Joint Committee on Taxation
April 2, 2003
JCX-28-03

DESCRIPTION OF CHAIRMAN'S MODIFICATION TO THE "ENERGY TAX INCENTIVES ACT OF 2003"[1]

A. Modifications to the Provisions of the Energy Tax Incentives Act of 2003

1. Section 45 credit at 1.8 cents per kilowatt hour

The chairman's mark is modified to provide a credit rate of 1.8 cents per kilowatt hour, rather than 1.5 cents per kilowatt hour, with no adjustment for inflation for production in years after 2003 from facilities placed in service after the date of enactment.

2. Modifications to alternative fuel vehicle credits, electric vehicle credits, refueling property credits, and credits for the retail sale of alternative fuels

Fuel cell vehicles

The Chairman's modification changes the credit amount for fuel cell vehicles.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Modification to the "Energy Tax Incentives Act of 2003,"* (JCX-28-03), April 2, 2003.

Table 1, below, is substituted for Table 1 of the Chairman's mark.

Table 1.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
Vehicle ≤ 8,500	$4,000
8,500 < vehicle ≤ 14,000..................................	$10,000
14,000 < vehicle ≤ 26,000................................	$20,000
26,000 < vehicle..	$40,000

<u>Automobiles and light trucks</u>

The Chairman's modification changes the proposed base credit amounts for automobiles and light trucks.

Table 2, below, is substituted for Table 3 of the Chairman's mark.

Table 2.–Hybrid Vehicle Base Credit Amount for Automobiles and Light Trucks, Dependent Upon the Power Available from the Rechargeable Energy Storage System as a Percentage of the Vehicles Maximum Available Power

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	but less than
$250	4% of maximum available power	10% of maximum available power
$500	10% of maximum available power	20% of maximum available power
$750	20% of maximum available power	30% of maximum available power
$1,000	30% of maximum available power	

<u>Heavy duty hybrid vehicles</u>

The Chairman's modification defines a heavy duty hybrid vehicle as a vehicle weighing more than 8,500 pounds.[2] The Chairman's modification also changes the proposed credit amounts for heavy duty hybrid vehicles weighing 14,000 pounds or less.

Table 3, below, is substituted for Table 5 of the Chairman's mark.

[2] Medium duty passenger vehicles as defined in 40 CFR 86.1830-01 are treated as a passenger automobile or light truck for the purpose of determining the allowable credit.

Table 3.–Hybrid Vehicle Base Credit Amount for Heavy Duty Vehicles Weighing Not More Than 14,000 pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	**but less than**
$1,000	20% of maximum available power	30% of maximum available power
$1,750	30% of maximum available power	40% of maximum available power
$2,000	40% of maximum available power	50% of maximum available power
$2,250	50% of maximum available power	60% of maximum available power
$2,500	60% of maximum available power	

The Chairman's modification changes the proposed base credit amounts for heavy duty hybrid vehicles weighing more than 14,000 pounds but not more than 26,000 pounds.

Table 4, below, is substituted for Table 6 of the Chairman's mark.

Table 4.–Hybrid Vehicle Base Credit Amount for Heavy Duty Hybrid Vehicles Weighing More Than 14,000 Pounds, But Not More Than 26,000 Pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	**but less than**
$4,000	20% of maximum available power	30% of maximum available power
$4,500	30% of maximum available power	40% of maximum available power
$5,000	40% of maximum available power	50% of maximum available power
$5,500	50% of maximum available power	60% of maximum available power
$6,000	60% of maximum available power	

The Chairman's modification changes the proposed base credit amounts for heavy duty hybrid vehicles weighing more than 26,000 pounds.

Table 5, below, is substituted for Table 7 of the Chairman's mark.

Table 5.–Hybrid Vehicle Base Credit Amount for Heavy Duty Hybrid Vehicles Weighing More Than 26,000 Pounds

Base Credit Amount	If Rechargeable Energy Storage System Provides:	
	at least	**but less than**
$6,000	20% of maximum available power	30% of maximum available power
$7,000	30% of maximum available power	40% of maximum available power
$8,000	40% of maximum available power	50% of maximum available power
$9,000	50% of maximum available power	60% of maximum available power
$10,000	60% of maximum available power	

Alternative fuel vehicles

The Chairman's modification changes the maximum allowable incremental cost for the purchase of a new alternative fuel vehicle to not more than between $5,000 and $40,000 depending upon the weight of the vehicle weight class.

Table 6, below, is substituted for Table 8 of the Chairman's mark.

