explanation of Provision

The bill extends the expiration date for eligible expenditures to include those paid or incurred before January 1, 2004.

In addition, the bill eliminates the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

Effective Date

The provision to extend the expiration date is effective upon the date of enactment. The provision to expand the class of eligible sites is effective for expenditures paid or incurred after the date of enactment.

C. Broadband Internet Access Tax Credit (sec. 303 of the bill and new sec. 48A of the Code)

Present Law

Present law does not provide a credit for investments in telecommunications infrastructure.

Explanation of Provision

The bill provides a 10 percent credit of the qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers "current generation" broadband services to subscribers in rural and underserved areas. In the addition, the bill provides a 20 percent credit of the qualified expenditures incurred by the taxpayer with respect to qualified equipment with which the taxpayer offers "next generation" broadband services to subscribers in rural areas, underserved areas, and to residential subscribers. Current generation broadband services is defined as the transmission of signals at a rate of at least 1.5 million bits per second to the subscriber and at a rate of at least 200,000 bits per second from the subscriber. Next generation broadband services is defined as the transmission of signals at a rate of at least 22 million bits per second to the subscriber and at a rate of at least 10 million bits per second from the subscriber.

Qualified expenditures are those amounts otherwise chargeable to the capital account with respect to the purchase and installation of qualified equipment for which depreciation is allowable under section 168.[26] In the case of current generation broadband services, qualified expenditures are those that are incurred by the taxpayer after December 31, 2000, and before January 1, 2004. In the case of next generation broadband services, qualified expenditures are those that are incurred by the taxpayer after December 31, 2001, and before January 1, 2005.
The expenditures are taken into account for purposes of claiming the credit in the first taxable year in which the taxpayer provides broadband service to at least 10 percent of the potential subscribers. In the case of a taxpayer who incurs expenditures for equipment capable of serving both subscribers in qualifying areas and other areas, qualifying expenditures are determined by multiplying otherwise qualifying expenditures by the ratio of the number of potential qualifying subscribers to all potential subscribers the qualifying equipment would be capable of serving.

Qualifying equipment must be capable of providing broadband services at any time to each subscriber who is utilizing such services. In the case of a telecommunications carrier, qualifying equipment is only that equipment that extends from the last point of switching to the outside of the building in which the subscriber is located. In the case of a commercial mobile service carrier, qualifying equipment is only that equipment that extends from the customer side of a mobile telephone switching office to a transmission/reception antenna (including the antenna) of the subscriber. In the case of a cable operator or open video system operator, qualifying equipment is only that equipment that extends from the customer side of the headend to the outside of the

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[26] The taxpayer's basis in the equipment is reduced by the amount of credit claimed.

building in which the subscriber is located. In the case of a satellite carrier or other wireless carrier (other than a telecommunications carrier), qualifying equipment is only that equipment that extends from a transmission/reception antenna (including the antenna) to a transmission/reception antenna on the outside of the building used by the subscriber. In addition, any packet switching equipment deployed in connection with other qualifying equipment is qualifying equipment, regardless of location, provided that it is the last such equipment in a series as part of transmission of a signal to a subscriber or the first in a series in the transmission of a signal from a subscriber.

A rural area is any census tract which is not within 10 miles of any incorporated or census designated place with a population of more than 25,000 and which is not within a county with a population density of more than 500 people per square mile. An underserved area is any census tract which is located in an empowerment zone, enterprise community, renewal zone, or any census tract in which the poverty level is greater than or equal to 30 percent and in which the median family income is less than 70 percent of the greater of metropolitan area median family income or statewide median family income.[27] A residential subscriber is any individual who purchases broadband service to be delivered to his or her dwelling.

Effective Date

The provision is effective for expenditures incurred after December 31, 2000.

[27] In the case of an area outside of a metropolitan area, this area median family income must be less than 70 percent of statewide median family income.

D. Tax-Credit Bonds for the National Railroad Passenger Corporation ("Amtrak") and the Alaska Railroad (sec. 304 of the bill and new sec. 54 of the Code)

Present Law

Present law does not authorize the issuance by any private, for-profit corporation of bonds the interest on which is tax-exempt or eligible for an income tax credit. Tax-exempt bonds may be issued by States or local governments to finance their governmental activities or to finance certain capital expenditures of private businesses or loans to individuals. Additionally, States or local governments may issue tax-credit bonds to finance the operation of "qualified zone academies."

Tax-exempt bonds

Interest on bonds issued by States or local governments to finance direct activities of those governmental units is excluded from tax (sec. 103). In addition, interest on certain bonds ("private activity bonds") issued by States or local governments acting as conduits to provide financing for private businesses or individuals is excluded from income if the purpose of the borrowing is specifically approved in the Code (sec. 141). Examples of approved private activities for which States or local governments may provide tax-exempt financing include transportation facilities (airports, ports, mass commuting facilities, and certain high speed intercity rail facilities); public works facilities such as water, sewer, and solid waste disposal; and certain social welfare programs such as low-income rental housing, student loans, and mortgage loans to certain first-time homebuyers. High speed intercity rail facilities eligible for tax-exempt financing include land, rail, and stations (but not rolling stock) for fixed guideway rail transportation of passengers and their baggage using vehicles that are reasonably expected to operate at speeds in excess of 150 miles per hour between scheduled stops.

Issuance of most private activity bonds is subject to annual State volume limits of $50 per resident ($150 million if greater). These volume limits are scheduled to increase to $75 per resident ($225 million if greater) over the period 2003 through 2007.

