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Chairman's Amendment in the Nature of a Substitute Relating to Provisions in the Taxpayer Relief Act of 1997 Canceled Pursuant to the Line Item Veto Act

This document, prepared by the staff of the Joint Committee on Taxation, describes the Chairman's amendment in the nature of a substitute relating to the provisions in the Taxpayer Relief Act of 1997 that provided for the treatment of sales of processing facilities to farmer cooperatives and for exceptions from subpart F for certain active financing income and that were canceled by the President pursuant to the Line Item Veto Act. Following is a description of the farmer cooperative proposal and the active financing income proposal as included in the Chairman's amendment in the nature of a substitute.

1. Tax-Free Rollover of Sale of Processing Facilities to Cooperatives

Present Law

There are no provisions under present law which permit the tax-free rollover of gain on the sale of stock in a processing or refining company to a farmers' cooperation.

However, if certain requirements are satisfied, a taxpayer may defer recognition of gain on the sale of qualified securities to an employee stock ownership plan ("ESOP") or an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property (sec. 1042). Gain is recognized when the taxpayer disposes of the qualified replacement property. One of the requirements that must be satisfied for deferral to apply is that, immediately after the sale, the ESOP must own at least 30 percent of the stock of the corporation issuing the qualified securities. In general, qualified securities are securities issued by a domestic C corporation that has no stock outstanding that is readily tradeable on an established securities market. Deferral treatment does not apply to gain on the sale of qualified securities by a C corporation.

Description of Proposal

The proposal would permit the tax-free rollover of up to $75 million per year of gain on the sale of all (i.e., 100 percent) of the stock of a corporation that owns a processing facility to any particular cooperative which is engaged in marketing agricultural or horticultural products. The seller would have to reinvest the proceeds from the sale of the stock of the corporation owning the processing facilities within one year of such sale in stock of an active C corporation other than stock in the selling of target corporations or any related person. In order to qualify, at least 50 percent of the product that the facility processes for any 3 of 5 taxable years after the sale must be purchased from the cooperative or from members of the cooperative. In addition, in the case of a cooperative that (1) had gross receipts in excess of $1 billion in any prior taxable

year, or (2) produced a "specialty product" (generally any farm product other than wheat, feed grain, oilseeds, cotton, rice, dairy products, cattle, sheep or hogs) at least 50 percent of the product that the facility processed for any 3 of 5 taxable years before the sale must have been purchased from the cooperative or from members of the cooperative.

The liquidation of the corporation owning the processing facilities into the cooperative would be a taxable liquidation and the basis of the assets in the hands of the acquired corporation would not be stepped-up to their acquisition price. The cooperative would be subject to a recapture tax if it were to sell the stock of the processing corporation with 3 years after it was acquired or if it failed to meet the post-acquisition 3-out-of-5 year use test. The amount of the tax based on the amount of gain deferred by the seller.

The proposal is similar to a provision in the recently-passed "Taxpayers Relief Act of 1997" that was vetoed by the President under his line-item veto authority in that both provisions would allow a tax-free rollover of gain on sale of a processing corporation to a cooperative. This proposal differs from the vetoed provision in the following respects:

(1) The proposal would have a cap under which the maximum amount of gain than could be deferred for sales to any particular cooperative would be $75 million per year.

(2) The proposal would prevent the conversion of a deferral provision into an exemption by preventing the reinvestment to be in stock of the selling corporation or a related person.

(3) The proposal would lengthen the period of time that the processing corporation must obtain more than 50 percent of its product from certain cooperatives or their members from one year to any 3 of the 5 years preceding the sale to the cooperatives. In addition, the proposal would require that the processing corporation must obtain more than 50 percent of its product from any cooperative or its members for any 3 of the 5 years following the sale to the cooperative. The effect of these differences should be to increase the portion of the tax benefit of the tax-free rollover that is passed through to the cooperative since only a sale to a limited number of cooperatives will be eligible for the tax-free rollover.

(4) The proposal would insure that assets stay in corporation solution unless gain is recognized by providing that the liquidation of the corporation owning the processing facilities would not be tax-free.

(5) The proposal would adopt an anti-churning rule that would impose a recapture tax on the cooperative if it were to sell the stock of the processing corporation within 3 years after its acquisition by the cooperative or if the processing facility does not continue to use the products of the cooperative.