Table 6.–Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating in Pounds	Maximum Allowable Incremental Cost
vehicle ≤ 8,500..	$5,000
8,500 < vehicle ≤ 14,000.................................	$10,000
14,000 < vehicle ≤ 26,000................................	$25,000
26,000 < vehicle...	$40,000

Battery electric vehicles

The Chairman's modification changes present law to provide for a credit equal to the lesser of $1,500 or 10 percent of the manufacturer's suggested retail price of certain vehicles that conform to the Motor Vehicle Safety Standard 500. The Chairman's modification also changes the credit amount for qualifying battery electric vehicles.

Table 7, below, is substituted for Table 10 of the Chairman's mark.

Table 7.–Credit for Qualifying Battery Electric Vehicles

Vehicle Gross Weight Rating in Pounds	Credit Amount
Vehicle ≤ 8,500	$3,500
8,500 < vehicle ≤ 14,000	$10,000
14,000 < vehicle ≤ 26,000	$20,000
26,000 < vehicle	$40,000

If an electric vehicle weighing not more than 8,500 pounds has an estimated driving range of at least 100 miles on a single charge of the vehicle's batteries or if it is capable of a payload capacity of at least 1,000 pounds, then the Chairman's modification changes the credit amount to $6,000.

Extension of present-law section 179A

The Chairman's modification adds an extension for the deduction for costs to qualified clean-fuel vehicle property and clean-fuel vehicle refining property through December 31, 2007 (December 31, 2011 in the case of property relating to hydrogen). The phase-down of present law for clean fuel vehicles is modified such that the taxpayer may claim 75 percent of the otherwise allowable deduction in 2004 and 2005 (2004 through 2009 in the case of property relating to hydrogen), 50 percent of the otherwise allowable deduction in 2006 (2010 in the case of property relating to hydrogen), and 25 percent of the otherwise allowable deduction in 2007 (2011 in the case of property relating to hydrogen).

Credit for installation of alternative fueling stations

The Chairman's modification changes the allowable credit amount of retail clean-fuel vehicle refueling property to not exceed $30,000 and also changes the credit amount of residential clean-fuel vehicle refueling property to not exceed $1,000.

Credit for retail sale of alternative fuels

The Chairman's modification changes the credit equal to the gasoline gallon equivalent to 30 cents per gallon of alternative fuel sold in 2003, 40 cents per gallon in 2004, 50 cents per gallon in 2005, and 50 cents per gallon in 2006.

3. Credit for residential energy efficient property

The Chairman's modification provides that oil and propane furnaces and water heaters that meet the same efficiency standards as their natural gas counterparts are eligible for the same credit.

4. Three-year applicable recovery period for depreciation of qualified energy management devices

The Chairman's modification clarifies that a qualified energy management device is not required to record or communicate price data.

5. Modification to investment and production credits for advanced clean coal technology units

The Chairman's mark is modified to provide that pressurized fluidized bed combustion technology is a qualifying advanced clean coal technology. A qualifying pressurized fluidized bed combustion technology unit is a unit placed in service after the date of enactment and before 2017 and having a design net heat rate of not more than 7,720 Btu (8,900 Btu if the unit is placed in service before 2009 and 8,500 Btu if the unit is placed in service after 2008 and before 2013).

The Chairman's mark is modified to provide that a qualifying integrated gasification combined cycle technology unit must have a design net heat rate of not more than 8,500 Btu if the unit is placed in service after 2008 and before 2013.

The Chairman's mark also is modified so that in the case of units placed in service after 2008 and before 2013 for which the unit net heat rate, Btu/kWh adjusted for the heat content for the design coal, is more than 8,125 Btu but less than 8,500 Btu, the production credit will be $0.0075 for the first five years of production and $0.0055 for the second five years of production. (This modifies the last line of Table 12 of the Chairman's mark.)

Lastly, the Chairman's mark is modified to provide that the Secretary of the Treasury may grant certificates to investments in advanced clean coal technology units to the point the 4,000 megawatts of electricity production capacity qualifies for the investment credit and production credit. From the potential pool of 4,000 megawatts of capacity, not more than 500 megawatts in total and not more than 250 megawatts in years prior to 2009 shall be allocated to units using pressurized fluidized bed combustion technology.

6. Amortization of geological and geophysical expenditures

The Chairman's mark is modified to provide that the amortization of geological and geophysical costs is changed from four years to two years.

7. Extension and modification of credit for producing fuel from a non-conventional source

The Chairman's modification increases the section 29 credit for oil from shale or tar sands, and gas from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass to $3.00.