Investment earnings on all tax-exempt bonds, including earnings on invested sinking funds associated with such bonds is restricted by the Code to prevent the issuance of bonds earlier or in a greater amount than necessary for the purpose of the borrowing. In general, all profits on investment of such proceeds must be rebated to the Federal Government. Interest on bonds associated with invested sinking funds is taxable.

Tax-credit bonds for qualified zone academies

As an alternative to traditional tax-exempt bonds, certain States or local governments are given authority to issue "qualified zone academy bonds." A total of $400 million of qualified zone academy bonds is authorized to be issued in each year of 1998 through 2001. The $400 million is allocated to States according to their respective populations of individuals below the poverty line.

Qualified zone academy bonds are taxable bonds with respect to which the investor receives an income tax credit equal to an assumed interest rate set by the Treasury Department to allow issuance of the bonds without discount and without interest cost to the issuer. The bonds may be used for renovating, providing equipment to, developing course materials for, or training teachers in eligible schools. Eligible schools are elementary and secondary schools with respect to which private entities make contributions equaling at least 10 percent of the bond proceeds.

Only financial institutions are eligible to claim the credits on qualified zone academy bonds. The amount of the credit is taken into income. The credit may be claimed against both regular income tax and AMT liability.

There are no arbitrage restrictions applicable to investment earnings on qualified zone academy bond proceeds.

Explanation of Provision

The provision authorizes the National Railroad Passenger Corporation ("Amtrak") and the Alaska Railroad to issue an aggregate amount of $10 billion of tax-credit bonds to finance its capital projects. Annual issuance of the bonds may not exceed $1 billion per year (plus any authorized amount that was not issued in previous years) during the ten Fiscal Year period, 2001-2010. Unused bond authority could be carried forward to succeeding years until used, subject to a limitation that no tax-credit bonds could be issued after fiscal year 2015.

Projects eligible for tax-credit bond financing are defined as the acquisition, construction of equipment, rolling stock, and other capital improvements for (1) the northeast rail corridor between Washington, D.C. and Boston, Massachusetts;[28] (2) high-speed rail corridors designated under section 104(d)(2) of Title 23 of the United States Code; and (3) non-designated high-speed rail corridors, including station rehabilitation, track or signal improvements, or grade crossing elimination. The last purpose is limited to a maximum of 10 percent of the proceeds of any bond issue. At least 70 percent of the tax-credit bonds must be issued for projects described in (2) and (3).

As with qualified zone academy bonds, the interest rate on Amtrak/Alaska Railroad tax-credit bonds will be set to allow issuance of the bonds at par, i.e., without any interest cost to Amtrak or the Alaska Railroad. In general, proceeds of Amtrak/Alaska Railroad tax-credit bonds would have to be spent within 36 months after the bonds are issued. As of the date the bonds were issued, Amtrak or the Alaska Railroad must certify that it reasonably expects --

[28] $92 million of Amtrak's tax-credit bond authority for Northeast Corridor projects is set aside for the acquisition and installation of platform facilities, performance of railroad force account work necessary to complete improvements below grade, and any other necessary improvements related to construction at the new railroad station at the James A. Farley Post Office Building in New York City. Projects finance with this $92 million of tax-credit bonds are not subject to the State contribution requirement, described below.

(1) to incur a binding obligation with a third party to spend at least 10 percent of the bond proceeds within six months (or in the case of self-constructed property, to have commenced construction within six months);

(2) to spend the bond proceeds with due diligence; and

(3) to spend at least 95 percent of the proceeds for qualifying capital costs within three years.

Amtrak/Alaska Railroad tax credit bonds may only be issued for projects that are approved by the Department of Transportation and with respect to which the issuing railroad has binding commitments from one or more States to make matching contributions of at least 20 percent of the project cost. Projects having State matching contributions in excess of 20 percent are given a preference. The State matching contributions, along with earnings on investment of the tax-credit bond proceeds must be invested in a trust account (i.e., an sinking fund) and used along with earnings on the trust account for repayment of the principal amount of the bonds.

Amtrak/Alaska Railroad tax-credit bonds can be owned (and income tax credits claimed) by any taxpayer. The amount of the credit will be included in the bondholder's income. Additionally, provisions are included in the proposal to allow the credits to be stripped and sold to different investors than the investors in the bond principal.

The required State matching contribution may not be derived from Federal monies. Any Federal Highway Trust Fund monies transferred to the States are treated as Federal monies for this purpose. During the period when tax-credit bonds are authorized, Amtrak is not allowed to receive any Highway Trust Fund monies other than those authorized on the date of the provision’s enactment.

Amtrak is required annually to submit a five-year capital plan to Congress, and to satisfy independent oversight requirements with respect to the management of tax-credit- bond-financed projects. Finally, the Treasury Department is required to certify annually that funds deposited in the escrow accounts for repayment of tax-credit bonds (with actual and projected earnings thereon) are sufficient to ensure full repayment of the bond principal.

Effective Date

The provision is effective for tax credit bonds issued by Amtrak or the Alaska Railroad after September 30, 2000.

E. Clarification of Contribution in Aid of Construction (sec. 305 of the bill and sec. 118 of the Code)

Present Law

Section 118(a) provides that gross income of a corporation does not include a contribution to its capital. In general, section 118(b) provides that a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution by a customer or potential customer. However, for any amount of money or property received by a regulated public utility that provides water or sewerage disposal services such amount shall be considered a contribution to capital (excludible from gross income) so long as such amount: (1) is a contribution in aid of construction, and (2) is not included in the taxpayer's rate base for rate-making purposes. If the contribution is in property other than water or sewerage disposal facilities, the amount is generally excludible from gross income only if the amount is expended to acquire or construct water or sewerage disposal facilities within a specified time period.