(6) The proposal would prevent a basis step-up without gain recognition by disallowing the application section 338(h)(10) to the acquiring cooperative.

This proposal in the Chairman's amendment in the nature of a substitute differs from the proposal in the original Chairman's mark[1] in that the amendment:

(1) Imposes a requirement that at least 50 percent of the product that the facility processes for any 3 of 5 taxable years after the sale must be purchased from the cooperative or from members of the cooperative.

(2) Provides that the requirement that at least 50 percent of the product that the facility processed for any 3 of 5 taxable years before the sale must have been purchased from the cooperative or from members of the cooperative only would apply in the case of a cooperative that (a) had gross receipts in excess of $1 billion in any prior taxable year, or (b) produced a "specialty product" (generally any farm product other than wheat, feed grain, oilseeds, cotton, rice, dairy products, cattle, sheep or hogs).

(3) Substitutes a recapture tax for the 10-percent excise tax in the case of certain post-acquisition prohibited transactions.

Effective Date

The proposal would apply to sales after December 31, 1997.

2. Exceptions under Subpart F for Certain Active Financing Income

Present Law

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

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

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[1] The proposal in the original Chairman's mark is described in Joint Committee on Taxation, *Description of Legislation to Restore and Modify Provisions in the Taxpayer Relief Act of 1997 Canceled Under the Line Item Veto Act* (JCX-47-97), September 19, 1997.

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

Present law provides rules determining whether contracts are treated as life insurance or annuity contracts for Federal income tax purposes. A statutory definition of life insurance contract, designed to limit the investment orientation of the contract, is provided in section 7702 (and section 101(f) provides similar rules for certain contracts issued before January 1, 1985). Certain variable contracts (other than pension plan contracts) are not treated as annuity, endowment, or life insurance contracts for any period (and any subsequent period) for which the investments made by the underlying segregated asset account are not adequately diversified (sec. 817(h)). In addition, a contract is not treated as an annuity contract unless rules are satisfied with respect to required distributions where the holder dies before the entire interest in the contract has been distributed (sec. 72(s)). Other rules determining whether contracts are treated as life insurance or annuity contracts also apply under present law.

Description of Proposal

In general

The proposal would provide temporary exceptions from foreign personal holding company income and foreign base company services income for subpart F purposes for certain income that is derived in the active conduct of an insurance, banking, financing or similar business. These exceptions would be applicable only for taxable years beginning in 1998.

The proposal is similar to a provision that was contained in the Taxpayer Relief Act of 1997 and that was canceled by the President in accordance with the Line Item Veto Act. The proposal reflects significant modifications to the canceled provision to address concerns about the breadth of that provision.

With respect to income derived in the active conduct of an insurance business, the proposal differs from the canceled provision in the following significant respects. First, rather than providing several alternative methods for determining reserves for life insurance and annuity contracts, such reserves would be the greater of: (1) the net surrender value of the contracts; or (2) the reserve determined using the U.S. method (i.e., the method that would apply if the company were subject to tax under subchapter L), but using foreign interest rates and

foreign mortality and morbidity. Second, the special rule for start-up companies that was included in the canceled provision would be eliminated, as would the look-through rule. Third, the proposal would provide that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), would not apply for purposes of determining reserves for a life insurance or annuity contract under sections 953 and 954 of the Code, provided that neither the policyholders, the insureds or annuitants, nor the beneficiaries with respect to the contract are U.S. persons.

With respect to income derived in the active conduct of a banking, financing, or similar business, the proposal differs from the canceled provision in the following significant respects. First, the exception from foreign personal holding company income generally would apply only to income derived from transactions with customers located in the same country in which the CFC is created or organized (or in which a qualified business unit of the CFC maintains its principal office and conducts substantial business activity). Second, the determination of where a customer is treated as located would be made under rules prescribed by the Secretary of the Treasury. Third, the look-through rule that was included in the canceled provision for purposes of determining the income eligible for the exception would be eliminated.

This proposal in the Chairman's amendment in the nature of a substitute differs from the proposal in the original Chairman's mark[2] only with respect to the rules for coordinating the new exceptions to foreign personal holding company income and foreign base company services income for certain active financing income with the dividend holding period requirements of section 901(k) (described below).