B. New Energy Provisions

1. Ethanol excise tax credit

Present Law

Alcohol fuels income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2007.[3]

A taxpayer (generally a petroleum refiner, distributor, or marketer) who mixes ethanol with gasoline (or a special fuel[4]) is an "ethanol blender." Ethanol blenders are eligible for an income tax credit of 52 cents per gallon of ethanol used in the production of a qualified mixture (the "alcohol mixture credit"). A qualified mixture means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the blender as fuel, or used as fuel by the blender in producing the mixture. Businesses also may reduce their income taxes by 52 cents for each gallon of ethanol (not mixed with gasoline or other special fuel) that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). The 52-cents-per-gallon income tax credit rate is scheduled to decline to 51 cents per gallon during the period 2005 through 2007.

A separate income tax credit is available for small ethanol producers (the "small ethanol producer credit"). A small ethanol producer is defined as a person whose ethanol production capacity does not exceed 30 million gallons per year. The small ethanol producer credit is 10 cents per gallon of ethanol produced during the taxable year for up to a maximum of 15 million gallons.

The credits that comprise alcohol fuels tax credit are includible in income. The credit may not be used to offset alternative minimum tax liability. The credit is a treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally.

Excise tax reduction

Registered ethanol blenders may forgo the full income tax credit and instead pay reduced rates of excise tax on gasoline that they purchase for blending with ethanol. Most of the benefit of the alcohol fuels credit is claimed through the excise tax system.

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[3] The alcohol fuels credit is unavailable when, for any period before January 1, 2008, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

[4] A special fuel includes any liquid (other than gasoline) that is suitable for use in an internal combustion engine.

The reduced excise tax rates apply when gasoline is being purchased for the production of "gasohol." Gasohol is defined as a gasoline/ethanol blend that contains 5.7 percent ethanol, 7.7 percent ethanol, or 10 percent ethanol. The Federal excise tax on gasoline is 18.4 cents per gallon. For the calendar year 2003, the following reduced rates apply to gasohol:[5]

5.7 percent ethanol	15.436 cents per gallon
7.7 percent ethanol	14.396 cents per gallon
10.0 percent ethanol	13.200 cents per gallon

The person liable for the tax is required to be registered with the IRS and (1) produces gasohol with gasoline within 24 hours of removing or entering the gasoline or (2) at the time the gasoline was sold, has an unexpired certificate from the buyer and has no reason to believe the certificate is false.[6]

If an ethanol blender is not registered with the IRS, the blender must pay the full excise tax of 18.4 cents per gallon on all gasoline that is blended with ethanol. The blender may claim the income tax credit for the ethanol. In addition, in lieu of the credit, the blender may file for a quick excise tax refund. The refund is equal to the difference between the gasoline excise tax that was paid and the tax that would have been paid by a registered blender on the gasoline/ethanol mixture being produced. Generally, the IRS pays these quick refunds within 20 days. Interest accrues if the refund is paid more than 20 days after filing.

The benefits provided by the alcohol fuels income tax credit and the excise tax exemption are integrated such that the alcohol fuels credit is reduced to take into account the benefit of any excise tax reduction.

Highway Trust Fund

In general, 18.3 cents per gallon of the gasoline excise tax is deposited in the Highway Trust Fund and 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank Trust Fund (the "LUST" rate). In the case of gasohol with respect to which a reduced excise tax is paid, 2.5 cents per gallon of the reduced tax is retained in the General Fund.[7] In the case of

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[5] These special rates will terminate on September 30, 2007 (sec. 4081(c)(8)). In addition, the basic fuel tax rate will drop to 4.3 cents per gallon beginning on October 1, 2005.

[6] Treas. Reg. sec. 48.4081-6(c). A certificate from the buyer assures that the gasoline will be used to produce gasohol within 24 hours after purchase. A copy of the registrant's letter of registration cannot be used as a gasohol blender's certificate.

[7] Sec. 9503(b)(4)(E).

gasoline taxed at a reduced rate prior to mixing, 2.8 cents of the reduced rate is retained in the General Fund.[8] The balance of the reduced rate (less the LUST rate) is deposited in the Highway Trust Fund.

Description of Proposal

In lieu of the reduced excise tax rates on gasoline used to produce gasohol, the proposal provides for an excise tax credit equal to the alcohol mixture credit. The alcohol fuel mixture credit is 52 cents and will decline at the same rate as the current alcohol fuels income tax credit to 51 cents in 2005, 2006, and 2007 for each gallon of alcohol used by a person in producing an alcohol fuel mixture. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon. This excise tax credit may be taken against excise tax liability. The excise tax credit is to be coordinated with the income tax credit. The proposal extends both the present-law alcohol fuels income tax credit and the new excise tax credit through December 31, 2010.