Explanation of Provision

The provision specifically defines contribution in aid of construction to include customer connection fees (including amounts paid to connect the customer's line to or extend a main water or sewer line). Thus, the provision permits customer connection fees received by a regulated public utility that provides water or sewerage disposal services to be treated as nontaxable contributions to capital (excludible from gross income). Amounts paid as a service charge for starting or stopping services to a customer continue to be includible in gross income of a taxpayer.

Effective Date

The provision is effective for amounts received after the date of enactment.

F. Treatment of Leasehold Improvements
(sec. 306 of the bill and sec. 168 of the Code)

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)).[29] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[30] 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)).[31]

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

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[29] 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.

[30] 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.

[31] 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).

abandoned by the lessor at the termination of the lease.[32] This rule conforms the treatment of 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.[33]

Explanation of Provision

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

Qualified leasehold improvement property is 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 original use of the qualified leasehold improvement property must begin with the lessee, and must begin after December 31, 2006. 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 does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building.

No special rule is specified for the class life of qualified leasehold improvement property. Therefore, the general rule that the class life for nonresidential real and residential rental property is 40 years applies.

For purposes of the provision, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee, provided the lease is in effect at the time the qualified leasehold improvement property is placed in service. A lease between related persons is not considered a lease for this purpose.

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[32] 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.

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

Effective Date

The provision is effective for qualified leasehold improvement property placed in service after December 31, 2006.

IV. TAX RELIEF FOR FARMERS

A. Farm, Fish, and Ranch Risk Management Accounts ("FFARRM Accounts") (sec. 401 of the bill and new sec. 468C of the Code)

Present Law

There is no provision in present law allowing the elective deferral of farm or fishing income.

Explanation of Provision

The bill allows taxpayers engaged in an eligible business to establish FFARRM accounts. An eligible business is any trade or business of farming in which the taxpayer actively participates, including the operation of a nursery or sod farm or the raising or harvesting of crop-bearing or ornamental trees. An eligible business also is the trade or business of commercial fishing as that term is defined under section (3) of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. 1802) and includes the trade or business of catching, taking or harvesting fish that are intended to enter commerce through sale, barter or trade.

Contributions to a FFARRM account are deductible and are limited to 20 percent of the taxable income that is attributable to the eligible business. The deduction is taken into account in determining adjusted gross income and reduces the income attributable to the eligible business for all income tax purposes other than the determination of the 20 percent of eligible income limitation on contributions to a FFARRM account. Contributions to a FFARRM account do not reduce earnings from self-employment. Accordingly, distributions are not included in self-employment income.

A FFARRM account is taxed as a grantor trust and any earnings are required to be distributed currently. Thus, any income earned in the FFARRM account is taxed currently to the farmer or fisherman who established the account. Amounts can remain on deposit in a FFARRM account for up to five years. Any amount that has not been distributed by the close of the fourth year following the year of deposit is deemed to be distributed and includible in the gross income of the account owner.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

B. Exclusion of Rental Income From SECA Tax (sec. 402 of the bill and sec. 1402 of the Code)

Present Law

Generally, SECA taxes are imposed on an individual's net earnings from self employment. Net earnings from self-employment generally means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions. One exclusion from net earnings from self employment involves certain real estate rentals. Under this rule, net earnings from self employment do not include income from the rental of real estate and from personal property leased with the real estate unless the rental income is received under an arrangement between an owner or tenant of land and another individual that provides: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant with respect to any such agricultural or horticultural commodities. Other rules apply to rental payments received by an individual in the course of the individual's trade or business as a real estate dealer.

Explanation of Provision

The bill provides that net earnings from self employment do not include income from the rental of real estate under a lease agreement (rather than an arrangement) between an owner or tenant of land and another individual which provides that: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant in the production or management of the production of such agricultural or horticultural commodities.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

C. Exclusion of Conservation Reserve Program Payments From SECA Tax (sec. 403 of the bill and sec. 1402 of the Code)

Present Law

Generally, SECA tax is imposed on an individual's self-employment income within the Social Security wage base. Net earnings from self-employment generally means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions. A recent court decision found that payments made under the conservation reserve program are includible in an individual's self-employment income for purposes of SECA tax.

Explanation of Provision

The bill provides that net earnings from self-employment do not include conservation reserve program payments for SECA.

Effective Date

The provision is effective for payments made after December 31, 2000.

D. Exemption of Agricultural Bonds From Private Activity Bond Volume Cap (sec. 404 of the bill and sec. 146 of the Code)

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds issued to finance loans to first-time farmers for the acquisition of land and certain equipment ("aggie bonds").

The volume of tax-exempt private activity bonds that States and local governments may issue in each calendar year (including aggie bonds) is limited by State-wide volume limits. The current annual volume limits are the greater of : (1) $50 per resident of the State; or (2) $150 million. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

Explanation of Provision

The bill exempts "aggie bonds" from the State volume limits.

Effective Date

The provision applies to bonds issued after December 31, 2000.

E. Modifications to Section 512(b)(13)
(sec. 405 of the bill and sec. 512 of the Code)

Present Law

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

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

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

Explanation of Provision

The bill provides that interest, rent, annuity, or royalty payments made by a controlled subsidiary to a tax-exempt parent is not Unrelated Business Income except to the extent that such payments exceed arm's length values, as determined under sec. 482 principles.