Income from the active conduct of an insurance business

The proposal would provide an exception from foreign personal holding company income for certain investment income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. The rules of this proposal would differ from the rules of present-law section 953 of the Code, which determines the subpart F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance with the rules of subchapter L of the Code. Review of the proposal's insurance rules would be appropriate when final guidance under section 953 is published by the Treasury Department. Among other issues, this review should consider whether it its more appropriate to determine the reserves for property and casualty contracts of CFCs using the applicable foreign interest rate and, if sufficient data is available, a foreign loss payment pattern, when using the applicable U.S. interest rate and U.S. loss payment pattern results in a materially different reserve amount.

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[2] The proposal in the original Chairman's mark is described in Joint Committee on Taxation, *Description of Legislation to Restore and Modify Provisions in the Taxpayer Relief Act of 1997 Canceled Under the Line Item Veto Act* (JCX-47-97), September 19, 1997.

The proposal would provide an exception for income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80 percent of its unearned premiums (as defined for purposes of the proposal). For this purpose, in the case of contracts regulated in the country in which sold as property, casualty, or health insurance contracts, unearned premiums and reserves would mean unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums would be determined in accordance with section 832(b)(4), and reserves for losses incurred would be determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a contract regulated in the country in which sold as a life insurance or annuity contract, reserves for such contracts would be determined as follows. The reserves would equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts, or (2) the amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under subchapter L of the Code, with the following modifications. First, there would be substituted for the applicable Federal interest rate an interest rate determined for the foreign country in which the qualifying insurance company was created or organized, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)). Second, there would be substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, there would be applied mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country.

In no event would the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve or any similar reserve. This rule would apply whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of contract.

The proposal would provide that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), would not apply for purposes of determining reserves for a life insurance or annuity contract under section 953 or 954 of the Code, provided that neither the policyholders, the insureds or annuitants, nor the beneficiaries with respect to the contract are U.S. persons. However, if any such persons are U.S. persons, this exception from the application of those rules would not apply.

The proposal also would provide an exception for income from investment of assets equal to (1) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which sold as property, casualty, or health insurance contacts, and (2)

10 percent of reserves (determined for purposes of the proposal) for contracts regulated in the country in which sold as life insurance or annuity contracts.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary exception, the proposal provides that, except as provided by the Treasury Secretary, income would be allocated to contracts as follows. In the case of a separate-account-type contract (including a variable contract not meeting the requirements of section 817), the income credited under the contract would be allocable only to that contract. Income not so allocated would be allocated ratably among all contracts that are not separate account-type contracts.

Under the proposal, a qualifying insurance company would mean any entity which: (1) is regulated as an insurance company under the laws of the country in which it is created or organized; (2) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks located within the country in which it is created or organized; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The proposal would clarify that the rules added by the proposal do not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to section 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

Income from the active conduct of a banking, financing, or similar business

The proposal would provide an exception from foreign personal holding company income for income that is derived in the active conduct by a CFC of a banking, financing, or similar business from transactions with customers located within the same country under the laws of which the CFC is created or organized. For this purpose, it is intended that income derived from the following types of activities would be considered to be income derived in the active conduct of a banking, financing, or similar business:

(a) regularly making personal, mortgage, industrial, or other loans in the ordinary course of the corporation's trade or business,

(b) factoring evidences of indebtedness for customers,

(c) purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(d) issuing letters of credit and negotiating drafts drawn thereunder for customers,

(e) performing trust services, including as a fiduciary, agent, or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments,

(f) arranging foreign exchange transactions (including any section 988 transaction within the meaning of section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers,

(g) arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers,

(h) underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers,

(i) engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets),

(j) providing charge and credit card services or factoring receivables obtained in the course of providing such services,

(k) providing traveler's check and money order services for customers,

(l) providing correspondent bank services for customers,

(m) providing paying agency and collection agency services for customers,

(n) maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority,

(o) engaging in hedging activities directly related to another activity described herein,

(p) repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity),

(q) engaging in financing activities typically provided by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors), and leasing activities to the extent incidental to such financing activities,

(r) providing financial or investment advisory services, investment management services, fiduciary services, or custodial services,

(s) purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock, debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity,

(t) effecting transactions in securities for customers as a securities broker,

(u) investing premiums accepted by insurance brokers or agents for transmittal to insurance companies on behalf of policyholders and other income from insurance brokerage or agency services, except to the extent that the income is derived from transactions that would give rise to foreign base company services income under section 954(e)(1), and

(v) any other activity that the Secretary of the Treasury determines to be a financing activity conducted by active corporations in the ordinary course of their business.