The proposal eliminates the alcohol blend rate tiers (i.e. 5.7 percent, 7.7 percent and 10 percent) for reduced rates of tax. Under the proposal the full rate of tax for gasoline is imposed on both alcohol fuel mixtures and gasoline used to produce an alcohol fuel mixture. Equivalent amounts of this tax are to be credited to the Highway Trust Fund. Registered ultimate vendors of gasoline used to produce an alcohol fuel mixture could seek a refund equal to the alcohol fuels mixture credit. If such claims are not paid within 45 days, the claim is to be paid with interest. The proposal also provides that in the case of an electronic claim, if such claim is not paid within 20 days, the claim is to be paid with interest.

The proposal eliminates the requirement that 2.5 and 2.8 cents per gallon of excise taxes be retained in the General Fund so that the full amount of tax is credited to the Highway Trust Fund.

Effective Date

The proposal is effective September 30, 2003.

2. Modify income tax and excise tax rules governing treatment of ETBE

Present Law

An 18.4 cents-per-gallon excise tax is imposed on gasoline. The tax is imposed when the fuel is removed from a refinery unless the removal is to a bulk transportation facility (e.g., removal by pipeline or barge to a registered terminal). In the case gasoline removed in bulk by registered parties, tax is imposed when the gasoline is removed from the terminal facility, typically by truck (i.e., "breaks bulk"). If gasoline is sold to an unregistered party before it is removed from a terminal, tax is imposed on that sale. When the gasoline subsequently breaks bulk, a second tax is imposed. The payor of the second tax may file a refund claim if it can

[8] Sec. 9503(b)(4)(F).

prove payment of the first tax. The party liable for payment of the gasoline excise tax is called a "position holder," defined as the owner of record inside the refinery or terminal facility.

A 52-cents-per-gallon income tax credit is allowed for ethanol used as a motor fuel (the "alcohol fuels credit"). The benefit of the alcohol fuels tax credit may be claimed as a reduction in excise tax payments when the ethanol is blended with gasoline ("gasohol"). The reduction is based on the amount of ethanol contained in the gasohol. The excise tax benefits apply to gasohol blends of 90 percent gasoline/10 percent ethanol, 92.3 percent gasoline/7.7 percent ethanol, or 94.3 percent gasoline/5.7 percent ethanol. The income tax credit is based on the amount of alcohol contained in the blended fuel.

ETBE is an ether that is manufactured using ethanol. Unlike ethanol, ETBE can be blended with gasoline before the gasoline enters a pipeline because ETBE does not result in contamination of fuel with water while in transport. Treasury Department regulations provide that gasohol blenders may claim the income tax credit and excise tax rate reductions for ethanol used in the production of ETBE. The regulations also provide a special election allowing refiners to claim the benefit of the excise tax rate reduction even though the fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

Description of Proposal

The proposal replaces the present-law regulatory procedures enabling refiners to claim excise tax benefits on ETBE-blended gasohol with a new excise tax credit alternative to the alcohol fuels income tax credit. Under the provision, in lieu of excise tax rate reductions for specified gasohol blends, a refiner blending ETBE and gasoline accrues an excise tax credit equal to the amount of the alcohol fuels credit or excise tax rate reduction otherwise available for the ETBE blended fuel. The refiner may use this credit to offset its excise tax liability for highway motor fuels under Code section 4081. Alternatively, the credit may be transferred to a registered position holder that is a member of the same controlled group of corporations as the refiner, and the position holder may use the excise tax credit to offset its liability for excise taxes under Code section 4081.

Effective Date

The proposal is effective for fuels blended after date of enactment.

3. Sale of gasoline and diesel fuel at duty-free sales enterprises

Present Law

A duty-free sales enterprise that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales enterprise on which neither federal duty nor federal tax has been assessed pending exportation from the customs territory of the United States. Conditions for qualifying as a duty-free enterprise include (but are limited to) locations within a specified distance from a port of entry, establishment of procedures for ensuring that merchandize is exported from the United States, and prominent posting of rules concerning duty-free treatment

of merchandise. The duty-free statute does not contain any limitation on what goods may qualify for duty-free treatment.

Description of Proposal

The proposal amends Section 555(b) of the Tariff Act of 1930 (19 U.S.C. 1555(b)) to provide that gasoline or diesel fuel sold at duty-free enterprises shall be considered to entered for consumption into the United States and thus ineligible for classification as duty-free merchandise.