Effective Date

The provision generally is effective for payments received or accrued after December 31, 2000. The binding written contract exception contained in the 1997 Act will apply to any payment received or accrued under such contract prior to January 1, 2001.

F. Charitable Deduction for Contributions of Food Inventory (sec. 406 of the bill and sec. 170 of the Code)

Present Law

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)). Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property. To be eligible for the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS.[34]

The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

Explanation of Provision

The bill amends Code section 170 to expand the augmented deduction such that any taxpayer engaged in the trade or business of farming is eligible to claim an enhanced deduction for donations of food inventory under section 170(e)(3).

The value of the enhanced deduction can be no greater than twice the taxpayer’s basis in the donated property. The bill provides that in the case of a cash method taxpayer, the taxpayer’s basis in the donated food will equal half of the fair market value of the donated food.

The bill modifies and clarifies the determination of fair market value for the donation of food inventory. Under the bill, the fair market value of donated food which cannot or will not be sold solely due to internal standards of the taxpayer, lack of market, or similar circumstances is determined without regard to such factors and, if applicable, by taking into account the price at which the same or similar food items are sold by the taxpayer at the time of the contribution or in the recent past.

The bill does not apply for taxable years beginning after December 31, 2003.

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[34] See, e.g., *Lucky Stores Inc. v. Commissioner*, 105 TC 420 (1995), holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

G. Coordinate Farmers and Fisherman Income Averaging and the Alternative Minimum Tax (sec. 407 of the bill and secs. 55 and 1301 of the Code)

Present Law

An individual taxpayer engaged in a farming business as defined by section 263A(e)(4) may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming. The averaging election is not coordinated with the alternative minimum tax. Thus, some farmers may become subject to the alternative minimum tax solely as a result of the averaging election.

Explanation of Provision

The bill extends to individuals engaged in the trade or business of fishing the election that is available to individual farmers to use income averaging.

The bill also coordinates farmers and fishermen income averaging with the alternative minimum tax. Under the bill, a farmer will owe alternative minimum tax only to the extent he or she will owe alternative minimum tax had averaging not been elected. This result is achieved by excluding the impact of the election to average farm income from the calculation of both regular tax and tentative minimum tax, solely for the purpose of determining alternative minimum tax.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

H. Cooperative Marketing to Include Value Added Processing Through Animals (sec. 408 of the bill and sec. 1388 of the Code)

Present Law

Under present law, taxable cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Tax-exempt cooperatives (sec. 521) are cooperatives of farmers, fruit growers, and like organizations organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers and turning back the proceeds of sales, less necessary marketing expenses on the basis of either the quantity or the value of products furnished by them.

The Internal Revenue Service takes the position that a cooperative is not marketing the products of members or other producers where the cooperative adds value through the use of animals (e.g., farmers sell corn to cooperative which is feed to chickens which produce eggs).

Explanation of Provision

The bill provides that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.

Effective Date

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

I. Extend Declaratory Judgment Procedures to Farmers' Cooperative Organizations (sec. 409 of the bill and sec. 7428 of the Code)

Present Law

Cooperatives may deduct from their taxable income amounts distributed to patrons in the form of patronage dividends, and certain other amounts paid or allocated to patrons, to the extent the net earnings of the cooperative from business done with or for patrons, provided that there is a pre-existing obligation to distribute such amounts (sec. 1382). Cooperatives that qualify as farmers' cooperatives under section 521 may claim additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income.

Under present law, there is limited access to judicial review of disputes regarding the initial or continuing qualification of a farmer's cooperative described in section 521. The only remedies available to such an organization are to file a petition in the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay tax and sue for a refund in a U.S. district court or the U.S. Court of Federal Claims.

In limited circumstances, declaratory judgment procedures are available, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures which are available include disputes involving the status of a tax-exempt organization under section 501(c)(3), the qualification of retirement plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166. In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

Declaratory judgment procedures are not available under present law to a cooperative with respect to an IRS determination regarding its status as a farmers' cooperative under section 521.

Explanation of Provision

The bill extends the declaratory judgment procedures to cooperatives. Such a case may be commenced in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, and such court has jurisdiction to determine a cooperative's initial or continuing qualification of a farmers' cooperative described in sec. 521.

Effective Date

The provision is effective with respect to pleadings filed after the date of enactment, but only with respect to determinations (or requests for determinations) made after January 1, 2000.

J. Small Ethanol Producer Credit
(sec. 410 of the bill and sec. 40 of the Code)

Present Law

"Small ethanol producers" are allowed a 10-cents-per-gallon production income tax credit on up to 15 million gallons of production annually. This credit is in addition to the 54-cents-per-gallon benefit available for ethanol generally.

Under present law, cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Under present law, the only credits that may be flowed-through to cooperative patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)), but not the small ethanol producer credit.

Explanation of Provision

The bill: (1) provides that the small producer credit is not a "passive credit"; (2) allows the credit to be claimed against the alternative minimum tax; and (3) repeals the present rule that the amount of the credit is included in income.

The bill also allows cooperatives to elect to pass-through small ethanol producer credits to its patrons. The credit allowed to a patron is that proportion of the credit the cooperative elects to pass-through for that year as the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

Effective Date

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

K. Payment of Dividends on Stock of Cooperatives Without Reducing Patronage Dividends (sec. 411 of the bill and sec. 1388 of the Code)

Present Law

Cooperatives, including tax-exempt farmers' cooperatives, are treated like a conduit for Federal income tax purposes since a cooperative may deduct patronage dividends paid from its taxable income. In general, patronage dividends are amounts paid to patrons (1) on the basis of the quantity or value of business done with or for its patrons, (2) under a valid enforceable written obligation to the patron to pay such amount, which obligation existed before the cooperative received such amounts, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests. The effect of this rule is to reduce the amount of earnings that the cooperative can treat as patronage earnings which reduces the amount that cooperative can deduct as patronage dividends.