This exception for income derived in the active conduct of a banking, financing, or similar business from transactions with same-country customers would apply only if the CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. For this purpose, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing or similar business if more than 70 percent of its gross income is derived from such business from transactions with customers located within the same country under the laws of which the corporation is created or organized. Alternatively, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if (i) it is engaged in the active conduct of a banking business and it is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified by regulations) or (ii) it is engaged in the active conduct of a securities business and it is registered as a securities broker or dealer or Government securities broker or dealer under the Securities Exchange Act of 1934 (or is any other corporation not so registered which is specified in regulations). In this regard, it is intended that these requirements for the active conduct of a banking or securities business would be interpreted in the manner provided in the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997); it further is intended that these requirements would be considered to be satisfied by an entity that is a qualified bank affiliate or qualified securities affiliate as defined under such proposed regulations. See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6.

For purposes of this exception, a customer of a CFC is any person that has a customer relationship with the CFC. However, a related person (within the meaning of sec. 954(d)(3)), officer, director, or employee of any CFC would not be treated as a customer with respect to any transaction a principal purpose of which is to satisfy any requirement for this exception. In applying this exception, certain income derived by a qualified business unit of a CFC would be treated as derived from transactions with customers located in the same country in which the CFC is created or organized. This treatment would apply to income derived by a qualified business unit of a CFC from transactions with customers that are located in the country in which

the qualified business unit maintains its principal office and conducts substantial business activity. The determination of where a customer is located would be made under rules prescribed by the Secretary of the Treasury.

An additional exception from the definition of foreign personal holding company income would be provided for certain income derived by a securities dealer within the meaning of section 475. This exception would apply to interest or dividends (or equivalent amounts described in sec. 954(c)(1)(E) or (G)) from any transaction (including a hedging transaction or a transaction consisting of a deposit of collateral or margin described in section 956(c)(2)(J)) entered into in the ordinary course of the dealer's trade or business as such a securities dealer, but only if there is material participation in such transaction by employees located in the country under the laws of which the dealer is created or organized (or, in the case of a qualified business unit of the dealer that both maintains its principal office and conducts substantial business in a country, employees located in that country).

Anti-abuse rule

The proposal provides an anti-abuse rule which would be applicable for purposes of these exceptions from foreign personal holding company income. For purposes of applying these exceptions, items with respect to a transaction or series of transactions would be disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions. The reach of this anti-abuse rule explicitly includes any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions and the organization of entities in order to satisfy any same country requirement for these exceptions.

Foreign base company services income

The proposal also would provide a corresponding exception from foreign base company services income. This exception would apply to income derived in connection with the performance of services that are directly related to a transaction the income from which is not foreign personal holding company income by reason of section 954(h). This exception also would apply to income derived in connection with the performance of services that are directly related to a transaction to which the additional exception for certain income of dealers applies.

Coordination with section 901(k)

The proposal in the Chairman's amendment in the nature of a substitute differs from the proposal in the original Chairman's mark with respect to the rules for coordinating the new exceptions to foreign personal holding company income and foreign base company services income for certain active financing income with the dividend holding period requirements of section 901(k). Under the proposal in the original Chairman's mark, the new exceptions to foreign personal holding company income and foreign base company services income would not

apply for any taxable year of a foreign corporation unless such corporation (and all members of an affiliated group of which it is a member) elect not to have the securities dealer exception to the dividend holding period requirement provided in section 901(k)(4) apply to taxes paid or accrued during such year by such foreign corporation or any member. The amendment would modify this rule. Under the amendment, the foreign tax credits that are allowable by reason of the securities dealer exception to the dividend holding period requirement would be reduced by an amount equal to the ratio of (1) the income from the active conduct of a securities business to which these active financing income exceptions apply, to (2) the total income from the active conduct of a securities business not currently includible in income under subpart F (including income to which these exceptions apply). Alternatively, if the corporation (and all members of an affiliated group of which it is a member) so elect, these exceptions for active financing income would not apply and the securities dealer exception to the dividend holding period requirement would apply without modification. These rules would apply on an affiliated group basis.

Effective Date

The proposal would apply only to the first full taxable year of a foreign corporation beginning in 1998, and to the taxable years of United States shareholders with or within which such taxable year of such foreign corporations ends.