Effective Date

The proposal is effective on the date of enactment.

4. Exempt certain prepayments for natural gas from tax-exempt bond arbitrage rules

Present Law

Interest on bonds issued by States or local governments to finance activities carried out or paid for by those entities generally is exempt from income tax.[9] Restrictions are imposed on the ability of States or local governments to invest the proceeds of these bonds for profit (the "arbitrage restrictions"). One such restriction limits the use of bond proceeds to acquire "investment-type property." The term investment-type property includes the acquisition of property in a transaction involving a prepayment. A prepayment can produce prohibited arbitrage profits when the discount received for prepaying the costs exceeds the yield on the tax-exempt bonds. In general, prohibited prepayments include all prepayments that are not customary in an industry by both beneficiaries of tax-exempt bonds and other persons using taxable financing for the same transaction.

On April 17, 2002, the Department of the Treasury issued proposed regulations regarding arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person.[10] The exception applies if at least 95 percent of the natural gas purchased with the prepayment is to be (1) consumed by retail customers in the service area of a municipal gas utility, or (2) used to produce electricity that will be furnished to retain customers that a municipal electric utility is obligated to serve under State or Federal law. An obligation that arises solely because of a contract is not an obligation to serve under State or Federal law. For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under State or Federal

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[9] Sec. 103.

[10] Prop. Treas. Reg. sec. 1.148-1(e)(2)(ii).

law to provide gas distribution services as provided in such law. Issuers may apply principles similar to the rules governing private use to cure a violation of the 95 percent requirement.[11]

A prepayment will not fail to meet the requirements for prepaid gas contracts by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if it is not dependent on performance by any person (other than the party to the swap contract) under another contract (for example, a gas contract or another swap contract). A natural gas commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas supplier to deliver gas for which the swap contract is a hedge.[12] The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

Description of Proposal

In general

The proposal creates a safe harbor exception to the general rule that tax-exempt bond-financed prepayments violate the arbitrage restrictions. The term "investment type property" does not include a prepayment under a qualified natural gas supply contract. The proposal also provides such prepayments are not treated as private loans for purposes of the private business tests.

Under the proposal, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility is not treated as the acquisition of investment-type property. A contract is a qualified natural gas contract if the volume of natural gas secured for any year covered by the prepayment does not exceed the sum of (1) the average annual natural gas purchased (other than for resale) by customers of the utility within the service area of the utility ("retail natural gas consumption") during the testing period, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility. The testing period is the 5-calendar-year period immediately preceding the calendar year in which the bonds are issued. A retail customer is one who does not purchase natural gas for resale. Natural gas used to generate electricity by a governmental utility is counted as retail natural gas consumption if the electricity was sold to retail customers within the service area of the governmental electric utility.

Adjustments

The volume of gas permitted by the general rule is reduced by natural gas otherwise available on the date of issuance. Specifically, the amount of natural gas permitted to be

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[11] See Treas. Reg. 1.141-12.

[12] Internal Revenue Service, *Clarification of Proposed Regulations Relating to Tax-Exempt Bonds Issued by State or Local Governments*, Notice 2002-52, 2002-30 IRB 1 (July 03, 2002).

acquired under a qualified natural gas contract for any period is to be reduced by natural gas held by the utility on the date of issuance of the bonds and natural gas that the utility has a right to acquire for the prepayment period (determined as of the date of issuance).[13] For purposes of the preceding sentence, applicable share means, with respect to any period, the natural gas allocable to such period if the gas were allocated ratably over the period to which the prepayment relates.

For purposes of the safe harbor, if after the close of the testing period and before the issue date of the bonds (1) the government utility enters into a contract to supply natural gas (other than for resale) for a commercial person for use at a property within the service area of such utility and (2) the gas consumption for such property was not included in the testing period or the ratable amount of natural gas to be supplied under the contract is significantly greater than the ratable amount of gas supplied to such property during the testing period, then the amount of gas permitted to be purchased may be increased to accommodate the contract.

The average annual retail natural gas consumption calculation for purposes of the safe harbor, however, is not to exceed the annual amount of natural gas reasonably expected to be purchased (other than for resale) by persons who are located within the service area of such utility and who, as of the date of issuance of the issue, are customers of such utility.

Intentional acts

The safe harbor does not apply if the utility engages in intentional acts to render (1) the volume of natural gas covered by the prepayment to be in excess of that needed for retail natural gas consumption, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility.