Explanation of Provision

The bill allows cooperatives to pay dividends on capital stock without those dividends reducing excludable patronage-sourced income to the extent that the cooperative's organizational documents provide that the dividends do not reduce amounts owed to patrons.

Effective Date

The provision applies to distributions in taxable years beginning after the date of enactment.

V. TAX INCENTIVES FOR THE PRODUCTION OF ENERGY

A. Allow Geological and Geophysical Costs to be Deducted Currently (sec. 501 of the bill and sec. 263 of the Code)

Present Law

In general

Under present law, current deductions are not allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate (sec. 263(a)). Treasury Department regulations define capital amounts to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use.[35]

The proper income tax treatment of geological and geophysical costs ("G&G costs") associated with oil and gas production has been the subject of a number of court decisions and administrative rulings. G&G costs are incurred by the taxpayer for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition and retention of oil or gas properties by taxpayers exploring for the minerals. Courts have ruled that such costs are capital in nature and are not deductible as ordinary and necessary business expenses.[36] Accordingly, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.[37] The term "property" includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proven at the time the costs are incurred.

Revenue Ruling 77-188

In Revenue Ruling 77-188[38] (hereinafter referred to as the "1977 ruling"), the Internal Revenue Service ("IRS") provided guidance regarding the proper tax treatment of G&G costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

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[35] Treas. Reg. sec. 1.263(a)-(1)(b).

[36] See, e.g., *Schermerhorn Oil Corporation*, 46 B.T.A. 151 (1942).

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

[38] 1977-1 C.B. 76.

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

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

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

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

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

The 1977 ruling further provides that if, on the basis of data obtained from a detailed survey that does not relate exclusively to any particular property within a particular area of interest, an oil or gas property is acquired or retained within or adjacent to that area of interest, the entire G&G exploration expenditures, including those incurred prior to the identification of the particular area of interest but allocated thereto, are to be allocated to the property as a capital cost under section 263(a).

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

Explanation of Provision

The provision allows geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be deducted currently.

Effective Date

The provision is effective for G&G costs incurred or paid in taxable years beginning after December 31, 2001.

B. Allow Certain Oil and Gas "Delay Rental Payments" to be Deducted Currently (sec. 502 of the bill and sec. 263 of the Code)

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 2634). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for "delay rental payments" as a condition of their extension. The Treasury Department has taken the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.

Explanation of Provision

The provision allows delay rental payments to be deducted currently.

Effective Date

The provision applies to delay rental payments incurred in taxable years beginning after December 31, 2001.

No inference is intended from the proposal as to the proper treatment of pre-effective date delay rental payments.

C. Allow Net Operating Losses from Oil and Gas Properties to be Carried Back for Up to Five Years (sec. 503 of the bill and sec. 172 of the Code)

Present Law

A net operating loss ("NOL") generally is the amount by which business deductions of a taxpayer exceed business gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[39] A carryback of an NOL results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year. Special NOL carryback rules apply to (1) casualty and theft losses of individual taxpayers, (2) Presidentially declared disasters for taxpayers engaged in a farming business or a small business, (3) real estate investment trusts, (4) specified liability losses, (5) excess interest losses, and (6) farm losses.

Explanation of Provision

The provision provides a special five-year carryback for certain eligible oil and gas losses of independent producers. The carryforward period remains 20 years. An "eligible oil and gas loss" is defined as the lesser of (1) the amount which would be the taxpayer=s NOL for the taxable year if only income and deductions attributable to operating mineral interests in oil and gas wells were taken into account, or (2) the amount of such net operating loss for such taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that is attributable to an eligible oil and gas loss is treated as a separate NOL and taken into account after the remaining portion of the NOL for the taxable year.

Effective Date

The proposal applies to NOLs arising in taxable years beginning after December 31, 2001.

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

D. Temporary Suspension of Percentage of Depletion Deduction Limitation Based on 65 Percent of Taxable Income (sec. 504 of the bill and sec. 613A of the Code)

Present Law

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 currently 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)). 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).[40]

Explanation of Provision

The provision suspends the 65-percent-of-taxable-income limit for taxable years beginning after December 31, 2000 and before January 1, 2004.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

[40] 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.

E. Tax Credit for Oil and Gas Production from Marginal Wells (sec. 505 of the bill and sec. 54A of the Code)

Present Law

There is no income tax credit for oil or gas production from marginal wells generally. Present law does, however, provide a tax credit for production requiring the use of certain tertiary recovery methods (the "enhanced oil recovery credit") (sec. 43).

Explanation of Provision

The provision provides an income tax credit equal to $3 per barrel of qualified crude oil produced from a marginal well and 50 cents per 1,000 cubic feet of qualified natural gas production. Qualified production is defined as production up to 1,095 barrels per year (3 barrels per day).

The credit applies fully only when oil prices are below $14. The credit phases-out ratably when the price of oil is between $14 and $17 per barrel for oil (and equivalent amounts for natural gas).

The credit can be claimed against both the regular income tax and the alternative minimum tax.

Effective Date

The proposal applies to production in taxable years beginning after December 31, 2000.