Definition of service area

Service area is defined as (1) any area throughout which the governmental utility provided (at all times during the testing period) in the case of a natural gas utility, natural gas transmission or distribution service, or in the case of an electric utility, electric distribution service; (2) limited areas contiguous to such areas, and (3) any area recognized as the service area of the governmental utility under State or Federal law. Contiguous areas are limited to any area within a county contiguous to the area described in (1) in which retail customers of the utility are located if such area is not also served by another utility providing the same service.

Ruling request for higher prepayment amounts

Upon written request, the Secretary may allow an issuer to prepay for an amount of gas greater than that allowed by the safe harbor based on objective evidence of growth in gas

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[13] For example, natural gas otherwise available on the date the bonds are issued includes supply covered by other prepayment contracts for the period, and supply held in storage or subject to an option to purchase by such utility that is available for retail natural gas consumption during the period covered by the prepayment. It does not include supply that could be purchased on the open market during the prepayment period.

consumption or population that demonstrates that amount permitted by the exception is insufficient.

Effective Date

The proposal is effective for obligations issued after the date of enactment.

C. Provisions to Discourage Corporate Expatriation

1. Tax treatment of inversion transactions

Present Law

Determination of corporate residence

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign. Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, or revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's managers and shareholders.

U.S. taxation of domestic corporations

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income is generally deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[14] and the passive foreign investment company rules.[15] A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

U.S. taxation of foreign corporations

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income

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[14] Secs. 951-964.

[15] Secs. 1291-1298.

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

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

U.S. tax treatment of inversion transactions

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

In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various "earnings stripping" or other transactions. This may include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations. These limitations under present law include section 163(j), which limits the deductibility of certain interest paid to related parties, if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income." More generally, section 482 and the regulations thereunder require that all transactions between related parties be conducted on terms consistent with an "arm's length" standard, and permit the Secretary of the Treasury to reallocate income and deductions among such parties if that standard is not met.

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

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

Description of Proposal

In general

The proposal defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity;[16] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[17]

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[16] It is expected that the Treasury Secretary will issue regulations applying the term "substantially all" in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.

[17] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions. However, regulated investment companies and certain similar entities are allowed

Except as otherwise provided in regulations, the provision does not apply to a direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. In determining whether a transaction would meet the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Stock sold in a public offering (whether initial or secondary) or private placement related to the transaction also is disregarded for these purposes. Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is granted authority to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person, a member of an expanded affiliated group, or a publicly traded corporation. Similarly, the Treasury Secretary is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

Transactions involving greater than 50 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a greater-than-50-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but: (1) any applicable corporate-level "toll charges" for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits; (2) the IRS is given expanded authority to monitor related-party transactions that may be used to reduce U.S. tax on U.S.-source income going forward; and (3) section 163(j), relating to "earnings stripping" through related-party debt, is strengthened. These measures generally apply for a 10-year period following the inversion transaction. In addition, inverting entities are required to provide information to shareholders or partners and the IRS with respect to the inversion transaction.

With respect to "toll charges," any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable,

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to elect to recognize gain as if sec. 367(a) did apply. This election is available for the calendar year of enactment and, if enactment occurs after October 31, the succeeding calendar year.

without offset by any tax attributes (e.g., net operating losses or foreign tax credits). To the extent provided in regulations, this rule will not apply to certain transfers of inventory and similar transactions conducted in the ordinary course of the taxpayer's business.

In order to enhance IRS monitoring of related-party transactions, the provision establishes a new pre-filing procedure. Under this procedure, the taxpayer will be required annually to submit an application to the IRS for an agreement that all return positions to be taken by the taxpayer with respect to related-party transactions comply with all relevant provisions of the Code, including sections 163(j), 267(a)(3), 482, and 845. The Treasury Secretary is given the authority to specify the form, content, and supporting information required for this application, as well as the timing for its submission.

The IRS will be required to take one of the following three actions within 90 days of receiving a complete application from a taxpayer: (1) conclude an agreement with the taxpayer that the return positions to be taken with respect to related-party transactions comply with all relevant provisions of the Code; (2) advise the taxpayer that the IRS is satisfied that the application was made in good faith and substantially complies with the requirements set forth by the Treasury Secretary for such an application, but that the IRS reserves substantive judgment as to the tax treatment of the relevant transactions pending the normal audit process; or (3) advise the taxpayer that the IRS has concluded that the application was not made in good faith or does not substantially comply with the requirements set forth by the Treasury Secretary.

In the case of a compliance failure described in (3) above (and in cases in which the taxpayer fails to submit an application), the following sanctions will apply for the taxable year for which the application was required: (1) no deductions or additions to basis or cost of goods sold for payments to foreign related parties will be permitted; (2) any transfers or licenses of intangible property to related foreign parties will be disregarded; and (3) any cost-sharing arrangements will not be respected. In such a case, the taxpayer may seek direct review by the U.S. Tax Court of the IRS's determination of compliance failure.

If the IRS fails to act on the taxpayer's application within 90 days of receipt, then the taxpayer will be treated as having submitted in good faith an application that substantially complies with the above-referenced requirements. Thus, the deduction disallowance and other sanctions described above will not apply, but the IRS will be able to examine the transactions at issue under the normal audit process. The IRS is authorized to request that the taxpayer extend this 90-day deadline in cases in which the IRS believes that such an extension might help the parties to reach an agreement.

The "earnings stripping" rules of section 163(j), which deny or defer deductions for certain interest paid to foreign related parties, are strengthened for inverted corporations. With respect to such corporations, the provision eliminates the debt-equity threshold generally applicable under section 163(j) and reduces the 50-percent thresholds for "excess interest expense" and "excess limitation" to 25 percent.

In cases in which a U.S. corporate group acquires subsidiaries or other assets from an unrelated inverted corporate group, the provisions described above generally do not apply to the acquiring U.S. corporate group or its related parties (including the newly acquired subsidiaries or

assets) by reason of acquiring the subsidiaries or assets that were connected with the inversion transaction. The Treasury Secretary is given authority to issue regulations appropriate to carry out the purposes of this provision and to prevent its abuse.

Partnership transactions

Under the proposal, both types of inversion transactions include certain partnership transactions. Specifically, both parts of the provision apply to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership (whether or not publicly traded), if after the acquisition at least 80 percent (or more than 50 percent but less than 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), and the "substantial business activities" test is not met. For purposes of determining whether these tests are met, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level.

Effective Date

The regime applicable to transactions involving at least 80 percent identity of ownership applies to inversion transactions completed after March 20, 2002. The rules for inversion transactions involving greater-than-50-percent identity of ownership apply to inversion transactions completed after 1996 that meet the 50-percent test and to inversion transactions completed after 1996 that would have met the 80-percent test but for the March 20, 2002 date.

2. Excise tax on stock compensation of insiders of inverted corporations

Present Law

The income taxation of a nonstatutory[18] compensatory stock option is determined under the rules that apply to property transferred in connection with the performance of services (sec. 83). If a nonstatutory stock option does not have a readily ascertainable fair market value at the time of grant, which is generally the case unless the option is actively traded on an established market, no amount is included in the gross income of the recipient with respect to the option until the recipient exercises the option.[19] Upon exercise of such an option, the excess of the fair market value of the stock purchased over the option price is included in the recipient's gross income as ordinary income in such taxable year.

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

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

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

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

Description of Proposal

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

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the inversion date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[20] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as defined by section 16(a)),[21] directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an inverted corporation only if gain (if any) is recognized in whole or part by any shareholder by reason of either the 80 percent or 50 percent identity of stock ownership corporate inversion transactions previously described in the provision.

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

[21] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

Specified stock compensation subject to the excise tax includes any payment[22] (or right to payment) granted by the inverted corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the inverting corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. Thus, the excise tax does not apply where a payment is simply triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock. For example, an arrangement under which a disqualified individual is paid a cash bonus of $500,000 if the corporation's stock increased in value by 25 percent over two years or $1,000,000 if the stock increased by 33 percent over two years is not specified stock compensation, even though the amount of the bonus generally is keyed to an increase in the value of the stock. By contrast, an arrangement under which a disqualified individual is paid a cash bonus equal to $10,000 for every $1 increase in the share price of the corporation's stock is subject to the provision because the direct connection between the compensation amount and the value of the corporation's stock gives the disqualified individual an economic stake substantially similar to that of a shareholder.

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

[22] Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

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

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

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and stock appreciation rights and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, are the fair market value of the stock as of the date of the inversion transaction. The value of any deferred compensation that could be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the inversion transaction (or the date of cancellation or grant, if applicable). It is expected that the Treasury Secretary issue guidance on valuation of specified stock compensation, including guidance similar to the revenue procedures issued under section 280G, except that the guidance would not permit the use of a term other than the full remaining term. Pending the issuance of guidance, it is intended that taxpayers could rely on the revenue procedures issued under section 280G (except that the full remaining term must be used).