F. Natural Gas Gathering Lines Treated as 7-Year Property (sec. 506 of the bill and sec. 168(e)(3) of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are set forth in Revenue Procedure 87-56.[41] Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by non-producers of natural gas. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. The uncertainty regarding the appropriate recovery period has resulted in litigation between taxpayers and the IRS. Recently, the 10th Circuit Court of Appeals held that natural gas gathering lines owned by non-producers fall within the scope of Asset class 13.2 (*i.e.*, seven-year recovery period).[42]

Explanation of Provision

The bill establishes a statutory seven-year recovery period for all natural gas gathering lines. A natural gas gathering line would be defined to include pipe, equipment, and appurtenances that are (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

Effective Date

The provision is effective for property placed in service on or after the date of enactment. No inference would be intended as to the proper treatment of such property placed in service before the date of enactment.

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[41] 1987-2 C.B. 674. Rev Proc 87-56 subsequently was clarified and modified by Rev. Proc. 88-22, 1988-1, CB 785.

[42] *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 TC 416 (1997). *See also True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

G. Clarification of Treatment of Pipeline Transportation Income (sec. 507 of the bill and sec. 954 of the Code)

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income, which in turn includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income (sec. 954(a)).

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

Explanation of Provision

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

Effective Date

The provision is effective for taxable years of CFCs beginning after December 31, 2001, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

TITLE VI. TAX INCENTIVES FOR CONSERVATION

A. Exclusion of 50 Percent of Gain on Sales of Land or Interests in Land or Water to Eligible Entities for Conservation Purposes (sec. 601 of the bill and new sec. 121A of the Code)

Present Law

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

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

Explanation of Provision

The bill provides a 50-percent exclusion from a taxpayer's gross income for gain realized on the qualifying sale of land, or an interest in land or water, provided the land, or interest in land or water, has been held by the taxpayer or the taxpayer's family for at least three years prior to the date of sale. A qualifying sale is a sale to any agency of the Federal Government, a State government, or a local government, or a sale to 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In addition, to be a qualifying sale, the entity acquiring the land, or interest in land or water, must provide the taxpayer with a letter detailing that the intent of the purchase is to further a qualified conservation purpose. A qualified conservation purpose is (1) the preservation of land areas for outdoor recreation by, or the education of, the general public, (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State or local governmental conservation policy that will yield a significant public benefit.

Effective Date

The provision is effective for sales after December 31, 2003.

B. Expand the Estate Tax Rule for Conservation Easements (sec. 602 of the bill and sec. 2031 of the Code)

Present Law

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

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

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

Explanation of Provision

The bill expands the availability of qualified conservation easements by eliminating the geographical boundary restrictions. Under the bill, the land qualifies without regard to the distance from which the land is situated from a metropolitan area, national park, wilderness area, or Urban National Forest.

Effective Date

The provision is effective for estates of decedents dying after December 31, 2001.

C. Cost-Sharing Payments Under the Partners for Wildlife Program (sec. 603 of the bill and sec. 126 of the Code)

Present Law

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

Explanation of Provision

The provision expands the types of qualified cost-sharing payments to include payments under the Partners for Wildlife Program.

Effective Date

The provision applies to payments received after the date of enactment.

D. Incentive for Certain Energy Efficient Property Used in Business (sec. 604 of the bill and new sec. 199 of the Code)

Present Law

No special deduction is currently provided for expenses incurred for energy efficient building property.

Explanation of Provision

The provision allows a deduction from income for expenses incurred for energy efficient commercial building property. Energy-efficient commercial building property is defined as property that reduces annual energy and power costs with respect to lighting, cooling, heating, ventilation, and hot water supply by 50 percent or more in comparison to a reference building. A reference building is defined as one which meets the requirements of Standard 90.1-1999 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America. The maximum deduction would be $2.25 per square foot. For all property eligible for the deduction, the depreciable basis of the property is reduced by the amount of the deduction. For public property, such as schools, the Secretary shall issue regulations to allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity owner.

Effective Date

The deduction is effective for taxable years beginning after December 31, 2000, and before January 1, 2004.

E. Extension and Modification of Tax Credit for Electricity Produced from Biomass (sec. 605 of the bill and sec. 45 of the Code)

Present Law

Section 45

An income tax credit is allowed for the production of electricity from either qualified wind energy facilities, qualified “closed-loop” biomass facilities, or qualified poultry waste facilities (sec. 45). The current value of the credit is 1.7 cents/kilowatt hour of electricity produced and the value of the credit is indexed for inflation. The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a qualified 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.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of 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. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

Section 29

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29) (referred to as the "section 29 credit"). Qualified fuels must be produced within the United States. Qualified fuels include:

(1) oil produced from shale and tar sands;
(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and
(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of nonconventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

Explanation of Provision

The bill provides that the present-law tax credit for electricity produced by wind, closed-loop biomass, and poultry waste facilities is expanded to include electricity produced from certain other biomass (in addition to closed-loop biomass and poultry waste) and electricity produced from landfill gas. Taxpayers producing electricity from other biomass or landfill gas may the claim credit for production of electricity for three years commencing on the later of January 1, 2001, or the date the facility is placed in service.

"Other biomass" is defined as solid nonhazardous, cellulose waste material which is segregated from other waste materials and which is derived from forest resources, but not including old growth timber. The term includes urban sources such as waste pallets, crates, manufacturing and construction wood waste, and tree trimmings, or agricultural sources (including orchard tree crops, grain, vineyard, legumes, sugar, and other crop by-products or residues). However, the term does not include unsegregated municipal solid waste, paper that is commonly recycled, or certain chemically treated wood wastes. Qualifying other biomass and landfill gas facilities are limited to facilities owned by the taxpayer.

A special rule modifies present-law definition of qualified closed-loop biomass facilities to include facilities in which electricity is produced from closed-loop biomass fuels co-fired with coal.

In the case of other biomass facilities, the credit applies to electricity produced after December 31, 2000 from facilities that are placed in service before January 1, 2002 (including facilities placed in service before the date of enactment of this provision). In the case of landfill gas facilities, the credit applies to electricity produced after December 31, 2000, from facilities placed in service after December 31, 1999, and before January 1, 2002. In the case of closed-loop biomass facilities in which closed-loop biomass fuel is co-fired with coal, the credit applies to electricity produced after December 31, 2000, from facilities that are placed in service before January 1, 2002 (including facilities placed in service before the date of enactment of this provision).

Effective Date

The provision is effective upon the date of enactment.

F. Credit for Certain Energy Efficient Motor Vehicles (sec. 606 of the bill and new sec. 30B of the Code)

Present Law

Present law does not provide a credit for the purchase of hybrid vehicles. However, taxpayers may claim a credit of 10 percent of the cost of an electric vehicle up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a vehicle powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The credit does not apply to property placed in service after December 31, 2004 and is reduced ratably between 2002 and 2004.

Taxpayers may claim an immediate deduction (expensing) for up to $2,000 of the cost of a qualified clean-fuel vehicle which is a car and up to $50,000 in the case of certain trucks or vans (sec. 179A). For the purpose of the deduction, gasoline and diesel fuel are not clean-burning fuels. The deduction expires after December 31, 2004, and is phased out ratably between 2002 and 2004.

Explanation of Provision

The bill provides a temporary tax credit for qualified hybrid vehicles, with a rechargeable energy system used in business and for personal use. For vehicles with a rechargeable energy system that provides five percent to less than 10 percent of the maximum available power, the credit amount is $500; for a system that provides 10 percent to less than 20 percent of maximum available power the credit is $1,000; for a system that provides 20 percent to less than 30 percent of maximum available power, the credit is $1,500; and for a system that provides 30 percent or greater of maximum available power, the credit is $2,000. The credit amount is increased for qualified hybrid vehicles that also actively employ a regenerative braking system that supplies energy to the rechargeable energy storage system. For a hybrid vehicle with a regenerative braking system that provides 20 percent to less than 40 percent of the energy available from braking in a typical 60 miles per hour to zero miles per hour braking event, the additional credit amount is $250, for 40 percent to less than 60 percent, the additional credit would be $500, and for 60 percent or greater, the additional credit is $1,000.

In addition, the sponsors note that this proposal is one portion of a package of proposals in the Alternative Fuels Incentives Act.[43] The proposals in that legislation include a tax credit for alternative fuel vehicles, a tax credit for retail sales of alternative motor vehicle fuels, and an extension of the deduction for certain refueling property. The sponsors note the Committee has

[43] The Alternative Fuels Tax Incentives Act, S. 2591, introduced by Senators Jeffords, Hatch, Rockefeller, Robb, L. Chafee, Bryan, and Kerrey on May 18, 2000.

explored these incentives in a hearing[44] and will continue to seek to address these proposals in appropriate legislation.

Effective Date

The credit is available for a hybrid vehicle placed in service after December 31, 2003, and before January 1, 2005.

[44] "Energy Tax Issues," U.S. Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight, July 18, 2000.

VII. ADDITIONAL TAX PROVISIONS

A. Limitation on Use of Non-Accrual Experience Method of Accounting (sec. 701 of the bill and sec. 448 of the Code)

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.

Explanation of Provision

The provision provides that the non-accrual experience method of accounting will be available only for amounts to be received for the performance of qualified personal services. Amounts to be received for all other services will be subject to the general rule regarding inclusion in income. Qualified personal services are personal 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.

It is believed that the formula contained in Temp. Reg. Section 1.448-2T does not clearly reflect the amount of income that, based on experience, will not be collected for many qualified personal services providers, especially for those where significant time elapses between the rendering of the service and a final determination that the account will not be collected. Providers of qualified personal services should not be subject to a formula that requires the payment of taxes on receivables that will not be collected. It is intended that the Secretary of the Treasury be directed to amend the temporary regulations to provide a more accurate determination for such qualified personal service providers of amounts to be excluded from income that, based on the taxpayer's experience, will not be collected. In amending such regulations, the Secretary of the Treasury should consider providing flexibility with respect to any formula used to compute the amount of the exclusion, to address the different factual situations of taxpayers.

Effective Date

The provision is effective for taxable years ending after date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the provision are treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment is to be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.

B. Repeal of Section 1706 of the Tax Reform Act of 1986 (sec. 702 of the bill)

Present Law

Under present law, determination of whether a worker is an employee or independent contractor is generally made under a common-law test. Section 530 of the Revenue Act of 1978 provides safe harbors under which a service recipient may treat a worker as an independent contractor for employment tax purposes (regardless of their status under the common-law test) if certain requirements are satisfied. One of the requirements of safe-harbor relief under section 530 is that the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period after 1977. In determining whether workers hold substantially similar positions, one of the factors that is to be taken into account is the relationship of the parties, including the degree of supervision and control of the worker by the taxpayer.

Under section 1706 of the Tax Reform Act of 1986, section 530 safe-harbor relief does not apply to certain technical services personnel.

Explanation of Provision

The bill repeals section 1706 of the Tax Reform Act of 1986. Thus, section 530 safe-harbor relief is available with respect to workers covered by section 1706, if the requirements of the safe harbor are otherwise satisfied. The bill does not repeal the consistency requirement with respect to workers covered by section 1706.