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

in respect to the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

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

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

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

Effective Date

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

3. Reinsurance agreements

Present Law

In the case of a reinsurance agreement between two or more related persons, present law provides the Treasury Secretary with authority to allocate among the parties or recharacterize income (whether investment income, premium or otherwise), deductions, assets, reserves, credits and any other items related to the reinsurance agreement, or make any other adjustment, in order to reflect the proper source and character of the items for each party.[23] For this purpose, related persons are defined as in section 482. Thus, persons are related if they are organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) that are owned or controlled directly or indirectly by the same interests. The provision may apply to a contract even if one of the related parties is not a domestic company.[24] In addition, the provision also permits such allocation, recharacterization, or other adjustments in a case in which one of the parties to a reinsurance agreement is, with respect to

[23] Sec. 845(a).

[24] See S. Rep. No. 97-494, "Tax Equity and Fiscal Responsibility Act of 1982," July 12, 1982, 337 (describing provisions relating to the repeal of modified coinsurance provisions).

any contract covered by the agreement, in effect an agent of another party to the agreement, or a conduit between related persons.

Description of Proposal

The proposal clarifies the rules of section 845, relating to authority for the Treasury Secretary to allocate items among the parties to a reinsurance agreement, recharacterize items, or make any other adjustment, in order to reflect the proper source and character of the items for each party. The proposal authorizes such allocation, recharacterization, or other adjustment, in order to reflect the proper source, character or amount of the item. It is intended that this authority[25] be exercised in a manner similar to the authority under section 482 for the Treasury Secretary to make adjustments between related parties. It is intended that this authority be applied in situations in which the related persons (or agents or conduits) are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character or amount of the item or items. No inference is intended that present law does not provide this authority with respect to reinsurance agreements.

No regulations have been issued under section 845(a). It is expected that the Treasury Secretary will issue regulations under section 845(a) to address effectively the allocation of income (whether investment income, premium or otherwise) and other items, the recharacterization of such items, or any other adjustment necessary to reflect the proper amount, source or character of the item.

Effective Date

The provision is effective for any risk reinsured after April 11, 2002.

[25] The authority to allocate, recharacterize or make other adjustments was granted in connection with the repeal of provisions relating to modified coinsurance transactions.

D. Provisions Relating to Alaska Natural Gas

1. Credit for production of Alaska natural gas

Present Law

Present law does not provide a credit for conventional production of natural gas or delivery of fuels to a pipeline. However, certain fuels produced from "non-conventional 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). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(2) 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 non-conventional 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).

Description of Proposal

The proposal provides a credit per million British thermal units (Btu) of natural gas for Alaska natural gas entering a pipeline during the 15-year period beginning the later of January 1, 2010 or the initial date for the interstate transportation of Alaska natural gas. Taxpayers may claim the credit against both the regular and minimum tax.

The credit amount for any month is a maximum of 52 cents (indexed for inflation) per million Btu of natural gas. The credit phases out as the price at the wellhead rises above 83 cents per million Btu. The credit is not available if the price at the wellhead rises above $1.35 (indexed for inflation) per million Btu.

Alaska natural gas is any gas derived from an area of the State of Alaska lying north of 64 degrees North latitude generally from the area known as the "North Slope of Alaska," but not including the Alaska National Wildlife Refuge.

Effective date

The proposal is effective on the date of enactment.

2. Treat certain Alaska pipeline property as seven-year property

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 generally set forth in Revenue Procedure 87-56.[26] Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years.

Description of Proposal

The proposal establishes a statutory seven-year recovery period and a class life of 10 years for any natural gas pipeline system, located in Alaska, that has a capacity greater than five hundred billion Btu of natural gas per day and is placed in service after 2014. For purposes of the proposal, a natural gas pipeline system is defined as any system used in the carrying of natural gas by means of pipes, including pipe, trunk lines, related equipment, and appurtenances. It does not include any natural gas processing plant related to the pipeline itself.

Effective Date

The proposal is effective on the date of enactment.

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[26] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

E. Extension of IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[27] extended the statutory authorization for these user fees[28] through September 30, 2003.

Description of Proposal

The proposal extends the statutory authorization for these user fees through September 30, 2013. The proposal also moves the statutory authorization for these fees into the Code.[29]

Effective Date

The proposal, including moving the statutory authorization for these fees into the Code and repealing the off-Code statutory authorization for these fees, is effective through September 30, 2007.

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[27] An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

[28] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Pub. Law No. 100-203, December 22, 1987).

[29] The provision also moves into the Code the user fee provision relating to pension plans that was enacted in section 620 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16, June 7, 2001).