Effective Date

The bill is effective for periods beginning after the date of enactment.

C. Expansion of Exemption from Personal Holding Company Tax for Lending or Finance Business Companies (sec. 703 of the bill and section 542 of the Code)

Present Law

Personal holding companies ("PHC") are subject to a 39.6 percent tax on undistributed PHC income. This tax can be avoided by distributing the income to shareholders, who then pay shareholder level tax. PHCs are closely held companies with at least 60 percent "personal holding company income" ("PHCI"). This is generally passive income, including interest, dividends, and rents. Certain rent is excluded from the definition, if rent is at least 50 percent of the adjusted ordinary gross income of the company and other undistributed PHCI does not exceed 10 percent of the adjusted ordinary gross income.

In the case of a group of corporations filing a consolidated return, with certain exceptions, the application of the PHC tax to the group and any member thereof is generally determined on the basis of consolidated income and consolidated PHCI. If any member of the group is excluded from the definition of a PHC under certain provisions (including one for certain lending or finance businesses), then each other member of the group is tested separately for PHC status.

A special rule of present law excludes a lending or finance business from the definition of a PHC if certain requirements are met. At least 60 percent of its income must come from the active conduct of a lending or finance business, and no more than 20 percent of its adjusted gross income may be from certain other PHCI. A lending or finance business does not include a business of making loans longer than 144 months (12 years). Also, the deductions attributable to this active lending or finance business (but not including interest expense) must be at least 5 percent of income over $500,000 (plus 15 percent of income under that amount).

Explanation of Provision

The provision modifies the personal holding company exclusion for lending or finance companies to provide that, in determining whether a member of an affiliated group (as defined in section 1504(a)(1)) filing a consolidated return is a lending or finance company, only corporations engaged in a lending or finance business are taken into account, and all such companies are aggregated for purposes of this determination. The effect of this rule is to treat a corporation as a lending or finance company if all companies engaged in a lending or finance business in the affiliated group, in the aggregate, satisfy the requirements of the exclusion.

The provision also repeals the business expense requirement and the limitation on the maturity of loans made by a lending or finance business.

The provision also broadens the definition of a lending or finance business to include providing financial or investment advisory services, as well as engaging in leasing, including entering into leases and/or purchasing, servicing, and/or disposing of leases and leased assets.

Rents that are not derived from the active and regular conduct of a lending or finance business would continue to be treated under the present law personal holding company income rules.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

D. Charitable Contribution Deduction for Certain Expenses Incurred in Support of Native Alaskan Subsistence Whaling (sec. 704 of the bill and sec. 170 of the Code)

Present Law

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

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

Explanation of Provision

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

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

Effective Date

The provision is effective for taxable years ending after December 31, 2000.

E. Treatment of Purchase of Structured Settlements (sec. 705 of the bill and new sec. 5891 of the Code)

Present Law

Present law provides tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (sec. 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (sec. 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity that funds the liability to pay damages, generally is subject to tax.

The exclusion for recipients of the periodic payments received under a structured settlement arrangement as damages for personal physical injuries or physical sickness can be contrasted with the treatment of investment earnings that are not paid as damages. If a recipient of damages chooses to receive a lump sum payment (excludable from income under sec. 104), and then to invest it himself, generally the earnings on the investment are includable in income. For example, if the recipient uses the lump sum to purchase an annuity contract providing for periodic payments, then a portion of each payment under the annuity contract is includable in income, and the balance is excludable under present-law rules based on the ratio of the individual's investment in the contract to the expected return on the contract (sec. 72(b)).

Present law provides that the payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient. Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain "factoring" companies in exchange for their payment streams. The tax effect on the parties of these transactions may not be completely clear under present law.

Explanation of Provision

The provision generally imposes an excise tax on any person acquiring a payment stream under a structured settlement arrangement. The amount of the excise tax is 40 percent of the excess of (1) the undiscounted amount of the payment stream acquired, over (2) the total amount actually paid.

The 40 percent excise tax does not apply, however, if the transfer is approved in advance in a final court order (or order of the responsible administrative authority) that finds: (1) that the transaction does not contravene any Federal or State statute or the order of any court or responsible administrative authority; and (2) is in the best interest of the payee, taking into account the welfare and support of the payee's dependents. Rules are provided for determining the applicable State statute.

The provision also provides that the acquisition transaction does not affect the application of certain present-law rules, if those rules were satisfied at the time the structured settlement was entered into. The rules are section 130 (relating to an exclusion from gross income for personal injury liability assignments), section 72 (relating to annuities), sections 104(a)(1) and (2) (relating to an exclusion for amounts received under workers' compensation acts and for damages on account of personal physical injuries or physical sickness), and section 461(h) (relating to the time of economic performance in determining the taxable year of a deduction).

Effective Date

The provision generally is effective for acquisition transactions entered into on or after 30 days following enactment. A transition rule applies during the period from that date to July 1, 2002. If no applicable State law (relating to the best interest of the payee) applies to a transfer during that period, then the exception from the 40 percent excise tax is available without the otherwise required court (or administrative) order, provided certain disclosure requirements are met. Under the transition rule, the person acquiring the structured settlement payments is required to disclose in advance to the payee: (1) the amounts and due dates of the payments to be transferred; (2) the aggregate amount to be transferred; (3) the consideration to be received by the payee; (4) the discounted present value of the transferred payments; and (5) the expenses to be paid by the payee or deducted from the payee's proceeds.

The provision providing that the acquisition transaction does not affect the application of certain present-law rules is effective for transactions entered into before, on, or after the 30th day following enactment.